Written Testimony of

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IMPROVING FINANCIAL INSTITUTION SUPERVISION: EXAMINING AND ADDRESSING REGULATORY CAPTURE

I. INTRODUCTORY REMARKS: QUALIFICATIONS AND SCOPE OF TESTIMONY

Thank you for inviting me to speak with you here today. My understanding is that you would like my testimony to discuss the role of supervision and examination of financial institutions, particularly the largest such institutions that the Federal Reserve[1] has a prominent hand in overseeing, in protecting (a) consumers of financial services, (b) participants (including savers and other investors) in the banking and broader financial markets, and especially (c) the integrity and stability of the financial system as a whole. I believe that you would like me to address in particular the danger of what often is called "regulatory capture" in this connection – the danger that excessive influence by or deference to regulated entities might pose to the supervisory task. This is of course a matter that has acquired renewed public salience of late in virtue not only of the financial dramas of 2008-09, but also of (a) certain regulatory reform recommendations made by experts in the wake of those dramas,[2] and (b) certain revelations of possible shortcomings in actually implementing the mentioned recommendations, as recently reported through media outlets including *ProPublica* and *This American Life*.[3]

My understanding is that you have invited my testimony on these matters in light of two sets of qualifications that might suit me to the task. The first is my academic and related professional expertise as a specialist in finance and its regulation. The second is my recent role as a Legal Department counterpart to the "Visiting Scholar" economists who regularly share

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[1] Also "Fed," "Board," "FRB."

[2] See, e.g., David Beim, Report on Systemic Risk and Bank Supervision, Federal Reserve Bank of New York, Discussion Draft, September 10, 2009, available at http://www.propublica.org/documents/item/1303305-2009-08-18-frbny-report-on-systemic-risk-and.html. Hereinafter "Beim Report."

[3] See, e.g., Jake Bernstein, "Secret Tapes Hint at Turmoil in New York Fed Team Monitoring JP Morgan," *ProPublica*, November 17, 2014, available at http://www.propublica.org/article/secret-tapes-hint-at-turmoil-in-new-york-fed-team-monitoring-jpmorgan; Jake Bernstein, "Inside the New York Fed: Secret Recordings and a Culture Clash," *ProPublica*, September 26, 2014, available at http://www.propublica.org/article/carmen-segarras-secret-recordings-from-inside-new-york-fed; Ira Glass, "The Secret Recordings of Carmen Segarra," *This American Life*, September 26, 2014, available at http://www.thisamericanlife.org/radio-archives/episode/536/the-secret-recordings-of-carmen-segarra.

expertise in pursuit of various projects while in residence at the Federal Reserve Bank of New York's[4] Research and Statistics Group. Because recent allegations concerning the FRBNY figured prominently in three of the recent media reports referenced above,[5] and because they concerned, moreover, events thought to have occurred while I was in residence there, I gather that you also are interested in my impressions of capture's presence or absence at this institution – the FRBNY – in particular.

As to the first set of qualifications, I hold the Edward Cornell Endowed Chair in Law at Cornell University,[6] where I have taught since 2004; and am a Fellow of The Century Foundation,[7] a long-established public policy institute with which I have been associated for nearly three years. I also am Chair of the Association of American Law Schools' Section on Financial Institutions and Consumer Financial Services,[8] a Member of the New York City Bar Association's Committee on Banking Law,[9] and in-house finance-regulatory consultant with Westwood Capital Group in New York.[10]

My principal fields of research, writing, teaching, and practical expertise lie in the realms of enterprise-organizational, finance-regulatory, and monetary law. Central banks like the Fed and their functions figure importantly in much of what I do in these connections. I am also the author of what soon will be the sole American law school coursebook that treats financial regulation in a comprehensive and integrated fashion,[11] while most of my other academic writing since 2008 has been on (a) the causes of our recent financial difficulties and (b) cures to the ills that have occasioned them.[12] Prior to entering the legal academy and then again during my sabbatical year of 2012-13, I worked at the International Monetary Fund,[13] the closest thing we have to a global central bank.[14] During my first stint there in 1999-2000, my work was on corporate- and finance-regulatory reform proposals under consideration in connection with the Asian, Russian, and Argentine financial difficulties of the era.[15] During my second stint in 2012-

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[4] Also "New York Fed's," "FRBNY's," "the Bank's."

[5] Sources cited supra, note 3.

[6] Webpage available at http://www.lawschool.cornell.edu/faculty/bio_robert_hockett.cfm.

[7] Webpage available at http://tcf.org/experts/detail/robert-c.-hockett.

[8] Webpage available at http://memberaccess.aals.org/eWeb/dynamicpage.aspx?webcode=ChpDetail&chp_cst_key=a99dc504-4ef4-43e4-bd35-7f0eb1083b7b.

[9] Webpage available at http://www.nycbar.org/banking-law.

[10] Webpage available at http://www.westwoodcapital.com/ourpeople/robert-hockett/.

[11] ROBERT HOCKETT, CASES AND MATERIALS ON FINANCE AND ITS REGULATION (West, 2014) (forthcoming).

[12] See, e.g., Robert Hockett, *A Fixer-Upper for Finance*, 87 WASH. U. L. REV. 1213 (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1367278; Robert Hockett, *The Macroprudential Turn: From Institutional "Safety and Soundness" to "Systemic Stability" in Financial Supervision*, 9 VA. L. & BUS. REV. 1 (2014) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2206189.

[13] Also "IMF," "the Fund."

[14] See Robert Hockett, *Bretton Woods 1.0: A Constructive Retrieval*, 16 N.Y.U. J. LEGIS. & PUB. POL'Y 1 (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1805962.

[15] See, e.g., Robert Hockett and Barry A.K. Rider, *The Regulation of Insider Dealing*, IMF White Paper, March 2000 (available on request).

13, my work was primarily on how best to implement, through law, certain new proactively bubble-preemptive, "macroprudential" approaches to financial regulation under consideration or in process of implementation in the U.S., the U.K., the E.U., and other jurisdictions.[16]

With respect to my second set of qualifications noted above, from the early summer of 2011 to the early autumn of 2012, I worked in a consultative capacity at the FRBNY, primarily in the Legal Department but in a sizable number of cases also with economist colleagues in the Research and Statistics Group. I was at the Bank more or less daily during the summers of 2011 and 2012, and during the long academic winter break of 2011-12. I was also there during all or nearly all Fridays and many Thursdays, as well as during all days of the long autumn and spring breaks, while school was in session at Cornell. The projects on which I worked at the Bank were numerous and fell under a variety of categorical headings, from helping to draft formal Comment Letters in connection with proposed rulemakings by other finance-regulatory agencies, through legal analyses tracing and assessing the likely domestic consequences of possible currency regime changes abroad, through helping to identify existing statutory and regulatory avenues through which to implement new macroprudential finance-regulatory tools here in the U.S., to topic suggestions for inclusion in policy speeches, preparing a seminar on the role of corporate governance in big bank risk-taking, and numerous legal analyses of possible reforms to the nation's secondary mortgage markets.

