CONGRESSIONAL TESTIMONY

Step One for Improving Financial Institution Supervision: Ending the Federal Reserve’s Regulatory Role

Testimony before Committee on Banking, Housing and Urban Affairs, Financial Institutions and Consumer Protection Subcommittee
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A critical lesson from the Fed’s first 100 years is that an overly broad interpretation of the Fed’s role in financial stability in fact undermines financial stability, contributing to a cycle of moral hazard, financial failures, and rescues. The Fed already has the tools and mandate it requires to provide monetary stability, which is its best contribution to financial stability.

—Renee Haltom and Jeffrey M. Lacker,

*Should the Fed Have a Financial Stability Mandate?*

*Lessons from the Fed’s First 100 Years,*


Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for the opportunity to testify at today’s hearing. My name is Norbert Michel and I am a Research Fellow in Financial Regulations at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. In my testimony I will argue that the Federal Reserve is not, and can never be, immune from the potential conflicts and capture problems that exist throughout U.S. regulatory agencies. I will also maintain that the supposedly new “macro-prudential” regulations are new only in the narrowest sense, and that we should not expect them to make financial markets any safer than they were prior to the subprime crisis. All reform proposals should include at least one major change to U.S. financial market regulation: transferring all regulatory authority from the Federal Reserve to the Federal Deposit Insurance Corporation (FDIC) and/or the Office of the Comptroller of the Currency (OCC).
It has long been recognized that, over time, government regulatory agencies tend to be “captured” by the firms they supervise. The term regulatory capture simply reflects that individuals who serve as regulators come to identify with the firms they are regulating at least as much as the agencies for which they are employed. Two sources of regulatory capture are (1) individual regulators are often drawn from regulated industries precisely because the supervisory agencies value their experience, and (2) regulated firms often hire individual regulators precisely because they value regulators’ experience. Working for either the regulatory agency or the regulated firm enhances employees’ value for the other, and individuals tend to move back and forth between government and private-sector jobs so much so that the process is characterized as a revolving door. A recent Federal Reserve Bank of New York (FRBNY) paper suggests that the increasingly complex nature of financial regulations only compounds this problem. The paper argues 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.” To completely stop this process in any given regulated industry—even if it could be done—would not necessarily produce superior outcomes because doing so would build regulatory agencies with very little knowledge of the industries they


supervise.\textsuperscript{3} A decline in overall regulation and complexity of rules, on the other hand, would necessarily reduce the extent of regulatory capture.

Without reducing regulation, we should never expect any outcome other than regulatory capture because, as public choice economics has demonstrated, all individuals tend to act in their own self-interests so as to make their lives easier.\textsuperscript{4} This principle applies equally to private and government-sector employees. Indeed, none of the recent revelations regarding questionable relationships between FRBNY regulators and Goldman Sachs employees are surprising to anyone who has studied regulation.\textsuperscript{5} In 2011, as just one recent example in financial markets, the Government Accountability Office (GAO) identified a number of potential conflicts between the Federal Reserve and the firms they were supervising. The report pointed out that the CEOs of both JP Morgan Chase and Lehman Brothers were FRBNY Class A directors prior to the crisis, and that there were “at least 18 former and current Class A, B, and C directors from 9 Reserve banks who were affiliated with institutions that used at least one emergency [lending] program.”\textsuperscript{6} Additionally, a former FRBNY chairman, Stephen Friedman, previously served as the head of the risk committee for Goldman Sach’s board of directors, and current FRBNY president William Dudley is a former Goldman partner.

