EXAMINING THE RELATIONSHIP BETWEEN PRUDENTIAL REGULATION AND MONETARY POLICY AT THE FEDERAL RESERVE

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

AND THE

SUBCOMMITTEE ON MONETARY POLICY AND TRADE

OF THE

COMMITTEE ON FINANCIAL SERVICES

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WITNESSES

TUESDAY, SEPTEMBER 12, 2017

APPENDIX

EXAMINING THE RELATIONSHIP BETWEEN PRUDENTIAL REGULATION AND MONETARY POLICY AT THE FEDERAL RESERVE

Tuesday, September 12, 2017

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
AND SUBCOMMITTEE ON MONETARY
POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Andy Barr [chairman of the Subcommittee on Monetary Policy and Trade] presiding.

Members present: Representatives Luetkemeyer, Barr, Rothfus, Royce, Huizenga, Pittenger, Tipton, Hill, Emmer, Davidson, Kustoff, Tenney, Hollingsworth; Clay, Moore, Sherman, Scott, Foster, Kildee, and Heck.

Ex officio present: Representative Hensarling.

Chairman BARR. The subcommittees will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittees at any time.

Today's hearing is entitled, "Examining the Relationship Between Prudential Regulation and Monetary Policy at the Federal Reserve."

I now recognize myself for 2½ minutes to give an opening statement.

Congress tasked the Federal Reserve System with responsibilities for both monetary policy and financial regulation. A fundamental question for today is whether these responsibilities complement or conflict with each other. The stakes are much more than academic. Monetary policy and financial regulation play foundational roles in the economic opportunities that can and should be available to every American household.

To fully realize these opportunities, we need monetary policies and financial regulations to build from the ground up. Only in that way can real goods and services, which include labor, reliably find their most promising opportunities and do so in a timely and efficient manner.

Today, we will examine how this most basic of economic services can be produced more consistently and distributed more broadly. We will examine whether monetary policy and financial regulation should be housed under the same roof as it is in our Federal Reserve System or if monetary policy and financial regulation could both work better with greater independence and accountability.

If monetary policy and financial regulation do not work, then our economy cannot work. When monetary policies and financial regulations lack independence and accountability, even the most dutiful efforts from households and businesses cannot bridge the gap to our full potential. Viewed in this light, Americans are rightly disappointed with our economic opportunities. Despite 8 years of recovery, growth has been slow and weak, and our economy has yet to realize its full potential. The accumulated loss of economic opportunity has risen to almost $13 trillion. That is almost $100,000 per household on average and considerably larger than China's economy, the world's second largest.

Putting an end to these losses is not enough. We must reestablish a more vibrant and resilient economy. The 3-percent growth we produced last quarter is a good start. To build on that promising economic report, however, we must make sure that our institutions for monetary policy and financial regulation are effectively organized.

I look forward to testimony from this afternoon's distinguished witnesses on how we can do just that.

The Chair now recognizes the ranking member of the Subcommittee on Monetary Policy and Trade, the gentlelady from Wisconsin, Gwen Moore, for 5 minutes for an opening statement.

Ms. MOORE. Thank so much, Mr. Chairman.

Good morning to our witnesses. I have to warn you to prepare yourself for a discussion on the dual mandate of the Fed, despite the title of this hearing. The other side always wants to challenge the propriety of being concerned about employment, which sounds like a good idea to me. I don't know why we would turn employment into a bogeyman.

But that being said, the central question that the Republicans will be asking here today is whether Congress should hamper the Federal Reserve's bank supervision authority. Now let me really quickly address the bad idea of creating a distinction between monetary policy and supervisory functions of the Fed as a raison d'etre for the GOP to cripple banking regulations through the appropriations process so that they can come in and just take money away from the Fed if they don't like what regulations come down the pike.

First, the Fed sets a single interest rate, and then those rates are transmitted to dealer banks. So the Fed uses the institutions it regulates as agents in transmitting monetary policy.

Secondly, the Fed acts as a lender of last resort. So it makes sense for it to oversee and have supervisory functions over those institutions that may one day need liquidity support, unless you want the Fed playing behind the eight ball in a crisis.

Thirdly, the Fed in its function as a central bank sets leverage requirements and underwriting standards. These are both supervisory and useful and targeted tools to combat market bubbles.

