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IMPROVING FINANCIAL INSTITUTION SUPERVISION: EXAMINING AND ADDRESSING REGULATORY CAPTURE

HEARING

BEFORE THE

SUBCOMMITTEE ON
FINANCIAL INSTITUTIONS AND CONSUMER PROTECTION

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE CAUSES, IMPLICATIONS, AND POTENTIAL METHODS OF ADDRESSING REGULATORY CAPTURE

NOVEMBER 21, 2014

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C O N T E N T S

FRIDAY, NOVEMBER 21, 2014

WITNESSES

IMPROVING FINANCIAL INSTITUTION SUPERVISION: EXAMINING AND ADDRESSING REGULATORY CAPTURE

FRIDAY, NOVEMBER 21, 2014

U.S. SENATE, SUBCOMMITTEE ON FINANCIAL
INSTITUTIONS AND CONSUMER PROTECTION,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Sherrod Brown, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN SHERROD BROWN

Chairman BROWN. The Subcommittee will come to order.

Thank you all for joining us. Thank you to Senator Reed and Senator Merkley, and there will be, I believe, another couple of Senators that will be along.

Six short years ago, we were in the midst of a massive financial crisis and the largest bailout in our country's history. The financial crisis was brought on as much by timidity and capture on the part of regulators and Congress as it was greed on the part of Wall Street. The Financial Crisis Inquiry Commission concluded that Wall Street watchdogs, quote, "lacked the political will in a political and ideological environment that constrained it as well as the fortitude to critically challenge the institutions and the entire system they were entrusted to oversee."

One Fed supervisor told the FDIC that the Nation's largest bank was, quote, "earning four to five billion dollars a quarter. When that kind of money is flowing out quarter after quarter, it is very hard to challenge." And so that bank's CEO famously concluded, as long as the music is playing, you have got to get up and dance.

If we learned anything from the financial crisis, it is that we all have responsibility to remain vigilant in our oversight of Wall Street risk taking. As we saw so clearly, short-term profits can quickly turn into long-term losses. The music stopped. The victims were, of course, not just Wall Street's bottom lines. The real victims were millions of Americans who lost their jobs, who lost their pensions, who lost their savings, who lost their homes.

Four years ago, we overhauled the Nation's financial regulations, handing a great deal of power to the Federal Reserve. As one Fed official told the Subcommittee in 2011, and I quote, "Improvements in the supervisory framework will lead to better outcomes only if day-to-day supervision is well executed, with risks identified early and promptly remediated. When we have significant concerns about risk management at complex firms, we raise those concerns forcefully with senior management at the firms, holding them accountable to respond and tracking their progress."

Six years after the crisis, 4 years after Dodd-Frank, 3 years after those comments, troubling reports suggest that it is back to business as usual at the Federal Reserve Bank of New York. Former employees have come forward with troubling reports about the examination teams of JPMorgan and Goldman Sachs, two of the Nation's largest, most complex banks. "Legal but shady transactions," quote-unquote; examiners engaged in an internal struggle; expertise that is not valued; low morale; all reports coming out from the examination teams; financial reform that ends up in a vacuum, and examiner told to "bite her tongue;" an institution that is like a giant Titanic, slow to move; a decision-making process that grinds everything to a halt; examiners being stonewalled by their supervisors, all direct quotes from these reports.

Yesterday, we learned of another example of the revolving door at work, a New York Fed examiner leaving to work at Goldman Sachs, then receiving confidential information from his old colleague. It is no wonder that Wall Street always appears to stay one step ahead of the sheriff. It is bad enough when banks can capture the agencies that regulate them or the Congress, which is all too often the case, also, that oversees those agencies. It is worse when they do not even have to because the agencies handcuff themselves or public servants attempt to curry favor with the companies which they supervise.

These recent reports should trouble any organization, but they are particularly catastrophic when the agency in question is responsible for four megabanks, four of the six largest banks in our country, four megabanks that alone account for $6 trillion in assets in some 11,000 subsidiaries. These banks operate in an average of 65 countries—65 countries. And a recent report by the Federal Reserve's Inspector General on the London Whale incident reinforced risky trades in a London office supervised by the New York Fed can reverberate back to our country.

With all of its resources and its new authority, is the Federal Reserve up to the task of regulating financial institutions that are so large and complex? That is the question. Or, are these Wall Street banks simply too big to regulate? We talk about too big to fail. Are they too big to manage? Are they too big to regulate? All important questions.

I would be interested in hearing Mr. Dudley's thoughts, especially on the question of are they too big to regulate, because the damage from the failure of any of these institutions, as we know, is not contained to Wall Street. It is also felt most acutely on Main Street. That is why it is so important that examiners and supervisors and regulators remember that their job is to serve the public, to serve Main Street, not the banks they oversee. That is why the Fed must put its financial stability mission on an equal footing with monetary policy, which has consistently, at least from many observers, been the problem, that the financial stability mission needs to be on an equal footing with monetary policy.

Congress and Dodd-Frank created a Vice Chair for Supervision at the Federal Reserve in this city, but by failing to even nominate someone to this position, the message that is sent from the President to the Board, to the supervisors, is that financial regulation is secondary. According to my research, the Reserve Banks are still dominated by monetary policy experts. Only two of the 12 Fed Reserve Bank presidents around the country—only two of the 12 have any background in supervision.

We are here today because of issues raised by Carmen Segarra. She has done—and she is here today, welcome—and she has done a public service in bringing them to light. The question for all of us is what we are going to do about them. Will we simply talk and move on, or will we do something?

I thank the witnesses for being here. I thank Senator Toomey, his staff. He could not join us today. I thank the Committee staff, other Members of the Subcommittee, for working with us.

I yield to Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, Mr. Dudley, for joining us today. Let me commend the Chairman and the Ranking Member for holding this hearing. It is very important.

In 2007, 2008, we discovered that there were systemic flaws in the regulatory structure of the United States and we tried to address those flaws in the Dodd-Frank legislation. We made some progress. But, one of the issues that was supported by my colleagues in the Senate but did not survive a conference with the House was requiring that the President of the New York Federal Reserve Bank be nominated by the President of the United States and confirmed by the Senate. I think that is appropriate and obvious. It does not have anything to do with personalities, because 4 years ago, I thought it was appropriate and responsive.

The fact is, the New York Fed is one of the biggest regulators of financial institutions in the United States and the only one that does not directly or indirectly have the thoughtful review by the Congress, the Senate, and the initial nomination by the President of the United States, and I just do not think that makes sense. So, I reintroduced the legislation and we are going to pursue it. I hope in this context, it will be successful.

And, it just strikes me, being from New England, I think these are lines originally attributed to Robert Frost, which is "Good fences make good neighbors." And, frankly, the perception today and the perception 4 years ago is there are no fences between the New York Fed and the banks they regulate, and that perception is wrong and we are here to see whether or not there is something we can do positively about that.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Reed.

Senator Merkley.

STATEMENT OF SENATOR JEFF MERKLEY

Senator MERKLEY. Thank you very much, Mr. Chairman.

Six years ago, when I came here, we were in the middle of a tremendous economic collapse due to the process in which there had been a huge surge in teaser rates, subprime mortgages, with kickbacks that went to mortgage originators, sizable kickbacks if they would steer their customer from a prime loan they qualified into a subprime. The responsibility for the oversight of this was in the Federal Reserve, and, indeed, monetary policy had been put in the penthouse, consumer protection had been put in the basement, and it as if the doors had been locked and the keys had been thrown away, and the result was a not only enormous direct harm to millions of families across the country, but eventually a collapse of the entire economy.

And, I look at various issues that keep arising, whether it is manipulation of LIBOR rates, or whether it is the deep conflict of interest in which large banks have both extensive commodity holdings and are able to affect the supply and demand of those holdings at the same time that they are making bets on the prices of those, and I just see a regulatory system that—I guess a polite version would be to say it is passive or asleep, but certainly we are not seeing anything close to a rigorous accountability for conflicts of interest and failures of oversight.

And, so, I am just very interested in hearing your thoughts today and look forward to the important discussion that should follow on from that. Thank you.

Chairman BROWN. Senator Manchin, who is not a Member of the Subcommittee, he is a Member of the full Committee, and thank you for your interest in joining us.

STATEMENT OF SENATOR JOE MANCHIN III

Senator MANCHIN. Thank you, Mr. Chairman. I appreciate very much you giving me the opportunity and the courtesy to join your Subcommittee today.

I've often said that Government needs to act as a partner, not an adversary, when it comes to boosting our economy. But, the Government also needs to protect consumers with the tools given to it by Congress. It is a difficult balance to strike, but when regulators fail to do so, we all suffer.

In my great State of West Virginia, regulators have often gone too far on several issues. Too often, it fails to strike the proper balance, leading to a regulatory overreach that handcuffs industry and the people of my great State suffer. Today, we are discussing a failure at the opposite end of the spectrum, but the result is the same: Main Street suffers.

The Federal Reserve is tasked with supervising the Nation's largest banks and is our first line of defense against another financial crisis. Yet, we have seen time and again the Fed has failed to strike the proper balance when regulating these large firms. The most obvious example is the 2008 financial crisis, from which we are still recovering. Their inability to properly regulate the banks led to an economic catastrophe. Despite passing Dodd-Frank and promising Americans that this would never happen again, can we really say we have learned our lesson? Have the regulators really learned their lessons?

Recently, a former Goldman employee released secret recordings that confirm many of our suspicions, that the Fed is too cozy with the very banks where tough oversight is needed. Her recordings laid out how her supervisors wanted the employees to soften her findings for fear of disappointing the large bank they are supposed to oversee. The Fed Office of the Inspector General provided additional proof of these concerning relationships when it concluded that lax supervision contributed to the London Whale incident at JPMorgan that resulted in almost $6 billion in losses. Both the recordings and the trading losses happened in 2012, just 4 years after the Great Recession. It seems little has changed and few lessons have been learned.

I am encouraged that the Fed announced yesterday that it would revise its supervisory standards and think more about how to deal with employees who have divergent views. That is a long time coming.

But, we have an opportunity to do more. That is why I teamed up with my good friend, Senator Warren, in penning an editorial asking the President to nominate candidates to the Board of Governors with experience investigating big banks and distinguishing between the greater risk posed by the biggest banks relative to community banks.

I understand the need for regulators who have industry experience and banking experience. New York Federal Reserve Governor Dudley's, qualifications are unquestioned. We know that, with your expertise and your background, that your contributions have been valuable and we appreciate that. But, you worked at Goldman Sachs for over 20 years, attained the coveted title of partner, and was its Chief Economist.

But, Governor Dudley is not the only Goldman employee at the New York Fed not by a longshot. In fact, I would hazard that the big bank alumni network at New York Fed is quite extensive. When a banking regulator hires mostly people who work at Goldman or JPMorgan or Morgan Stanley or any of the six largest banks they are tasked with overseeing, is it any surprise that the culture at the Fed is poor at supervising these very institutions that they once worked for?

As Senator Warren and I have said, the stakes could not be higher. With the proper supervision, we might have averted the 2008 crisis that cost so many people on Main Street in America their jobs and wiped out over a decade of economic success. We owe it to the American people to learn from our mistakes and ensure we never put them in that position again.

My little State consists mostly of community banks, as you know, and they are getting hit hard now by the overreach, if you will. All the problems started with the banks that the Fed is tasked to oversee, and we would hope that you would take that to heart and look at ways that you can find people with diverse, not special interests, but diverse interests to do that job.

Thank you, sir.

Chairman BROWN. Thank you, Senator Manchin.

Senator Warren.

STATEMENT OF SENATOR ELIZABETH WARREN

Senator WARREN. Thank you, Mr. Chairman.

We need bank regulators who work to protect the American people, not the profits of giant banks, and that is what this hearing is about today. I want to thank you, Mr. Chairman, for holding this hearing, and I want to thank my colleagues for being here. I want to thank my friend, Senator Manchin, for our work together on trying to focus on the Fed, the Fed nominees, and the role of the Fed, not just in monetary policy, but in supervising the largest financial institutions in this country.

I am looking forward to our getting to the questions, so with that, I am going to yield back the remainder of my time.

Chairman BROWN. Thank you, Senator Warren.

William Dudley is the tenth President and Chief Executive Officer of the Federal Reserve Bank of New York. Mr. Dudley served as the President of the Markets Group at the New York Fed from 2007 to 2009. Before that, as Senator Manchin said, he was Chief Economist at Goldman Sachs. He worked at Goldman Sachs for 21 years.

President Dudley, welcome. Please proceed.

STATEMENT OF WILLIAM C. DUDLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL RESERVE BANK OF NEW YORK

Mr. DUDLEY. Thank you. Chairman Brown and Members of the Subcommittee, thank you for this opportunity to testify on the effectiveness of financial institution supervision and the issue of regulatory capture.

In 2008 and 2009, our country faced its worst financial crisis since the Great Depression. At the Federal Reserve, the crisis raised two fundamental questions. First, how can we improve the stability of the financial system? And, second, how can we improve our supervision of financial institutions?

Due in large part to our efforts, the financial system today is unquestionably much stronger and much more stable now than it was 5 years ago. In the area of bank capital, new regulations, including Basel III standards and periodic stress tests, such as the Comprehensive Capital Analysis and Review, or CCAR, have increased both the quantity and quality of equity capital at the largest financial institutions we regulate and supervise. Since these stress tests commenced in 2009, the largest banks have more than doubled their Tier I capital. Firms that fail our tests face severe consequences, including restrictions on the payment of dividends and share buy-backs.

The Federal Reserve has also imposed new liquidity regulation and stress testing and has put more focus on corporate governance, not only policies and procedures, but how risk decisions are actually made. We have also increased public and nonpublic enforcement activity, including fines and restrictions on the growth of banks with poor risk management. And, we assisted in the recent criminal pleas by Credit Suisse and BNP Paribas, which ended the concept of “too big to jail.”

We also placed greater emphasis on the reform of banker conduct. I have proposed four specific reforms to curb incentives for illegal and unduly risky behavior. First, increase deferred compensation for senior managers and material risk takers.

Second, impose de facto performance bond on bank employees for the payment of fines funded through this deferred compensation.

Third, create a database of bank employees dismissed for bad behavior.

And, fourth, ban any banker convicted of a crime of dishonesty from the financial system, both the regulated and shadow banking sectors.

The process of supervision has changed in several important respects since the crisis. Consequential supervisor decisions are now made on a systemwide level through the Large Institutions Supervisory and Coordinating Committee, or LISCC. LISCC is comprised of representatives from across the Federal Reserve, including several other Reserve Banks and the Board of Governors. The New York Fed supplies only 3 of its 16 members. Through its Operating Committee, the LISCC coordinates the supervision of the largest supervised institutions. These committees promote objectivity by ensuring that no Reserve Bank and no one person has the power to make a final decision on important supervisory matters.

We have also increased our use of crossfirm horizontal review. This technique facilitates a better assessment of the financial system's health and safeguards against regulatory capture by providing insight from examiners assigned to many different institutions.

And, we reorganized the New York Fed's Supervision Group to enhance the effectiveness of our supervision. Many of the changes directly reflect the recommendations in a 2009 report that I commissioned from David Beim. For example, we reassigned senior personnel to front-line positions at the largest supervised institutions. We increased training for all managers in supervision. We hired more risk specialists and business line specialists. We continue to require that examiners rotate to another institution after 3 to 5 years. And, we have taken concrete steps to encourage examiners to speak up, which is now a factor in their annual performance reviews. We created programs to encourage peer recognition of innovative ideas. And, we require examination teams to spend more time at the New York Fed headquarters. This helps facilitate communication between our senior management and examiners.

Before concluding, let me share my view of what we should expect from bank supervision. Supervision must be fair, that is, applied consistently across the firms we supervise. We all need to know the rules and follow the same rulebook. Supervision must be conscientious. This means we must be committed to sustained self-improvement. To this end, we will be working with the Board of Governors as it reviews whether the LISCC Operating Committee receives all material information necessary to reach sound supervisory decisions. Finally, supervision must be effective, which means being tough on banks that demonstrate illegal, unsafe, or unsound practices. A good measure of our effectiveness is the improved strength and stability of banks since the financial crisis.

The Federal Reserve cannot prevent all illegal or otherwise undesirable conduct at banks, but we can help create more resilient, less complex, and better managed organizations and a more stable financial system. Of course, we are not perfect, but we always strive to improve and to retain your trust.

Thank you again for this opportunity to speak with you. I look forward to taking your questions.

Chairman BROWN. Thank you very much, President Dudley. I appreciate your testimony and appreciate the discussions we have had over the last number of years.

You have been in this job, more or less, for 6 years now, 5½ years. The public confidence still—you said it has been put to rest, the too big to jail. I am not sure that the public would really believe that or agree with that. I think that I heard you say that all your staff, including you, go through annual ethics training. I hear a pretty sunny description in your testimony of conditions now, even though public confidence in Wall Street has not grown particularly since 2009, even with Dodd-Frank and the improvements that we have made.

So, three stories in the last 6 weeks have laid out clear issues at the New York Fed, three stories in just the last 6 weeks. They identify issues that do not appear to be isolated incidents. So, tell us—or, do you agree these are serious problems that cause troubling questions still about the New York Fed, about the work environment there, about its relations with Wall Street? Are these serious problems that raise troubling questions or no?

Mr. DUDLEY. I think the issue of regulatory capture, Senator, is a serious issue and one that we always have to work to guard against. I think that the Federal Reserve employees at the Bank of New York that I have worked with for 6 years act in the public interest. I think that we should be judged on where the banking system is today compared to where it was 6 years ago. A lot more capital, a lot more liquidity, significant improvements in risk management, empowering the professionals in the organizations to take on the business line revenue producers. So, I think we have made a lot of progress.

Does that mean that we are where I want to be? Absolutely not. I recently gave a speech on bank culture, and I think the bank culture needs to be improved significantly. I think there are a number of things that we can do in that space to improve incentives, to get the behavior that we absolutely require from the banking industry.

Chairman BROWN. It strikes me that when the most recent incident with the Goldman employee and the former employee of the Fed, that they pretty surely engaged in illegal activity, and I wonder what kind of environment, when you rightly—I mean, you talk about the ethics training, you talk about the fact that they know these things are illegal. You say that too big to jail is a thing of the past. It just does not seem to a lot of us that the environment there speaks very strongly to that kind of behavior.

Let me shift to another issue quickly. In the September *ProPublica* story, you hear Mr. Silva and Ms. Segarra struggling to define their roles as supervisors in the Santander transaction. In your statement, you said effective supervision means tough supervision. What exactly does that mean? How do you define that mission for supervisors and examiners, tough supervision?

Mr. DUDLEY. I would define tough supervision as, obviously, resisting any notion of regulatory capture. In the Banco Santander case, which was part of that story, we did a very detailed vetting of that issue. We followed up with the Bank of Spain to see what their views were on the transaction. They had no objection. We evaluated whether the transaction was going to cause significant reputational harm to Goldman Sachs, it was going to cause problems for them in terms of their ability to operate. The transaction was judged by our Legal Department to be legal and it was publicly disclosed. And, as a consequence of all those things, we did not prevent the transaction from going forward.