Before proceeding to the principal substance of my testimony, I should emphasize three final points about my role with the FRBNY. The first is that some of the work that I did at the Bank was confidential in character, and I will of course be taking care not to violate any such confidences in my testimony. The second is that I do not believe that you wish me to do otherwise,[17] and do not believe in any event that many, if any, of the matters about which I shall be maintaining confidence are within the scope of that about which you wish me to testify. Finally the third is that, notwithstanding various accusations or criticisms of the FRBNY, the FRB, or the Federal Reserve System more generally that one sometimes encounters from the "left" or the "right," I have found those with whom I have worked or become acquainted in the Federal Reserve System to be serious, conscientious, and able public servants. Some of them, though, do think the institution can be improved, and have sometimes reported discouragement as to how seriously or otherwise their suggestions are taken.

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[16] See, e.g., Robert Hockett et al., *Implementing Macroprudential Finance-Oversight Policy: Legal Considerations*, Draft IMF White Paper, February 2013, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2340316; also Robert Hockett et al., *Implementing Macroprudential Policy – Selected Legal Issues*, IMF Board Paper, June 17, 2013, available at http://www.imf.org/external/np/pp/eng/2013/061713.pdf; and Robert Hockett, *Practical Guidance on Macroprudential Finance-Regulatory Reform*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 22, 2013, available at http://blogs.law.harvard.edu/corpgov/2013/11/22/practical-guidance-on-macroprudential-finance-regulatory-reform/.

[17] Do please of course let me know if I'm wrong in assuming this.

Insofar as there are improvements that might be made to the FRBNY or the Fed more broadly in their regulatory capacities, then – and I'll urge below that there are – these opportunities for improvement are not, so far as I can tell, rooted in any lack of integrity or raw ability on the part of Fed personnel. They seem to have much more to do with the internal structure of institutional decision-making. My proposed avenues for possible reform are accordingly structural rather than personal in character.

II. Background to Today's Hearings: Supervisory Role of the Fed, Post-Crisis Reform Proposals, & Recent Allegations of Inadequate Reform Implementation

As many of you here today know, the U.S. is more or less unique among comparable jurisdictions in the number of distinct financial regulators that oversee its complex and sprawling financial system. At least three distinct regulatory agencies (the Fed, FDIC, and OCC[18]) oversee federally-chartered or -insured commercial banks, for example, while state regulators supervise state-chartered commercial banks alongside those banks' federal insurer, the FDIC. Other regulators (primarily the NCUA and, until 2011, the OTS[19]) have, along with the Fed in the case of some holding companies,[20] helped supervise some of the nation's noncommercial ("thrift" and "credit union") banking institutions, while still others (FHA and FHFA[21]) oversee the nation's system of home mortgage finance. Meanwhile, another regulator (the SEC[22]) has primary responsibility for overseeing the nation's securities markets and the firms, including broker-dealers ("investment banks") and investment companies ("mutual" and "closed-end" funds) that operate therein. And yet another regulator (the CFTC[23]) oversees the derivatives markets.

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[18] The FDIC is the Federal Deposit Insurance Corporation, which insures all federally chartered and nearly all state chartered depository institutions. The OCC is the Office of the Comptroller of the Currency, housed in the Department of Treasury, which charters national banks and administers the lending-limit and other portfolio-shaping regimes to which those banks are subject, among other things. Its counterpart in the case of state-chartered banks is typically called the state "banking commissioner."

[19] The NCUA is the National Credit Union Administration, charged with regulating that form of noncommercial (i.e., non-shareholder-owned) depository institution known as the "credit union." The OTS was the Office of Thrift Supervision, which used to regulate other forms of noncommercial ("thrift") institutions, and whose former duties since 2011 have been parceled out among the other depository institution regulators.

[20] See below for more on the Fed's supervisory role vis-à-vis holding companies that own depository institutions of various stripes – commercial banks, thrifts, etc.

[21] FHA is the Federal Housing Authority, which since 1934 has provided default insurance on qualifying mortgages (the now familiar 30-year fixed rate was its invention) and assisted with home refinance and home borrower education. FHFA is the Federal Housing Finance Agency, which primarily regulates such secondary mortgage market makers as Fannie Mae.

[22] The SEC is the Securities and Exchange Commission, which since 1934 has regulated the securities markets, the broker-dealer firms that operate in those markets, and the investment companies, including mutual funds, that specialize in investing in those markets. It also regulates those who serve as investment advisors to such companies, as defined by the Investment Advisors Act of 1940.

[23] The CFTC is the Commodity Futures Trading Commission, which is the SEC's counterpart in the derivatives markets.

Finally, under the McCarran-Ferguson Act of 1945, state insurance commissioners take primary responsibility for regulating the nation's (since 2010, non-SIFI[24]) insurance firms, including the actions they take in their capacities as financial intermediaries.

Although it is simply one among the many aforementioned financial regulators, the Fed has long stood apart as a sort of "first among equals" among them, and the New York Fed in particular has stood out in turn as a sort of "first among equals" among the regional Fed banks themselves – the entities that all jointly constitute, along with the Board, the Federal Reserve System itself. The reasons for this "first among equals" character are not difficult to appreciate. As the primary agent of the nation's monetary policy, the Fed has long had to concern itself with the financial system as a whole in view of the dollar's role as principal reserve asset and purest form of liquidity in that system. Activity in the financial markets bears directly upon demand for, and the consequent relative value of, the dollar. An agency charged with maintaining "stable prices" – i.e., a non-fluctuating dollar – then, as is the Fed,[25] cannot but concern itself with events in financial markets. Effectively maintaining *price* stability requires among other things that one safeguard *financial* stability.

These same considerations account for the *New York* Fed's special role within the Federal Reserve System itself. For one thing, the "financial system" is primarily headquartered in, and conducts most of its business in, Manhattan, while the New York Fed is that instrumentality of the Federal Reserve System with jurisdiction over the Fed's Second District which includes New York. For another thing, the Fed conducts much of its monetary policy through so-called "open market operations," pursuant to which it acts to maintain price stability by purchasing and selling securities – primarily government securities – with a view to increasing or decreasing the supply of dollars in private banking institutions' reserve accounts day by day. The *New York Fed* in turn is that instrumentality of the Federal Reserve System which *conducts* these trades, which it does with private "dealer banks" operating primarily nearby in lower Manhattan.

It is for all of these reasons, along with some others, that the Fed is often thought to be charged with an "unwritten third" mandate sounding in "financial stability," along with its express "stable prices" and "maximum employment" mandates.[26] It is probably likewise at least partly for these reasons that the Fed has possessed, since 1956, another role that lends it yet more systemic importance: that is its role, under the Bank Holding Company Act signed into law that

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[24] SIFIs are "Systemically Important Financial Institutions," a category that embraces two subcategories of institution defined under the Dodd-Frank Act, more on which infra.

[25] See 12 USC 223a.

[26] See, e.g., Chair Janet Yellen, *Semiannual Monetary Policy Report to Congress*, July 15, 2014, available at http://www.federalreserve.gov/newsevents/testimony/yellen20140715a.htm; also Christian Ackman, "The Unwritten Mandate: Is Financial Stability Worth the Fed's Time?," *Seeking Alpha*, November 4, 2014, available at http://www.nasdaq.com/article/the-unwritten-mandate-is-financial-stability-worth-the-feds-time-cm409827 . Note that this is the case even post-instituting of the Financial Stability Oversight Council ("FSOC") under Dodd-Frank.

year, as the "umbrella" regulator of large financial firms that own commercial banks and other species of financial firm.