Fourth, the supervision provides valuable insight on the economic outlook, which plays a role in how the Fed sets the monetary policy.

Finally, the Fed, of course, is the systemic regulator of our financial system. Following the 2008 financial crisis, Dodd-Frank corrected a glaring hole—no, let me just call it a crater—in making the Fed the regulatory agency of systemically significant firms.

The U.S. economy has grown post-Dodd-Frank, and the financial system is far safer and fairer for consumers. So the "wrong choice" Act was a little more than a poisonous tonic for a healthy system.

And I would reserve the balance of my time, Mr. Chairman.

Chairman BARR. The Chair now recognizes the chairman of the Subcommittee on Financial Institutions and Consumer Credit, the gentleman from Missouri, Blaine Luetkemeyer, for 2½ minutes for an opening statement.

Chairman LUETKEMEYER. Thank you, Mr. Chairman. I appreciate the opportunity to hold this hearing with you. And thank you for your leadership on these issues.

The Financial Institutions Subcommittee has examined the growing role and influence of Federal financial regulators in the post-Dodd-Frank and Obama era. The Federal Reserve in particular seems to be taking its supervisory authority to unparalleled heights. Financial institutions operate in a world of ambiguous guidance and aggressive enforcement. There is a near unanimous feeling that document productions fall into a black hole with the Fed providing little to no meaningful feedback on supervisory issues.

Financial institutions also recognize that Fed policies are inconsistent. Several weeks ago, I had a conversation with two financial institutions that offered a nearly identical product. One Fed district expressed interest in seeing the product offered more widely. Another said the product was a danger to consumers and should be shut down. I have also shared the story of small town and mid-Missouri that I represent, which has been in Fed purgatory for 5 years. The Fed staff decided it didn't like certain products, products to which the FDIC and State of Missouri did not object and in fact suggested be made more readily available. This inconsistent approach to regulation has a negative effect on the economy at the local, national, and global levels. Federal Reserve officials have said their work as prudential regulators informs their monetary policy decisions, helping them to meet the charge to ensure global financial stability. But the reality is that the Federal Reserve's regulatory regime does not necessarily translate to a more stable economy. So we ask ourselves whether or not it is appropriate for the Federal Reserve to be both a prudential regulator and the sole dictator of monetary policy.

As I said in the past, it is time to take the power out of Washington and demand a reasonable financial regulatory structure. It is time to ensure that monetary policy decisions that impact the daily lives of our constituents are made in a sound, unbiased manner. We have a distinguished panel with us today, and I look forward to the testimony.

Thank you, Mr. Chairman.

And I yield back the balance of my time.

Chairman BARR. The gentleman yields back.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 2 minutes for an opening statement.

Mr. SHERMAN. When we are talking about the structure of the Fed, we see a dramatically antidemocratic institution exercising governmental power. First, the New York Bank gets a seat on the Open Market Committee, whereas the California Bank, with twice as many people, doesn't. Second, substantial Fed powers in the hands of those who are put on the Board in an election by banks. This is the only institution of governmental power in our country where we have the one—not "one person, one vote" but "$1 billion in banking, one vote."

Second, our system does not provide capital to small businesses, other than SBA. Small businesses are told: Use your credit cards to finance business expansion or get some sort of shadow bank 36 percent loan. This is where the jobs, technology, and innovation is going to come from, but it won't come from small business if we tell people, tell banks they can't make a prime-plus-5 loan. That is in effect what we have done. Back in the old days, you used to be able to go to a business that had a 1 in 20 chance, 1 in 40 chance of failure, and still make a loan and charge a few extra percentage points. Now we have crushed that out of the banking system to the huge disadvantages of small business.

Speaking of huge, too-big-to-fail is too-big-to-exist. And as the Wells Fargo example shows us, it is too-big-to-manage.

Finally, when it comes to the Fed, we need lower interest rates to create the labor shortage necessary to create major increases in wages in our country. And we have low inflation, so we can do that instead. In this committee room, the Fed is often told to raise interest rates, and that is antithetical to creating the labor shortage that is necessary to help most Americans. And, of course, we need more, not less, quantitative easing.

Finally, the Fed was able over to turn over $100 billion of profit to the United States Government. We usually have the debt clock in back of our witnesses, and now we have been pressuring the Fed to stop giving us the $100 billion by reducing its balance sheet.