\textsuperscript{3}There is at least some evidence that “revolving door laws,” though designed to mitigate regulatory capture, produce little benefit for consumers. See, for example, Mark Law and Cheryl Long, “What Do Revolving Door Laws Do?” \textit{The Journal of Law & Economics,} Vol. 55, No. 2 (2012), pp. 421–436.
\textsuperscript{4}Essentially, this principle is also rooted in the U.S. Constitution. As noted by James Madison in the \textit{Federalist} No. 10, “It is in vain to say that enlightened statesmen will be able to adjust these clashing interests, and render all subservient to the public good. Enlightened statesmen will not always be at the helm. Nor, in many cases, can such an adjustment be made at all without taking into view indirect and remote considerations, which will rarely prevail over the immediate interest which one party may find in disregarding the rights of another or the good of the whole.”
A second GAO report from 2011 shows the FRBNY designed emergency lending programs only after it consulted with the intended beneficiaries. The report states that “FRBNY’s Capital Markets Group contacted representatives from primary dealers, and commercial paper issuers, and other institutions to gain a sense of how to design and calibrate some of its emergency programs.” While these issues raise concerns about potential conflicts of interest, such relationships are hardly new. However, recent empirical evidence suggests regulatory capture has higher costs than previously believed via insider trading. One particular study argues that “the presumed protectors of the shareholders and the general public interests appear to be using their positions to their advantage.” These findings, as well as the fundamental principles of public choice economics, suggest that the recent growth of federal regulatory power in the financial industry will expand the regulatory capture problem.

The 2009 Beim report fails to adequately acknowledge the causes of the capture problem, and instead treats capture as a managerial problem. As a result, the Beim report places entirely too much faith in regulators’ ability to understand and forecast future financial crises. For instance, the report notes: “Assuming that systemic risk above some level should be controlled, the regulator has two problems: recognition and action.” The real problem, though, is that these difficulties are all but insurmountable because of basic incentive and knowledge problems. Market participants have much stronger incentives—

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8See D. Reeb, Y. Zhang, and W. Zhao, “Insider Trading in Supervised Industries,” *Journal of Law and Economics*, Vol. 57 (August 2014). The study’s findings suggest regulators are the source of information leakage; compared to non-supervised firms, the paper finds more trading based on insider information in general, and also to an even greater degree in industries which exhibit higher regulatory capture.
a profit–loss motive—than regulators to discipline inefficient and/or overly risky firms. Additionally, no individual, whether a regulator or an industry employee, has any particular advantage over any other individual at identifying specific systemic risk episodes *ex ante*. Put differently, it is unreasonable to expect that any regulator or financial-industry employee could have identified exactly when short-term credit markets would freeze due to overly risky activity in the asset-backed securities markets. The Beim report mistakenly attributes this lack of foresight to the fact that “virtually no one imagined that such a collapse could happen in 21st century America.”

In fact, many people had warned of the potential problems that a failure in these markets could cause. A 2003 report by the Office of Federal Housing Enterprise Oversight, for example, warned: “Recent analyses of systemic risk have concluded that some non-bank financial institutions are now so large and integral to the financial sector as a whole that their failure could lead to a systemic event.”

Furthermore, in the two years leading up to the meltdown, markets undoubtedly recognized the growing risk of a financial crisis; the ratio of market-value to book-value equity for the largest U.S. financial institutions declined steadily.

For all of these reasons, and more, the Beim report’s recommendations for future supervisory policy are misguided. Even though the Federal Reserve was responsible for safety and soundness of all bank holding companies prior to the crisis, the Beim report

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suggests that future crises can be avoided if we simply improve the Federal Reserve’s culture and focus. The report acknowledges that the “recent systemic collapse is the greatest departure from bank safety and soundness in our lifetimes,” but then argues that “[f]rom now on systemic risk must be the most important single issue in bank supervision.”13 Essentially, these recommendations amount to the utopian fantasy that we can avoid future crises if we simply design more appropriate regulations and a better organization, one that cannot be captured. Aside from the fact that changing the culture of the regulators to prevent capture requires reversing basic tendencies in human nature, there is no reason to believe that relying on these supposedly new “systemic risk” regulations will prevent future crises. It is far more likely, in fact, that the new Dodd–Frank framework increases the likelihood of future crises.

**History Casts a Long Shadow over Macropru**

The 2010 Dodd–Frank Act, among other things, effectively mandated the type of systemic risk regulations called for in the Beim report. These so-called macroprudential regulations (implemented largely via the Basel III capital requirements) are supposed to be an improvement because they are tailored to prevent financial difficulties at any one institution from carrying over into the broader economy. Older (microprudential) regulations, supposedly, were too focused on maintaining the safety and soundness of individual banks. This ostensible improvement should be viewed with extreme caution for several reasons.