The associated macroprudential and "umbrella"-regulatory roles had grown quite systemically significant already by 1999, when the Graham-Leach-Bliley Act ("GLBA") partially repealed the longstanding Glass-Steagall restrictions on commercial bank affiliation with investment banks and thereby opened the door to a new form of financial conglomerate – the "Financial Holding Company" – operating simultaneously in the banking, securities, insurance, and other financial markets. The Fed's role became all the *more* systemically significant thereafter, once GLBA assigned it "umbrella" regulator status vis-à-vis not only traditional bank holding companies, but also these inherently systemically significant, multiple-subsector-straddling conglomerates themselves. Here too, moreover, the *New York* Fed in particular was bound to emerge as a "first among equals" among the Fed regional banks, since the principal financial conglomerates in question – the likes of J.P. Morgan Chase, Goldman Sachs, and Morgan Stanly – are, yet again, headquartered primarily in Manhattan.

A final systemically important role that the Fed plays, now largely though not solely in virtue of its role as umbrella regulator of banking and other financial conglomerates, has to do with consumer protection and fair access to banking services. Until the Dodd-Frank Act of 2010 instituted a new, independent Consumer Financial Protection Bureau ("CFPB") housed in the Fed, the Fed was the principal federal guarantor of various forms of consumer protection afforded clients of the financial services industry. While the new CFPB has taken over much of this mandate over the past several years, the Fed continues to exercise jurisdiction over certain spheres of concern that either overlap with or rest adjacent to traditional consumer protection. Among these are equal credit opportunity,[27] home mortgage disclosure,[28] electronic fund transfers,[29] certain aspects of Community Reinvestment Act ("CRA") compliance,[30] consumer leasing,[31] fair credit reporting,[32] and truth in lending.[33]

The specific statutory and regulatory channels through which the Fed has pursued its systemic stability and related mandates are many. Prior to the crisis of 2008-09, the principal regulatory functions that still are in place to this day were these: first, administration of the reserve requirement,[34] interbank liability limit,[35] interbank "managerial-interlock" limit,[36]

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27 See 12 CFR 202.
28 See 12 CFR 203.
29 See 12 CFR 205.
30 See 12 CFR 207 and 12 CFR 228.
31 See 12 CFR 213.
32 See 12 CFR 222.
33 See 12 CFR 226.
34 See 12 CFR 204.
35 See 12 CFR 206.
36 See 12 CFR 212.

“insider” lending limit,[37] holding company capital adequacy requirement,[38] broker-dealer and margin credit limit,[39] and affiliated lending limit regimes;[40] second, regulation of savings & loan, mutual, and (optionally) securities holding companies;[41] third, oversight and enforcement of the “international operations”[42] and “changes in bank control” regulatory regimes;[43] and fourth, enforcement of the aforementioned consumer protection and community reinvestment regimes. All of these channels have obvious systemic stability significance, but also can be viewed as having individual institutional “safety and soundness” significance – which the Beim Report that I’ll discuss below, as well I myself and others back in the early months of the crisis, feared to have constituted the Fed’s primary understanding of these powers’ significance prior to the crisis.[44]

Post-crisis, the Fed has emerged more explicitly and self-consciously as a macroprudential, or “systemic risk” regulator. This change is manifest in the fact that under Dodd-Frank it’s been given additional regulatory functions rooted in its early role as an emergent but not quite yet fully emerged systemic risk regulator. These new functions bear a more unambiguously macroprudential significance, with less in the way of individual-institutional “safety and soundness” importance than had its regulatory functions of pre-Dodd-Frank vintage. These functions include, among others: the regulation of systemically important financial market utilities as defined under Dodd-Frank;[45] the promulgation and administration of a margin and capital requirement regime for swap dealers and participants as defined under Dodd-Frank;[46] administration of the orderly liquidation plan regime for systemically significant financial institutions (“SIFIs”) per Dodd-Frank;[47] administration of the credit-risk retention regime applicable to asset-backed securities (“ABS”) sponsors established by Dodd-Frank;[48] administration of the proprietary trading (“Volcker Rule”) regulatory regime established under Dodd-Frank;[49] and the development and application of enhanced prudential standards for SIFIS under Dodd-Frank.[50]

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[37] See 12 CFR 215.

[38] See 12 CFR 217.

[39] See 12 CFR 220-221.

[40] See 12 CFR 223.

[41] See 12 CFR 238, 12 CFR 239, and 12 CFR 241.

[42] See 12 CFR 211, and 12 CFR 214.

[43] See 12 CFR 225.

[44] “Safety and soundness” is a phrase-of-art that figures into many bank-regulatory provisions of Title 12 of the U.S. Code and rules promulgated thereunder, referring to individual banking institutions’ robustness to various risks that financial institutions typically face over their life cycles.

[45] See 12 CFR 234.

[46] See 12 CFR 237.

[47] See 12 CFR 243.

[48] See 12 CFR 244.

[49] See 12 CFR 248.

[50] See 12 CFR 252.

In carrying out these functions, of course, a critical tool at the Fed's disposal is the system of regular, ongoing bank examinations carried out in the FRBNY's case by its Financial Institution Supervision unit. The examination process is the crucial "interface" between the content of the Fed's regulatory mandate, on the one hand, and the actual behavior of those institutions the Fed regulates, on the other hand. Members of the New York Fed's Supervision unit, who now number in the hundreds, are accordingly charged with continuous monitoring of regulated entities' activities on site, and are authorized to demand all manner of evidence necessary to the task of ensuring that financial institutions' day-to-day activities comport fully with the sundry rules the Fed promulgates and enforces under its statutory authority in the name of systemic financial stability.

To facilitate continuity in monitoring, acquisition of relevant information, and follow-up with regulated entity personnel when acquired information raises "red" (or even "yellow") flags, the examination regime actually houses examiners on the premises of the regulated entities themselves. This of course brings obvious advantages to the supervision process. But it also raises systematic vulnerabilities on the part of examination staff to "cultural" or attitudinal "capture" by the supervised entities. This is, of course, precisely what some recent news reports mentioned above suggest has happened at FRBNY, so I'll return to the matter further on in my testimony.

To sum up, then, what all of the aforementioned Fed roles and enforcement powers have in common for present purposes is their capitalizing in varying degree upon the Fed's potential, de facto, and de jure roles as a systemic risk – or, again, macroprudential – regulator of the financial system considered as a whole. This systemic-risk-regulatory common denominator is important to highlight in the present context for at least three reasons.

First are two implications it carries. One of these is that the Fed must, in this capacity, virtually by regulatory definition be "contrarian"-minded. The macroprudential or systemic risk-regulatory task is a countercyclical task; in the oft quoted words of the late great Fed Chairman of the 1950s to the early 1970s, William McChesney Martin, the role of the Fed is to "lean against the wind," or to "take away the punch bowl just as the party is getting started."[51] But a countercyclical role is a countermajoritarian role. It is an inherently unpopular, "wet blanket" role. Those who discharge the role are accordingly apt to be resented rather as children resent parents who tell them it's bed time. Fed personnel must accordingly be endowed with either the psychological or the institutional capacity to "hold firm." In view of the challenges to relying on personalities alone in this context, however, I will argue below that internal structural reforms are apt to bear most fruit in the present connection.