I yield back.

Chairman BARR. The gentleman's time has expired.

We will now turn to our witnesses.

Dr. Charles Calomiris is the Henry Kaufman professor of financial institutions at the Columbia Business School, director of the Business School's Program for Financial Studies and its Initiative on Finance and Growth in Emerging Markets, and a professor at Columbia's School of International and Public Affairs. His research spans the areas of banking, corporate finance, financial history, and monetary economics. He is a distinguished visiting fellow at the Hoover Institution, a fellow at the Manhattan Institute, a member of the Shadow Open Market Committee and the Financial Economists Roundtable, and a research associate of the National Bureau of Economic Research. He received a BA in economics from Yale University, magna cum laude, and a Ph.D. in economics from Stanford University. Professor Calomiris holds an honorary doctorate from the University of Basel.

Dr. Steven G. Cecchetti is the Rosen Family Chair in International Finance at the Brandeis International Business School, a research associate of the National Bureau of Economic Research, and a research fellow of the Center for Economic Policy Research.

His research interests include monetary policy, the economics of financial regulation, macroeconomic theory, and price and inflation measurement. From 2008 to 2013, Professor Cecchetti served as economic adviser and head of the Monetary and Economic Department at the Bank for International Settlements. During his time at the Bank for International Settlements, Dr. Cecchetti participated in numerous post-crisis, global regulatory reform initiatives. Professor Cecchetti holds an undergraduate degree from the Massachusetts Institute of Technology, a doctorate from the University of California, Berkeley, and an honorary doctorate in economics from the University of Basel.

Mr. James Sivon is a partner in the Washington, D.C., law firm of Barnett, Sivon & Natter, and is testifying today on behalf of the Financial Services Roundtable as a specialist on financial services law and regulations. Mr. Sivon is a member of the Executive Council of the Federal Bar Association's Banking Law Committee and the Executive Committee of the Exchequer Club. He is a former senior vice president and general counsel for the Association of Bank Holding Companies, and he served as the staff director for the Republican Members of the U.S. House Committee on Banking, Finance, and Urban Affairs. He received his undergraduate degree from Denison University, and his law degree from Georgetown University Law Center.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, each of your written statements will be made a part of the record.

Dr. Calomiris, you are now recognized for 5 minutes.

Mr. CALOMIRIS. Thank you, Mr. Chairman.

STATEMENT OF CHARLES W. CALOMIRIS, HENRY KAUFMAN PROFESSOR OF FINANCIAL INSTITUTIONS, COLUMBIA BUSINESS SCHOOL, COLUMBIA UNIVERSITY

Chairman Barr, Chairman Luetkemeyer, Ranking Members Moore and Clay, it is a pleasure to be with you today, and I will deliver a summary of my written testimony, which I have submitted.

The Federal Reserve is now more politicized than it has been at any time in its history, and, consequently, it is also less independent in its actions than almost any time in its history.

As the Fed accumulates more and bigger political lightning rods of discretionary power, the Fed finds itself increasingly politicized and less independent, both in the realm of monetary policy and in regulatory and supervisory reactions. With discretionary power inevitably comes attacks by special interests seeking to manipulate those powers. The Fed finds itself making political deals with special interests and their representatives largely as a result of its burgeoning discretion.

Also, Fed leaders routinely offer distorted and self-interested opinions about reform proposals while pretending that their opinions should be viewed as unbiased professional analysis. Fed Chair Janet Yellen's August 2017 Jackson Hole speech was a full-throated defense of the status quo of financial regulation. But that speech ignored scores of studies that contradict the narrative that she offered. Many of the studies she ignored were written by economists working at the Federal Reserve Board, the various Federal Reserve banks, the OFR, as well as top academic researchers.

Don't be fooled by the charade: Financial regulatory policy is unbalanced, unlikely to prove effective in achieving its stated objectives, and fails to meet basic standards of due process for a democracy operating under the rule of law.

Reforms can fix those problems. And I want to emphasize I am here to talk about reform, not just deregulation.

The ideal set of reforms would include clear rules to guide both monetary policy and regulatory policy, would avoid undesirable conflicts of interest, especially by placing day-to-day regulatory and supervisory authority in an agency other than the Fed, and would establish administrative and budgetary discipline over the process of regulation supervision.