What we did do with respect to Goldman Sachs in that case was we made it very clear that the implication that we were somehow approving the transaction was false and that they need to clarify with Banco Santander that in no way had we approved the transaction. And, we also required them to go back and establish clearly to us that in no other cases were they representing that transactions were occurring with the Fed's blessing. We in no way think that it is appropriate for a firm to imply that we are warranting what they are doing when that is not the case.

Chairman BROWN. Your language was not approving—you were not approving the transaction, but—that was your language, my language—but you let it go. Senator Reed in his opening statement said that the Federal Reserve—that the New York Fed is one of the most powerful regulators in the United States. I would amend it to say one of the most powerful regulators, economic regulators, in the history of the world, maybe, but certainly in the world.

So, I want to go back and talk about that. A decade or so ago, the former head of the Fed's Banking Supervision and Regulation Division was testifying about Enron and they said that banks should not, quote, "engage in borderline transactions that are likely to result in significant reputational or operational risk to the banks." That was in 2002.

In 2012, 10 years later, Mr. Silva described the Santander deal as "legal but shady," his quote. The supervision team believed it was window dressing. The lawyer said it was not clearly illegal. The Bank of Spain did not object. So, there is nothing that they, as regulators, could do. So, while you did not approve it, you let it go.

So, the question is, who is responsible for the Fed's deteriorating standards of, quote, "no borderline transactions" to "legal but shady"? I mean, no borderline transactions is pretty clear. Legal but shady, well, then that is—is there—I mean, why the deterioration of that standard? Why the lower standard today?

Mr. DUDLEY. I do not think the standard has been lowered at all. The transaction was fully vetted. We followed up with the Bank of Spain. We made an assessment of whether this posed a threat to Goldman Sachs' reputation and ability to operate, to their safety and soundness, and concluded that that did not reach the threshold in this particular case.

Chairman BROWN. Thank you.

Senator Reed.

Senator REED. Well, thank you very much, and thank you, Mr. Dudley, for your testimony.

You know, I picked up on one of your comments which you said, I think, completely—with complete sincerity, which is we have to resist any notion of regulatory capture. I would suggest the very definition of regulatory capture is when the regulated entities choose the person to regulate them, and that is essential what they do with you, and not just you, but your predecessors. And, that is why I think it is essential to do what we tried to do in Dodd-Frank, which is to move the selection of the President of the Federal Reserve Bank of New York out of the industry in New York and do as we do for Governors of the Board, make them subject to nomination and confirmation.

In addition to your regulatory powers supervising these institutions, you are a member of the Open Markets Committee. You are the only member that is not nominated and confirmed, and yet you serve on that. You also are the Vice Chairman, which gives you more powers, all of that insulated from the review by the President and by the Congress.

And, I think it goes to the very essence of what we are talking about here today and what I commend you for trying to change, which is the culture of the Federal Reserve Bank of New York. But, the culture starts at the top, and the perception is that you, essentially, were hired by the people you are regulating. I think that cultural message goes—permeates throughout the entire organization. I do not think it is a conscious excuse for people to be less than professional. In fact, my contact with the Federal Reserve, your colleagues, they are extraordinarily professional. They want to do a good job.

But, this culture begins at the top and it is a culture in which you are perceived—and perception sometimes is more powerful than any reality—as essentially hired and serving at the, if not the will, at least with the influence of those you regulate. Do you have a response?

Mr. DUDLEY. Yes, I do, Senator. First of all, I am definitely not hired and appointed by the people that I regulate. The Dodd-Frank Act clearly establishes that the selection of the President of the Federal Reserve Bank of New York and other Presidents in the Federal Reserve Bank System are done by the Class B and C directors, which exclude the bank directors. So, the bank directors play no role whatsoever in the selection——

Senator REED. No direct role.

Mr. DUDLEY. No role.

Senator REED. No role.

Mr. DUDLEY. No role in the selection of the Federal Reserve Bank President of New York.

Senator REED. Does any governmental entity, any representative of the people play a role in your selection?

Mr. DUDLEY. Yes, indirectly. The Board of Governors—it is a two key appointment process. The Board of Governors, excluding the bank directors, makes a recommendation to the Board of Governors, and the Board of Governors, who have all been appointed by the President, confirmed by the Senate, approve the President's selection. If they do not like the list that the Board of Directors has sent down to them, they can demand a different list. So, it is a two key approach. The nonbank directors and the Board of Governors make the selection.

Senator REED. Well, why, if we have the authority, which we do, to select the Board of Governors, should we not—and, by the way, we essentially confirm and select every other regulator, the Comptroller of the Currency, the Board of the FDIC—why should we not have the same authority with you, in whom, I would argue, you have more authority, more influence, and more impact on every phase of the economic policy of the United States than any one of these other individuals?

Mr. DUDLEY. Well, I think, Senator, the answer is that it is the prerogative of Congress to decide how the Federal Reserve Act is written and how the President of the Federal Reserve Bank of New York and other Federal Reserve Presidents are selected, so I——

Senator REED. So, you would have no objection if you were subject to confirmation and——

Mr. DUDLEY. It is completely up to Congress to decide how it works.

Senator REED. I agree, and since you do not have any objection to that process, I hope you can formally endorse our proposal. Thank you.

Chairman BROWN. Thank you, Senator Reed.

The Federal Reserve Board of Cleveland just chose its new Governor and the process, first of all, is unknown to the public. It is anything but a public process. It is unknown to the public and maybe unknowable to the public. I would guess if you asked the 100 members of the Senate, how is a Federal Governor in Kansas City or Minneapolis or Atlanta or Dallas or St. Louis or Cleveland or Philadelphia or anywhere else chosen, or Richmond, they probably would not know and understand, and the public input is—I mean, you said indirectly—Senator Reed.

Senator REED. If I may, you are selected by the Class B directors?

Mr. DUDLEY. Class B and Class C.

Senator REED. And, how are they selected?

Mr. DUDLEY. They are selected—the Class C are selected by the—approved by the Board of Governors, and the Class B are subject by a vote of the banking—I think of the banking authorities——

Senator REED. Of the banks.

Mr. DUDLEY. But, let us talk about who those people are.

Senator REED. I know who they are, sir, and if you want to talk personalities, we can. I want to talk about reforming the law and the structure of governance.

Mr. DUDLEY. I understand. I understand.

Senator REED. Your Class B directors are essentially chosen by the banks, and that is not lost on anyone. I just want to make that point. Excuse me.

Chairman BROWN. OK. I appreciate that. And, you, I am sure, say that Janet Yellen and a number of Fed Governors had something that was extraordinary in this world, a meeting with the public. I guess Governor Powell was there, Governor—who else was there—Brainard and Fischer, the new ones. Brainard and Fisher were also there.

And, one of the questions that they had was they come into this ornate conference room at the Fed and were, I am sure, overwhelmed by that, and then they really expressed their understanding of—their lack of understanding of how all this comes together, and that sits with us, that responsibility, because we have not changed it. There are forces working in Congress in far too many cases resistant to that change, but more on that later.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair.

Mr. Dudley, you referred to the Credit Suisse arrangement as ending too big to jail. Credit Suisse was involved in an operation that involved creating secret offshore accounts in the names of sham entities and foundations. How many of the names of the Americans who were involved in creating those accounts were turned over as part of that criminal prosecution?

Mr. DUDLEY. I do not know the answer to that, Senator.

Senator MERKLEY. You do not know the answer to that?

Mr. DUDLEY. No, I do not.

Senator MERKLEY. Well, the answer is none, and can you explain why that is?

Mr. DUDLEY. I cannot explain why that is, Senator.

Senator MERKLEY. That is just a fundamental fact of that case that you are presenting as too big to jail. How many of the Americans who created these secret accounts were prosecuted?

Mr. DUDLEY. I do not know, Senator.

Senator MERKLEY. Well, the answer is none, because no names were turned over.

Did the information related to that prosecution, which you said that shows the Fed is now involved in ending too big to jail, did the information come from the Fed that led to that prosecution?

Mr. DUDLEY. I do not know, Senator.

Senator MERKLEY. It is hard to imagine, since the casual reader of the newspaper would know that it came from Senator Levin's hearings and the report that his committee put out that had extensive disclosure that led to this investigation.

So, the basic information on that case is that hundreds of Credit Suisse employees were involved in the scheme to create these secret offshore accounts in the name of sham entities. So, if we have ended too big to jail, how many of those hundreds of the Credit Suisse employees have been indicted for criminal activity?

Mr. DUDLEY. I do not know the answer to that.

Senator MERKLEY. Would you be surprised if the answer is zero?

Mr. DUDLEY. I would be surprised, probably.

Senator MERKLEY. Well, I find it fascinating that you are presenting this as the end of too big to jail. How many people are actually in jail right now because of that investigation?

Mr. DUDLEY. It is the end of too big to jail for the corporation, which pled guilty——

Senator MERKLEY. But——

Mr. DUDLEY. The corporation pled guilty——

Senator MERKLEY. You do not put corporations in jail.

Mr. DUDLEY. There was no—the argument that was made a year ago, or a year and a half ago, was that large financial institutions could not plead guilty to crimes because this could destabilize those institutions, which could lead to problems, and the view was that was unfair because the view was, why should these entities be too big to jail? Why should they be able to escape guilty pleas because of their size? And, I think we have actually set a new precedent over the last year where no bank is too big to be found guilty if they have committed a crime.

Senator MERKLEY. OK, but that does not involve jail. Jail involves putting people in jail. I just—I think ordinary Americans would find it fascinating that this plea agreement, which basically involved a financial payment, a fine, constitutes somehow ending too big to jail if nobody is going to jail. There may have been some folks who went to jail. There were some eight folks 3 years earlier who were indicted. I do not know the outcome of those cases, but that would be a small touch on this.

I just think it—is it not ironic that it took a U.S. Senate investigation by Carl Levin to provide the facts that led to this particular case getting handled?

Mr. DUDLEY. I do not have a good way of judging that, Senator.

Senator MERKLEY. But, you are the regulator. Should not the regulator have discovered these facts? Why did it take the U.S. Senate Committee to find out the facts if you are the regulator? Why did the regulator not find out these facts?

Mr. DUDLEY. I do not know the answer——

Senator MERKLEY. Does this not indicate you are just asleep at the switch?

Mr. DUDLEY. I do not—I do not agree with that characterization——

Senator MERKLEY. Well, then, why did you not find out these issues? If the U.S. Senate Committee, long, far removed could find out this information, and you have all kinds of people daily reviewing the activities, how is it possible you could fail to see the information that the U.S. Senate Committee came up with?

Mr. DUDLEY. Well, for——

Senator MERKLEY. Does this disturb you? Do you think there needs to be some change in these practices? You presented a very glib presentation of everything being wonderful. But, does not this set of facts say that maybe there is need for some fundamental reform?

Mr. DUDLEY. We—Senator, we are continuing to try to see how we can do our job better. But, I think, especially for foreign institutions where we only have insight into the U.S. entity, it is very hard to know what is happening globally. So, I would——

Senator MERKLEY. But these were activities of the U.S. entity. Is that really an excuse, that it is—I mean, this is a U.S. subsidiary of the foreign entity. Is that really an excuse? I mean, if the U.S. Senate can find out the activities of the U.S. subsidiary, can not your regulators, who are there on a daily basis, find it out?

Mr. DUDLEY. Senator, I think that when we focus on supervision, our orientation is toward safety and soundness of the firms that we supervise and the financial stability of the global financial system. I do not think that we have spent—ever spent a tremendous amount of resources on issues of tax evasion.

Senator MERKLEY. Are you familiar with the settlement involved granting Credit Suisse an exemption from Federal law that requires the bank to hand over its investment advisor lists?

Mr. DUDLEY. I do believe that they were granted an exemption.

Senator MERKLEY. OK. Well, it might be an appropriate part of the story to present, and also that the plea agreement was deliberately announced when the markets were closed. There was an awful gentle touch in even how this plea agreement was handled, and I just want to have a coherent picture for the public to see. Those are parts of the story.

I will conclude there. Thank you.

Chairman BROWN. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

Thank you for being here, President Dudley. So, President Dudley, last month, you gave a speech about improving the culture at the big banks and you noted the long list of illegal and unethical behavior leading up to the financial crisis and its aftermath and you discussed the problem as fundamentally cultural. You said, and I am quoting you here, "The problems originate from the culture of the firms and this culture is largely shaped by the firms' leadership." I agree with you. I think there is a terrible cultural problem on Wall Street.

But, given the long list of supervisory failures at the New York Fed, both before and during your tenure as President, would you say that the New York Fed has its own cultural problems?

Mr. DUDLEY. Well, first, I would not accept the premise that there has been a long list of failures by the New York Fed since my tenure. Our culture, we continue to strive——

Senator WARREN. I have to stop you there, Mr. Dudley. That is part of why we called this hearing, is the evidence of the failures at the Fed. So, are you saying that these are not true? I mean, are you denying the facts that have already been reported and established about this?

Mr. DUDLEY. Well, first of all, I am not clear that there are facts. Number two, let us judge how the financial system is today in terms of its safety and soundness. I think you would admit that we are in a much better place today in terms of bank capital, bank liquidity, the ability of banks to resist stress——

Senator WARREN. Mr. Dudley, I am sorry, and I do not want to interrupt here, except I would like you to answer the question. The question is, do you think—you castigated the banks, and I think quite rightly so, the large financial institutions, for having serious cultural problems, as you put it, in terms of their behavior. The question I am asking you is do you think the New York Fed also has serious cultural problems?

Mr. DUDLEY. I do not think we have serious cultural problems to the same degree, but are we perfect? Absolutely not. One reason why I commissioned the Beim report in 2009 is I thought we could improve how we conduct bank supervision.

Senator WARREN. Right. And, did you carry out the recommendations, all of the recommendations of the Beim report?

Mr. DUDLEY. I would say that we carried out the vast majority of the recommendations.

Senator WARREN. Well, we will have Mr. Beim here to talk about how much you carried out the recommendations of the Beim report. But, you know, it is interesting to me that you would say you do not think there is a problem, because that is entirely consistent with where you have been before. I remember your immediate reaction to the release of the Segarra tapes, and you said, quote, "I do not think anyone should question our motives or what we are trying to accomplish."

I want to look back at your speech on bank culture. You said there that because culture is largely shaped by the firm's leadership, the solution needs to originate from within the firms, from their leaders. And, you later said that as a first step, senior leaders need to hold up a mirror to their own behavior and critically examine behavioral norms at their firm.

Now, are you holding up a mirror to your own behavior when you say that no one should question your motives or what you are trying to accomplish?

Mr. DUDLEY. I commissioned the Beim report, in part because I thought we could do better. I—we have implemented many of the—most of the recommendations of the Beim report because we thought that would improve how supervision at the New York Fed is——

Senator WARREN. And that was in 2009. Here we are in 2014 with tapes of how the New York Fed is not working. So, the question is, are you holding up a mirror to your own behavior?

Mr. DUDLEY. I do not accept the characterization that those tapes show that the Fed Reserve is not working correctly. There are 46 hours of tapes. There was about 10 minutes of those tapes that were released. To say that that is sort of the definitive record of how the New York Fed conducts supervision, I think is just——

Senator WARREN. I am sorry. Surely, you are not going to take the position, Mr. Dudley, that if most of the time most of what the Fed does is boring or even does its job, that it is OK every now and again to throw in 10 minutes of backing people off their regulatory duties, of standing up for the banks, of overruling those who find problems and say they want to pursue them. You think that is not a problem if the rest of the time you are doing your job?

Mr. DUDLEY. I have no way of assessing how accurate that 10 minutes is because I have had no access—I have had no ability to listen to the full 46 hours of tapes.

Senator WARREN. It——

Mr. DUDLEY. So, I have no idea of—I have no idea of assessing whether those 10 minutes are reflective of what is going on at the New York Fed or whether they are a snippet that distorts what is the situation at the New York Fed. That is point number one.

Point number two is, look at what we did——

Senator WARREN. I am looking at what you did.

Mr. DUDLEY. The allegation——

Senator WARREN. You backed up——

Mr. DUDLEY. The issues raised——

Senator WARREN. When Goldman was unhappy——

Mr. DUDLEY. The issues——

Senator WARREN. ——you told the lead investigator to back up.

Mr. DUDLEY. The issues raised in those tapes that were on the NPR story, Banco Santander, conflicts of interest, were fully vetted by us. The record shows that we fully vetted those issues. We did not—we did not repress them. We did not table them. We investigated those issues.

Senator WARREN. Mr. Dudley, you castigated the large financial institutions for having a cultural problem, and I believe in your speech you described that cultural problem as what is wrong internally that would cause them to end up in a place where many of them broke the law, where many of them took on incredible risks that threatened to bring this economy all the way to its knees. And, I am asking you the same kind of question. You want the big financial institutions to hold up a mirror and look at their behavior, because, you say, otherwise, we are not going to get a change. You say that change has to start at the top, with the leaders of those institutions.

Well, you are the leader of the New York Fed. We have here a description from Senator Merkley of a hearing that has been conducted by the Senate that manages to find serious problems in the large financial institutions that were not uncovered by the New York Fed, and the question is, why not? You had first supervisory responsibility. That was supposed to be the full-time job of the New York Fed, but you gave a pass on it. We have got on tape higher-ups at the New York Fed calling off the regulators.

And, I am just asking the same kind of question. Is there a cultural problem at the New York Fed? I think the evidence suggests that there is, and I would go to the point that you made when you were talking to the big financial institutions. Change has to come from the top and it has to go all the way through the institution. Without that, the Fed is not able to do its job.

You know, we have to remember——

Mr. DUDLEY. I agree with you. I agree with you on that.

Senator WARREN. Well, I am glad you agree with me on this——

Mr. DUDLEY. I agree with you on that.

Senator WARREN. ——but either you need to fix it, Mr. Dudley, or we need to get someone who will.

Thank you, Mr. Chairman.

Chairman BROWN. Thank you, Senator Warren. There will be at least another round for all of us.

Senator WARREN. Thank you.

Chairman BROWN. An interesting set of questions from all my colleagues. Senator Merkley mentioned a Levin hearing. I want to mention another Levin hearing that is actually going on today about commodities. Yesterday, he had people from Goldman in. Today, he has others concerning banks' involvement in commodities and infrastructure. One of the banks you regulate has 35 electric companies, 100 oil tankers, I believe 35 electric companies. You are responsible at the New York Fed—the banks that are most in commodities are, of the six largest banks, are pretty much concentrated in the four banks that you regulate in New York City, so the responsibility for day-to-day supervision of these holding companies that engage in the vast majority of these activities. Should banks be engaged in these activities and investments?