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[51] See, e.g., sources cited supra, note 12; also Robert Hockett, *Recursive Collective Action Problems: The Structure of Procyclicality in Financial Markets, Macroeconomies, and Formally Similar Contexts*, 2 J. FIN. PERSP. _ (2015) (forthcoming), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239849.

The second implication entailed by the Fed's long implicit and now explicit macroprudential role is that any deficiency in the manners in which the Fed or the New York Fed in particular carry out their regulatory mission is at least potentially a deficiency that places the financial system itself, not merely particular institutions therein or their clients, at risk. The regulatory regimes that the Fed and the FRBNY administer all are now aimed, among other things, at preventing a repeat performance of the catastrophic events of 2008-2009 and their debt-deflationary sequelae. Deficiencies in that administration accordingly should be, and are, viewed as deficiencies that invite precisely this danger. The only real question is whether there have been, or still are, any such deficiencies to rectify.

The third and related reason for highlighting the Fed's macroprudential role here is that the recent allegations concerning the Fed and the FRBNY that have occasioned today's hearing all ultimately sound in this same, macroprudential concern. They are all to the effect that these institutions first failed to prevent the 2008-09 market calamity in the manner they could have and should have done, and now are placing the system at risk of a repeat performance, owing to laxity in the manner with which they have pursued their systemic stability mandates via the bank examination process. The truth or falsity of these allegations is accordingly of the utmost importance, and I will accordingly be offering my own observations both on the allegations and on what seems to me to be warranted by way of follow-up as I proceed.

The critique of the pre-2008 performance that has drawn most attention of late is the internal report for the New York Fed produced by Professor David Beim of the Columbia Business School.[52] One reason that this report has drawn the attention it has, I suspect, is that it quite simply and compellingly, in my view, lays the New York Fed's pre-2008 failures at the door of two basic shortcomings. The first is the *intellectual* shortcoming of simple failure to appreciate and act upon the role of the FRB and FRBNY as systemic risk – i.e., what I also am calling "macroprudential" – regulators as elaborated above.[53] This shortcoming would have led the Bank both (a) to fail to seek certain systemic-stability-relevant categories of information in the examination process conducted pursuant to the Fed's regulatory mandates, and (b) to miss certain systemically significant implications carried by such information as it *did* manage to accumulate.

The second shortcoming that Professor Beim highlighted was a tendency on the part of FRBNY's bank examiners to defer to regulated entities in their information-gathering tasks, hence to refrain from following up even on the comparatively small number of "red flags" that their non-systemically focused attentions permitted them to notice. Professor Beim found this shortcoming to have been reinforced, moreover, by certain structural proclivities toward

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[52] See Beim Report, supra, note 2.

[53] For what this might be worth, I have long been told by colleagues at the FRBNY that during the Greenspan era there was little tolerance at FRB for dissent at FRBNY. I suppose it is possible, then, that some at FRBNY might not have suffered the intellectual blindspot identified by Professor Beim, but rather were stymied by the "higher-up" in Washington who notoriously denied central banks' capacity to spot bubbles before they had burst.

excessive risk-aversion and "groupthink" within the institution – proclivities that tended to squelch, Professor Beim found, the "hard questions" and "follow-up" that the Bank's few contrarian examiners wanted to pose and conduct.

My firm impression is that both the Fed and the FRBNY have made significant strides in addressing the *first* shortcoming identified by Professor Beim. And I say this as one who himself long decried the Greenspan-associated orthodoxy of the late 1980s, 1990s, and early 2000s, to the effect that the Fed could neither spot, nor, therefore, preempt asset price bubbles of the kind that imperiled financial stability. In light of both (a) the routinely non-Greenspanian policy pronouncements we now hear from both Fed and FRBNY officials, and (b) the research agendas well underway in most of the regional Fed Banks, I think it probably fair to say that the Fed has done best where Professor Beim's – along with my and others' – first criticism is concerned. The old "lean versus clean" debate seems largely to have been won, at the Fed and the FRBNY as well as in their peers and counterparts abroad, by the "leaners."[54]

With respect to Professor Beim's *second* criticism, however, things look less favorable for the Fed and the FRBNY. And this itself seems to constitute a second reason that Professor Beim's report has drawn so much attention of late. In short, the aforementioned *ProPublica*, *This American Life*, and other news accounts all highlight recent anecdotal reports tending to show both a continuing pattern of deference to regulated entities – i.e., of a species of "capture" – and a "groupthink"-style quashing of regulatory zeal on the part of those few "contrarian" bank examiners and others who work at the Fed or the FRBNY, all notwithstanding the recommendations for *counteracting* such tendencies made in Professor Beim's FRBNY-internal Report.

What, then, to make of these charges? At this point it will be instructive for me to shift into at least partly personal anecdote mode, in that much of my own experience at FRBNY seems to have bearing both upon Professor Beim's findings and recommendations, and upon the aforementioned tales recently told by the media. As a specialist on central banking and financial regulation, of course, I tended to reflect on these experiences even while experiencing them, and I have continued thus to reflect ever since. I will therefore regularly "hook" the experiences that I turn now to recounting back "up" with the legal and policy considerations elaborated above.

The most salient feature of my experiences with the Fed, against the backdrop of the foregoing remarks, is a certain paradoxical character that they all jointly share as a set. On the one hand, I never personally experienced anything like the internal pressures that Professor Beim and recent reports identify as mechanisms tending toward groupthink and reinforcing habits of deference to regulated entities. Indeed, as I'll elaborate, my personal experience has been by and large quite dramatically to the contrary. On the other hand, I was no regular employee subject to

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[54] See, e.g., Hockett, *Macroprudential Turn*, supra note 12; also Robert Hockett, *Leaning, Cleaning, and Macroprudence*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, March 27, 2013, available at http://blogs.law.harvard.edu/corpgov/2013/03/27/leaning-cleaning-and-macroprudence/.

the usual pressures associated with the employment relation, nor did I work in the FRBNY's Supervision unit as distinguished from its Legal and Research & Statistics units. I also, it must be said, did sometimes hear stories from *colleagues* who spoke with concern of precisely such mechanisms and tendencies as Professor Beim's Report highlights and as the recent media accounts suggest.

My attempt to explain this contradiction to myself and, now, to others here present leads me to certain provisional hypotheses concerning how (some degree of) regulatory capture might be subtly and subconsciously at work at the Fed, the FRBNY, and perhaps other agencies. It also leads me to thoughts about how we might counteract it – means that focus on institutional structure rather than personality.

Here, then, is my own New York Fed story in a bit more detail. Both my background at the IMF and my scholarly work on the causes of the 2008-09 crisis had led me by autumn of 2008 to become convinced that central banks are the key agents able to spot and preempt asset price bubbles, busts, and associated financial instability. This in turn led me both (a) to seek to determine how the Fed and other central banks had managed to fail to "see it coming" or *prevent* "its" coming in the lead-up to 2008, and (b) to think-up means by which the Fed and other central banks might do better in future. The tentative conclusions to which I was coming by late 2008 and early 2009 were by and large those that Professor Beim reached, at least with respect to the first failing he identified at FRBNY – the failure to appreciate the essentially systemic role that the Fed and other central banks are both able and, in the Fed's case at least, statutorily required to play.

