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TESTIMONY

LEGISLATION TO REFORM THE FEDERAL RESERVE ON ITS 100-YEAR ANNIVERSARY

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Committee on Financial Services, US House of Representatives

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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to be here today. I welcome the chance to discuss some of the potential effects of this legislative proposal to reform the 100-year-old Federal Reserve. I will focus my remarks on the portions of the proposed legislation that relate to the Federal Reserve's role as a regulator and supervisor of financial institutions—an area in which its ambitions outstrip its capabilities. Reform is needed to curb the Federal Reserve's expansive regulatory approach, which threatens to increase instability in the financial system. Reform should include increased congressional oversight, enhanced transparency, greater internal discipline, and a larger role for public participation.

WHY REFORM IS NEEDED

The Federal Reserve now actively seeks to secure for itself an increasingly large and interventionist role in regulating and supervising financial institutions, rather than concentrating on monetary policy. This aggressive and expansive regulatory approach relies on government control of the financial system, undermines private firms' ability to manage themselves, and threatens to destabilize—rather than to secure—the financial system. Attempts to oversee the Federal Reserve's regulatory functions clash with its deep traditions of opacity and independence developed in the monetary policy context.

The Federal Reserve's Expansive Regulatory Role

The Federal Reserve's regulatory powers are far-reaching. Dodd-Frank expanded the Federal Reserve's regulatory jurisdiction, and Board and regional bank officials frequently make the case for further expansion.[1]
The Fed's stable of regulated entities includes banks, bank holding companies, foreign banking organizations, savings and loan holding companies, supervised securities holding companies, financial market utilities, and systemically important financial institutions. The Federal Reserve chairman, through her membership on the

1. For a discussion and illustration of that growing role, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank" (infographic, Mercatus Center at George Mason University, Arlington, VA, November 2013), http://mercatus.org/sites/default/files/The-Federal-Reserve-Expanding-Regulatory-Authority.pdf.

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Financial Stability Oversight Council, participates in selecting the financial market utilities and systemically important financial institutions that are subject to Federal Reserve regulation.

The Federal Reserve has embraced an assertive post-crisis regulatory and supervisory approach. As has become the vogue among central bankers, the Federal Reserve has turned to macroprudential regulation, an approach that highlights financial stability. The Federal Reserve views itself as a sort of central planner charged with ordering the activities of private participants in the financial system to preserve systemic stability.[2] Because the objectives are not limited to the stability of any particular institution, financial institutions may be directed to take steps that are for the purported good of the system, even if those steps are not in the best interests of the institution in question. Chair Janet Yellen recently explained that macroprudential policy is often a superior substitute for monetary policy in the pursuit of financial stability, but that "adjustments in monetary policy may, at times be needed to curb risks to financial stability."[3] This linkage raises questions about whether the Federal Reserve may try to use monetary policy tools to cover up supervisory missteps.

To drive bank behavior in its favored direction, the Federal Reserve uses—among other tools—the Dodd-Frank Act stress tests (DFAST) and the Comprehensive Capital Analysis and Review (CCAR), which includes quantitative and qualitative components. The Federal Reserve's use of stress testing, which grew out of crisis-era initiatives to determine how much capital banks needed are well intentioned, but the Federal Reserve's nontransparent approach to stress testing is flawed. For example, it does not publicly divulge the supervisory models pursuant to which it assesses banks.

Rather than dealing with business realities, banks must guess at the supervisory hypotheticals and qualitative criteria against which they will be assessed. The consequences of getting it wrong are severe—a negative result on the stress test harms a bank's reputation and stock value.[4] Given the high stakes, trying to figure out what is of concern to the regulators becomes a higher priority than identifying and managing actual operational, business, and market risks.

Federal Reserve staffers are indirectly and subtly reshaping the banking system with their models, scenarios, and assumptions. These may be flawed, colored by inappropriate influence from favored banks, or inadequately tailored to banks' unique circumstances. As we have seen in other contexts, regulatory directives can drive unhealthy market behavior and undermine the stability of the financial system.[5]

The Federal Reserve's Opacity and Lack of Accountability

The lack of transparency and accountability is not limited to stress testing. The Federal Reserve's regulatory approach, perhaps informed by its tradition of monetary policy independence, is at odds with the widely accepted principles of transparency and public participation that should govern agency activities. The Federal Reserve does not adhere to its own directive requiring for most rules that economic analysis be conducted and available to the public and that meetings to consider the rules be public.[6]

2. For a discussion of the difference between micro- and macroprudential regulation, see Andrew Crockett, General Manager, Bank for International Settlements, Chairman, Financial Stability Forum, "Marrying the Micro- and Macro-prudential Dimensions of Financial Stability" (speech, September 21, 2000), http://www.bis.org/review/rr000921b.pdf. Mr. Crockett explains, "To bring out the contrast, think of the financial system as a portfolio of securities, ie, the individual institutions. The macro-prudential perspective would focus on the overall performance of the portfolio; the micro-prudential vision would give equal and separate weight to the performance of each of its constituent securities."

3. Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, "Monetary Policy and Financial Stability" (speech before the International Monetary Fund, July 2, 2014), http://www.federalreserve.gov/newsevents/speech/yellen20140702a.htm.

4. Stephanie Armour, Dan Fitzpatrick, and Ryan Tracy, "Fed Kills Citi Plan to Pay Investors," *Wall Street Journal*, March 26, 2014, http://online.wsj.com/news/articles/SB10001424052702303325204579463652083306902.

5. See, for example, Stephen Matteo Miller, "Long Live Risky Finance?" *Economic Intelligence* (blog), *US News & World Report*, June 23, 2014, http://www.usnews.com/opinion/economic-intelligence/2014/06/23/why-are-cdos-and-structured-notes-making-a-comeback; Roberta Romano, "For Diversity in the International Regulation of Financial Institutions: Critiquing and Recalibrating the Basel Architecture," *Yale Journal on Regulation* 31 (2014): 1–76.

6. Board of Governors of the Federal Reserve System, Statement of Policy Regarding Expanded Rulemaking Procedures, 44 Fed. Reg. 3957 (1979).

The Federal Reserve is not subject to the regulatory analysis standards that add a measure of transparency and accountability to government agencies' rulemaking. Along with most federal financial regulators, the Board of Governors of the Federal Reserve System is an independent regulatory agency.[7] The significance of this categorization is that the Federal Reserve is not subject to the executive orders that have required most regulators to conduct regulatory impact analysis for more than three decades.[8] As a consequence, extensive new regulatory obligations are being imposed on the financial sector and passed on, at least in part, to consumers of financial services without consideration of their benefits, costs, and unintended consequences.

The Federal Reserve's new emphasis on macroprudential regulation could exacerbate accountability and transparency problems if the Federal Reserve cites the link with monetary policy to assert its independence in connection with its macroprudential regulatory activities. Governor Daniel Tarullo, acknowledging that the Federal Reserve has not disclosed its supervisory models in connection with the DFAST and CCAR, pointed to alternative forms of "oversight and accountability"—an internal group of model validation experts and the six external experts on the Model Validation Council.[9] Internal staff reviews and a handful of outside experts are not a substitute for broader public engagement.

The Federal Reserve actively engages with its international counterparts. Cross-border dialogue is important, given the global nature of our financial markets. Domestic regulators, however, are not authorized to delegate domestic regulatory decisions to multinational groups of regulators. Agreements made abroad—whether at the Basel Committee or at the Financial Stability Board (FSB)—are not automatically binding in the United States, but in practice are highly influential on domestic regulatory outcomes. FSB members, for example, commit to implement international standards.[10] The Federal Reserve's active participation in the FSB raises concerns that it will use the FSB to steer domestic policy.[11] International discussions are not an appropriate substitute for the notice-and-comment rulemaking process, which is designed to elicit and incorporate public comment.

WHAT CAN BE DONE?

Under Dodd-Frank, the Federal Reserve enjoys considerable discretion in choosing which financial institutions it will regulate and how it will regulate them. Such broad discretion, however, risks undermining the Federal Reserve's credibility. In order for the Federal Reserve to be a more effective regulator, it needs to be subject to greater oversight by the public and Congress. Its regulatory and supervisory approaches should be governed by consistent, reasonable procedures that are transparent to regulated entities, their investors and creditors, and the customers they serve.

Congressional Oversight

The Federal Reserve would benefit from greater congressional oversight, particularly because the budget for its regulatory activities is outside the congressional appropriations process. One way to enhance accountability would be to require more frequent appearances by the Federal Reserve chairman. Oversight would also be enhanced by a specific congressional focus on the Federal Reserve's regulatory agenda. Dodd-Frank attempted to do this through the creation of a presidentially nominated and Senate-confirmed Vice Chairmanship for Supervision.[12] The persistent vacancy in that position during a period of active rulemaking has impeded congressional oversight. Measures to ensure that the Federal Reserve keeps Congress apprised of upcoming rules, regardless of whether the Vice Chairman position is filled, would facilitate congressional oversight and public transparency.