Mr. DUDLEY. I think there are serious questions of whether they should be. You know, really two things that I think are relevant. One are—is the amount of potential risk they are taking. You know, an Exxon Valdez or a BP oil well blowout, if that were to happen where a major U.S. financial institution had an interest, either directly or indirectly, could lead to very large losses for that institution. So, that concerns me.

And, the second thing that potentially concerns me is are the banks able to do this business with less capital than what a nonbank entity would be required to actually carry out this business.

So, this is something that the Federal Reserve is looking at very intently. We put a comment out for—we have a proposal out for comment. The comments have come back, and I expect you will hear more from us relatively shortly.

Chairman BROWN. You said this raises serious questions. Were you, President Dudley, was the New York Fed raising these questions prior to the *New York Times* article of, I believe, a year and a half ago about Detroit Metro Aluminum? Were you asking those questions before they did?

Mr. DUDLEY. Well, I cannot address the specific question of Metro Aluminum, but as you look——

Chairman BROWN. Let me back up.

Mr. DUDLEY. If you——

Chairman BROWN. Not Metro Aluminum, but were you asking questions about any of the—the Metro Aluminum, in essence——

Mr. DUDLEY. We were——

Chairman BROWN. ——published story about all the commodities. Were you——

Mr. DUDLEY. We were looking at this commodity question——

Chairman BROWN. What questions were you asking about——

Mr. DUDLEY. And, if you look at the report that came out of Senator Levin's committee, there are a lot of references to the work that was actually done by the New York Fed that was looking at the operations of these entities. So, this is something that very much has been on our radar screen.

Chairman BROWN. Yes. I am glad to hear that. But, I guess, maybe that is our fault, but I do not remember hearing much about activities of the Fed questioning or regulating or looking into that. It sort of begs the question—in Michael Silva's words, he said your examiners are reined in by Federal Reserve lawyers and economists. The Levin report on this documents an example of JPMorgan using an aggressive legal interpretation to allow them to exceed by more than 100 percent the cap on commodities exposure.

You mentioned the capital they hold and the huge risks. Morgan Stanley's CEO told employees an oil tanker spill, one of the shipping units, is a risk we just cannot take. Some of them evolved into that. Some of them are digging in, and the capital they are holding, it is questionable whether it really is adequate capital, depending on the interpretation of the quality of the capital. We know that. You suggest that.

But, as I said, the Levin report documents an example with the aggressive legal interpretation to allow them to exceed, dramatically exceed the cap on commodities exposure. Fed lawyers said that Morgan's interpretation was permissible, they did not object, despite the fact that JPMorgan's interpretation made New York Fed examiners very concerned. So, it goes back, perhaps, to the culture at the Fed in New York. It goes back to—I mean, fundamentally, the question, why are risk-averse lawyers who are unwilling to challenge banks' risky practices taking precedent over examiners who are trying to do their jobs.

Mr. DUDLEY. I do not know the specifics in this case to be able to give you a good answer. Obviously, the—my personal view is it is not just the letter of the law, it is the spirit of the law that we should expect firms to conform to.

Chairman BROWN. And, from your observations, from your management seat at the Fed and your history there, both in your prior job and this job over the last 6, 7 years, from your, I assume—you are a very well-read man. I assume you have followed this pretty closely on the commodities issue. You know the risk on oil tankers. You know the risk on electricity generation. You know the risk on some of the ownership, they are a broad, broad ownership. Some of the banks that you regulate have acknowledged the risk and are starting to get out of it. You know what Federal law is on capital standards and what the cap is. So, I mean, how do you justify that these lawyers are overruling these examiners trying to do their jobs?

Mr. DUDLEY. The point I would make is that this is something that the Federal Reserve is looking at very, very closely. That is why we went out for comment on this. And, we are evaluating it, evaluating some of the issues that I mentioned, and I would say, stay tuned.

Chairman BROWN. Does it trouble you that Goldman Sachs yesterday in Senator Levin's committee, when, I mean, Goldman Sachs was defended by some of my colleagues, as they always are here in some venue, but Goldman really dug in. Does it bother you that they dug in and perhaps doubled down on their ownership of these commodities?

Mr. DUDLEY. I do not know. I did not hear the testimony, so I do not know the specifics to be able to fairly comment on them, Senator.

Chairman BROWN. OK. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chairman.

Mr. Dudley, in 2009, a team of experts from across the Fed recommended that the New York Fed conduct a, quote, "full scope examination" of the JPMorgan unit that was later involved in the London Whale. When you got that recommendation in 2009, did you act on it?

Mr. DUDLEY. First of all, that was not a recommendation that came up to me for my approval. In 2009, there were a lot of demands on the New York supervision staff at JPMorgan and the prioritization was—the decisions on the prioritization were made not to pursue the examination of the CAO because of a lack of resources, given all the other things that we were engaged in, for example, the SCAP, and in 2010, the first Comprehensive Capital Analysis Review process. So, a lot of competing ideas about what to examine. We try to prioritize those on the way that we think makes the most sense. After the fact, you know, with the benefit of hindsight, one could reasonably say, well, why did we not tackle that, and I think that is a criticism that is always going to be there when something goes awry.

I would point out that the activities of the London Whale took place in the bank, in London. The OCC has said publicly that this was their primary responsibility. But, the most important thing I would stress is that JPMorgan had sufficient capital and liquidity resources, so when they announced the losses associated with the London Whale, there were no negative consequences to the bank's ability to provide credit to households and businesses. The bank's ability to do what it needs to do to support the U.S. economy was not impaired at all——

Senator MERKLEY. That is a different question, so let us go forward here.

In 2009, there was also an internal New York Fed report that found that supervisors at the New York Fed were too reluctant to criticize Wall Street, hindering its ability to spot and eradicate problems. Based on that internal report back in 2009, what actions did you take to change the culture of the bank?

Mr. DUDLEY. We took many, many actions as a response to that report and also other judgments that we made. Number one, we dramatically upgraded the senior supervisory officers that interact with the bank's senior management and board of directors.

Number two, we established business line specialists that really looked at the issue of how do these banks make money and what risk do they take to make the money that we do. We embedded the risk specialists in the examination teams so that they were more involved with the bank and understood the bank's risk taking activity on credit, liquidity, operational risk. There is a whole series of changes that were made, I think, to improve the effectiveness of supervision by the New York Fed and in the Federal Reserve System.

Another big change was the creation of the LISCC, so a systemwide committee to review all of the big firms, looking at them on a crossfirm basis, so not relying just on the judgment of the supervisory team at one specific bank, but comparing their findings with the findings at other institutions. The stress tests that were imposed was also a very important crossfirm exercise to understand better how—not how is this firm doing absolutely, but how is it doing relative to its peers and where could it actually improve its performance. So, I think there are a lot of changes that we made in response to the financial crisis that have made our supervision more effective.

Senator MERKLEY. Well, I did not actually ask the question you are answering. I was asking specifically about the internal report which says supervisors were too reluctant to criticize Wall Street. And, so we have a pair of bookends. We have the 2009 report, which occurred during your first year. Now, we have the other end of the bookend, basically, these tapes which show, at least on one 10-minute instance, substantial supervisory input saying, go easy on the banks. It does not look like much changed between 2009 and 2014, but perhaps we will get the chance to explore that further.

Let me turn to this fundamental question on commodities. The real concern here is, and you will recall the *New York Times* series that looked at the series of warehouses that Goldman Sachs had across the country. Is there a fundamental problem for a very large bank—there are few institutions in the world that have enough money to be able to essentially influence the supply and demand of products—but, is there a fundamental problem for banks to be able to trade on the price, if you will, the value of commodities at the same time that they own so much of the delivery system, or control so much of the delivery system that they can affect supply and demand? Is that a problem, or do you see that as simply, no, that makes money for the bank. Therefore, it makes it safer and sounder and that is a good thing. Are you arguing that that is the case, that that is a good thing?

Mr. DUDLEY. I do not think you would ever want a situation where the commodity market prices was anything less than fully competitive. So, I do not think you would ever want a situation where one entity had such a big role in the market that they were actually influencing the price of the commodity.

Senator MERKLEY. Well, this is happening regularly. We have banks that control pipelines. We had JPMorgan involved, and paid a big fine for it, for trying to control and having an influence over the electric markets, kind of Enron style. We certainly have this case of these aluminum warehouses. So, if you think that that is inappropriate, what are you doing to advocate an end to this fundamental conflict of interest?

Mr. DUDLEY. Well, I think that there is no question that if banks are found that they are actually manipulating prices, they should be prosecuted for that, and the New York Fed has basically been shining a light on the whole commodity space over the last few years, doing a lot of work here to understand what the risks are and what the threats are to financial stability.

Senator MERKLEY. Is it your recommendation today that the Fed aggressively require divestment of commodities by banks that are also trading in the price of those commodities?

Mr. DUDLEY. Well, that is certainly not a recommendation for me to make. It is a decision for the Board of Governors, and I think you will be hearing from the Board of Governors on this issue relatively soon.

Senator MERKLEY. But, if the Board of Governors was to ask your advice—I mean, you are definitely part of the Fed—what would you say to them? They are turning to you for advice. Is this a good thing that this is allowed? Because, I can tell you, I have had conversations with different members of the Board of Governors and they say, well, you know, it is kind of grandfathered, and, well, we do not want to get too involved in it——

Mr. DUDLEY. Well, I would say two things——

Senator MERKLEY. ——and are you saying there is no problem, or is there a problem?

Mr. DUDLEY. I would say two things. One, we do have to be concerned about the commodities activities that expose the bank to the risk of very large losses. So, the tail risk problem, I think, is a completely legitimate issue that we need to care about. We do not want a bank to get into trouble, because they decided that they had to be in the physical commodities business. So, that is number one.

And, number two, I do not think we want anywhere in the financial system, in the commodities space, be it a regulated bank or someone else, that has the power to actually manipulate commodity prices. So, I think that applies not just for banks, but for any entity participating in the commodity markets.

Senator MERKLEY. Thank you.

Chairman BROWN. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So, I want to ask a simple question. How would you describe the New York Fed's supervisory responsibilities? What are you supposed to do and what are you not supposed to do?

Mr. DUDLEY. Well, I think of it as the Fed's supervisory responsibilities are mainly about ensuring the safety and soundness of the institutions that we supervise, in other words, that they have sufficient capital, sufficient liquidity, good corporate governance, good risk management systems, that the risk managers are on par with the revenue generators, in other words, they actually have clout in their organizations——

Senator WARREN. Good——

Mr. DUDLEY. ——that the banks have good culture——

Senator WARREN. Good, and good culture. Good. So, I just want to break that down a little bit about what safety and soundness means. Are there bank transactions that are perfectly legal but that could threaten the safety and soundness of a bank or of the broader financial institution?

Mr. DUDLEY. I think that there are financial transactions that could pose reputational risk to the bank, that could damage the bank, and I think those type of transactions would need to be evaluated.

Senator WARREN. I am sorry, need to be evaluated. The question is, are there activities that are perfectly legal but that could pose a risk under safety and soundness and, therefore, should be shut down?

Mr. DUDLEY. If the reputational risk were potentially large enough to threaten the integrity of the institution or——

Senator WARREN. That was the question, to threaten the safety and soundness.

Mr. DUDLEY. I think—I think that is certainly a possibility.

Senator WARREN. OK. So, illegality is not the test. The test is what threatens the safety and soundness, and it is possible to have an activity——

Mr. DUDLEY. I think it is possible.

Senator WARREN. ——that is perfectly legal——

Mr. DUDLEY. I think it is possible.

Senator WARREN. ——but that threatens the safety and soundness, either of the financial institution or of the——

Mr. DUDLEY. I think it is possible.

Senator WARREN. ——or of the larger financial system. OK. Good. So, what about a transaction that does not threaten the safety and soundness of the bank, but is arguably illegal? That is, the Fed would have a credible argument that the transaction is illegal, but the bank might be able to show in court that the transaction is legal. What are the Fed's obligations there?

Mr. DUDLEY. Well, I think if we think a transaction may be illegal, it is appropriate for us to refer it to the enforcement authorities.

Senator WARREN. OK. So, if you think that it is arguably illegal, you think you should go ahead and enforce at that point?

Mr. DUDLEY. Absolutely.

Senator WARREN. OK. And, I often describe our Federal regulators as the cop on the beat. That is, they are out there to look for illegal or unsafe conduct, try to stop that conduct before it happens. Is that an accurate way to describe what the New York Fed supervisory role is?

Mr. DUDLEY. I would characterize it slightly different. Our main goal is to ensure the safety and soundness of the institutions that we supervise. If, in the process of doing that, we see behavior that we think is illegal, then our job is to refer it to the enforcement agencies. But, I do not really think of it as quite the way you characterize it, as cop on the beat. I think of it more like a fire warden. Make sure that the institution is run well so that, you know, it is not going to catch on fire and burn on, and managed in a way that if the institution is stressed, that it does not collapse and threaten the rest of the financial system.

So, I think there is an enforcement element to it, but I do not think our primary purpose as supervisors is really the cop on the beat. Now, that does not mean that if we see something, we should walk by it and ignore it. I do not think that is the case at all——

Senator WARREN. But, you do not think you should be doing any investigation? You should wait to see if it jumps in front of you?

Mr. DUDLEY. Well, because I think our primary focus on supervision is ensuring that the bank is safe and sound, that it is run well.

Senator WARREN. That means you need to know enough about the bank's activities, not just illegal activities, but all of their activities, so that you can stop any activity, illegal or not, that threatens the safety and soundness either of the bank or of the financial system. And, yet, you think you should not be investigating them?

Mr. DUDLEY. But, I think where you——

Senator WARREN. I do not understand what the distinction is you are——

Mr. DUDLEY. Well, I think what you are proposing is something that, I think, would be very difficult to do in practice, which is sort of evaluating every transaction that the bank does on a transaction-by-transaction basis, and I just do not think that is practical.

Senator WARREN. Look, I understand, just like any cop, you make decisions about when you are going to investigate more and what you think is suspicious and where you are going to look for things, and I understand that, but that is what it means to be a cop on the beat.

Mr. DUDLEY. So, I will give you an example on reference rates. You know, once we became aware of the problems in LIBOR, we started to look at the banks' reference rate setting behavior more broadly. So, if there is a——

Senator WARREN. Fair enough. Do you wish you had looked a little earlier?

Mr. DUDLEY. Well, my point is——

Senator WARREN. Excuse me. Do you wish you had looked a little earlier?

Mr. DUDLEY. I think it is fair to say——

Senator WARREN. Maybe investigated a bit more before they had cheated people for years?

Mr. DUDLEY. But, my point is, once we become aware of something, of course, we are going to investigate it.

Senator WARREN. And——

Mr. DUDLEY. But, the notion that we are going to be aware of everything that is going on in these large institutions in real time, I just do not think——

Senator WARREN. I would just like to hear you say that you are really going to try to investigate things, though, and I think LIBOR is not an example that works for you. I think you should have been investigating a whole lot earlier.

But, I tell you what. Let us take a look at this. We have got our safety and soundness. We at least can agree on that, that this is important. It is not just illegal behavior that you stop, it is any behavior that threatens safety and soundness of the bank, and illegal behavior, if you happen to stumble across it, which I think is what you said to me. So, let us focus——

Mr. DUDLEY. I would not say stumble. I would say, see.

Senator WARREN. But you are not looking.

Mr. DUDLEY. No, we are looking. Our eyes are open.

Senator WARREN. All right. So, let us take a look at the cases from the Segarra recordings. Let us focus on the deal between Goldman Sachs and this Spanish bank, Santander. Michael Silva was the New York Fed's head supervisor assigned to Goldman and he said he had concerns about the Goldman-Santander deal, but he was "reined in"—this was his quote—by the New York Fed's General Counsel, Tom Baxter. Now, do you think it was appropriate for Mr. Baxter to rein in Mr. Silva?

Mr. DUDLEY. Well, I am not sure that that is actually what happened. The way I understand it is the——

Senator WARREN. This is the quote from the person who says he was reined in.

Mr. DUDLEY. Well, that may be the way he was experiencing it at the time, but let me tell you what I think actually happened, that the transaction went to the Legal Department of the Federal Reserve Bank of New York to be evaluated about whether it was legal or not, and the legal group of the New York's Federal Reserve Bank of New York determined that the transaction was legal.

Now, you know, Michael may have felt that he was being reined in because he would have liked the transaction to be illegal so he had a stronger basis——

Senator WARREN. I am sorry. Let us stop right there, Mr. Dudley. The reason we spent all that time talking about safety and soundness is I thought that what we established—and, I thought, that part, we agreed on—is that the test for safety and soundness is not whether or not the activity is legal or illegal. The test is whether or not it might threaten the safety and soundness of the financial institution.

And, I recall that when we talked about illegal behavior, you said just—I think it was just a couple of minutes ago—that it was appropriate for the New York Fed to shut down activities that were arguably illegal, not to wait until you could prove they were illegal, but that were arguably illegal, even if the institution might be able to defend itself in court, indeed, if it might be able to win in court. I am pretty sure that was the question I asked and I am pretty sure that is what you said yes to.

Mr. DUDLEY. We made a determination that the transaction was legal, so we had eliminated the issue of whether it was illegal or not illegal. We made a determination. Then we went back to the Bank of Spain and asked them what was their view of the transaction.

Senator WARREN. So, here is what I do not understand. You are supposed to be supervisors.

Mr. DUDLEY. Right.

Senator WARREN. Did the General Counsel have more information than the lead supervisor in this case?

Mr. DUDLEY. Well, I think the Legal Department has a better—a sense of what is legal than the lead supervisor.

Senator WARREN. I know, but we are talking about—I think we have been through this—about safety and soundness——

Mr. DUDLEY. Right.

Senator WARREN. ——and about what is arguably illegal.

Mr. DUDLEY. Right.

Senator WARREN. Is there any better information that the General Counsel has that was not available to the lead investigator? Who has the most information about the case, the lead investigator?

Mr. DUDLEY. Well, I think that the lead investigator probably has the most information about the case, but I think the General Counsel and the Legal Department has a better view on whether the transaction is legal or not. I mean, the key point here is did the transaction threaten the reputation of Goldman Sachs to threaten its safety and soundness, and the conclusion made by the supervisory team was, no, not in this case. Now, it could——

Senator WARREN. No, let us be clear.

Mr. DUDLEY. Now, could it——

Senator WARREN. The supervisory team——

Mr. DUDLEY. Could it——

Senator WARREN. No, this is not what Mr. Silva has been quoted as saying. He said he wanted to investigate more. He said he wanted to go further. He gets reined in, and he gets reined in by General Counsel.

Mr. DUDLEY. But, I think that——

Senator WARREN. This goes back to the cultural——

Mr. DUDLEY. But, I think it——

Senator WARREN. ——question we asked earlier, why it is that you are not trying to empower the investigators.

Mr. DUDLEY. But, we did investigate.