This in turn led me to seek means of involving myself in the mission of the New York Fed, which seemed to me not only conveniently located in relation to my school, but also optimally situated to commence the project of developing means of "macroprudentially" overseeing the U.S. financial system. Because I tended to seek practical work during summers between school years already (in order to avoid losing touch with the realities of finance and the law thereof), I decided simply to find a way to do such practical work within the FRBNY by the next summer's academic break.

Not long after arriving at the aforementioned decision I met Tom Baxter, the General Counsel[55] of FRBNY, at a conference to which we had both been invited. We had heard about one another from mutual friends and former colleagues, and seemed immediately to form a rapport at this conference. I spoke to him about the idea of perhaps starting something like the FRBNY Research and Statistics Group's Visiting Scholar program within the Legal Department, and he seemed intrigued. He then mentioned that a recent internal report – presumably Professor Beim's – had singled out "groupthink" as a principal cause of the FRBNY's failure to have "seen

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[55] Also "GC."

it coming" and failure to have acted to head "it" off in the leadup to 2008.[56] Perhaps I, he said, could help set up some sort of internal "contrarian thinking" office at FRBNY. As an academic, he continued, I might be particularly well suited to doing that. This prospect excited me very much – indeed it seemed right up my alley – and within a few months we'd arrived at an arrangement pursuant to which I would begin working at the Bank at the end of the then-current academic year.

Almost immediately upon my arrival at FRBNY the following summer, I was given a marvelous variety of "out of the box" tasks. Tom and one or two of his Deputies quickly undertook to introduce me to various people in various FRBNY departments, including many economists in Research and Statistics, with the advertisement that I was there to help with "pushing the envelope" type projects. I also was introduced all around the Legal Department with the same description. In the first week, then, I was introduced to, among others, Meg McConnell from Research and Statistics, who I gather was one of those who assisted Professor Beim in the work that culminated in his report. Meg suggested that I help a team she was heading to develop metrics the Bank might employ with a view to determining when leverage buildups within the financial system were reaching systemically dangerous levels. This was *exactly* the sort of thing I thought that macroprudentially serious central banks *ought* to be doing, so I was very excited about this suggestion. Meg also later (in November or December of 2011, I think) solicited my suggestions for "out of the box" research and policy proposals both (a) to put on the Bank's research agenda and (b) even mention in speeches by high level Bank officials.

I was also given a sizable number of mortgage market related projects while at the Bank. Some of these, too, were "envelope-pushing" or "out of the box." Tom, for example, was intrigued by the prospect of developing an electronic mortgage registry system that might more effectively provide certainty of title than MERS as then constituted.[57] One of Tom's Deputies, for her part, was interested in possibly developing an official FRBNY position concerning reform of certain articles of the Uniform Commercial Code, uncertainties in connection with which seemed likewise to have played some role in rendering titles in real estate uncertain. Another Bank Legal officer asked for my help in developing a mortgage bridge loan assistance program akin to Pennsylvania's HEMAP program geared to keeping distressed mortgagors in their homes,[58] while two other Deputy GCs asked me to trace in advance the likely legal

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[56] This was in late 2010, so one supposes that Professor Beim's report would still have been fresh in FRBNY officials' minds.

[57] MERS is the privately owned Mortgage Electronic Registration System, more information on which is available at https://www.mersinc.org/about-us/about-us.

[58] HEMAP is the Home Emergency Mortgage Assistance Program, more information on which is available at http://www.phfa.org/consumers/homeowners/hemap.aspx. For the plan that we ultimately came up with, see Robert Hockett and Michael Campbell, *The Home Mortgage Bridge Loan Assistance Act of 2012*, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1987093; also Robert Hockett and Michael Campbell, *White Paper in Support of the Home Mortgage Bridge Loan Assistance Act of 2012*, New York City Bar Association, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1987159. The bill has been taken up for

consequences of certain possible fundamental currency regime changes abroad and another asked me to help design a seminar on the role of internal governance in generating or tolerating excessive risk-taking by financial institutions.

Most of the mentioned law-related projects were at least somewhat unorthodox relative to the usual fare of the Legal Department. Projects conducted with economists in Research and Statistics, for their part, were certainly unorthodox relative to the Greenspan era systemic risk orthodoxy that had prevailed up to the time of the Beim Report. Moreover, at least one Deputy General Counsel with whom I worked enthusiastically shared my view, somewhat unorthodox at the time but since seemingly embraced by the Fed Board itself, that Dodd-Frank's Title 8 offered all the legal authority necessary for the Fed to regulate the repo markets and other critical components of the "shadow banking" sector – effectively disagreeing with those who have criticized Dodd-Frank for not addressing that critical piece of the landscape that ultimately brought us the 2008-09 crisis.[59]

In view of all of this, I found myself quite impressed, again and again, by what struck me as the fresh, independent-minded quality of the people with whom I worked at the Bank. Indeed it seemed to me that mindsets here were at least as free as many of those I encounter regularly within the academy. As if to top off these impressions, two somewhat controversial extracurricular initiatives in connection with which I was a central character received a great deal of media attention during my time at FRBNY, and in both cases the Bank was effectively encouraging – or at the very least not *dis*couraging.

The first of these extracurricular projects was the "Way Forward" white paper that Daniel Alpert, Nouriel Roubini and I, "mavericks" all, authored for the New America Foundation in October 2011.[60] As some here might recall, this drew a great deal of media and legislative attention for several months,[61] during all of which time my FRBNY colleagues to a person were congratulatory, encouraging, and even a bit seemingly proud. The second such project was the eminent domain plan for underwater PLS mortgage debt that I and colleagues "went public" with six months later in the spring of 2012.[62] This one, as some here will recall, elicited a veritable firestorm of objections, primarily from banking and other concerns that the FRBNY itself

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consideration in the New York State Senate. See New York State Senate, Bill S5035A-2013, available at http://open.nysenate.gov/legislation/bill/S5035A-2013.

[59] See, e.g., VIRAL ACHARYA ET AL., RESTORING FINANCIAL STABILITY: HOW TO REPAIR A FAILED SYSTEM (2009).

[60] See Daniel Alpert, Robert Hockett, and Nouriel Roubini, *The Way Forward: Moving from the Post-Bubble, Post-Bust Economy to Renewed Growth and Competitiveness*, New America Foundation, October 11, 2011, available at http://newamerica.net/publications/policy/the_way_forward.

[61] See, e.g., media collected at this webpage: http://www.lawschool.cornell.edu/spotlights/Robert-Hockett-Co-Authors-The-Way-Forward.cfm.