First, this claim ignores that Congress created the Federal Reserve in 1913 to prevent banking crises from causing widespread economic harm, not simply to save a few

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individual banks. Further, the Fed, Congress, and the U.S. Treasury have openly discussed their roles in stemming economy-wide systemic risk and financial stability for decades. For instance, systemic-risk concerns were mentioned in Federal Reserve testimony before the House Subcommittee on Economic Stabilization in 1991, shortly after the Basel I accords were accepted. Additionally, in 1996, the Fed specifically accounted for system-wide risk in its new rating system for financial institutions known as the CAMELS rating. Prior to this change, the Fed used a CAMEL rating; the 1996 change merely added the “S” which stood for “sensitivity to market risk.” Aside from these issues, no empirical evidence shows that any of the new Basel III regulations will prevent financial crises any better than the old rules did, and at least some evidence suggests they definitely will not.

In reference to these new macroprudential policies, Columbia Professor Charles Calomiris notes that “there is no agreement about precisely what objectives will motivate policy, what indicators will be relied upon to achieve those objectives, or what changes in capital requirements or other measures will be undertaken in response to changes in those yet-to-be-defined, multiple, and hard-to-observe

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indicators."17 Perhaps more troublesome is the fact that some of the most glaring weaknesses of the previous Basel framework remain unchanged in the new rules.

In recognition of the high cost and inherent agency problems associated with equity capital, the original Basel accords sought to better match capital requirements to the risk level of banks’ assets. That is, the rules sought to effectively lower the amount of capital banks held based on the perceived riskiness of specific bank assets. Not only were these rules crafted based on the “risk bucket” approach developed by the Federal Reserve in the 1950s, but the Fed (jointly with the FDIC and OCC) amended these rules in 2001 so that banks could hold even less capital for highly rated (privately issued) mortgage-backed securities.18 After the 2001 rule change, known as the recourse rule, certain AA- and AAA-rated asset-backed securities were given the same low-risk weight (20 percent) as agency-issued mortgage-backed securities. While much has been made of the “reach for yield” leading up to the crisis, evidence clearly shows that the 10 largest U.S. banks expanded their purchases of these private-label mortgage-backed securities and collateralized debt obligation bonds as soon as the rule was changed. Even though these banks’ assets doubled from 2001 to 2007, their risk-weight-adjusted assets barely increased.19 These facts provide clear evidence that these purchases (as sanctioned by federal regulators) were made for capital relief and safety first, and yield last.

Aside from the fact that the Federal Reserve—as well as other regulatory agencies—mistakenly endorsed these assets as low risk, there is an even more

17See Calomiris, “The Unlikely Return to ‘Normalcy’ in U.S. Monetary Policy,” p. 3.
19Friedman and Wladmir, p. 81.
fundamental problem with statutorily required minimum capital ratios. Such rules are viewed as providing a capital cushion to absorb losses, but when banks fail to meet the minimum required they are penalized. Thus, regulatory capital ratios do not represent \textit{usable} capital cushions because banks can only breach them if their regulator provides forbearance.\textsuperscript{20} When regulators allow such forgiveness, of course, the statutory capital requirements no longer represent a binding constraint on firms. Yet another core problem with statutory capital ratios is that they are arbitrarily determined outside any market-based system. For all of these reasons, the public should be wary of the notion that these rules will actually help to stem future crises.

It is also true that once statutory capital requirements are in place, purchasing specific assets to lower required capital can in no way represent “gaming” the system. Banks that simply followed the established rules by purchasing more mortgage-backed securities, for instance, cannot legitimately be accused of doing anything nefarious. There is very little reason, in fact, to believe that banks thought the securities they were buying after 2001 would lose value in the manner they eventually did—bank managers tend to prefer staying in business, after all. Regardless, the Basel requirements were—and still are—a system designed to match lower capital requirements against lower risk assets, and it is this part of the rules that were—and are—always destined to break down.