Senator WARREN. All right——

Mr. DUDLEY. We went to the Bank of Spain.

Senator WARREN. Well, you investigated——

Mr. DUDLEY. We—the Bank of Spain——

Senator WARREN. So, let us talk about that.

Mr. DUDLEY. OK.

Senator WARREN. You described this deal as—your team identified the deal as shady, right? I think this was the team did. And, as Michael Silva, who is the lead examiner here, said, the deal with Goldman was, quote, "designed to help Santander artificially enhance its capital position." Now, what that means is that this shady deal was clearly intended to help Santander evade the regulations, in this case, capital standards, of the European banking authority. That was the intent of the deal. Once you knew about this plan, did your team contact the European banking authority to let them know what Santander and Goldman were up to?

Mr. DUDLEY. I do not know the answer to that. We did contact the Bank of Spain to——

Senator WARREN. That was not my question, whether or not you contacted the Bank of Spain that was trying to evade capital standards. My question is, did you contact——

Mr. DUDLEY. I do not know the answer to that.

Senator WARREN. ——your counterparts on the regulatory side?

Mr. DUDLEY. I do not know the answer to that, Senator.

Senator WARREN. Is there any evidence that you ever got in touch with them?

Mr. DUDLEY. I just do not know the answer to that question.

Senator WARREN. You know, I do not understand——

Mr. DUDLEY. My point is——

Senator WARREN. ——why this would not be a priority. You come across a deal——

Mr. DUDLEY. But——

Senator WARREN. ——where two parties are getting together——

Mr. DUDLEY. The transaction was not a secret. It was disclosed. It was not a secret. It was not like this transaction was held in—it was in the dark. It was publicly disclosed.

Senator WARREN. What was not disclosed about this transaction is the capital standard and what the intent of this deal was, and that was to help Santander evade its capital standard, in other words, to help it evade its regulator. That is the European banking authority, and apparently, you did not inform them about what they were up to.

You know, I just want to say on this, we have talked about the report that Professor Beim did, and there are two parts to the supervisory process, recognizing the potential problems and then acting on them. And, the point he makes in his report—I just want to quote from it—is, "the problem of recognition is hard," but, he goes on to say, "the problem of action is yet more difficult. We find that during the run-up to the recent crisis, many potential issues were identified, but did not ring alarms and were not acted upon. Action requires support from the highest levels of management in the interest of financial stability, even if this makes the banks less profitable. Supervisors must be willing to stand up to banks and demand both information and action, especially when things appear to be going very well."

Mr. DUDLEY. And, I agree with that.

Senator WARREN. Based on your responses today, the New York Fed is not there in terms of acting on the issues it identifies. It is not even close. What we have got here, action is warning a foreign regulator about a plot to evade the law that you have uncovered. Action is about shutting down shady transactions that could imperil the safety and soundness of the bank. And, until you are willing to take meaningful action, our financial system and our whole economy remain at risk.

Sorry for going over so long, Mr. Chairman.

Chairman BROWN. Thank you, Senator Warren.

President Dudley, your predecessor some years ago reportedly recognized risks bubbling up in the credit default swap market and learned that LIBOR was being manipulated, but did little at the time besides telling a few people about it. Examiners discussed this Santander transaction, but still no one seemed to try to stop it. The Inspector General's report summary says that examiners were concerned about JPMorgan's Chief Investment Office, but never got around to doing anything about it. Even in your initiative on bank culture, you have talked about the issue, but only, I guess, recently taken action. Low disclosure, inaction, reliance on markets to self-correct, strike us, I think, strike me as sort of Greenspan-era relics. Why are we still using this same failed model?

Mr. DUDLEY. We are not. We are not——

Chairman BROWN. I am not sure——

Mr. DUDLEY. I mean, I have said repeatedly on the record that financial stability is on equal footing of monetary policy. Without financial stability, monetary policy cannot be effective. I mean, you cited some of the things that you think we should do that we did not do, but there are a lot of things that we have done. The banking system today is demonstrably much sounder than it was five or 6 years ago, more capital, more liquidity, better governance, better risk management. I think a lot of—all these things, I think, have been accomplished over the last——

Mr. DUDLEY. I am not sure those words would not have been said by President Geithner seven or 8 years ago in front of this Committee, that the system is sound, that there seemed to be no bells going off.

Mr. DUDLEY. Well, I think the fundamental difference, Senator, is that we spend a lot of time now on financial stability issues at the Federal Reserve Bank of New York, at the Board of Governors, at the Federal Open Market Committee. You know, I, for years, have rejected the Greenspan view that you clean up after financial bubbles only after they blow up. I was on record in 2006, before I joined the Federal Reserve, that I did not agree with that philosophy. I think you have to be proactive in preventing excesses in the financial system from developing. If you are not, you threaten the financial stability of the system. That impairs the ability of monetary policy to guide the economy. And, as we saw in the financial crisis, households and businesses suffer. My goal in my job is to make sure that we never have a financial crisis like that again. It is just totally unacceptable.

Chairman BROWN. Well, you claim here to be proactive, and there are so many examples where it seems otherwise. You know, the Levin reports we talked about, it seems that the *ProPublica* stories, the stories that break with Goldman the other day, the Segarra story, I mean, it just seems that it is reacting to issues that others bring forward, usually public, and then the reaction is there. I mean, I see the story in the paper this morning that yesterday, the Fed put out some statements—it seems like they do that often, maybe it is just coincidence—often a day or two before either a Levin hearing or one of our Subcommittee hearings.

For example, Goldman did not prohibit its investment bankers from an egregious practice, holding stock in companies involved in deals that they advise, until after the first *ProPublica* story. That was 2 years after they had a $110 million settlement for their El Paso deal. It was done at their own initiative, not at your urging, apparently. I mean, what good is supervision if you observe but not challenge? What good are words if they are not backed up by actions? And, it seems that when bankers can crash the economy, they are not sent to jail, and so few have. You gave that one example, but what lesson—and then I look at the Goldman employee that used to be with you and you say you have an environment where people are doing the right thing and this former employee with this present employee can deal in inside information, knowing it is illegal, knowing they deserve to go to jail for something like that, yet those things happen. Why should we believe that things have changed as dramatically at the Fed in New York as you say they have?

Mr. DUDLEY. Well, let us turn to that last example. First of all, we have extensive training programs, compliance regimes, to make it clear that confidential supervisory information should never leave the bank. And, if someone is a bad actor and does something that is inappropriate, what is the consequence to them? The consequence to them is we fire them and we refer the case to the criminal authorities. We have a zero tolerance policy for that sort of thing. That is all I——

Chairman BROWN. You have a zero tolerance policy, perhaps. I believe you. I mean, I know you say that. I believe you. But, there does not seem to be much fear. I mean, people enforce laws in different ways in countries across the board, and fear plays some role. If I get caught, I pay a serious price. But, there does not seem—if the Justice Department, if the Feds, if others are not really willing to send people to jail virtually almost ever for almost any of the most egregious practices——

Mr. DUDLEY. People——

Chairman BROWN. ——they are more likely to do these things.

Mr. DUDLEY. People who have disclosed confidential supervisory information have gone to jail. They have pled—have been found guilty——

Chairman BROWN. Occasionally. Let me——

Mr. DUDLEY. So—and, I think they should. I mean, I think, basically, if someone willfully is disclosing confidential supervisory information, so not an inadvertent mistake, I think they—our policy would be to dismiss the employee, refer it to the criminal—to the enforcement agencies for criminal prosecution, and that would be our policy in every case.

Chairman BROWN. So, good. Thank you for that. Let me go back. In October, you quoted an article on corporate culture. It said that ethical problems in organizations originate not with, quote, "a few bad apples, but with the barrel makers." Yesterday, the *Times* reported one of your employees was passing that confidential supervisory information to one of your former employees working at Goldman who relayed the information, what you were just talking about, related to investment banking executives to use for the benefit of their clients. When you were Goldman's Chief Economist almost a decade and a half ago, one of your employees obtained and then shared illegal insider information with Goldman's Treasury desk. As you suggested, he was sentenced to 33 months in prison.

So, where do these ethical problems originate? Was it the culture at Goldman? Was it you, as the barrel maker, in that case? Why do these things happen? Why did it happen then if there are these ethics constraints in place or ethics teachings in place and legal constraints, and why did it happen recently at the Fed?

Mr. DUDLEY. I cannot answer that question. What I can tell you is that we do everything in our power to make sure that the incentives are such that people will not engage in that type of behavior. So, that means punish, you know, very clear what the consequences of the actions are, and the consequences are severe.

So, I mean, one of the things—one of the points I made in the speech on culture is that we have to get the incentives right so people actually have severe consequences when they misbehave. So, that is the one thing that we can do. And, I think at the Federal Reserve Bank of New York, the incentives are right. We will follow up. We will be severe. We will refer these type of cases for criminal prosecution.

Chairman BROWN. Do your public statements now, since yesterday, and your response to this and hearings like this put a little more fear of God into your employees that might be tempted?

Mr. DUDLEY. I would hope that the consequences—we will have to—obviously, I cannot comment on the details of this particular investigation because it is ongoing. But, I would hope in cases of this sort that the person loses his job, the case is referred for criminal prosecution, the prosecution—that the prosecutors take up the case and drive it to a conclusion. That is what I would hope should happen. And, I think, if that happens, that is a good thing, because then people see the consequences of their actions.

Chairman BROWN. And you will continue to make public statements that the era of too big to jail is behind us?

Mr. DUDLEY. I think we made a lot of progress, because we are now finding firms guilty where we were not willing to find those firms guilty before because we were worried that if we found them guilty, that it could somehow potentially destabilize the financial system. We have gotten past that, and I think it is really important that we got past that.

Chairman BROWN. And, as Senator Merkley said, firms do not go to jail.

Mr. DUDLEY. That is fair. But, the Federal Reserve does not have the enforcement powers to send people to jail. That is really up to the enforcement authorities. We do not have the ability to jail people. We do not have the ability to prosecute people in court, to find them guilty and send them to jail. That is just not within the Fed's remit.

Chairman BROWN. You certainly have an ability to——

Mr. DUDLEY. We have the ability to——

Chairman BROWN. ——set the table so that law enforcement can and should.

Mr. DUDLEY. We have the ability to cooperate with the law enforcement agencies, and we do.

Chairman BROWN. You, in response to a number of questions around the table, you spoke of the two missions that should be coequal. I am not sure your statements in the past have suggested that you believe, until recently, that they are coequal, monetary policy and safety and soundness. I appreciate your evolution, if that is right, or your acknowledgment that it is—that they are coequal.

Mr. DUDLEY. I have said that for many years. There is a——

Chairman BROWN. Well, you say it, but let me give one example. About a year, a little more—last summer, the summer of 2013, when Chairman Bernanke was still the Chair of the Fed, I asked him about the higher supplemental leverage ratio for the eight largest U.S. banks. I think you know of Senator Vitter's and my efforts on higher capital standards and the sort of news reports and debate, heightened public debate that swirled around that, and then—I am not crediting Senator Vitter and me, but what the Fed, the FDIC, and the OCC did in terms of higher capital standards.

So, I asked Chairman Bernanke about these higher leverage ratios for the eight largest U.S. banks, five of which you supervise, the four largest and Bank of New York Mellon. Chairman Bernanke said that we should, quote, "do whatever we need to do to make sure that the U.S. financial system is safe." But, the *New York Times* then reported in March that you expressed concerns to the Board in Washington that the leverage ratio could inhibit the execution of monetary policy. So, how does that mean that you give them sort of equal standing in your job and equal standing from the Fed generally that monetary policy is important, but no more important than safety and soundness, that, in fact, safety and soundness is a coequal, if you will, with monetary policy?

Mr. DUDLEY. Well, we want to balance those two goals. We want monetary policy to be effective and we also want to have financial stability. And, we want to make sure that the balance is struck correctly.

Chairman BROWN. So, are you saying that higher safety and soundness, higher capital standards mean——

Mr. DUDLEY. No——

Chairman BROWN. ——would compromise monetary policy?

Mr. DUDLEY. No.

Chairman BROWN. Is that what you were trying to say?

Mr. DUDLEY. I am not. This is a very, very narrow issue. It is an issue about whether reserves held at the Federal Reserve by banks should be included in the leverage ratio or not. That is a very technical issue that I thought we should look at, just to understand the implications of the leverage ratio in terms of its effects on monetary policy. It is not in any way subordinating financial stability to a lower position than monetary policy——

Chairman BROWN. That is the way——

Mr. DUDLEY. All I——

Chairman BROWN. I believe that is the way it is interpreted.

Mr. DUDLEY. All I wanted to do was look at it. That is all I wanted to do, is make sure that we understand how these things are interconnected. That is it. Eyes open. Understanding how these things are interrelated. That is it.

Chairman BROWN. It would certainly appear that you expressed reservations——

Mr. DUDLEY. I think——

Chairman BROWN. ——with capital standards——

Mr. DUDLEY. I think it was—no, I really object to that characterization. I am completely in favor of higher capital standards for banks, absolutely have been supportive, supported the SIFI surcharge on the large complex institutions, favored the leverage ratio because I think the credibility of the risk-weighted asset standards is a little bit in question, so it is useful to have a belt and suspenders. So, I have no objection to having a leverage ratio.

Chairman BROWN. Is this the first public statement you have made about support of higher capital standards, about these specific capital standards?

Mr. DUDLEY. I do not recall, Senator.

Chairman BROWN. Well, I——

Mr. DUDLEY. But, I do support the capital standards. There is no question.

Chairman BROWN. I think you would remember if you had said it, because it is a pretty important issue——

Mr. DUDLEY. I presume—I am sure I have said it many times, because I very much endorse what we have done in terms of raising capital standards for the large complex institutions that we regulate. As I said in my prepared remarks today, absolutely in favor of it.

Chairman BROWN. I mean, you——

Mr. DUDLEY. No question. This is——

Chairman BROWN. I am not asking what you say when you sit around the table at every FOMC meeting, but I think it would be important——

Mr. DUDLEY. I participated in the Basel discussions, and very much, I was always on the side of pushing for a higher capital.

Chairman BROWN. OK. I hope you will continue to, then.

Senator Merkley, this is the last round. Any other questions?

Senator MERKLEY. Thank you.

Professor Beim's report said that changing the culture of the Fed required hiring out-of-the-box thinkers, even at the risk of getting disruptive personalities. It called for expert examiners who would be contrarian and ask difficult questions and challenge prevailing orthodoxy.

As I am looking at some of the commentary with Carmen Segarra, she took minutes from a meeting and those minutes reflected kind of a hesitancy to apply regulatory standards aggressively, and she was called into the office of Mike Silva. Silva had worked at the Fed for 20 years. He was now the senior Fed officer stationed inside Goldman. What Mike Silva said to Carmen made her very uncomfortable, and essentially, she was pressured repeatedly to not, if you will, reflect the culture of the Fed in these minutes that showed kind of this "go easy" situation.

Carmen sounds like just the sort of person that Professor Beim's report suggested the Fed needed to kind of shake up the place, and yet she did not last long. Do you agree with Professor Beim that the Fed needs to hire people who challenge the institutional culture?

Mr. DUDLEY. We definitely want people that speak up and express their views, but we also want people that are fact-based so that if the facts point in one direction, that that is where their conclusion leads them.

In the case that you are discussing, this was a question about whether Goldman Sachs had a conflict of interest policy or not, and Mike Silva and other senior people on the supervision side at the Federal Reserve Bank in New York, and, in fact, up to the Operating Committee that consists of people well beyond the Federal Reserve Bank of New York, concluded that Goldman Sachs did, in fact, have a conflict of interest policy, and he wanted to turn the discussion to not whether they have a policy or do not have a policy, but whether they have a good policy or not, and he was encouraging her to investigate whether they had a satisfactory policy or not.

But, the debate was—you know, I think if judging from the tapes, which I think are a very incomplete record, there was this lack of willingness to agree on whether they had a conflict of interest policy or not, and, basically, this issue was vetted. I think the position of the senior supervisors was that there was a conflict of interest policy and that is what the debate was about. That——

Senator MERKLEY. Let me go to a more fundamental question, then. I will accept that different folks have different opinions about what happened there. But, more fundamentally, is there a revolving door policy that bans people who have worked as regulators from then going back to work on Wall Street?

Mr. DUDLEY. There are varied sets of restrictions. I would not say that it bans people from going to work on Wall Street. I can lay out what the restrictions are. So, anyone in the bank who leaves the bank cannot come back and lobby the bank on any particular matter that they worked at while they were at the Federal Reserve Bank of New York.

Number two, if someone from the supervision staff or officer leaves the Supervision Department, they cannot come back and talk to the Fed about anything, any business matter, for a year.

And, third, no deputy senior supervisor or officer or senior supervisor or officer can leave the bank and work for an entity that they were supervising, accept compensation from that firm, for over—for a year.

In addition, if someone does leave, you know, someone who is on an exam team leaves the bank to go to a bank that they are supervising, there is a review made of their examination papers to make sure that there was no bias in terms of how they examined the banking institution.

You know——

Senator MERKLEY. Let us do this——

Mr. DUDLEY. ——a legitimate question is whether, one, you should make these standards even higher, but there are a whole set of standards in place.

The other thing I would say, if you would just give me one more moment, Senator, is I do not think it is a—I do not think revolving door is really the apt description for the Federal Reserve Bank of

New York, because despite the fact that we have added a lot of people to the staff—we have grown from 520 to 700 in the Supervision Department—the average tenure in supervision at the New York Fed is over 9 years. So, that does not strike me that a revolving door is an apt description of what is happening at the Federal Reserve Bank in New York.

Senator MERKLEY. I think I heard from your last standard that if you are below a certain level in the bank, you can be an examiner and then go to work for the group you examined. Is that appropriate?

Mr. DUDLEY. That is a reasonable question that, I think, needs to be looked at in more detail.

Senator MERKLEY. Will you commit to taking a look at that and letting us know your opinion on it?

Mr. DUDLEY. I would be worth—I would be willing to commit to taking a look at that.

Senator MERKLEY. Thank you. I think, because there is a sense that at one point, the regulatory career path was over here and the banking world career path was over here, and there was a regulatory culture that was very different, but that the process now where people come and go in and out of Wall Street to the regulators creates enormous inclination toward being very deferential to institutions that might then pay substantial salaries when you go back into that world, and I think that that question really does need to be examined. It is a difficult problem. You need the expertise of people who really understand the system, so I understand that. But, I think it is something that may help explain some of the cultural issues that seem to be coming up time and time again.

The last point I will make, and I am out of time, so I will just make the point, is that you repeatedly referred to safety and soundness. When we were looking back at the issue of the Fed's failure to regulate teaser rate mortgages and the kickbacks that steered people into subprimes, a lot of the, kind of, inclination was, well, banks were making money from this and that increased their safety and soundness.

