<u>Financial Regulation and the Federal Reserve System</u>

As Prepared For Delivery
By: Dr. Martin Regalia, Chief Economist, U.S. Chamber of Commerce

Looking at today's economy we see an economy that has been growing now for over seven years, but, at a growth rate that has averaged just over 2% per year. As a result we still have a negative GDP gap, and have not re-attained our long run potential. This is really unprecedented. Usually we regain out long-run potential after an economic downturn in less than a year but this time after more than 7 years we are still not back where we should be. And, CBO says we are not likely to get there anytime soon.

While millions of jobs have been created, and the measured unemployment rate is below 5%, millions of potential workers have left the workforce and are not even looking for work and millions more are working part-time because they cannot find full-time jobs. The participation rate is at a 40-year low and shows little sign of regaining former levels.

Wages have been stagnant, and the Fed remains so concerned about the economy that they refused to normalize policy.

Now many, especially those in the Administration will tell you that this is a new norm, that it is because of the deep financial crisis. But these excuses are baloney. More and more evidence and more and more economists say that the weak recovery is the result of bad policy -- particularly bad regulatory policy. And nowhere is that bad regulatory policy more evident than in the financial markets where unnecessary, poorly crafted, redundant and punitive regulations emanating from the Dodd-Frank legislation have crippled the flow of credit.

So, today I would like to talk about the regulation of our financial institutions and markets, and the Federal Reserve's role in that process, and to make a plea for rethinking and retooling that role and those regulations.

The Fed currently has a vast regulatory reach. It is the primary regulator of state-chartered commercial banks that choose to be members of the Federal Reserve System, bank holding companies, thrift holding companies and their subsidiaries, U.S.

branches of foreign banks, foreign operations of U.S. banks, EDGE Act corporations, and financial market utilities.

The Fed also acts as umbrella-regulator for financial holding companies. The Fed is also the primary regulator for systemically important financial institutions or SIFIs (which by the way do not have to be a financial institution at all but can be anyone operating in the financial system so designated by the Financial Stability Oversight Council (FSOC), of which the Fed is a member. The Fed is also the financial agent for the US government, and designs and implements monetary policy.

The Fed conducts all these activities as an independent agency within the federal government. As such, the Congress has general oversight authority over the Fed but the Fed's specific approach is not directed by the Congress or the Administration, nor is the Fed's budget appropriated by Congress. The Fed quite simply has a lot of autonomy. This autonomy is the subject of today's presentation

This is a very complex topic, even for experts in the field, so at the start let me summarize my basic argument so you can see where I'm going. I want to affirm the importance of the Fed's independence in executing monetary policy. We have too many examples of what happens when a country's monetary authority is politicized and we are not suggesting that we go down that road. We can't let that happen.

But, the Fed also has accumulated vast regulatory and supervisory authority over financial institutions and markets in the years since it was founded and the scope and administration of this authority are, I believe, legitimate areas for debate. The Fed has consistently maintained that their regulatory authority was necessary for the proper implementation of monetary policy and because monetary policy should be independent of political influence, so should the accompanying supervision and regulation. Let me say at the outset that I do not adhere to this logic.

Let me emphasize that I am not questioning the need for supervision and regulation in promoting safety and soundness and ensuring the stability of the financial system, but I am suggesting that there is room for debate on where that authority is housed and especially how it is administered.

In extending the cloak of independence to its regulatory and supervisory function, the Fed has set itself apart from most other regulatory agencies in its ability to act without broad and comprehensive private sector comment or response. For good reason, the

Congress requires agencies like the Environmental Protection Agency and the Occupational Safety and Health Administration, and even the IRS, to follow certain procedures such as allowing for public comment on regulatory proposals. The Fed should be required to do no less.

I think we need a debate in this country as to whether the central bank should also be the central federal financial institution regulator. Other countries have had this debate and many have come up with different answers.