A less drastic set of reforms that wouldn't remove the Fed from those activities could still accomplish a great deal of improvement. Specifically, if it were possible to establish clear rules governing both monetary and regulatory policy and impose administrative and budgetary discipline on the process of regulation, then, even if regulatory and supervisory powers remained vested in the Fed, the problems associated with Fed conflicts and politicization would be substantially reduced.

Requiring Congress to weigh the social costs and benefits that arise in regulation likely would limit special interest manipulation of regulatory discretion after regulations are passed. I would refer you to a recent paper by two political scientists, Gordon and Rosenthal, for a discussion of how the delegation to regulatory discretion undermined the intended risk-limiting provisions of Dodd-Frank with respect to the mortgage market.

Most importantly, to improve and depoliticize regulation, Congress must establish clear rules that limit the use of unaccountable discretion, must establish budgetary authority for regulatory implementation, and must limit the abusive reliance on guidance in regulatory actions by requiring a much greater reliance on formal rulemaking consistent with the Administrative Procedures Act. If this were done alongside the establishment of a flexible monetary policy rule, that would go a long way toward restoring balance in the regulatory process, depoliticizing the Fed, and ensuring accountability of monitoring regulatory policy. These changes would have major positive consequences for the economy.

Only by clarifying the goals of the Fed and requiring it to work within clear rules can regulatory and monetary policy be improved to make those policies focus on long-run objectives, avoid short-run politicization, ensure appropriate balance and due process in regulation supervision, and make the Fed accountable to the will of the people. Thank you.

[The prepared statement of Dr. Calomiris can be found on page 44 of the appendix.]

Chairman BARR. Thank you.

Dr. Cecchetti, you are now recognized for 5 minutes.

STATEMENT OF STEPHEN G. CECCHETTI, ROSEN FAMILY CHAIR IN INTERNATIONAL FINANCE, BRANDEIS INTERNATIONAL BUSINESS SCHOOL, BRANDEIS UNIVERSITY

Mr. CECCHETTI. Thank you, Chairman Barr, Ranking Member Moore, Ranking Member Clay, and members of the subcommittees. Thank you for inviting me to present my views on the relationship between prudential supervision and monetary policy.

The U.S. financial system is far more resilient today than it was a decade ago. And the likelihood of another systemwide crisis is now lower. As a consequence of post-crisis regulatory reforms, banks have more loss-absorbing equity capital than they had in 2007, and they also face liquidity requirements. And the biggest among them must meet rigorous stress tests. Importantly, this new environment ensures that all large complex financial organizations are much less likely to become a burden on the taxpayer.

It is important that we build on this progress. Regulations must remain sufficiently strict and supervisors must interpret and imply the rules rigorously.

My comments today focus on governance. I will make two points. First, prudential supervision needs to be an independent function sheltered from day-to-day political influence with control of its own budget. And, second, the central bank should be a lead supervisor, supervising systemically important institutions.

Starting with independence, we all agree that, because of their ability to take a long view, independent central banks deliver lower inflation without sacrificing higher employment and higher growth. What is true for monetary policy is true for supervisors. Supervisors can maintain a long-term view if they are sheltered from political influence, including having control over their own budget. This form of independence gives them the ability to credibly enforce rigorous regulatory standards, thereby promoting financial resilience and reducing public costs.

It is equally important that the central bank be a leading supervisor. Supervision is integral to the central bank's core functions as the lender of last resort, the monetary authority and the organization responsible for the health and stability of the overall financial system. Let me explain why.

To protect the integrity of the system and the public finances, the lender of last resort needs to be able to determine a borrowing institution's solvency and the value of the collateral being posted to back a loan. That is, a lender needs to know whether the borrower will be able to repay. This requires confidential financial assessments, knowledge of the firm's business practices, and the skills to value illiquid assets—all things that supervisors generally have.

Importantly, this information has to be available to high-ranking central bank officials on very short notice. In some cases, decisions have to be made in a matter of minutes. So the quality of data must be without question, and it cannot be in the hands of people who may or may not choose to share it.