Regulators failed to measure mortgage-security risk properly in this particular case, but such a problem will always exist because the true risk of any financial asset can never be

\textsuperscript{20}For this reason it is not surprising that many banks hold a buffer slightly above the minimum required, and this was even the case leading up to the 2008 crisis; according to the FDIC, U.S. commercial banks exceeded their minimum capital requirements by 2 to 3 percentage points (on average) for six years leading up to the crisis. Juliusz Jablonski and Mateusz Machaj, “The Regulated Meltdown of 2008,” \textit{Critical Review} Vol. 21, Nos. 2–3 (2009), pp. 306–307.
known with certainty *ex ante*. Therefore, we should not expect the new regulations promulgated via the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act to perform any better than the previous regulatory framework. While Dodd–Frank did not explicitly require adoption of the Basel III rules, the bill included language—mostly in Sections 165 and 171—that effectively directed federal banking agencies to implement the Basel III proposals. Under these proposals, with some exceptions for the smallest banks, U.S. depository institutions will need to adhere to higher risk-based capital, leverage (overall debt), and liquidity (short-term debt) standards as well as to a new countercyclical capital conservation buffer. This capital conservation buffer is supposed to maintain credit availability by increasing banks’ capital when economic conditions improve and decreasing it when economic conditions worsen.21 The new Basel III rules are supposed to be an improvement over earlier versions because—via the Federal Reserve’s new “stress tests”—they apply a “macro” regulatory view as opposed to micro-level scrutiny. We should put very little faith in this tool to make markets safer for several reasons.

First, as mentioned previously, the general concept of focusing on macro risks versus micro risks is not new at all. Second, these stress tests, though technically different than the tools previously used, fail to overcome the basic problems of statutory capital minimums because they are merely a new arbitrary method for determining capital requirements. The Fed conducts stress tests by running a mathematical model to estimate

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how much capital banks need to remain solvent under “stressed” economic conditions. But these models necessarily rely on imperfect assumptions and data to forecast capital needs, and all such modeling depends on the naïve belief that the macro-economy can be precisely explained with mathematical equations. The Fed had no particularly credible track record of forecasting prior to Dodd–Frank, and there is no reason to believe it will improve now that it has a more expansive forecasting mandate. The Federal Reserve’s Open Market Committee meeting minutes clearly show that Fed officials failed to forecast the 2008 crisis, yet the Fed now has the responsibility to tell large financial firms how to forecast their own financial risks. At best, this exercise is futile, at worst, it exemplifies the ultimate version of what Nobel Laureate F. A. Hayek termed a fatal conceit.22

Conflicts Compounded Because the Fed “Prints” the Money

The Fed’s shortcomings as a forecaster and regulator are compounded by the fact that the central bank serves as the financial system’s lender of last resort (LLR). Though the Fed can regularly provide liquidity to the entire market by purchasing Treasury securities (open-market operations), even during a financial crises, the Fed has a long history of providing credit directly to insolvent institutions.23 For example, as of August 31, 1925, 593 member banks had borrowed continuously from the Fed for at least one


year as opposed to on a short-term basis. Research also shows that at least 80 percent of the 259 member banks that failed between 1920 and 1925 were habitual borrowers at the discount window prior to their failure, and evidence suggests that the Fed was continuously providing capital loans to more than 400 insolvent banks during the late 1980s and early 1990s. The Fed is even responsible for what monetary scholar Anna Schwartz called “the ‘too-big-to-fail’ doctrine in embryo” in the 1970s. In this particular instance, ostensibly worried about fallout from Penn Central’s bankruptcy, the Fed announced that it would provide discount window lending to banks to assist in meeting the needs of all businesses that could not issue new commercial paper.

Thus the Fed showed it would go to great lengths to stem a financial crisis in the event a large firm—one that was not even a financial firm—might fail. This action, of course, implied that the bankruptcy of a large firm would cause a financial crisis (the so-called contagion effect), although no analysis, only conjecture, establishes such a position. Yet, there is still not a single example of contagion causing a solvent financial firm to collapse. Furthermore, evidence suggests that no amount of Fed lending will stem a crisis because these systemic events are caused by solvency problems as opposed to liquidity problems. Regardless, the fact that the Fed used its Section 13(3) lending authority to allocate more than $16 trillion in credit to several financial firms during the

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26 Ibid., p. 62.
subprime crisis—at approximately $13 billion below market rates—should come as no surprise because it merely reflects the continuation of a long-term trend. The fact that Dodd–Frank has given the Fed even more regulatory responsibility, with a nebulous mandate of maintaining financial stability, while not stripping the Fed of emergency lending authority, all but guarantees future bailouts of failing firms and/or their creditors. Historically unable to restrain from allocating so-called emergency credit to failing firms, the Fed now has even more incentive to prop up insolvent financial institutions because it is all but guaranteeing firms’ safety and soundness. U.S. markets are now structured with a captured regulatory system where the primary regulator can create as much money as it wants to provide credit to financial firms and/or their creditors.