Whether the Fed remains at the center of financial regulation or not, I do think we need to remove the blanket of independence with respect to the Fed's regulatory function and to ensure that procedures are in place that will foster the appropriate level of communication between the regulator and the regulated. The Fed should be subject to all the same process rules and procedures Congress has established for other regulators.

While this conclusion may seem radical to some, a bit of history may provide some background and make it seem less so. So forgive me while I digress for a moment.

The Fed's Roots in History

We can divide our 250 years of financial history in to two roughly equal parts – pre-Federal Reserve and post Federal Reserve. The pre-Fed era was characterized by a hodgepodge of independent banking and financial institutions that were geographically diverse chartered by the states, or after the 1860s, by the states and the Federal government. Supervision and regulation was inconsistent to say the least. There were two abortive attempts to establish a central bank before the 1830s, but neither lasted long out of a basic concern over concentrating too much power. Even the currency wasn't standardized until after the 1860s.

Because of the asset and liability maturity structure of banking institutions– in effect they borrowed short-term and lent long-term – and their geographic isolation these institutions were subject to periodic liquidity constraints which when dire enough led to bank runs, failures and even broad banking system panics.

Even the system of correspondent banking which was developed to provide independent banks with a broader geographic and liquidity footprint was insufficient to stem the panics.

Changes were implemented at the time of the civil war to standardize the currency and permit the chartering of national banks, but without a central bank backed by the Federal Government the periodic failures, runs and panics continue into the early 20th century. This period of instability culminated in the particularly troubling Panic of 1907 and led to the establishment of the Federal Reserve System.

The Federal Reserve Act was passed in 1913 and established The Federal Reserve System as a central bank. While economic historians may differ a bit on details, there is general agreement that the Congress intended that the Fed would provide a safe and elastic currency that would expand and contract with the needs of the economy and thus stop the panics and bring stability to the system. The intent was not to directly address the panics but, instead, to stabilize the money supply and thus prevent panics. Because there was political opposition to the centralization of power, the system included 12 regional banks and a central board in Washington D.C.

At the time of its founding the Fed's main tool for monetary policy was the discount window. If a member bank faced a liquidity shortage, it could bring assets – essentially loans that they had made to support commerce -- to the Fed and use them as collateral to obtain cash. Since the Fed was backed by the government there would be no shortage of liquidity, depositors' fears would be calmed, and thus no run on the bank. Any bank that was a member of the Fed and had suitable collateral could borrow from the Fed. Moreover, there were few if any limits on this access to liquidity at the discount window. Thus, the primary goal of the Fed at its inception was management of the money stock and by extension providing stability to the financial system, it was not to address crises after they developed.

In addition to its monetary policy function, the Fed was granted supervisory and regulatory authority over national banks and state-chartered banks that chose to be members of the system, namely those institutions that could borrow from the Fed. This authority gave the Fed both a prudential risk management tool and allowed the Fed greater control over the institutions through which the Fed conducted monetary policy.

This initial granting of supervision and regulatory authority seems to be the origin of the Fed's contention that supervisory and regulatory authority is a necessity for conducting monetary policy -- a theme we will come back to time and again as a justification for the Fed's ever-expanding role as a financial regulator.

The Fed is credited by some scholars with preventing some panics during the early 1920s. Yet a mere decade and a half after creation of the Fed our financial system was plunged into one of the worst financial disasters in our history. Clearly, the establishment of the Fed was not the solution to financial panics that Congress envisioned.

Some economists and financial market scholars contend that a change in the way that the Fed implemented monetary policy actually exacerbated the downturn. The Fed's original approach placed few restrictions on the use of the discount window except the type of collateral. But in the 1920s, the Fed changed its monetary policy approach to rely more heavily on buying and selling of government debt obligations on the open market (so-called open market operations) to control the money stock. The discount window evolved into a "lender of last resort" function and access to it began to be discouraged or limited to times of stress. The discount window was relegated to more of crisis management tool in the Fed's arsenal. Further, the Fed created the impression that financial institutions turning to the discount window were tainted by bad practices in some way.