Turning to the relationship between monetary policy and prudential supervision, to quote from Paul Volcker's testimony before the Financial Services Committee in May of 2010, these two functions are inextricably intertwined. As a practical matter, it is impossible to say where one stops and the other one starts. This is true because the people engaged in these functions operate as a team, sharing knowledge and expertise that each requires from the other. That is, monetary policymakers require supervisory information to evaluate the state of the financial system and supervisors use monetary policymakers' understanding of economic prospects to evaluate the safety and soundness of individual institutions.

Finally, there is the fact that the central bank is responsible for systemic stability. The Federal Reserve does not have an explicit financial stability mandate, but without a stable financial system, the Fed would surely fail to achieve their statutory objectives of maximum employment, stable prices, and moderate long-term interest rates.

Identifying threats to the financial system requires a specialized set of skills as well as day-to-day access, all things that the Federal Reserve has information on.

In closing, let me emphasize my firm belief that when supervisors are independent of political interference, complete with budgetary autonomy, the financial system is more stable and taxpayer costs are lower. Furthermore, a supervisory function is essential for effective and efficient execution of core central bank functions. As the lender of the last resort, the monetary policy authority, and the guardian of health and stability of the overall financial system, it is essential that the Federal Reserve remain a leading supervisor, especially for systemically important institutions. The American public would be ill-served if that were to change.

Thank you. And I would be pleased to respond to questions.

[The prepared statement of Dr. Cecchetti can be found on page 117 of the appendix.]

Chairman BARR. Thank you.

And Mr. Sivon, you are recognized for 5 minutes.

STATEMENT OF JAMES C. SIVON, PARTNER, BARNETT SIVON & NATTER P.C., ON BEHALF OF THE FINANCIAL SERVICES ROUNDTABLE

Mr. SIVON. Chairman Barr, Ranking Member Moore, Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittees, my name is Jim Sivon, and I am appearing on behalf of the Financial Services Roundtable (FSR). Thank you for inviting FSR to participate in the hearing.

A decade ago, gaps in regulations contributed to a financial crisis. Subsequent actions by Congress and regulators in the industry itself have restored the stability of the financial system. Since the crisis, large bank holding companies have increased their capital levels by $700 billion and increased their aggregate holdings of highly liquid assets by more than 50 percent.

Yet some of the regulations put in place since the crisis are holding back a more robust recovery. Data on loans to mortgage borrowers and small businesses illustrates this problem. Also, an analysis of post-crisis lending conducted by the Federal Reserve Board has found that lending growth by the more heavily regulated large banks lags behind lending growth of small banks.

FSR believes that the goal of prudential regulation should be to promote both financial stability and economic growth. FSR appreciates the steps the Board has taken to tailor some regulations. However, more could be done.

I will briefly describe some of FSR's recommendations for tailoring existing regulations, starting with the capital planning and stress testing rules.

The capital planning and stress testing rules have helped FSR members build stronger capital positions and improve risk-management practices. Recent stress test results show that large bank holding companies can withstand an economic downturn even more severe than the 2008 financial crisis. However, the rules could be adjusted without impairing their fundamental purpose. FSR supports more disclosure regarding the models used by the Board in conducting stress tests. Disparities in loss projections between the models used by FSR members and those used by the Board create a level of uncertainty that impacts lending practices.

The stress test results also indicate that we have reached a point where the capital and liquidity rules could be adjusted to promote more economic growth without jeopardizing financial stability. For example, FSR recommends that the supplementary leverage ratio exclude risk-free assets from the calculation of a company's total assets and that the liquidity rule be revised to give more favorable treatment to certain securities and the runoff assumptions in that rule be aligned with the historical experience.

Resolution planning has helped FSR members rationalize operations and contracts, yet this requirement, combined with separate recovery planning requirements, is an area where greater coordination among the agencies is needed. As a result of the Dodd-Frank Act, the Board gained regulatory authority over a number of insurance companies. While the Board has indicated a willingness to tailor regulations for those companies, FSR believes the Board could be more attentive to the differences between the business of insurance and the business of banking.

FSR recommends that the Board and other Federal regulators revisit the Volcker Rule. For example, FSR recommends that the Rule exempt institutions that are not complex or interconnected and that the prohibitions on trading and investments be narrowed.