[62] See, e.g., media collected at this webpage: http://www.lawschool.cornell.edu/spotlights/Hockett-Reveals-Plan-to-Address-Underwater-Mortgage-Loans.cfm.

regulates.[63] And yet here, too, my FRBNY colleagues seemed untroubled and unembarrassed. Indeed, FRBNY even published a brief article I wrote on the plan in its flagship journal, *Current Issues in Economics and Finance*.[64] That brought, among other things, two attack pieces in the same week, singling out both the Bank and myself by name, on the *Wall Street Journal*'s notoriously ugly op-ed pages.[65] And yet here, too, the Bank and its personnel seemed unapologetic, in effect rolling their eyes at the frivolity and gratuitous snark of at least one of the pieces – though it might bear noting that by this point (June of 2013) I had long since commenced my sabbatical back at the Fund in DC, and might accordingly have been simply unaware of other, less favorable internal reactions at FRBNY.

Perhaps needless to say, none of these experiences seems itself to support the proposition that the FRBNY is a zombified groupthink-plagued institution prone to rolling over in the face of actual or likely anger from the financial services industry. Nor, of course, do Chairmen Bernanke and Yellen's, or other Fed Board members', or President Dudley's and other FRBNY officials', regular public pronouncements concerning the dangers of widening economic inequality or the need to reduce principal on still-underwater mortgage loans suggest any such thing.[66] And this is all notwithstanding that nearly all such pronouncements appear to draw ire from self-described "conservatives," "liberals," "libertarians" and "progressives" alike – as well as their representatives in Congress. For all of these reasons, then, some of what I have recently read and heard about goings-on at the Fed and the FRBNY have surprised me.

But now for the other limb of the "paradox." First off, it seems to me to bear repeating that I was different from others at FRBNY in a crucial respect: my livelihood did not ride on the Bank's approval of what I thought or did, and I was brought in expressly *as* an independent academic meant to help counteract possible "groupthink." Those with whom I worked, then, including those "higher up," accordingly would have had different expectations of me than they had of regular employees, while I for my part was bound to feel more free to express my opinions and make my suggestions than regular employees presumably would have felt.[67]

Second, I cannot deny having been told by some with whom I worked both at FRBNY and, later, at FRB, that they themselves had experienced pressures of the kind that are described

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[63] Id. Also media collected at this webpage: http://www.lawschool.cornell.edu/spotlights/Cities-Begin-Moving-on-Hockett-Municipal-Plan.cfm.

[64] See Robert Hockett, *Paying Paul and Robbing No One: An Eminent Domain Solution for Underwater Mortgage Debt*, 19 (5) CURRENT ISSUES IN ECONOMICS AND FINANCE 1 (2013), available at http://www.newyorkfed.org/research/current_issues/ci19-5.html.

[65] Both op-eds are available, along with other coverage of the *Current Issues* paper, at http://www.lawschool.cornell.edu/spotlights/NY-Fed-Report-by-Hockett-Revives-Discussion-of-His-Municipal-Plan.cfm.

[66] See, e.g., speeches collected at these websites: http://www.federalreserve.gov/newsevents/speech/2014speech.htm; http://www.newyorkfed.org/newsevents/speeches/.

[67] I think it would still, in this case, be impressive that they brought me in at all under such auspices, and indeed one set of suggestions I'll make below aim to institutionalize this form of impressiveness.

in the recent reports mentioned above, and that they knew nontrivial numbers of others who had experienced the same. Indeed these colleagues in effect suggested that Carmen Segarra's story is but the tip of a possibly deep iceberg. Moreover all such cases, it seems, shared a common pattern: A report would be sought by "higher ups." The report would be drafted. The report then would be sent back with requests that particular conclusions that seemed a bit hard on either the regulated entity or the Fed or FRBNY be "toned down." The drafter would then agree to do the toning down, but would make clear that in doing so s/he would not then be honestly reporting his or her actual beliefs but rather those of the "higher ups." The response from the latter then would in some cases be some form or other of "passive aggression," resulting ultimately in demoralization or even exit.[68] This pattern is of course striking in light of Carmen Segarra's story, as well as in light of the 2009 Beim Report. Again, I must emphasize that I never personally experienced anything like this; quite the contrary, in fact. But I've heard enough stories from or about people who say that they have to feel warranted in offering some suggestions below.

What, then, to make of all this? How to reconcile my own experience with some of the experiences reported by others whose perceptions, memories, and general integrity I trust? *Part* of the answer might lie in that different status I held as just mentioned. But this seems unlikely to be all of it, given how many at both FRB and FRBNY openly congratulated me for, and even expressed pride in, some of the "out of the box" projects with which I was both internally and externally associated while I was there. Even these people's being vicariously "out of the box" in this manner seems to suggest that there is no more "zombification" on the part of regular staff than there was of myself.

I am tempted provisionally to conclude, then, that there must certain *structural* circumstances that account for the "disconnect" between my experiences with the Fed on the one hand, and those reported by others at the Fed on the other hand. There must be some feature of the institution that *encourages or permits* "groupthink" in *some* contexts while *not* doing so in *other* contexts. I'll turn now to elaborating my best guesses at present, along with associated proposals for possible reform.

III. Possible Structural Dangers of FRB/FRBNY "Capture" and Their Possible Cures

There seem to me to be at least three mutually complementary reasons that some of my colleagues' and recent media reports might be right in ascribing "capture" to the FRB and FRBNY in some contexts, even while my own experiences have been quite the contrary in other

[68] See Beim Report, supra, note 2. See also, e.g., Shahien Nasiripour, "Federal Reserve Employees Afraid to Speak Put Financial System at Risk," *Huffington Post*, August 28, 2013, available at http://www.huffingtonpost.com/2013/08/28/federal-reserve-employees-survey_n_3826165.html?utm_source=Alert-blogger&utm_medium=email&utm_campaign=Email%2BNotifications.

contexts. One stems from the inherently "countermajoritarian" character of a countercyclical mandate, which is bound to elicit some sense of worry on the part of the countercyclical regulator at least in contexts where the proverbial "rubber" meets the proverbial "road" as it does in the context of bank-examining. Another reason stems from the deeply ingrained, perhaps even "hard-wired," human tendency to want things to go smoothly between ourselves and those with whom we are in close contact on a daily basis, as examiners are with the personnel of the institutions that they examine – particularly when they are continuously in residence at the regulated entities themselves. Finally the third reason stems, I suggest, from the inherently "dual," "public-private" character of the FRBNY itself – a duality which might sometimes find its way into the person of one or another of the Bank's General Counsels.

The imperatives at work in the Bank's public and private roles are sometimes at odds with each other, which yields two important entailments: first, that expectations and behaviors in contexts more closely associated with the one character of the FRBNY might well be radically different from those in contexts more closely associated with the other character of the institution; and second, that anyone charged with responsibility for activities in *both* spheres – as are, for example, the General Counsel of the Fed Board itself and those of the regional Fed banks – might at least sometimes be subject to certain internal cognitive or attitudinal conflicts that can lead him or her to be quite "out of the box" in some cases while being quite temperamentally "conservative" or "risk-averse" in other cases.

I turn now turn to briefly elaborating a bit on all three of the factors that I've just identified, then suggest structural means by which we might mitigate their occasional possibly detrimental effects.