This evolution of the role of the discount window may seem esoteric, but its effects were enormous, even tragic. The Fed had replaced an automatic mechanism which expanded and contracted the money supply based on the economy's needs with its own discretion, and the Fed had dramatically degraded its most powerful tool for dealing with bank runs. This change also removed, or at least stretched the connection between monetary policy and the supervision and regulatory function.

Despite the Fed's failure to prevent the Great Depression, or as some would contend, its complicity in making it even worse, Congress spent the next 80 years adding to the Fed's regulatory and supervisory power.

The Fed after the Great Depression

In the late 1920s and early 1930s, the Congress passed a series of laws that were intended to compartmentalize the financial system. Essentially, the theory was that the best way to prevent widespread financial contagion was to keep industry segments each in their own box. Most critically, the McFadden Act limited bank branching thus constraining bank size, and the Glass-Steagall Act separated commercial banking from investment banking. The Congress also established the Federal Deposit Insurance

Corporation to insure bank deposits and remove the incentive for depositors to "run" on a bank.

The Congress also restructured the Fed's Board of Governors, removing the Secretary of the Treasury from the Board, and making the Board more fully independent of the Executive Branch. The Federal Open Market Committee was also established to oversee the conduct of monetary policy. Creating an independent Fed was intended to remove political influence from the conduct of monetary policy, but by extension it also insulated the Fed's regulatory and supervisory function from the executive branch procedural rules and isolated the Fed's regulatory process from direct oversight by Congress and systematic feedback from the regulated institutions and markets.

The Fed's use of the discount window as a lender of last resort also exacerbated moral hazard in the system. Because institutions had access to a residual line of credi**t,** there is a potential for them to act with less concern for risk. This moral hazard in turn supported the desire for more enhanced supervision and regulation. In effect, the Fed's policy created a greater need for regulation which the Fed was only happy to provide.

Even as the Congress was delegating ever-more regulatory and supervisory authorities to the Fed, the economy's needs for more financial services continued to grow in size type and quality of services. When the growing regulatory state impinged on financial innovation, the innovation moved to the unregulated fringe of the financial system.

As this innovation gained notice, often as a result of some manner of financial problem or concern, Congress would seek to extend the regulatory system to cover them. Often, this expansion of regulatory reach was entrusted to the Fed.

Thus began a 50 plus year vicious circle of broader regulation forcing innovations in the system beyond the reach of regulation. Innovation, which is vitally important for growth, at times led to excesses which in turn led to Congress granting the Fed more regulatory and supervisory authority.

The post-WWII growth and maturation in the economy saw financial institutions seeking more flexibility through the establishment of bank holding companies. This innovation led to passage of the Bank Holding Company Act of 1956 which brought bank holding companies under Fed supervision and regulation.

But the 1956 Act defined a bank holding company as an entity owning two or more banks and so institutions began organizing into single bank holding companies to avoid Fed oversight. The Bank Holding Company Act of 1970 closed this loophole and swept these institutions under the Fed as well.

The growth of global financial markets and the influx of subsidiaries of foreign banks into U.S. markets in the 1970s led to the passage of the International Banking Act of 1978 and, yep you guessed it, these institutions were swept in under the Fed's regulatory umbrella too!

The decades of the 1980s and 1990s was a time of substantial transformation of financial markets and institutions. Globalization was becoming more important, inflation had driven interest rates significantly higher and competition among institutions, and between financial institutions and non-regulated capital market entities, intensified greatly. Thrift institutions were under severe stress and mass failures were imminent. This time around, however, Congress' approach was vastly different. Rather than attempting to draw distinctions between different types of institutions and different type of financial activities, Congress chose to deregulate to the extent of eliminating artificial barriers between diverse forms of financial services, and to allow more competition in the marketplace to drive down costs and spur innovation.