And, this is something I am very concerned about when I was asking the question about the ownership of assets, like aluminum warehouses and pipelines and power stations. Most entities could not hold enough to influence the supply and demand, but big banks can. They can put their thumb on the scale while they are making these bets. And, putting your thumb on the scale makes money. And, so, there is the apparent inclination to say, well, this is not a safety and soundness issue because it makes banks more profitable, and yet there is something fundamentally wrong with it, apart from safety and soundness, which is essentially a monopoly control or influence that raises the price of the end product. So, everybody buying a can of beer in an aluminum can is paying a little bit more for that beer. Folks buying power are paying a little bit more. People buying oil or gasoline are paying a little bit more. And, that, too, should be a concern.

I was glad to hear you say you thought it was inappropriate, but I must say, the Fed has been completely absent on this, continuously referring to "this was grandfathered," and, "well, we will be taking a look at this over here," and never getting to the heart of saying that this fundamental conflict of interest should be addressed, and that is unfortunate, because American consumers pay a big price for that.

Mr. DUDLEY. Senator, if I could just make one comment, I completely agree with you that profits do not necessarily ensure that an institution is safe and sound. It depends on what risks that the institution is taking to achieve those profits, both risk in the sense of credit risk, liquidity risk, but also reputational risk. And, we have seen firms that have apparently made profits and the profits have turned out to be illusory. So, I completely agree with your point on profitability.

Chairman BROWN. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. I will be quick. I just have one question I want to get to here.

I am very glad that you commissioned the Beim report in 2009, and you have discussed how seriously you took that report. How many times did you talk with Professor Beim in the 5 years since the report came out?

Mr. DUDLEY. I do not think I have talked to him at all. I thought—I got what I wanted from him. I got a report that was very critical of the way we were doing things, that made a very detailed set of recommendations, and we basically—you know, that is not the only input in terms of how we have revamped supervision over the last 5 years——

Senator WARREN. But, you never spoke to him again?

Mr. DUDLEY. ——but—well, I spoke to him today.

[Laughter.]

Mr. DUDLEY. So, I did speak to him again, but——

Senator WARREN. Well, good. Let us talk about what comes out of today, then. So, I understand that you believe that you have made progress in implementing the recommendations from the Beim report. You have referred to it several times during this hearing. So, my question is, why do we not get some independent confirmation about that? I do not want to put Professor Beim on the spot here, but if he is willing to do so, would you be willing to have him come back to the New York Fed, do new staff interviews, and do a new public report on your efforts to implement his recommendations from 2009? I am sure it would be of great interest to this Subcommittee.

Mr. DUDLEY. Let me put it this way, Senator. I will definitely think about it, recognizing in fact, though, that there is a number of studies that are already in train to look at the issue of whether the information that needs to get to the——

Senator WARREN. So, you already have a number of studies that are going to come out and be public studies evaluating whether or not——

Mr. DUDLEY. Well, the——

Senator WARREN. ——the Beim report recommendations have been implemented?

Mr. DUDLEY. No. The Federal Reserve Board announced that they are going to have two studies, an internal study and a study that is going to be done by the Inspector General, that is going to look at the issue of whether the appropriate information that needs to be available to make good supervisory decisions is available and whether the divergent viewpoints are also available to the senior policymakers. So, those studies are already underway. We are also doing a number of studies at the New York Fed to look at the issue of data security, to look at the issue of——

Senator WARREN. Well, I am glad there are other studies underway. I have no doubt about that. But, given the number of times you have turned to the Beim report and said during the course of this hearing that the Beim report is the evidence of how seriously you took the problems at the New York Fed and your determination to change it, and yet you have never spoken to Professor Beim in the 5 years since then, and I have just asked you, why not invite Professor Beim to come back in. You thought his report was really terrific in 2009. Ask him to come back in and do an evaluation of whether or not the recommendations have been implemented. I asked you for a "yes" here. I would like to have a "yes."

Mr. DUDLEY. I would like to think about it, Senator.

Senator WARREN. OK. Thank you, Mr. Chairman.

Chairman BROWN. President Dudley, thank you for joining us.

Mr. DUDLEY. Thank you.

Chairman BROWN. Thanks for your public service.

Mr. DUDLEY. Thank you.

Chairman BROWN. The Chair calls up the next panel, please.

David Beim is a retired Professor of Professional Practice at Columbia Business School. Professor Beim worked for 24 years as an investment banker at First Boston, Bankers Trust, and Dillon Read.

Robert Hockett is the Edward Cornell Endowed Chair in Law at Cornell, where he has taught since 2004. Professor Hockett is also a Fellow at the Century Foundation and an in-house finance regulatory consultant with Westwood Capital. Professor Hockett has spent time at the International Monetary Fund as well as the Federal Reserve Bank of New York.

Norbert Michel is a Research Fellow in Financial Regulations at the Heritage Foundation. Prior to joining Heritage, Dr. Michel was a tenured professor at Nicholls State University College of Business in Thibodaux, Louisiana.

So, welcome, all three of you. If you are prepared, Professor Beim, you are comfortable, ready to go, turn your microphone on and let us hear from you. And, please keep your remarks close to 5 minutes, all of you, and we will have questions.

STATEMENT OF DAVID O. BEIM, PROFESSOR OF PROFESSIONAL PRACTICE, COLUMBIA BUSINESS SCHOOL

Mr. BEIM. I know the time is short, and you have my written testimony, so I will just give you a quick oral summary of what I consider the most important points.

First of all, I would like to emphasize that the report that I did in 2009 was not just me. It was not just me looking at the Fed and making observations. It was the Fed looking at itself. I was given a team of eight senior vice presidents, who were terrific. They were people of positions in great responsibility and obviously very bright, and what you see in the report is largely their words and the words of witnesses that we all called together. We worked together through the summer. This was very much a collective effort, and furthermore, it was certainly focused on culture. It was certainly clear to us that Mr. Dudley wanted us to focus on culture, and we did, because culture really does govern people's behavior.

The issue that I see today as being particularly important is the revolving door law, and that was referred to briefly in the preceding testimony, but I think that this is very near the center of the problem, because it is not—the existing law is, I think, really unfortunately weak. Very few regulators go to work for the very bank they were regulating. The problem is not that. The problem is that regulators and bankers form a community. They know each other. They talk to each other. They exchange—they talk about each other. This is a community of people who share a common interest in banks and bank regulation.

And, what I would recommend is that anyone who has been part of the bank regulatory world should not join any bank for 3 years, because I think it is impossible to take out of the heard of someone like Mike Silva the possibility that he might be offered a job not by Goldman Sachs, whom he regulated, but by any bank. And, indeed, in the end, he was given a job by GE Capital, not a bank he regulated. But, the fact that you are likely, highly likely to get an offer, if you are as bright and uprising as Mike Silva, you are highly likely to get an offer from some bank, cannot help but govern your behavior toward the bank you are regulating.

And, so, I would recommend a significant strengthening of the revolving door law so that regulators cannot go to work for any bank for 3 years, and that would force an identity decision, am I a banker or am I a regulator, and keep people on one track or the other.

You have asked me to talk about developments since my report, and as Mr. Dudley just said, I have not been to the Fed since my report. One of the hazards of being a consultant is that most consultants in most cases do not get invited back and do not know if their recommendations ever did any good or not. You just hope for the best, but it is a little bit blind following that. So, it is not unusual that he should not have called me, but I really have little to add except what I see in the press.

I do think it is rather striking that *ProPublica* and NPR put together a story of my report kind of side by side with Carmen Segarra's recordings because many of the issues that I was reporting in 2009 are illustrated—in technicolor, really—in the tape recordings, and it does suggest to me that not as much change has happened as I would have hoped and that, indeed, there is a continuing cultural problem and culture is slow to change. You should not be surprised. Cultures do not change quickly. A culture takes a very, very long time to change and it needs a lot of incentives to change. So, I am not surprised that these practices continue.

As to the other two articles, I think you see examples of things other than revolving door. I think you see bureaucratic infighting in the *ProPublica* piece on the London Whale. I think you see—in the *Times* piece on the Goldman leak, I think you see further hazards of having people in this community of regulators cum bankers moving so freely back and forth. I really think the most important step that Congress can take to fix this problem of excessive coziness between regulators and banks is to stop the revolving door. Pass something far stronger than what you have currently got.

Chairman BROWN. Thank you, Professor.

Professor Hockett.

STATEMENT OF ROBERT C. HOCKETT, EDWARD CORNELL PROFESSOR OF LAW, CORNELL LAW SCHOOL

Mr. HOCKETT. Thanks for having me here, Senators. So, I think I am here in two capacities, on the one hand, as a scholar in financial law and central banking and on the other hand as somebody who has spent a fair bit of time over at the New York Fed. So, I will keep my remarks fairly brief right now because there is a lot more detail in the written testimony that I have submitted and I assume that there will be a chance to talk in more detail over the Q and A, as well.

So, I have just got basically five quick points to make here. The first is just to remind us all that the Fed is the primary macroprudential or systemic risk regulator of our financial system now. That means the stake of its regulatory mandate, or, I should say, the stakes of its regulatory mandate are especially high. The stability of the entire financial system, hence, of the monetary system, and of the macroeconomy itself, and, hence, of employment in this country, very much ride on the Fed's properly executing its financial stability mandate.

Second, the bank examination process is particularly critical in this connection. It is the clutch, you might say, that engages the engine of the regulatory regime, on the one hand, to the actual behavior of participants in the financial markets on the other hand.

So, third, for this reason, recent allegations of Fed, and especially FRBNY, or New York Fed capture, where this function is concerned, where the examination function is concerned, are particularly seriously, right, particularly troubling, particularly potentially problematic.

Fourth, then, when I read and reflect on these allegations as they have appeared in the press and, of course, here today, I actually, quite candidly, find myself confronted with a bit of a paradox. On the one hand, I had not directly experienced anything like capture over at the FRBNY myself, right.

Indeed, Tom Baxter, the General Counsel of the New York Fed, when he brought me on, referred to the Beim report over and over and over again, and in particular, referred to the so-called group think problem, and he acknowledged that that had, indeed, been a problem, and said that one of the reasons that he was bringing me on board for a bit was because he thought I would be something of a contrarian or something of an out-of-the-box type. I suppose that is sort of a backhanded compliment, or maybe a two-sided compliment, but in any event, I took that to mean that he was actually being serious or taking seriously the group think claims.

Moreover, a lot of the projects that I was assigned to work on over at the New York Fed were themselves sort of out-of-the-box programs, or, I am sorry, projects, and anything but group think thought projects.

And then, finally, third, just as one sort of particularly dramatic example, some of you here know that I have been pushing for some years now an eminent domain solution to the ongoing underwater mortgage loan problem in this country, and as you know, also, the financial services industry and the banking industry have been particularly hostile, to say the least, to that plan, and yet the New York Fed asked me to do a write-up on the plan and then they published it, actually, in their own flagship journal. And, indeed, the week that it came out, there were two in a row, actually, two op-eds in the *Wall Street Journal*'s particularly atavistic op-ed page, attacking the Fed and me, by name.

So, all of that, on the one hand, makes one think, well, they cannot be that captured, right? On the other hand, militating in the other direction, my auspices at the New York Fed were, of course, somewhat unique, somewhat different, right. I was brought in as an outsider, as an academic who was independent, and the expectations of me, accordingly, were much different than, I suppose, the expectations of regular Fed employees are.

Second, I was not in examination at all. I did not spend any time in the Supervision Department or conducting bank examinations or accompanying examiners. So, it could be that there are problems in that department that are not in other departments.

And then, finally, third, I have to say that I have heard multiple stories from others, from friends and colleagues, both at the FRBNY and at the Fed Board here in D.C., that sound remarkably like Ms. Segarra's. The same pattern, essentially, characterizes all of these stories, which, of course, is at least potentially concerning.

So, then, finally, fifth, then, what do I conclude from this, what are my provisional conclusions, well, first, I think that the stories that I just mentioned of other examiners and other employees that have been similar to Ms. Segarra's ought to be followed up on. I think it would be very much worthwhile to speak with the other Carmen Segarras, so to speak, to find out what their stories actually are and to go into detail on those, just to see how pervasive or otherwise the apparent or possible problem might be.

Second, I think that putting in place some kind of contrarian thinking department, or institutionalizing contrarian thinking over at the New York Fed in the way that Professor Beim suggested might be a good idea. Indeed, Tom Baxter, the General Counsel of the New York Fed, when he brought me on, he was the first one who brought to my attention the idea that they were actually thinking about putting in place some kind of a contrarian thinking department and actually suggested that one of the projects that he might put me on would be to sort of help maybe start setting something like that up. That did not end up happening, but I do not think that that is necessarily because they do not want to do it. It might be that they have just been distracted because there is so much else that they have been doing, in particular, implementing a lot of the Dodd-Frank provisions. So, it might be that they have just been sort of busy and distracted, but I think they ought to be encouraged, probably, to go ahead and set that up.

Another possibility would be to go something like the route that I take, I think that Walter Wriston did at Citi at one point, where there were sort of parallel departments that were established and they were sort of encouraged to be in competition with one another. So, you had the contrarian counterpart to each sort of substantive department. Maybe something a bit like that would be in order or possibly be helpful at the New York Fed.

Finally, and sort of relatedly, it is sort of tempting to think in terms of maybe setting up—putting in place two, say, general counsels at most regulatory agents, one of whom is much more concerned with zealously pursuing the affirmative regulatory mission of the regulatory agency in question, and the other of whom is concerned with sort of covering the back side, as it were, of the agency in question, making sure that it is complying with law, that it is not getting into trouble, because the latter role is an inherently risk averse or cautious one. The former role, on the other hand, is an inherently proactive one that is apt to be best pursued by somebody who is zealous and trying to push the envelope and trying to sort of lean forward.

So, those are just sort of some provisional thoughts about what we might do going forward, but again, more in the Q and A, I am sure, and more in the written testimony. Thanks much.

Chairman BROWN. Thank you, Mr. Hockett.

Dr. Michel.

STATEMENT OF NORBERT J. MICHEL, RESEARCH FELLOW IN FINANCIAL REGULATIONS, HERITAGE FOUNDATION

Mr. MICHEL. Thank you. Good morning, Chairman Brown, Members of the Subcommittee. Thank you for the opportunity to testify here at today's hearing. My name is Norbert Michel. I am a Research Fellow in Financial Regulations at the Heritage Foundation, and the views that I express in my testimony today are my own. They should not be construed as representing any official position of the Heritage Foundation.

The aim of my testimony this morning is to argue that Congress should end the Federal Reserve's role as a regulator. There are three main issues I would like to address today.

First, regulatory capture at the Fed is actually nothing new. The recent stories in *ProPublica* and *This American Life* did provide valuable insight because they brought greater attention to regulatory capture, an issue that most nonpolicy wonks probably do not hear very much about. But, these stories reveal nothing surprising to anyone who has studied either the history of the Federal Reserve or, more broadly, market regulation.

The Fed was literally captured at birth by Wall Street icons such as J.P. Morgan and Henry Goldman and the revolving door sort of started right away. This is a perfectly natural outcome, though, because regulators have to know something about the industry that they are supervising, and on the other side, industry employees have to know something about the regulatory process that they are required to follow. The reality is that potential conflicts and outright capture do arise from this symbiotic relationship, and really, the only way to mitigate these problems is to reduce the level and complexity of regulation.

The excellent report by Professor Beim takes a different view and essentially argues that more properly trained regulators with a better focus will overcome the capture problem. But with all due respect, Professor, that is an ineffective approach that has not really worked well in the past and there is no reason to expect that it is going to work any better this time.

That brings me to my second issue, which is that these new macroprudential safeguards mandated by Dodd-Frank will be ineffective. History simply does not bode well for the macroprudential concept. We do tend to have short memories, so it is worth pointing out that the Federal Reserve System was created in 1913 with nothing like a micro focus. The main focus has always been macro from the outset. It was to prevent banking panics from doing damage to the broader economy. That is a macro concept. There was nothing about individual bank safety, per se.

The more recent past also seems to have sort of slipped away. In 1996, the Fed changed the rating system it was using to gauge banks' financial health. It was previously the CAMEL rating, an acronym for Capital Adequacy, Asset Quality, Management Administration, Earnings, and Liquidity. It became the CAMELS rating. The letter "S" stood for—anybody know that one?—sensitivity to market risk, a macro concept.

Aside from regulators' long history of being concerned with much more than just micro risk, no empirical evidence shows that any of these new macrofocused tools will prevent financial crises any better than the old ones did. In fact, one of the only countries that had fully implemented these types of regulations prior to the subprime crisis, which was Spain in the year 2000, suffered through at least as severe a crisis as everybody else.

Furthermore, the new rules did not do anything to one of the old rules that we know failed spectacularly. The Fannie and Freddie issued mortgage-backed securities and foreign and sovereign debt are still given preferential capital treatment under the new rules. Regulators were clearly wrong about those risks in the beginning and we have done nothing to correct that mistake.

And, that brings me to my third and final point, which is that ending the Fed's role as a regulator is long overdue. Regrettably, Dodd-Frank took us in the opposite direction and expanded the Fed's role. This is something that can only lead to more capture problems.

Interestingly enough, expanding the central bank's regulatory power is counter to the international trend. More than a dozen developed countries prior to the subprime crisis, including the UK and Sweden, had already removed regulatory functions from their central banks, and that is exactly what we should do in the U.S.

The current structure that we have jeopardizes the long-term price stability goal of monetary policy, but it simply does not have to be this way, because financial regulations and monetary policy are completely separate functions. Congress can strengthen financial markets and reduce political pressure in the Fed by transferring the Fed's regulatory authority to either the FDIC and/or the Office of the Comptroller.

Thank you for your consideration.

Chairman BROWN. Thank you very much, Dr. Michel, and thanks to all of you.

I was a little disappointed that as soon as the Fed panel—as soon as President Dudley concluded his testimony, that all of the Fed employees left. I think that they might want to hear from the three of you, all knowledgeable people that might not see the world quite the way they do, and it is—I am just disappointed. I hope that somebody from the Fed is at least monitoring this and will hear the comments of all three of you.

Mr. MICHEL. Everybody is watching online.

Chairman BROWN. Well, yeah, as they head to the train station for their one o'clock train, they are watching online.

[Laughter.]

Chairman BROWN. Anyway, Professor Beim, I very much appreciate your line to not take it out of his head that he might join some bank at some point. I think that is precisely right and the conflicts of interest.

Let me ask just a couple of questions and have all three of you answer them. We will wrap up fairly quickly, because you have been patient. This hearing has gone on 2 hours, and you have sat and waited.

President Dudley said that the LISCC Operating Committee, quote, "provides an important safeguard against regulatory capture by ensuring that no one person or Reserve Bank has the power to make a final decision on a matter of significance." Do you agree with this diagnosis of and prescription for addressing regulatory capture?