**End the Fed’s Role As a Regulator**

Some momentum to strip the Federal Reserve of its regulatory functions did exist prior to the 2008 crisis. Under the direction of former Treasury Secretary Henry Paulson, for instance, a special task force recommended that most of the Fed’s regulatory authority be dramatically reduced and/or transferred to other agencies. Such a shift in policy would have been counter to the historical trend in the U.S. The 1999 Gramm–Leach–

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Bliley Act (GLBA), for instance, expanded the Fed’s authority to define financial activities, and also widened the central bank’s authority to allow mergers and acquisitions. However, stripping the Fed of regulatory authority would have been entirely consistent with the international trend during the last few decades of the 20th century, whereby roughly a dozen developed countries took regulatory authority away from their central banks.30 While critics of this type of policy change argue the Federal Reserve needs information to make better decisions during a financial crisis, access to information is very different from the authority to write (and enforce) rules and regulations.

In reality, removing regulatory functions from the Federal Reserve is long past due. Policymakers should not leave the Fed—with its history of regulatory capture and credit allocation to failing firms (and their creditors)—in charge of regulating financial markets and providing emergency lending, while simultaneously being responsible for conducting the nation’s monetary policy. Beyond the basic temptation to provide so-called emergency funds to failing firms it regulates, the Fed also faces the incentive to use monetary policy actions to counter any regulatory failings. This combination further reduces the ability of markets to discipline poorly managed firms, injects even more politics into central banking, and jeopardizes the long-term price stability goal of monetary policy. As pointed out by Federal Reserve researchers M. Goodfriend and R. King, though, a central bank does not need to function as a regulator in order to conduct monetary policy.31 It makes sense to strip the Federal Reserve of its regulatory authority

so that the central bank can, instead, focus on monetary policy. In fact, evidence supports
the notion that separating a central bank from its regulatory role is beneficial. For
example, one recent National Bureau of Economic Research (NBER) study, using data
for 140 countries from 1998 through 2010, reports the following:

Countries with independent supervisors other than the central bank have fewer
nonperforming loans as a share of GDP [gross domestic product] even after
controlling for inflation, per capita income, and country and/or year fixed effects.
Their banks are required to hold less capital against assets, presumably because
they have less need to protect against loan losses. Savers in such countries enjoy
higher deposit rates. There is some evidence, albeit more tentative, that countries
with these arrangements are less prone to systemic banking crises.32

Put differently, the best way for the Fed to contribute to financial stability is for it to
focus on monetary stability. If the Federal Reserve is stripped of its regulatory authority,
no less than six federal agencies—the FDIC, the OCC, the Securities and Exchange
Commission, the Federal Housing Finance Agency, the Consumer Financial Protection
Bureau, and the Commodity Futures Trading Commission—as well as state regulatory
agencies, would still serve financial markets in supervisory roles. There simply is no
evidence that the Fed has any competitive advantage over either the FDIC or the OCC in
terms of regulating depository institutions, or over any of the other agencies in regulating
financial markets.

https://www.richmondfed.org/publications/research/working_papers/1988/wp_88-1.cfm (accessed
November 18, 2014).
32 See Barry Eichengreen and Nergiz Dincer, “Who Should Supervise? The Structure of Bank Supervision
and the Performance of the Financial System,” NBER Working Paper No. 17401, September 2011,
Conclusion

The Federal Reserve will never be immune from potential conflicts and capture problems as long as it serves as a financial market regulator. All potential problems are compounded by the fact that the Federal Reserve is responsible for the nation’s monetary policy. The broad new stability mandate Dodd–Frank granted the Fed has only made matters worse because the Fed may be even more tempted to give greater weight to its financial stability goals than to its monetary policy goal of price stability. Given the Fed’s long history of allocating credit directly to insolvent firms, it makes even less sense to leave the Fed in charge of both monetary policy and supervising the nation’s largest financial institutions. The 100-year anniversary of the Federal Reserve System is the perfect time to reform the nation’s central bank, and a key improvement would be to transfer all of the Fed’s regulatory authority to the FDIC and/or the OCC.

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