The Depository Institution Deregulation and Monetary Control Act of 1980 began the process by removing the Regulation Q ceiling that restricted the payment of interest on deposits and allowing institutions to compete directly with different interest rate offerings. The Act also expanded the types of institutions that were required to hold reserves at the Fed and by extension the types of financial institutions that had access to the Fed's discount window. While the Fed's direct regulatory reach was not expanded, the lender of last resort function was now extended to non-banks and the Fed's role in promoting financial market stability was enhanced. But, the broader "lender of last resort" role contributed to increased moral hazard in the financial system. In short, the expansion of lender of last resort at a time of rapid financial innovation meant more opportunities for market participants to bet with the house's money.

This trend was continued in the 1990s with the Riegle-Neal Interstate Banking and Branching Efficiency Act, which effectively repealed the branching restrictions of the

McFadden Act. Then, at the end of the decade, the Gramm-Leach-Bliley Act effectively repealed the activity restrictions of Glass-Steagall. So by the turn of the 21st century we had a highly integrated financial system but only the traditional banking institutions were regulated and much of the financial activity, especially the higher risk activity, was taking place outside of these regulated institutions.

A bursting housing bubble exposed the risks inherent in many of these unregulated activities, and also exposed the extreme interconnectedness of the financial system, threatening the failure of both unregulated entities and their related counterparties in the regulated world (indeed threatened the system itself). Congress once again stepped into the breach and passed the most extensive regulatory expansion in history.

The so-called Dodd Frank bill removed some regulatory and supervisory agencies, combined others, and created a few totally new ones. It also expanded the Fed's role in the regulatory process, made the Fed the systemic regulatory of the financial system and gave the Fed the regulatory and supervisory envelope that we presented at the beginning of this presentation.

So, why the long-winded history review? Well, if the old adage of those being ignorant of history being doomed to repeat it has any validity, there should be some lessons or conclusions here.

The first lesson is that the regulatory reform process in this country was an evolutionary process that was totally backward looking: Wait until a problem crops up and then try to address it. Such, evolutionary processes often result in a system with a lot of appendages and little cohesion. And, I think that describes our situation to a "T".

The second lesson is that politics and pragmatism will always trump principle. Thus, at each stage in the regulatory history, when Congress was faced with a problem they turned to the same expedient conclusion – give it to the Fed.

Why the Fed? Well after 1933, the Fed was independent. So if the existing regulatory apparatus failed to prevent the next problem, as it did in every case, then there was an independent agency to blame. And, more importantly, the Fed was off budget and self-funded with the proceeds from their monetary operations, so giving the Fed the new regulatory authority was easier than increasing funding to an existing supervisory agency or creating a new one. Moreover, the Fed wanted and actively lobbied for the increase in authority under the claim that it was necessary for the implementation of monetary policy.

A third, conclusion, is that the Fed which started with a single simple mandate to provide for an elastic currency, gradually, but inexorably developed a secondary mandate to provide for maximum growth subject to price stability and a third mandate to ensure the stability of our broad financial system. Importantly, this third mandate could only be achieved with an ever growing regulatory reach.

But problems can occur when an ever expanding regulatory and supervisory authority is placed in an independent agency with few checks and balances. One big problem is that regulated entities are then deprived of the formal opportunity to object or even comment in a manner to which the regulator must respond. Congress long ago realized such an arrangement can lead to regulatory overreach. It can also insulate a regulatory agency from effective criticism which itself can deter an agency from learning about the effects of its proposals on the private sector and therefore incorporating comments in regulatory revisions. Regulatory independence, can lead to regulatory autonomy and even regulatory arrogance and that is not a good progression.

What is interesting is that Congress kept going back to this flawed approach of increasing Fed empowerment. At each step in our financial history, the Fed's expanding regulatory reach was unable to prevent the next problem. Their founding in 1913 to prevent financial panics was followed by the Great Depression; after all the increases in regulatory and supervisory authority given to the Fed in the 50s, 60s, and 70s, we still saw financial stress in the late 80s and early 90s – and then the Great Financial Crisis of 2007-2008.