Mr. BEIM. I do not think that is a particularly effective approach. I think what you, in my opinion, what you need is not more vetting and more people bringing their ideas together, you need more independent thinkers. I have long believed that the big problem within the Fed is that the people march like an army. There is this huge tendency to defer to authority, to defer to supervisors, to defer to banks. I mean, there is very little independence of judgment by independent individual regulators.

And, so, my prescriptions come in that direction. I think one needs to look at the incentives of individuals, and that is why I focus on the revolving door rules. If a regulator is constantly thinking, one of these days, I hope I am going to get one of these jobs that pays a lot more than what I have got, it cannot help but affect his judgment or her judgment in the way that they handle particular cases. They are human beings. They respond to ordinary incentives. I would change those incentives by typing the revolving door.

Chairman BROWN. Professor Hockett.

Mr. HOCKETT. Yes. So, I am in agreement with Dr. Beim. I think that what President Dudley suggests could be helpful, but I think it is only going to be marginally so in the sense that, well, sure, not all of the Regional Reserve Banks have the same opinions and the same perspectives, and so if you get more perspectives in there, that is going to be all to the good.

I also agree that the revolving door can be a problem, but I tend to think that probably what is most important is another suggestion that Professor Beim made in his report in 2009, and that is that you not only have to have some kind of contrarian thinking department or contrarian thinkers there, but they have to have somebody who is their sort of ultimate superior who has the same status as all of the other sort of sub-Presidential top deputies over at the Fed. The department has to have a certain sort of prestige attached to it. It cannot be viewed as a sort of a passel of lovable eccentrics, right. They have got to be taken seriously, right. They have got to be—they have got to have the same kind of status and respect at the institution that others have, and that is partly a cultural matter, but it is partly an institutional or structural matter and I think we have to treat it that way.

Chairman BROWN. Dr. Michel.

Mr. MICHEL. I think that if you increase the number of years that somebody has to stay out of the industry, you come up with a new set of incentive problems, somebody who is never going to want to leave and then you have sort of a permanent bureaucracy mentality, which probably does not get you what you want, either. Essentially, we are saying, fix the bureaucracy by making it a bigger bureaucracy. I do not think that anybody should be surprised that you have an enormous number of complex rules and somebody could leave a regulatory agency after writing and enforcing those rules and make a lot of money in a private industry that is regulated by those complex rules. I mean, you have to change that structure.

Chairman BROWN. My second question. I will start with you, Dr. Beim. *ProPublica* described the experience of two different examiners. Ms. Dobbeck was lead examiner at Citigroup when it required billions of dollars in bailout funds, and she was an examiner at JPMorgan during the London Whale. She was described as stonewalling her own examiners. She is now the head of the New York Fed's supervisory policy. Ms. Segarra was a forceful examiner. She questioned her institution and her supervisors. She spoke her mind. She was fired.

What do these cases say about the Fed, about the attributes rewarded or punished at the Fed? Your thoughts.

Mr. BEIM. I think the question answers itself. I think the fact is that people who fall in line and do what their bosses want generally get ahead at the Fed, and people who speak out are frequently hammered down. And, so, it just has not changed very much. From what I have seen in 2009 to what I hear today, it sounds like the same.

Chairman BROWN. Professor Hockett.

Mr. HOCKETT. Yes. A similar impression at my end. I tended to sort of gravitate toward and befriend and spend time with those who were probably the most contrarian thinking over there when I was there, and likewise with the Fed Board. I think I mentioned in my written testimony that I was here in D.C. for the year of 2012–2013 during my sabbatical, working over at the IMF, again, my first gig, and I spent a good bit of time with Fed Board employees, as well. And, there, too, I sort of gravitated toward and ended up becoming friends with the more contrarian thinkers, and it seems to be not to be without significance that most of those folk have since left, and I do not think that they left simply, you know, sort of happily, but, again, you would have to talk with them to get the fuller details.

Chairman BROWN. Dr. Michel.

Mr. MICHEL. I think it highlights a bigger issue, which is that you have these rules, and if a bank is following the rules and they are legal, should a regulator or any other authority have the ability to arbitrarily say, no, we do not think that is a good idea, you cannot do it, even though you are following the rules. And, I do not know the merits of her case, so I am not commenting on those specifically, but in the broader picture, it is a very good question. Should there be an arbitrary power to do something like that? What does that mean for any company?

Chairman BROWN. Senator Merkley.

Senator MERKLEY. Thank you, Mr. Chair.

I wanted to go back to the challenge of regulatory capture. Professor Beim, you note that there are kind of three factors that contribute to, I think what you describe as the weak form of regulatory capture.

Mr. BEIM. Right.

Senator MERKLEY. One is how you will be treated by your supervisors and how you will fit into the agency. Certainly, that affects your career path within the agency.

The second is the possibility of being hired by regulated companies who pay a lot more than the Government does as a way to pursue a career path.

And, the third is that in your role as a regulator, you need not just information, as you put it, but insight——

Mr. BEIM. Right.

Senator MERKLEY. ——and that being handed stacks of numbers will not give you that insight, so that you are compelled to have a collaborative rather than a confrontational relationship.

Mr. BEIM. That is correct.

Senator MERKLEY. And, it seems to me on that third point that the best—the very good examiners are going to need that, and that is a challenge for everyone, regardless of whether they are thinking about offending their supervisors or the prospects for a job outside.

And, you also note in your testimony that one thing that would help create a regulatory frame of mind would be a 3-year period before moving into regulated companies. I was struck—I have here the Federal Deposit Insurance Act rules over whether or not you can go to work immediately, and only certain officers are affected by this, the current 1-year gap——

Mr. BEIM. Mm-hmm.

Senator MERKLEY. ——and it only affects being hired by a group you directly regulated, is my understanding from looking at this. And, then I also—there is a waiver process where even that minor ability can be waived by the head of the Federal Reserve by signing a statement that they do not see an inherent conflict of interest.

Mr. BEIM. Right. Yes.

Senator MERKLEY. Do you have any idea how much that waiver process is used to get rid of even that 1-year restriction?

Mr. BEIM. I do not have knowledge of how frequently the waiver provision is used, but I think that you correctly frame a situation that is ridiculously easy to avoid, that it is simply too easy to get around the current legal restrictions we have. Even as mild as they are, people get around them. They do not seem to be effective. I think the current law is not effective in accomplishing what it set out to accomplish. I think it needs to be much, much more tightly written.

Senator MERKLEY. We had just here a moment ago the head of the New York Fed——

Mr. BEIM. Right.

Senator MERKLEY. ——and he cited this provision, these revolving door provisions.

Mr. BEIM. Yes.

Senator MERKLEY. And, it sounded like from his description like he is pretty much following what is in the statute——

Mr. BEIM. Yes.

Senator MERKLEY. ——but, would he have the power to internally set much stronger restrictions as a matter of policy for the New York Fed if he wanted to take on this issue?

Mr. BEIM. I am not sure he has the legal ability to restrict the movement of his employees after they leave him. I think it takes Congress to do something like that.

Senator MERKLEY. OK. Well, that is an interesting point to look at.

Now, I know in your recommendation for this 3-year break——

Mr. BEIM. Right.

Senator MERKLEY. ——and Mr. Michel has noted that he thinks that would cause other problems in terms of, I am not sure exactly. Do you want to repeat your concern?

Mr. MICHEL. Different incentive problem.

Senator MERKLEY. Which——

Mr. MICHEL. Different incentive problems. I could elaborate, if you would like.

Senator MERKLEY. Please, yes. Go ahead. Medium length.

Mr. MICHEL. So, the longer you make the period that they cannot go back—let us just say they can never, go to the extreme. So, once you are a regulator, you can never go work for the private firm you were regulating. Well, now the only way you are going to get competent people in that position is to pay them a lot of money, and once you have got them inside the OCC or the Fed making an enormous amount of money, they really do not have very much incentive to care about much of anything except that they have a lifetime job. So, that is a different incentive structure there.

Senator MERKLEY. OK. Thank you.

And, I think—my impression is that we have a challenge that has been created by the increasing complexity of the financial world. If we turn the clock back 30 years ago, the banking system was a much simpler organization to understand. The transactions were much simpler to understand.

Mr. BEIM. Right.

Senator MERKLEY. Now, we have this complexity, and I think in your own testimony, you talk about how the regulators came to get coached on what a swap was——

Mr. BEIM. Yes, exactly.

Senator MERKLEY. ——and that even after you had walked them through it, they clearly only had a basic elementary understanding.

Mr. BEIM. You can visualize the scene.

Senator MERKLEY. Yes. You were probably drawing little pictures for them and so forth.

Mr. BEIM. Yes, right. Arrows.

Senator MERKLEY. Yes. And, so, how do we solve that problem? If we need the expertise that comes from having been in these sophisticated transactions in order to understand and regulate them, how do you pull people—would you be able to recruit the expertise needed if you had a 3-year restriction on returning to the private world?

Mr. BEIM. I think you would have—if you did this, I think you would have to have some way of weeding out people who are not effective and rewarding people who were effective in the direction you wanted to go. People really respond to incentives, and so one of the problems of Government service in an agency like the Federal Reserve is frequently that you get paid by grade and time served and not by your performance.

If, in addition to this kind of restriction, regulators could pay for performance, you could reward the kind of behavior you wanted to reward and punish the kind of behavior you wanted to suppress, and people who simply got to be stale old bureaucrats would sort of fade into less significance. You do not easily have that freedom of managing people, but I think you should. I think that would be another way to approach the problem, is not to allow people to revolve back and forth, which creates all kinds of incentive issues. I would rather see a class of professional regulators very well trained and very well incentivized to do that which is right rather than just be paid on time and grade.

Senator MERKLEY. And, you feel that that training and those incentives could overcome the challenge of not, if you will, having had the years within kind of the banking side of these complex transactions?

Mr. BEIM. It will never be perfect, but I think that you can go a very long ways. It is possible—I mean, the executive training today is really good. We have a big program at Columbia, and so does every university. You get state-of-the-art transactions forward in front of executives so that they see what is going on. If you are willing to invest the time and effort, you can get excellent training for people. And, then, if you have a rewards system that rewards them for getting well trained and using their training in an effective way to counter things that they see need countering in their supervised institutions, I think you could have a regulatory system that works.

Senator MERKLEY. Today, the—I will ask this last question, then I will——

Senator WARREN. That is fine.

Senator MERKLEY. The testimony we had was that after the 2009 report that you prepared, that all kinds of changes have happened within the Fed to respond to this problem of regulatory capture and to exercise regulatory provisions in an aggressive manner. Do you agree that the New York Fed has gone through a transformational reorganization that has solved this problem?

Mr. BEIM. Well, they certainly have gone through some reorganization. They certainly have done their best to make some changes. But, it looks like that is just not enough and that further change is required. So, yes, I think Mr. Dudley was being honest in saying that he had made a lot of changes. He really wanted to have these changes work. I do not doubt his good will and good intentions. It is just that when you look at the outcomes, such as we have seen in three recent stories, it has not gone far enough.

Senator MERKLEY. It has——

Mr. BEIM. And, again, culture is slow to change. It does not change quickly. It takes a constant, determined effort and very careful attention to incentives.

Senator MERKLEY. Thank you very much, all of you.

Chairman BROWN. Thanks, Senator Merkley.

I was interested—and then I will turn it to Senator Warren for the last round of questions—Dr. Michel, you pretty much said that if we followed Professor Beim, we would not attract good people because they could not make the kind of money that a regulator who moves to a Wall Street Bank can make.

And I am reminded—I am a bit incredulous that the number of my colleagues when I was in the House were—I do not hear it as much in the Senate—that say—that are making as Members of Congress, making in those days $150,000, $160,000, say, 10 years ago, and the number of them that say, "I am leaving Congress so I can go out and make money." You know, $160,000 is not bad in this society, but I just am always kind of troubled by this attitude that you just cannot—you know, some people actually choose to be public servants because they believe in a public mission——

Mr. BEIM. Sure. Sure.

Chairman BROWN. ——and I look at the people sitting back here——

Mr. BEIM. But that is——

Chairman BROWN. ——most of whom will not become bank lobbyists, frankly. They love what they do and want to protect the public and want to work, but, I am sorry——

Senator WARREN. ——at that point.

[Laughter.]

Mr. MICHEL. No, and that is fine, but that is still an incentive structure that you have to overcome. That is still a basic——

Chairman BROWN. Fair enough, and I do not want to start that, because it is not my turn to ask questions.

Senator Warren, wrap it up.

Senator WARREN. Thank you, Mr. Chairman. I will.

Thank you all for being here today. Professor Beim, let me start where I left off with Mr. Dudley. Would you be open to returning to the New York Fed and producing a follow-up report on how well it has done at implementing your recommendations?

Mr. BEIM. Yes, of course. I would be flattered and delighted to do that.

Senator WARREN. Good. You might also be very helpful. All right. That is terrific.

You know, we need to put a lock on the revolving door. The hard question is exactly how to do it, and I appreciate the recommendations. My colleagues have already asked the appropriate questions around this. I just want to point out one other part to this, and that is we should remember that the revolving door spins in both directions.

We need to ensure that regulators are not captured by the big banks in exchange for the hope of future jobs, but we also need to ensure that we do not give a lot of key regulatory positions to Wall

Street insiders. You know, appointing bank executives to regulate their former coworkers did not work in the past, and, in fact, it has led to the kind of passive and timid supervision that brought down our financial system 6 years ago. We cannot build a strong, reliable bank oversight system so long as the revolving door keeps putting bank executives in the role of temporary cops. We need real cops on the beat, not rent-a-cops on temporary leave from their high-paying banking jobs.

So, I do not have to pursue more. I just want to make that point, that we have got to worry about this revolving door both ways.

Mr. BEIM. Yes. I would like——

Senator WARREN. You wanted to add something, Professor Beim?

Mr. BEIM. I would just like to add that we are almost unique among developed countries in the extent of our revolving door practices that we tolerate. I mean, in most countries, you have got a professional class of civil servants who do very conscientious jobs in just the way that you were describing, and it works. Those systems work.

Mr. MICHEL. And virtually every one of those Nations had a financial crisis just like we did——

Mr. BEIM. And——

Mr. MICHEL. We are overselling——

Mr. BEIM. Well, Professor——

Mr. MICHEL. We are overselling the ability that we have to prevent a financial crisis by doing these window dressing-type things.

Mr. BEIM. It may be we do not prevent another financial crisis. That is incredibly hard to do. There is just a lot that goes into that besides revolving door——

Mr. HOCKETT. Can I just add one quick point——

Mr. BEIM. There are other goals, absolutely.

Mr. HOCKETT. So, one of the—the main argument that is made in favor of the revolving door is the complexity argument, right. It is very difficult to sort of make sense of the transactions and of the institutions in question without somebody who has actually experienced them. One thing we ought to consider, it seems to me, given that commonly heard justification, is whether the complexity itself out there in the financial world is not, in many ways, gratuitous, right.

I think a lot of it has to do with the creation of artificial rent-grabbing opportunities, and we ought, then, to think about a product approval regime for complex derivatives, kind of an FDA-type regime for derivatives, and maybe look back at the institutions themselves and ask ourselves whether it really makes sense to keep the institutions as complex as we have. And, of course, it also makes sense to raise the salaries of the people who are regulating them, but——

Senator WARREN. All right, Mr. Hockett. Since you stepped in and it is still in my time period, I am going to say this is part of the reason we need a 21st century Glass-Steagall law. If banking were boring, if banking were just about banking, then we would not have so much complexity in the system and it would be far easier to regulate the banks themselves. As for the nonbank financial institutions, then we could have people who specialize in that kind of expertise.

Listen to the rest of this panel. The notion that we are asking bank regulators to be able to evaluate the risk associated with trading in aluminum warehousing, to trade in oil tankers on the Straits of Hormuz and what kind of reserves you need against that is crazy. It helps put our system at greater risk and it increases the likelihood of regulatory capture all at the same time, so——

Mr. HOCKETT. From your mouth to Congress's ears.

Senator WARREN. Yes.

Chairman BROWN. Thank you all. Thanks very much for joining us. Committee Members may have written questions. Please get back to us within a week on those questions and answer, and if you have additional statements you want to make, certainly do that.

A special thanks to the Committee staff that has been so helpful for the last 2 years, and especially on this very complicated hearing with very complex issues, Laura Swanson, Elisha Tuku, Phil Rudd, and Casey Scott, and special thanks to my two staff people who have been dogged and incredible in this, Graham Steele and Megan Cheney.

The Subcommittee is adjourned.

[Whereupon, at 12:19 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF WILLIAM C. DUDLEY

PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL RESERVE BANK OF NEW YORK

NOVEMBER 21, 2014

Introduction

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee, thank you for this opportunity to testify on the effectiveness of financial institution supervision and the issue of regulatory capture.

In 2008 and 2009 our country faced its worst financial crisis since the Great Depression. I mention those years as a touchstone for my remarks today. Despite the passage of time and an economy that is steadily improving, the financial crisis is hardly something that happened in the remote past. For the too many people who are still unemployed or underemployed, or who otherwise continue to struggle financially, it is living history.

While the causes of the crisis remain subject to debate, it is undeniable that banking supervisors could have done better in their prudential oversight of the financial system. This conclusion raises two fundamental questions:

- *First*, how can we improve the stability of the financial system? In other words, how can we make the financial system more resilient and productive?
- *Second,* how can we improve our supervision of financial institutions?

The Federal Reserve is working diligently to improve both stability and supervision. The two concepts are linked. Since the financial crisis, the Federal Reserve has made significant changes to the substance and process of supervision. As a result, the financial system is unquestionably much stronger and much more stable now than it was 5 years ago.

Substantive Changes

Since the financial crisis, the Federal Reserve has redoubled its attention to bank capital. Capital is the financial cushion that banks hold to absorb loss. [1] It provides an economic firebreak that helps prevent systemic stress from turning into a full blown crisis.

Before the crisis, capital requirements were too low and inconsistent across jurisdictions. Moreover, too much of the capital held by banks was of poor quality, and their internal capital assessments were not forward looking. [2] Since the crisis, new regulation and heightened supervision have increased both the quantity and the quality of equity capital at the largest financial institutions that we regulate and supervise. The Federal Reserve and other Federal banking regulators implemented so called "Basel III" international capital standards in July 2013, which raised the minimum ratio of common equity Tier 1 capital to risk-weighted assets. Federal regulation also now requires stricter criteria for instruments to qualify as regulatory capital and higher risk weights for many classes of assets. And the Federal Reserve mandated a new minimum supplementary leverage ratio that includes off balance sheet exposures for the largest, most internationally active banking organizations and a leverage surcharge for large U.S. banking organizations.