With respect first to the countermajoritarian character of the Fed's countercyclical risk-regulatory role, then, Fed Chairmen themselves are notoriously unpopular when they act to rein-in loose money or credit conditions during times of boom that appear headed toward ultimate bust. If that is the case even in respect of figures so powerful as Fed Chairman faced with diffuse public and political criticism, how much more must it be true in the case of lower-ranked officials faced with the concentrated rancor of testosterone-poisoned Wall Street bankers each day? For reasons rooted in such considerations it seems to be the case that the best Fed Chairmen and best bank examiners are those with stiff backbones. Indeed I have often suggested, and heard verified by Fed colleagues, that Fed Board members and bank examiners really should be "professional jerks," or "boors," who either are shameless or afflicted by something like Asperger's Syndrome. This is of course somewhat to overstate the case, but the point still remains.

The problem, however, is that people of the mentioned sort tend to impose costs on the places at which they work in addition to providing what ever benefits they do.[69] Moreover, simple reliance on hiring by "personality type" seems a thin reed on which to rest effective countercyclical finance-regulatory policy. Better, I'll suggest presently, would be some means of institutionalizing and insulating the "professional boor" role – preferably in a manner that does not require the "boors"' actually being boors.

Complementing the pressures of unpopularity that the Fed's countercyclical role places upon its personnel at all levels is the general human tendency to want to "go along to get along" in relations with others, whether the "others" be one's colleagues or one's adversaries or "regulatees." Stockholm Syndrome, one might say, tends in the long run to counteract Asperger's Syndrome. This bears at least two salient implications. First, those who have regular day-to-day contact with regulated entities are going in general to tend, over time, to want to "go easy on" if not indeed "identify with" those whom they regulate. And second, even those who do not find themselves all that tempted to go easy on or identify with those whom they regulate might nevertheless find themselves longing to get on well at least with their colleagues and their "superiors" up the chain of command. Add to all this the natural tendency to hope that a regulated entity will be more forthcoming with requested data if one is but "friendly" with them, and you have yet another recipe for systematic tendencies toward deference.

Here, too, in the absence of certain neutralizing structural measures, it would seem to require a rare personality type to avoid falling into the pitfalls of "going along to get along." One would have to be capable of being firm on the one hand, while being courteous or even courtly on the other. Many of us strive to be that kind of person, but few seem entirely to succeed, and in any event here again it seems foolish to rest all of one's macroprudential hopes on the thin reed of seeking out ideal personalities. There just aren't enough George Washingtons out there to count on.

Finally, with respect to the Fed's – and especially the regional Fed banks' – dual role as a manner of private-public partnership, here is a possible source of inadvertent "capture" that seems to have drawn very little attention yet likely is very important. First, then, recall that the New York Fed conducts monetary policy through open market operations by trading in securities with various designated "dealer banks." Relatedly, during the immediate post-crisis period the FRBNY also ran funds – the "Maiden Lane" entities – that purchased mortgage-backed securities ("MBS") with a view to stabilizing the secondary mortgage markets. In all such capacities, the Bank acts as a bank among banks, in effect acting as a sort of colleague or peer to those (other) banks. This doubtless encourages attitudes of reciprocity, collegiality, perhaps

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[69] See, e.g., ROBERT SUTTON, THE NO A__HOLE RULE: BUILDING A CIVILIZED WORKPLACE AND SURVIVING ONE THAT ISN'T (2010).

even equality toward those institutions. Those attitudes then might spill over into excess "politeness" even in regulatory contexts.

On the other hand, of course, the FRBNY also is the Fed's primary regulatory "interface" with the most systemically important financial institutions that it supervises. In this capacity it is an authority, an enforcement agency, a kind of "policeman" or "night watchman." The attitudes appropriate to this role sound more in vigilance and even suspicion than they do in collegiality or reciprocity. Yet in the FRBNY we seem to want one institution to perform functions that encourage both sets of mutually contrasting attitudes.

This duality problem might also afflict some highly placed personnel within the institution who effectively embody in their persons the very duality that characterizes the FRBNY itself. And this might in turn account for the stark differences between my own experiences with such "higher ups" on the one hand, and those of some of my colleagues on the other hand.

Consider the role of the General Counsel, for example. On the one hand, the GC is like any in-house counsel at any private firm, including any financial firm. A critical part of her role will be "keeping the firm out of trouble," and she will accordingly – and indeed appropriately – be prone to adopting an attitude of caution where setting firm policy and advising firm action are concerned. When that happens in ways that yield consequences we do not like, we will be tempted to call it "risk-aversion," even *morbid* risk-aversion. When it happens in ways that yield consequences we do like, we'll call it "prudence" or "appropriate caution."

On the other hand, another part of the role of an FRBNY GC – or indeed any regulator's GC – is more proactive. For inasmuch as the institution is itself meant to be proactive – as is the FRBNY in its ex ante bubble-preemptive, macroprudential regulatory role – its GC's job will be to facilitate its thus acting, by identifying the legal authority for and legal means by which to act in the context in question. Here, then, we will want the GC to be somewhat less risk-averse and rather more "forward-leaning." She should be confident and forthright about the institution's – now in its public rather than private role – mission, which is meant to safeguard the full general public rather than just the institution itself or the sectional interests it's charged with supervising.

Yet this attitude is of course at odds with the other one, and this might yield either of several upshots: (a) the GC might be continually conflicted and accordingly appear to be acting "erratically" at times; (b) the GC might ultimately resolve the unremitting conflict by allowing one of the conflicted attitudes finally to gain the upper hand, and from then on tend to give short shrift to which ever institutional role is associated with the discarded attitude; or (c) the GC might simply seem to some people in some contexts to be "risk-averse," while appearing to other people in other contexts to be "proactive."

When I reflect on my own experience at the New York Fed on the one hand and the tales told me by others there on the other hand, I am tempted to think that at least option (c) might be

sometimes at work. It would account at least in part for the much more "positive" experiences I've had at FRBNY than have some others. I am less certain about options (a) and (b), however, as I simply lack any data that would clarify whether either of those have occurred. For present purposes I'll accordingly think of them simply as structural tendencies one might expect to be present.

What I do feel confident about, then, is the advisability of certain structural *reforms* at FRBNY that might mitigate all three of the vulnerabilities just elaborated – those associated with a macroprudential regulator's inevitable unpopularity, with its personnel's natural tendency to want to avoid conflict, and with its dual role as a simultaneously public and private actor. I've got two principal suggestions here, each of which warrants some elaboration.

My first suggestion is very much in keeping both with Professor Beim's suggestions of 2009 and with ideas that Tom Baxter himself broached enthusiastically at FRBNY when I first arrived there. The contrarian role must be permanently institutionalized in some manner, I believe, both at FRBNY and probably at many other regulatory agencies as well. The institution requires some permanent means of self-evaluation and self-criticism much as our society itself has in the institutions of the press and the academy. This can be done in a variety of ways, of course; but key to any particular method adopted, I think, will be the establishment of some unit or department explicitly charged with the "skeptical" or self-critical task. Any such unit or department then should have the following basic characteristics.

First, deliberate, explicit, self-conscious identification on the part of the department itself and of the Bank as a whole of the department as precisely what it is – a mode of institutional self-evaluation and self-criticism. This self-understanding should ultimately determine the criteria by which the department's actions are evaluated and by which its hiring and promoting policies are developed.