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7. "Independent regulatory agencies" are enumerated in 44 U.S.C. § 3502(5).
8. For a discussion of federal financial regulators' limited economic analysis obligations, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *George Mason Journal of Law, Economics & Policy* 9 (2013): 569–613.
9. Daniel K. Tarullo, "Stress Testing after Five years," (speech at the Federal Reserve Third Annual Stress testing Modeling Symposium, June 25, 2014), http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm.
10. Financial Stability Board, *FSB Framework for Strengthening Adherence to International Standards*, June 9, 2010, http://www.financialstabilityboard.org/publications/r_100109a.pdf.
11. Governor Tarullo, for example, currently serves as chairman of the FSB's Standing Committee on Supervisory and Regulatory Cooperation.
12. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1108, 124 Stat. 2126 (amending 12 U.S.C. § 242).

Enhanced salary disclosures and ethics rules for Federal Reserve employees would reflect the increasingly important role that they play in reshaping the financial markets. Current salary figures, of course, must be viewed in the context of future earning potential. A recent Federal Reserve Bank of New York study found evidence in support of the idea that bank regulators "have an incentive to favor complex rules because 'schooling' in these regulations enhance regulators' future earnings, should they transition to the private sector."[13]

Discipline, Transparency, and Public Participation in Rulemaking

Requiring the Federal Reserve to conduct and make available for public comment economic analysis in connection with its rules would add transparency and accountability to its regulatory functions. Doing so would improve the quality of rules by incorporating insights from the public, and any resulting "marginal delay in writing a rule likely is a fraction of the time the rule will be in place."[14] In practice, such a requirement would cause the Federal Reserve to undertake several common-sense steps before adopting a rule: (1) identify a problem that requires intervention by the Federal Reserve and alternative ways to solve that problem, (2) study the costs and benefits of each reasonable solution, and (3) identify metrics to facilitate a retrospective review to make sure the rule is achieving its objectives effectively and without harmful unintended consequences.

Another way to improve the Federal Reserve's regulations is by soliciting public comment in the period before the Federal Reserve enters into deliberations with its international counterparts. Such a pre-comment period would not be a substitute for the comment period during notice-and-comment rulemaking, but it would enable the Federal Reserve to enter international discussions with the benefit of public input on the subject at hand. Given the degree to which international negotiations serve as the basis for subsequent Federal Reserve rulemaking, affording the public an opportunity for early input would greatly enhance the Federal Reserve's regulatory transparency and accountability.

Internal Dialogue

External input would improve Federal Reserve rulemaking, but internal dialogue among the members of the Board of Governors—each of whom brings different expertise to the job—is also important. Allowing each member to have her own staff would enrich the internal discussion. The member's staffers would be able to pursue issues she perceives to be of particular importance, rather than being reliant on the general Federal Reserve staff that answer to the chairman. Other agencies, such as the Securities and Exchange Commission and the Commodity Futures Trading Commission, allow each commissioner to have dedicated staff.

CONCLUSION

As the Federal Reserve celebrates one hundred years, reform efforts are timely. Consideration of fundamental questions about the Federal Reserve's role in the regulatory landscape and in the markets should accompany those efforts.[15] Specifically, Congress should consider the propriety, efficacy, and danger of the Federal Reserve's current regulatory and supervisory approach—one in which a group of politically unaccountable staffers uses imprecisely defined discretion, unwritten standards, and complex rules to reshape the banking system. Congress also should consider the potentially harmful implications of centralizing and homogenizing banks' strategic, managerial, and risk determinations. Finally, Congress should look for alternative ways of addressing concerns about systemic instability and contagion. These might include removing the government guarantees that weaken

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13. David Lucca, Amit Seru, and Francesco Trebbi, "The Revolving Door and Worker Flows in Banking Regulation," Federal Reserve Bank of New York Staff Report No. 678 (June 2014), 4, http://www.newyorkfed.org/research/staff_reports/sr678.pdf.
14. Abby McCloskey and Hester Peirce, "Holding Financial Regulators Accountable: A Case for Economic Analysis," (American Enterprise Institute, Washington, DC, May 2014), http://www.aei.org/papers/holding-financial-regulators-accountable.
15. Some of those questions were asked in Renee Haltom and Jeffrey M. Lacker, "Should the Fed Have a Financial Stability Mandate? Lessons from the Fed's First 100 Years," *Federal Reserve Bank of Richmond 2013 Annual Report* (2014), https://www.richmondfed.org/publications/research/annual_report/2013/pdf/article.pdf.

private risk management, introducing mechanisms that reward private risk monitoring, and replacing regulators' model-based rules with simple standards.

Thank you for the opportunity to be here today. I look forward to your questions.

ABOUT THE AUTHOR

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