In support of these new regulations, capital assessment has become a focus of supervision since the financial crisis. Examiners monitor capital reserves and put banks through periodic stress tests that are evaluated on a crossfirm basis. This has been one of the great advancements of bank oversight following the crisis. These evaluations enable supervisors to assemble a composite assessment of the Nation's banking sector, which materially assists the Federal Reserve in its statutory mandate to promote financial stability. [3]

The Dodd-Frank Act mandates supervisory stress tests that assess whether large bank holding companies have a sufficient level of capital to absorb losses during adverse economic conditions. [4] The Federal Reserve also conducts a capital planning exercise, called the Comprehensive Capital Analysis and Review or "CCAR." This evaluation combines the quantitative results from the Dodd-Frank Act stress tests with a qualitative assessment of whether the largest bank holding companies have vigorous, "forward looking capital planning processes that account for their unique

[1] I use the terms "bank" and "financial institution" interchangeably, but note that the two terms are not synonymous in Federal regulation.

[2] See generally Joint Notice of Proposed Rulemaking, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action", June 12, 2012, at 32, available at *https://www.fdic.gov/news/board/2012/20120612__notice__disb.pdf.*

[3] See, e.g., 12 U.S.C. §5365(a)(1).

[4] See 12 U.S.C. §5365(i).

risks."[5] The criteria for both sets of stress tests are dynamic and change in response to evolving risks. For example, past tests have assumed a sharp, sudden, and widespread drop in markets triggered by, say, a large Eurozone shock. The tests also evaluate market interconnectedness, including the risk of major counterparty default.

To increase public transparency, the Federal Reserve now publishes the overall results of its stress tests. This helps rebuild confidence in the strength of the financial system. The most recent round of stress tests concluded in the first quarter of this year. In my view, the results were encouraging, although not uniformly satisfying. In general, "firms participating in CCAR have more than doubled their Tier 1 common capital since 2009, an increase of $500 billion of additional, high-quality capital in the U.S. financial system."[6] This impressive statistic notwithstanding, the Federal Reserve objected to capital plans from 5 of the 30 participating firms. Four of those five firms submitted plans that raised firm specific, qualitative concerns. The remaining firm failed to meet a minimum quantitative requirement.[7]

The consequences of failing to pass a stress test can be severe. If its capital plan has been rejected, the Federal Reserve may, among other things, restrict a bank holding company from paying or increasing dividends on its common stock or increasing any repurchase of its common stock, or both.[8] For example, as a result of this year's CCAR, Citigroup was not permitted to begin a new common stock repurchase program or to increase its quarterly common stock dividend.[9]

As a companion to improved capital, the Federal Reserve also assesses liquidity—that is, how quickly a bank can convert its assets into cash. Prior to the crisis, liquidity practices did not generally anticipate the possibility of severe drops in the prices of saleable assets. Following the crisis, the Federal Reserve imposed new liquidity regulations, including the Basel III Liquidity Coverage Ratio. The objective of these new regulations is to require large firms to hold levels of liquid assets sufficient to protect against constraints on their funding during times of financial turmoil. We have also implemented liquidity stress test assessments for systemically important financial institutions. These assessments provide important insight into the adequacy of liquidity positions and bank preparedness for upcoming regulatory standards.

Beyond capital and liquidity, the Federal Reserve has increased its focus on risk management practices at the largest and most systemically important financial institutions. We learned from the crisis that risk management in the financial services industry had not always kept pace with changing market practices. We have responded in several ways.

For example, we have paid greater supervisory attention to corporate governance. We significantly increased the depth and frequency of interaction between senior supervisors from the Federal Reserve and directors and executives at banks. This supplements our ongoing assessment of management's oversight of risk. Our review entails a critical analysis not only of firm policies, procedures, and limits, but also of the quality of the risk reports escalated to senior management, the capabilities of the firm's risk monitoring program, and the adequacy of control functions.

We have also increased our enforcement activity for violations of law or unsafe or unsound conduct. Since 2009 the Federal Reserve has taken 36 public enforcement actions against institutions supervised by the New York Fed, which included $1.2 billion in fines. On top of this, five firms supervised by the New York Fed paid $1.3 billion into a qualified settlement fund for mortgage borrowers, and the same five institutions were required to provide over $2 billion in other foreclosure prevention assistance. These statistics do not include nonpublic enforcement actions, including restrictions on the further growth of banks that do not have satisfactory risk management regimes. And, earlier this year, we assisted in consigning the concept of "too big to jail" to history when Credit Suisse and BNP Paribas pleaded guilty to criminal charges. I am gratified that the Attorney General and the United States

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[5] Board of Governors of the Federal Reserve System, Press Release, October 23, 2014, available at *http://www.federalreserve.gov/newsevents/press/bcreg/20141023a.htm.*

[6] Daniel Tarullo, "Stress Testing After Five Years", Remarks at the Federal Reserve Third Annual Stress Test Modeling Symposium, Boston, Massachusetts, June 25, 2014, available at *http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm.*

[7] See Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2014: Assessment Framework and Results", March 2014, at 78, available at *http://www.federalreserve.gov/newsevents/press/bcreg/ccar__20140326.pdf.*

[8] See 12 CFR §§225.8(c)(2) and (e)(2)(iv).

[9] See Citigroup, Inc., "Citi Statement on 2014 CCAR Results", March 26, 2014, available at *http://www.citigroup.com/citi/news/2014/140326b.htm.*

Attorney for the Southern District of New York have acknowledged the work of the Federal Reserve in supporting our law enforcement partners.[10]

The New York Fed has also devoted significant resources and attention to the reform of bank culture and conduct. Increased capital and liquidity are important tools to promote financial stability, but in the end a bank is only as trustworthy as the people who work within it. I have personally delivered a strong message that the culture of Wall Street is unacceptable.[11] Bad conduct by bankers damages the public trust placed in banks. In my view, this loss of trust is so severe that it has become a financial stability concern. If bad behavior persists, it would not be unreasonable—and may even be inevitable—for one to conclude that large firms are too big and complex to manage effectively.

Our Nation's largest financial institutions need to repair the loss of public trust in banks. This means a back-to-basics assessment of the purpose of banking, including duties owed to the public in exchange for the privileges banks receive through their bank charters and other functions of law. Among these privileges are deposit insurance and access to a lender of last resort.

As part of this effort, I have proposed four specific reforms to curb incentives for illegal and unduly risky conduct at banks. First, banks should extend the deferral period for compensation to match the timeframe for legal liabilities to materialize—perhaps as long as a decade. Second, banks should create de facto performance bonds wherein deferred compensation for senior managers and material risk takers could be used to satisfy fines against the firm for banker misbehavior. Third, I have urged Congress to enact new Federal legislation creating a database that tracks employees dismissed for illegal or unethical behavior. Fourth, I have requested that Congress amend the Federal Deposit Insurance Act to impose a mandatory ban from the financial system—that is, both the regulated and shadow banking sectors—for any person convicted of a crime of dishonesty while employed at a financial institution.

Supervisory Process

In tandem with our attention to capital, liquidity, and risk management, we have made important changes to the process of supervision.

For starters, the Federal Reserve now makes its most consequential supervisory decisions on a systemwide level through the Large Institution Supervision Coordinating Committee or "LISCC." The committee comprises representatives across professional disciplines from several Reserve Banks and the Board of Governors. The New York Fed supplies only three of its 16 members. LISCC sets supervisory policy for the 15 largest, most systemically important financial institutions in our country and develops innovative, objective, and quantitative methods for assessing these firms on a comparative basis. LISCC also coordinates the supervision of the largest supervised institutions through its Operating Committee, which reviews and approves supervisory plans for exams, receives regular updates on major supervisory issues, and makes material supervisory decisions regarding matters that affect the firms' safety and soundness. In this respect, the Operating Committee provides an important safeguard against regulatory capture by ensuring that no one person or Reserve Bank has the power to make a final decision on a matter of significance.

Another procedural change is our increased application of crossfirm, horizontal review. This technique enables peer-to-peer comparison of banks, facilitates a better assessment of the overall health of the financial system, and safeguards against regulatory capture by providing insight from across the Federal Reserve System. The analysis is done not only at the level of the Board of Governors—for example, through CCAR and Dodd-Frank stress testing—but also within the New York Fed. We hold weekly discussions among senior supervisory and risk officers to identify developing concerns that may pose a systemic risk. A current subject of horizontal analysis is leveraged loans—specifically, whether lax underwriting practices for such loans could pose a significant risk to financial stability.

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[10] See U.S. Department of Justice, "BNP Paribas Agrees To Plead Guilty To Conspiring To Process Transactions Through the U.S. Financial System for Sudanese, Iranian, and Cuban Entities Subject to U.S. Economic Sanctions", June 30, 2014, available at *http://www.justice.gov/usao/nys/pressreleases/June14/BNPParibasPlea.php.*

[11] See William Dudley, "Ending Too Big to Fail", Remarks at the Global Economic Policy Forum, New York City, November 7, 2013, available at *http://www.newyorkfed.org/newsevents/speeches/2013/dud131107.html;* William Dudley, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry", Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, Federal Reserve Bank of New York, New York City, October 20, 2014, available at *http://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html.*

In addition, we have reorganized the supervision group at the New York Fed in a number of ways that promote unbiased analysis and professional objectivity. Many of these changes directly reflect the recommendations in a 2009 report that I commissioned from David Beim, which was featured in the recent *This American Life* program about supervision at the New York Fed. For example:

- Over the last 5 years, we have reassigned some of our most senior personnel to front-line positions at the largest supervised institutions. We also recruited experienced executives with financial backgrounds from outside the New York Fed. The purpose of these personnel changes was to position leaders with the confidence and depth of professional experience necessary to challenge the leadership of supervised financial institutions.
- We increased training, especially for more senior examiners. Since 2011, we have required enhanced training for senior supervisory officers on corporate governance, business strategies, and risks. Our goal is to deliver stronger and clearer supervisory views to boards of directors and senior management. Also since that year, we have offered a customized management development program for managers in the supervision group.
- We hired more risk specialists and created the role of business-line specialist to assess the risks and vulnerabilities in firms' business models.
- We continue to require that examiners rotate to another institution after 3 to 5 years. This tenure allows enough time to gain an understanding of a firm without sacrificing examiner independence.
- We have taken concrete steps to encourage examiners to speak up, which we view as a core competency. For example, we evaluate examiners on their level of engagement with colleagues and their willingness to share insights.
- We created programs to encourage peer recognition of good ideas, including funding for new supervision ideas proposed and voted on by supervisory staff.
- We increased the opportunities for feedback to senior managers, including the head of supervision, in addition to other channels already provided by the New York Fed. Among other improvements, we conduct regular town halls and provide a standing, online forum as a device to funnel questions to group leaders. In both settings, questions and answers are offered in an open, transparent manner.
- And we require examination teams to spend more time at New York Fed headquarters and less time "in the field." Additional time at headquarters promotes crossfirm discussion and direct communication between senior managers and examiners. For example, we offer a seminar series at which group leaders discuss key issues in supervision with our supervision staff.

Each and together, these improvements to the substance and process of supervision contribute to financial stability by providing greater insight into bank resiliency and risk. But these enhancements are not self-executing. They depend on the hundreds of examiners who are dedicated professionals working in the public interest. Our examiners fulfill their obligations with considerable care, mindful of the stakes to Main Street when something goes wrong on Wall Street. I am grateful for their efforts.

Reasonable Expectations

Before concluding, let me offer a broader view of what we at the Federal Reserve expect from prudential supervision. Very briefly, I submit that supervision should be fair, conscientious, and effective.

Fair supervision means that the rules are applied consistently across the firms we supervise. We all need to know the rules and follow the same rule book. It also entails a commitment to independence from business or political influence, as envisioned by the Federal Reserve Act 100 years ago.

Conscientious supervision means we must be committed to sustained and, if necessary, radical self-improvement. The Beim report is an example of our willingness to commission and accept self-critical analysis and our commitment to improve. But we cannot stop there. To this end, we will be working with the Board of Governors on its upcoming review of whether the LISCC Operating Committee receives information that is sufficient to reach sound supervisory decisions. One subset of this systemwide inquiry will analyze regulatory capture—specifically, how divergent views are presented to decision makers at the Board. The review is expected to take several months.

Effective supervision means tough supervision and demands a focus on large banks that pose systemic risk. Bank supervisors cannot prevent all fraud or illegal conduct or forestall all undesirable behavior in large, complex financial institutions. But we can help create more resilient, less complex, and better managed organizations that promote, rather than undermine, financial stability.

Conclusion

The Federal Reserve will continue to improve its supervision and regulation of financial institutions. We understand the risks of doing our job poorly and of becoming too close to the firms we supervise. We work hard to avoid these risks and to be as fair, conscientious, and effective as possible. Of course, we are not perfect. We cannot catch or correct every error by a financial institution, and we sometimes make mistakes. But in my view, a good measure of the effectiveness of supervision is the improved strength and stability of banks since the financial crisis. Thanks in part to enhanced supervision and regulation, banks "have the ability to meet their financial obligations and continue to make a broad variety of financial products and services available to households and businesses even in times of economic difficulty."[12] I can promise you that we will always strive to improve and that we will work hard to earn and retain your trust.

I look forward to taking questions.

PREPARED STATEMENT OF DAVID O. BEIM

PROFESSOR OF PROFESSIONAL PRACTICE, COLUMBIA BUSINESS SCHOOL

NOVEMBER 21, 2014

Introduction

My name is David Beim. From 1966 to 1990 I worked as an investment banker for The First Boston Corporation, Bankers Trust Company and Dillon Read & Co, with 2 years (1975–77) as Executive Vice President of the Export-Import Bank of the United States. In 1989 I began to teach as an adjunct at Columbia Business School, and in 1991 joined the faculty of that school as a Professor of Professional Practice.

At Columbia Business School I taught a number of MBA courses including Banking Fundamentals, International Business, Emerging Financial Markets, Corporate Finance, Business Ethics and Corporate Governance over the 25-year period 1989–2014. In addition I taught in a wide range of executive education programs. I retired from Columbia on June 30 of this year.

In 1997 I performed a consultancy study for the Federal Reserve Bank of New York (NY Fed) regarding the effectiveness of its bank examination procedures. In that connection I interviewed a number of bank CEOs and senior NY Fed officials. My overall conclusion was that the NY Fed's examinations were too low-level, too bottom-up. I recommended that each examination should begin top-down, with a view of each bank's strategy for making money and the risks such a strategy would likely entail. That would provide a context for seeing whether such risks were indeed a problem for the particular bank. I believe that this study was well received and significantly affected the way examinations have since been conducted.

In the late spring of 2009 I received a call from Bill Dudley, President of the NY Fed, inviting me to conduct a new consultancy project, this one about systemic risk. The United States, like all other countries, has had numerous banking failures over many years. But the events of 2008 were unlike ordinary bank failures—they represented a systemic financial collapse, in which the capital of almost all major financial institutions was exhausted simultaneously. We have not had a systemic financial collapse in the United States since 1931, and most people thought we would never have another.

The Federal Reserve had not seen these events coming, but neither had almost anyone else. Mr. Dudley wanted me to sit down with eight of his top Senior Vice Presidents and work together through the summer to determine what lessons had been learned, and what changes the NY Fed needed to make in its procedures or in its culture to better understand and foresee systemic problems, i.e., problems affecting not just one bank but all banks jointly. He emphasized that he wanted complete candor so that genuine reforms could be initiated.

The summary of our findings is as follows: "Our review of lessons learned from the crisis reveals a culture that is too risk-averse to respond quickly and flexibly to new challenges. Officers are intensely deferential to their superiors, similar to an

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[12] Scott G. Alvarez, Testimony before the Committee on Financial Services, United States House of Representatives, April 8, 2014, available at *http://www.federalreserve.gov/newsevents/testimony/alvarez20140408a.htm.*

army. Knowledge is too often hoarded in silos. Business organizations including banks have moved away from structured hierarchies in favor of more modern, flexible organizational forms, and [the NY Fed] needs to adopt some of these attributes to be effective in grasping and acting on systemic issues. This requires a significant degree of cultural change and has implications for human resources and management."

We found that NY Fed officers were excessively deferential to their superiors and that the entire organization was excessively deferential to the banks being supervised. There was huge emphasis on consensus. This is in sharp contrast to academic culture, for example, where disagreement and vigorous debate are highly valued. Among our recommendations was one giving officers more incentives for disagreement and contrarian thinking.

I delivered the final draft of our report in late summer, and Mr. Dudley seemed very pleased. The report was of course highly confidential and never intended for public distribution. However in 2010 the Congress created the Financial Crisis Investigative Commission (FCIC) to investigate the causes of the crisis. The FCIC subpoenaed a large number of documents from many agencies including the Federal Reserve, and ended by posting these on its Web site. In this way my confidential report was made public.

Last June I was called by a producer from National Public Radio, who said that its highly regarded program "This American Life" wanted to interview me about the report. I agreed, since the document was already in the public domain, but said I would have to stay within the four corners of the document, which I did. Their story, which aired in late September, connected my report to the story of Carmen Segarra, a NY Fed examiner who was indeed contrarian and outspoken, but who was soon dismissed. At the time of the interview I knew nothing of Carmen Segarra. The program received a great deal of attention, and the present hearings reflect the high level of public interest in this subject.

Regulatory Capture

"Regulatory capture" is a provocative phrase describing an excessively close relationship between a regulator and the companies it regulates. But we need to be careful, since the phrase is used to describe two quite different situations:

1. In what I call the "strong form" of regulatory capture, regulation confers an economic benefit that companies actively want, for example by keeping prices high or restricting competition, and the regulator agrees to supply it to them.
2. In what I call the "weak form" of regulatory capture, regulation is negative for the companies, but the regulator does not strictly enforce the rules, and fails to control company behavior in the way intended by the law.

There is a large academic literature on the strong form of regulatory capture, dating from the 1970s.[1] The financial bailouts of 2008–9, which were undoubtedly a great benefit to the banks, have sometimes been called an example of regulatory capture of the Federal Reserve by the banks. I do not share this view, as the bailouts were an action of the entire U.S. Government and not just one agency. They were an emergency action to prevent the U.S. financial system from total collapse, an event that could have brought us back to the 1930s. In my view this action was entirely in the public interest. If one bank fails it should be closed, but if all banks fail simultaneously the system needs to be rescued. All relevant modern Governments believe the same and did the same. My 2009 report found no evidence that the NY Fed was putting the interests of banks ahead of the public interest.

We did, however, find a great deal of the weak form of regulatory capture, an obvious pattern of timidity toward the banks being regulated: "supervisors paid excessive deference to banks and as a result they were less aggressive in finding issues or in following up on them in a forceful way . . . A very frequent theme in our reviews was a fear of speaking up . . . Ideas get vetted to death."

No one should imagine that the Federal Reserve is unusual in this respect. All bank regulators face the same issue, as indeed do all regulators of economic activity. What causes this timidity? It seems to make a mockery of regulation. Why aren't regulators tougher?

I believe the answer is connected with the general insight, also first explored by economists in the 1970s, that both companies and Government agencies are operated by individuals who have private interests, and that these private interests may drive institutional behavior in unexpected ways. For example, bribery happens to

[1] The seminal article is George Stigler, 1971, "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science* 2:3–21.

some degree in all countries and is an obvious example of the private goals of Government officials undermining public goals.