Second, sufficiently many personnel within the department or unit in question as to enable an "esprit de corps" to develop within it – perhaps something a bit like what the Rangers are to the U.S. Army, or what the Marines are to ground forces more generally. The goal must be, not to establish a unit with a few lovable or barely tolerated token eccentrics, but to put in place a bona fide institutional unit on par with all the others, whose successes or otherwise are determined by all in the full institution as riding on how good they prove ultimately to be in ferreting out problems and developing successful solutions to them.

In a sense, what we want is for personnel in this department to be simultaneously admired (perhaps even envied) and perhaps even mildly feared by others in the institution (in the sense of fearing to miss red flags that the contrarians later find), such that some others might in time even ask to be transferred to the department in question. Success here, it bears noting, will not only boost the likelihood of errors' being spotted or avoided by department personnel themselves. It also will likely, over time, work to encourage heightened vigilance by others in the institution,

who either "want to be like" those in the department in question, "want to avoid being shown up" by the same, or both.

Finally third, it probably goes without saying that whoever leads the group or department in question should be possessed of a status equivalent to that of other top level FRBNY personnel. This person, in other words, should command the same respect in the institution as do the GC, the head of Research and Statistics, the head of Supervision, and so on. This status and respect should, in turn, effectively carry over to the department or unit itself. Those who work within it should have "cover" from their department head and the FRBNY as a whole when, inevitably, they raise hackles among regulated entities and even among some in other units of FRBNY itself.

There is some irony in this set of suggestions. The reason is that helping to envisage or even begin the process of setting up some such department was among the first possible projects that Tom Baxter suggested when we first spoke of my possibly taking up residence there. I am told by other colleagues, moreover, that prospects of this sort have been under occasional discussion at FRBNY ever since the Beim Report was completed. I think, then, that there is already significant willingness on the part of key FRBNY personnel to explore and then tentatively begin the process of constructing some such department or unit. Given how enthusiastic Tom seemed to be, my guess is that others would be as well.

That this has not happened yet, then, I suspect is rooted less in lingering skepticism or ambivalence about the idea than it is in sheer busyness on the part of FRBNY staff. The Dodd-Frank mandated tasks of new regulatory rulemaking and "living will" drafting and improving, among other things, have had many FRBNY staff running a bit ragged in recent years, and it is accordingly understandable that something as fundamental as adding and constructing an entirely new unit has not yet been effected. I nevertheless believe that this project should be resumed at the earliest feasible opportunity. It would serve to counteract *both* the inherent unpopularity *and* "Stockholm Syndrome" vulnerabilities noted above.

My second principal suggestion is somewhat more "out of the box" and perhaps speculative than the first. It is that the Fed itself begin a process of considering whether it might be advisable and feasible to bifurcate Fed legal departments, and perhaps even the role of the General Council itself, at the regional Fed banks if not at the Fed Board itself. My reasons stem from the reflections above concerning the dual role that the GC and his or her staff play when the institution itself plays a dual role as do the regional Fed banks and as does the New York Fed in particular.

My impression, on the basis of both direct and reported experience, is that Fed and Fed Bank GCs – not to mention the GCs at other regulatory agencies like the FDIC and FHFA, for

example – tend to become enormously influential figures within their institutions.[70] This is partly because they are in most cases the most highly placed officials without term limits, meaning that more transitory "higher ups" tend to rely on them heavily as high level repositories of institutional memory.

It is also, of course, because all institutional decision-makers know that they must comport with the law, while their GCs are in most cases their principal if not sole authoritative expositors of what the law actually permits or requires. Deference of the sort highlighted by Professor Beim and other recent reports, then, tends to be especially strong where the GC is the person deferred-to. And this means that how ever the GC resolves the internal ambivalence mentioned above is apt to become internal institutional orthodoxy.

The "contrary thinking" unit considered a moment ago might, of course, serve partly to mitigate any such problem. But it will be inherently limited no matter how well insulated or respected it is. For again, *everything* done by or in the institution in question is subject to law, and the GC at present is the sole final "oracle" reporting to all what the law actually *is* in a given situation.

How, then, to address the risks that inhere in this situation? One way would be to ensure that at least one subunit within any legal department be charged solely and uniquely with performing the functions associated with the Bank's public (regulatory) aspect on the one hand, and those associated with its more private (internal compliance) aspect on the other hand. The head of each such subunit, in turn, would be of equal status and only one hierarchical step below the GC him or herself. In cases where these two heads counseled irreconcilable actions (or inaction), the GC would then make the final call, perhaps with the assistance of other highly placed members of the legal staff or even outside counsel retained on a limited basis for the purpose. (Academics like myself might even be briefly retained or invited in.)

To some extent, of course, legal departmental divisions already feature variations on this form of bifurcation. The problem as I see it, however, is that these departments are typically divided into *more* than two parts, and the inherently dual public-private, proactive-reactive nature of the institution and its GC's roles accordingly goes underappreciated. Appropriate focus on "leaning forward" where regulation is concerned even while maintaining caution where compliance with Fed-binding law is concerned might accordingly be muddled or missing.

Another, slightly more radical approach to our dilemma, then, would be to bifurcate the role of the GC itself, with one GC charged primarily with helping to craft means of proactively enforcing that institution's regulatory mandate, and the other charged primarily with taking care to "cover the institution's backside" by ensuring that it is in compliance with other laws

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[70] For more on this phenomenon, see, e.g., Jesse Eisinger, "The Power Behind the Throne at the Federal Reserve," *New York Times Dealbook*, July 31, 2013, available at http://dealbook.nytimes.com/2013/07/31/the-power-behind-the-throne-at-the-federal-reserve/?_r=0.

applicable to *it* rather than to the firms and markets it regulates. This possibility might initially appear to be only superficially different from that of bifurcating the department while retaining the unitary GC as final arbiter. I think that the difference is apt to be more than superficial, however, in view of the institutionally-wide "authoritative" character of the GC's final pronouncements on what the law says, permits, and prohibits.

Allowing for the possibility of *two* "authoritative" pronouncements rather than one is accordingly apt, I suspect, to be salutary in cases where there is disagreement between counsel. For it will serve to remind staffers throughout the institution that the law often features enough play in the joints to allow for attempting a novel and possibly in the end successful argument in favor of some proactive regulatory measure even when somewhat more risk-averse lawyers might incline to "playing it safe" by doing nothing. Moreover, even the one potential disadvantage I can see as possibly being raised by the bifurcation option – institutional impasse wrought by a "push-me, pull-you" dispute between the two general counsels – would seem readily resolvable by, once again, bringing in outside counsel to assist the Bank's Board and/or President in making the final call.

I think, then, that this option ought to be fully considered and vetted. I do not yet commit myself to it, but I do think it to warrant full inclusion on the agenda of options to consider as we all decide where we're to go from here.

CONCLUSION

I hope that the foregoing written testimony serves as a useful supplement to my oral testimony before you today. Please do not hesitate to let me know if I might be of further assistance. I am happy to elaborate further on anything said orally or written above in this supplement, as I have tried to keep myself as brief as possible in both. Thank you again for inviting my thoughts and recollections on the matters under discussion.