I would not be surprised to see more financial stress and even possibly highly disruptive financial crises in the United States in the future. Why? Because innovation will always seek the unregulated fringe and innovation will always push the envelope a bit too far! Not because those doing the innovation are necessarily reckless or greedy, but because the innovators themselves are not always aware of how their actions individually so benign can collectively put the financial system at risk.

At the same time, we have to be careful not to throw out the baby with the bath water. Without innovation, whether in financial services, manufacturing, or wherever, our economy cannot continue to grow.

Another lesson from this history is that the Fed's role in the financial system has changed over time, sometimes dramatically. From its original single mandate to create a safe and elastic currency, Congress has added more specific mandates, such as, to provide for maximum growth subject to price stability. However, with the continuing addition of regulatory and supervisory powers, Congress has also implicitly given the Fed a broad financial stability role. While there may be no problem with the Fed having such far reaching roles, there is clearly a need for the Fed to manage these roles differently. Where independence is necessary for monetary policy, it may not even be a benefit for regulation and supervision.

Failure to solicit broad meaningful feedback on regulation and to establish procedures which provide for a critique of the proposed regulations and/or the regulatory process virtually ensures that regulation will produce unintended consequences. It is simply not good public policy. Failure to promote communication can lead to a regulatory detachment and even regulatory aloofness

In researching this presentation, I came across such an example. After the implementation of Dodd-Frank, the Fed was asked by a number of Senators on the Senate Banking Committee for information on economic analysis in five specific rulemakings. In June 2011, The Office of the Inspector General at the Federal Reserve dutifully responded in great detail on how the Fed had done the economic analysis, but noted in the reply that the Fed could improve its approach by updating its Rulemaking Procedures Policy Statement. Yet, when we recently asked to get a copy of the updated procedure statement, we were told it had never been done! The Fed chose to ignore its own suggestion on how to improve the process!

The Chamber believes that in its regulatory and supervisory role, The Fed should abide by the same basic principles as other regulators, namely transparency, accountability, and due process.

The Chamber strongly believes that all regulators must be fully transparent in their deliberations and decision making, and invite and address public input as part of the policymaking process, and the Fed is no exception. In fact, the Fed's tendency towards opacity as a regulator domestically, and in its capacity as a participant in international policymaking, has contributed to a reduction in access to capital and liquidity that is hurting Main Street businesses. We therefore support both structural and process changes that will make the Fed a more transparent and accountable regulator.

What I've talked about so far implies a fairly fundamental rethinking of how the Fed regulates. But the Chamber is not here to just criticize, we also want to provide solutions. Earlier today, the Chamber released its Federal Reserve Reform agenda. This agenda includes the following suggested reforms:

1. Create a transparent strategic regulatory plan.
2. Subject regulation to transparent, robust cost-benefit analysis.
3. Taylor rules for non-bank SIFIs.
4. Hold public meetings to consider regulations and international regulatory agreements.
5. Shine more light on interactions with the Financial Stability Board, the International Association of Insurance Supervisors, the Bank for International Settlements, and the Basel Committee on Banking Supervision.
6. Consolidate examinations and data-collection with other regulators.
7. Fill the position of Vice Chair of Supervision.
8. Enter into MOUs with functional regulators.

None of these recommendations would prevent or impede the Federal Reserve in executing its mission. We believe that our suggested reforms will make the Federal Reserve and the other Banking Regulators more efficient in executing their mission by using smart regulatory tools. We believe the implementation of these reforms will benefit the Federal Reserve by ensuring that it can continue to regulate financial institutions under its jurisdiction, monitor and address systemic risk in a targeted and coordinated way while considering the impact on Main Street companies and the economy. We have reached the position that we have through a long evolution, but the unintended consequences of regulations are having a real-life impact upon our financial system and as a result on economic growth. We believe that these recommendations will correct flaws in our system in a way that will benefits the Federal Reserve, the financial markets and the overall U.S. economy.