But short of bribery, which is everywhere illegal, private goals of Government officials can and do undermine public goals in dozens of subtle and legal ways. An individual bank regulator is a human being with ambitions and needs. First, of course, he or she wants to get ahead in the organization, and this generally means agreeing with bosses and colleagues—hence the emphasis on consensus. When an individual regulator disagrees with the position his agency is taking, shutting up and avoiding conflict probably serves his general goal of being well regarded by his colleagues.

More importantly, I believe that bright regulators in mid-career all harbor some hope that they will be offered a good job with one of the regulated companies. Large banks, like other large companies, pay higher salaries than Government agencies, and this creates a powerful incentive for regulators to behave in a deferential manner toward such banks, so that he or she might be well regarded enough to be offered a job.

The NPR broadcast on the NY Fed played detailed recordings of conversations among NY Fed officials about regulating Goldman Sachs, in which the lead regulator, a man named Mike Silva, tells his colleagues that he is going to press Goldman hard but at the moment of truth behaves in a very timid manner toward that bank. Mr. Silva was actually part of the team of eight SVPs with whom I worked in producing my report. He is a bright, articulate man, and like most NY Fed officials is hard working and conscientious. However, in 2013 he left the NY Fed to join GE Capital. How could the possibility of an opportunity like this not have been in the back of his mind when he was making decisions about how tough to be with banks?

Information Asymmetry

Another factor that helps to explain the weak form of regulatory capture is information asymmetry: companies being regulated know a lot more about their businesses than the regulators who are supposed to control them. I witnessed this in my own career when I was the head of investment banking for Bankers Trust Company, which was regulated by NY Fed.

In 1979 I became very interested in swaps, a basic kind of derivative, when they were new and not well understood. I began to build a capacity in my department to offer swaps and we rapidly found our volume increasing. About a year later I got a polite call from the NY Fed asking if they could bring a team over to our bank so that we could explain swaps to them. I readily agreed, and spent several hours explaining swaps to them. However, even after this candid presentation, the officials had only an elementary understanding of swaps compared to the bankers who had been working with them full time. In short, the regulators often struggle to catch up with banks that are innovating and figure out what they are doing.

Information asymmetry puzzles many observers, including the NPR journalists who interviewed me about my NY Fed report. “Can’t a regulator just demand the information, and don’t the banks have to supply it?” they asked. Well yes, I would answer, but there is a difference between information and insight.

Banks supply great quantities of data to regulators, but what do the data mean? What strategy is being pursued and how do these transactions contribute to the strategic goals? Real understanding requires more than numbers. You have to talk to the people involved to understand the meaning of the data.

I believe that regulators are deferential to banks in part because they need banks to share insights into the strategy and meaning of their transactions. Such insights can only be gained if the working relationship is collaborative, not confrontational. Confrontation usually leads to delivering the facts but not more.

I have not visited the NY Fed since my 2009 project, so I know little about what has happened there since, except for articles in the public press. The NPR broadcast about Carmen Segarra in September and the related story in *ProPublica* [2] seem to confirm that the Fed is still surprisingly bland in enforcing its rules against big banks.

A subsequent article in *ProPublica* concerning JPMorgan Chase [3] seems to show that the problems of effective regulation by the NY Fed have not yet been solved. The villain in this story is Dianne Dobbeck, who is portrayed as authoritarian and negative, blocking the NY Fed’s own risk team from investigating the “London Whale” trading losses. The story claims that Ms. Dobbeck had her mind made up

[2] *http://www.propublica.org/article/carmen-segarras-secret-recordings-from-inside-new-york-fed*

[3] *http://www.propublica.org/article/secret-tapes-hint-at-turmoil-in-new-york-fed-team-monitoring-jpmorgan*

and did not want to hear negative information about the bank. This sounds like another example of weak-form regulatory capture.

What Can Be Done?

Regulatory capture, particularly in its weak form, is a widespread problem that goes way beyond banking and undermines much of our regulatory system. So let me come to the bottom line: what can be done about it?

There is quite a lot that the NY Fed and other regulatory agencies can do on their own, with no need for new legislation, many of them detailed in my report.

Informational asymmetry can never be fully solved, but it can be alleviated by upgrading the staff, hiring bright and independent-minded people, giving them extensive opportunities to upgrade their skills and providing more explicit incentives for them to act in independent ways.

This means doing what the big banks have done: decentralize authority and give more responsibility for problem solving to lower-level officers. The culture should be less like an army and more open to questioning and challenging. I understand that the Federal Reserve is in fact moving in the opposite direction, centralizing more regulatory authority in Washington, which in my view is a mistake.

But the most important step to control regulatory capture is one that Congress can and should do: strengthen the "revolving door" laws by prohibiting all regulators from working in the regulated industry for fully 3 years after leaving Government.

The United States has a number of ethics laws that try to restrict various classes of Government employees from moving to private sector companies with whom they have conducted Government work for 1 year. However, these rules are usually narrowly written and have dozens of easy loopholes, so that in practice they seem to have little effect.

I am not an expert in such laws, but I quote the following from a Congressional Research Service publication:[4]

> Under amendments to the Federal Deposit Insurance Act, certain officers and employees of a "Federal banking agency or a Federal reserve bank," who are involved in bank examinations or inspections, are restricted from any compensated employment with those private depository institutions for a period of 1 year after leaving Federal service. This restriction applies to employees who served for at least 2 months during their last year of Federal service as "the senior examiner (or a functionally equivalent position)," and who exercised "continuing, broad responsibility for the examination (or inspection)" of a depository institution or depository institution holding company. These former employees are barred for 1 year from receiving any compensation as an "employee, officer, director, or consultant" from the depository institution, the depository institution holding company that controls such depository institution, or any other company that controls the depository institution, or from the depository institution holding company or any depository institution that is controlled by that the depository institution holding company.

This is narrowly written and restricts only the senior examiner from working for the very bank he examined. If you really want to push back against regulatory capture, the law needs to be greatly broadened: it should apply to all officers of a bank regulator working for any bank for a period of 3 years.

Few bank regulators are offered jobs by the very bank they were regulating, but bank regulators as a group form a kind of community with all regulated banks, where many people know each other. No one can predict which individual will be offered a job by which bank, but it is highly predictable that some regulators will be offered a job by some banks. This likelihood affects the way all regulators deal with all banks—how could it not?

To reduce regulatory capture and stiffen the backbones of individual regulators, this easy revolving door must be stopped. This would force more individuals to make an identity decision early in their careers: am I a regulator for the long term or am I a banker?

Ethics laws in general and revolving door laws in particular tend to be unpopular with the people they affect, since they reduce choices. But the long-term effect would be a stronger boundary between the regulators and the banks. It would be a major step toward better regulation of banks, and I recommend it to you as the most important step you could take to reduce regulatory capture.

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[4] "Post-Employment, 'Revolving Door', Laws for Federal Personnel", by Jack Maskell, Legislative Attorney, January 7, 2014.

PREPARED STATEMENT OF ROBERT C. HOCKETT

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NOVEMBER 21, 2014

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 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 3 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 occa-

[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 JPMorgan", *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.*

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

[5] Sources cited supra, n. 3.

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

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

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

[9] Web page available at *http://www.nycbar.org/banking-law.*

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

[11] Robert Hockett, "Cases and Materials on Finance and Its Regulation" (West, 2014) (forthcoming).

sioned 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 2012–13, 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 UK, 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.

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.

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[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. and 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. and 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).

[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.

Background to Today's Hearings: Supervisory Role of the Fed, Post-Crisis Reform Proposals, and 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. 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 nonfluctuating 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.

[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-a-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.

[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 U.S.C. 223a.

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 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-a-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 JPMorgan 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] "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 and loan, mutual, and (optionally) securities holding companies;[41] third, oversight and enforcement of the

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[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.
[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.
[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.

"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]

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

[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.

"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.

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 nonsystemically focused attentions permitted them to notice. Professor Beim found this shortcoming to have been reinforced, moreover, by certain structural proclivities toward 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

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[51] See, e.g., sources cited supra, n. 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.*

[52] See Beim Report, supra, n. 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.

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 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 and 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

[54] See, e.g., Hockett, "Macroprudential Turn", supra, n. 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/*.

[55] Also "GC."

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 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 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

[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 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.*

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 discouraging.

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 6 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 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 employ-

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[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 Web page: *http://www.lawschool.cornell.edu/spotlights/Robert-Hockett-Co-Authors-The-Way-Forward.cfm.*

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

[63] Id. Also media collected at this Web page: *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 Web sites: *http://www.federalreserve.gov/newsevents/speech/2014speech.htm; http://www.newyorkfed.org/newsevents/speeches/.*

ees, 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 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.

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 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

[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.

[68] See Beim Report, supra, n. 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.*

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 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 vig-

[69] See, e.g., Robert Sutton, "The No A-Hole Rule: Building a Civilized Workplace and Surviving One That Isn't" (2010).

ilance 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.

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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.*

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 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.

PREPARED STATEMENT OF NORBERT J. MICHEL

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NOVEMBER 21, 2014

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", Federal Reserve Bank of Richmond 2013 Annual Report (2014)

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 "macroprudential" 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).

Regulatory Capture, the Beim Report, and Recent FRBNY Issues

It has long been recognized that, over time, Government regulatory agencies tend to be "captured" by the firms they supervise.[1] 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."[2] 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.[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.[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.[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 JPMorgan Chase and Lehman Brothers were FRBNY Class A directors prior to the crisis, and that there were "at least 18 former and current Class

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[1] See Roger Sherman, "Market Regulation" (Boston, MA: Pearson, 2008), and Richard A. Posner, "The Concept of Regulatory Capture: A Short, Inglorious History", in Daniel Carpenter and David Moss, eds., *Preventing Regulatory Capture: Special Interest Influence and How To Limit It,* The Tobin Project, 2013, *http://www.tobinproject.org/sites/tobinproject.org/files/assets/Posner%20The%20Concept%20of%20Regulatory%20Capture%20(1-16-13).pdf* (accessed November 18, 2014). The capture theory was originally developed in the seminal work of George Stigler, "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science,* Vol. 2 (Spring 1971), pp. 3–21. Stigler argued that Governments stifle competition because they end up regulating at the behest of firms who capture regulatory agencies.

[2] See David Lucca, Amit Seru, and Francesco Trebbi, "The Revolving Door and Worker Flows in Banking Regulation", Federal Reserve Bank of New York Staff Report No. 678, June 2014, p. 4, *http://www.newyorkfed.org/research/staff_reports/sr678.pdf* (accessed November 18, 2014).

[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?" *The Journal of Law & Economics,* Vol. 55, No. 2 (2012), pp. 421–436.

[4] Essentially, this principle is also rooted in the U.S. Constitution. As noted by James Madison in the 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."

[5] See Jake Bernstein, "Inside the New York Fed: Secret Recordings and a Culture Clash", *ProPublica*, September 26, 2014, *http://www.propublica.org/article/carmen-segarras-secret-recordings-from-inside-new-york-fed* (accessed November 18, 2014).

A, B, and C directors from 9 Reserve banks who were affiliated with institutions that used at least one emergency [lending] program."[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.

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."[7] 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."[8] 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."[9] 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—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."[10] 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 nonbank financial institutions are now so large and integral to the financial sector as a whole that their failure could lead to a systemic event."[11] Furthermore, in the 2 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.[12]

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 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 col-

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[6] See Government Accountability Office, "Federal Reserve Bank Governance: Opportunities Exist To Broaden Director Recruitment Efforts and Increase Transparency", October 2011, GAO-12-18, p. 39.

[7] See Government Accountability Office, "Federal Reserve System Opportunities Exist To Strengthen Policies and Processes for Managing Emergency Assistance", July 2011, GAO-11-696, p. 80.

[8] See 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 nonsupervised 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.

[9] David Beim and Christopher McCurdy, "Federal Reserve Bank of New York Report on Systemic Risk and Bank Supervision", August 18, 2009, discussion draft, p. 1.

[10] Ibid., p. 14.

[11] See "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO", Office of Federal Housing Enterprise Oversight, February 2003, p. 5, *http://www.fhfa.gov/PolicyProgramsResearch/Research/PaperDocuments/SYSTEMIC%20RISK.pdf* (accessed November 18, 2014).

[12] See Charles Calomiris and Richard Herring, "Why and How To Design a Contingent Convertible Debt Requirement", in Y. Fuchita, R. Herring, and R. Litan, eds., "Rocky Times: New Perspectives on Financial Stability" (Washington, DC: Brookings Institution Press, 2012), pp. 117–162.

lapse 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 individual banks. Further, the Fed, Congress, and the U.S. Treasury have openly discussed their roles in stemming economywide 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. [14] Additionally, in 1996, the Fed specifically accounted for systemwide 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." [15] 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. [16] 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 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

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[13] Beim and McCurdy, p. 14.

[14] See John P. LaWare, testimony before the Subcommittee on Economic Stabilization, Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, May 9, 1991, *https://fraser.stlouisfed.org/docs/historical/federal%20reserve%20history/bog_members_statements/laware_19910509.pdf* (accessed November 18, 2014).

[15] The remaining letters of the acronym are as follows: Capital adequacy, Asset quality, Management administration, Earnings, and Liquidity. See press release, Federal Reserve Board of Governors, December 24, 1996, *http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm* (accessed November 18, 2014).

[16] See Paul H. Kupiec, "Basel III: Some Costs Will Outweigh the Benefits", American Enterprise Institute for Public Policy Research Financial Services Outlook, November 2013, *http://www.aei.org/outlook/economics/financial-services/banking/basel-iii-some-costs-will-outweigh-the-benefits/* (accessed November 18, 2014). See also Charles Calomiris, "The Unlikely Return to 'Normalcy' in U.S. Monetary Policy", Shadow Open Market Committee, November 20, 2012, *http://shadowfed.org/wp-content/uploads/2012/11/Calomiris-SOMC-Nov2012.pdf* (accessed November 18, 2014).

[17] See Calomiris, "The Unlikely Return to 'Normalcy' in U.S. Monetary Policy", p. 3.

[18] For more on the risk-bucket approach, see Howard D. Crosse, "Management Policies for Commercial Banks" (Englewood Cliffs, NJ: Prentice Hall, 1962), pp. 169–172. The later amendment regarding the lower weight for highly rated private-label mortgage securities was known as the recourse rule. See J. Friedman, and K. Wladmir, "Engineering the Financial Crisis: Sys-

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 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 usable capital cushions because banks can only breach them if their regulator provides forbearance.[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 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 microlevel 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 deter-

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temic Risk and the Failure of Regulation" (Philadelphia, PA: University of Pennsylvania Press, 2011), ch. 2, p. 69.

[19] Friedman and Wladmir, p. 81.

[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 6 years leading up to the crisis. Juliusz Jablecki and Mateusz Machaj, "The Regulated Meltdown of 2008", *Critical Review* Vol. 21, Nos. 2–3 (2009), pp. 306–307.

[21] One other downside is that the new regulations appear to be at least partly responsible for a drop in the number of new banks created and for increased concentration in the industry—a risk not addressed in Basel III. The number of banking institutions in the U.S. is now at its lowest level since the Great Depression. See Ryan Tracy, "Tally of U.S. Banks Sinks to Record Low: Small Lenders Are Having the Hardest Time With New Rules, Weak Economy and Low Interest Rates", *The Wall Street Journal*, December 3, 2013, *http://online.wsj.com/news/articles/SB10001424052702304579404579232343313671258?mod=WSJ_hps_LEFTTopStories* (accessed November 18, 2014).

mining capital requirements. The Fed conducts stress tests by running a mathematical model to estimate 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 naive belief that the macroeconomy 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 1 year as opposed to on a short-term basis.[24] 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.[25] 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.[26]

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.[27] 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 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.[28] The fact that Dodd-Frank has given the Fed even

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[22] See Kevin Dowd, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve", Cato Institute Policy Analysis No. 754, September 3, 2014, *http://www.cato.org/publications/policy-analysis/math-gone-mad* (accessed November 18, 2014).

[23] More generally, the Fed has never consistently adhered to the classic prescription for a LLR: provide temporary liquidity to solvent institutions, against good collateral, at penalty rates. See Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What To Do About It", Heritage Foundation Backgrounder No. 2943, August 20, 2014, *http://www.heritage.org/research/reports/2014/08/the-feds-failure-as-a-lender-of-last-resort-what-to-do-about-it?ac=1* (accessed November 18, 2014).

[24] For a complete history of the Fed's overly generous lending policies, see Anna Schwartz, "The Misuse of the Fed's Discount Window", *Federal Reserve Bank of St. Louis Review,* Vol. 74, No. 5 (September/October 1992), p. 58, *http://research.stlouisfed.org/publications/review/article/2582* (accessed November 18, 2014).

[25] Schwartz, "The Misuse of the Fed's Discount Window", pp. 58–59.

[26] Ibid., p. 62.

[27] See N. Boyson, J. Helwege, and J. Jindra, "Crises, Liquidity Shocks, and Fire Sales at Commercial Banks", Financial Management, January 30, 2014, *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021386* (accessed November 18, 2014). Using data from 1980 to 2008, the study shows that funding does not typically dry up in a crisis (even the recent subprime crisis) but weak banks do, in fact, face declines in capital market borrowing.

[28] The U.S. Government Accountability Office (GAO) estimates that from December 1, 2007, through July 21, 2010, the Federal Reserve lent financial firms more than $16 trillion through its Broad-Based Emergency Programs. See U.S. Government Accountability Office, "Federal Reserve System: Opportunities Exist To Strengthen Policies and Processes for Managing Emergency Assistance", Report to Congressional Addressees, July 2011, GAO-11-696, p. 131, *http://www.gao.gov/new.items/d11696.pdf* (accessed November 18, 2014). Subsidy figures are taken from Bob Ivry, Bradley Keoun, and Phil Kuntz, "Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress", *Bloomberg Markets Magazine,* November 27, 2011, *http://*

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.[29] Such a shift in policy would have been counter to the historical trend in the U.S. The 1999 Gramm-Leach-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 Finan-

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www.bloomberg.com/news/print/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html (accessed November 18, 2014).

[29] See U.S. Department Of The Treasury, "Blueprint for a Modernized Financial Regulatory Structure", March 2008, (accessed November 18, 2014).

[30] See Charles Calomiris, "Alan Greenspan's Legacy: An Early Look; The Regulatory Record Of The Greenspan Fed", American Economic Association Papers and Proceedings, 2006, 96, pp. 170–173, *https://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/4435/Greenspan__Fed.pdf* (accessed November 18, 2014).

[31] See M. Goodfriend and R. King, "Financial Deregulation, Monetary Policy, and Central Banking", Federal Reserve Bank of Richmond Economic Review (May/June 1988), *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, *http://www.nber.org/papers/w17401* (accessed November 18, 2014).

cial 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.

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.