FSR also has three general recommendations for better aligning financial regulation with economic growth. First, FSR recommends that prudential standards be based upon risk assessments, not arbitrary asset thresholds. Second, FSR encourages Congress to promote greater coordination among Federal financial regulators. Enhancing coordination would not require restructuring of the agencies. Greater coordination could be achieved through the enactment of a set of guiding principles, such as those proposed by the Executive Order on core principles for regulating the U.S. financial system.

Finally, FSR recommends that Congress evaluate the impact of the current expected credit loss, or CECL, accounting standard, which we believe will require an adjustment on how bank capital standards are calculated.

Thank you again for the opportunity to address the Board's role as a prudential regulator, and I would be pleased to answer any questions.

[The prepared statement of Mr. Sivon can be found on page 125 of the appendix.]

Chairman BARR. The gentleman yields back.

And the Chair now recognizes himself for 5 minutes for questions.

Dr. Calomiris, in Dr. Cecchetti's testimony, he argued that monetary policy and prudential supervision are complementary, and I believe he quoted former Chairman Volcker in making the argument that the two are inextricably intertwined. And I hear this frequently when I have conversations with Fed officials who make the argument that their supervisory activities inform their monetary policy decisionmaking.

There are dissenting views on this argument. Vincent Reinhart, the former Secretary of the Fed's Monetary Policy Committee, observed that if the FOMC made materially better decisions because of the Fed's role and supervision, there should be instances of informed discussion of the linkages. Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that historical resource. I don't think they will be able to do so.

Lars Svenson, who served on the faculty of Princeton and as a Deputy Governor for the Central Bank of Sweden, presented research to the Federal Reserve Bank of Boston in 2015, arguing that, "monetary policy cannot achieve financial stability."

And even former Fed Chairman Ben Bernanke expressed concern about expanding the Fed's dual mandate to also include responsibility for "reducing risks to financial stability."

So my question to you, Dr. Calomiris, is, could we enjoy better monetary policy and financial regulation if there was more independence and accountability?

Mr. CALOMIRIS. Absolutely. And I think there is a confusion between—that often comes up among three different activities. One of them is called regulation. The other is called supervision. And the third one is called examination. Now, in the Treasury White Paper of 2008, where they proposed removing the Fed from day-to-day control over regulation, supervision, they specifically pointed out that that would not mean that the Fed would be removed from constant contact with financial institutions and from the participation examination process which is necessary to its role as lender of last resort. And that is what Paul Volcker was referring to. And when Paul Volcker was testifying about those matters, he also pointed out, very much consistent with my testimony, that the increased regulatory functions that were envisioned in Dodd-Frank for the Fed were going to be a politicization problem.

Chairman BARR. Can I follow up right there?

Mr. CALOMIRIS. It is a very important distinction.

Chairman BARR. In the argument about politicization, can you give a concrete example or two of how the combination of Fed regulation and monetary policy politicizes each of them?

Mr. CALOMIRIS. Yes. Well, the most common pattern over the past few decades has been that Fed officials are extremely concerned about insulating their independence in monetary policy, and they often basically use regulatory policy as a sacrificial lamb. So they make political deals on the regulatory policy side in order to preserve the monetary policy autonomy. Now they wouldn't need to do that if monetary policy actually followed rules, because then that would ensure, that would defend them against those attacks.

So, by combining the regulatory policy and the monetary policy, basically, the Fed has often been put into a position—I am not attacking individual Fed policymakers—where they make concessions to special interests on regulatory policy in order to try to defend their discretion in monetary policy.

I can give you a few recent examples. I think the Fed's complicity in Operation Choke Point was a disgrace. That was true of the other regulators too, by the way. But this is something where basically if we can have our regulatory officials engaging in Operation Choke Point, there is pretty much nothing that we can't have them engaged in. We are not protected in any way for living in a country, a popular sovereignty country under rule of law. And that was clearly under political pressure and, again, deals that are being made with certain constituencies.

And I think that there are other examples. There have been rumors at the highest levels of the Federal Reserve, people I know, that actually Members of Congress have been very involved in trying to get appointments to occur in certain Federal Reserve presidencies. I can go on. There is a long list.

Chairman BARR. In the remaining time, do you think that funding the Fed's regulatory and supervisory responsibilities through appropriations would strengthen monetary policy independence?

Mr. CALOMIRIS. Absolutely. And it would because it would, again, help defend the Fed policymakers as all rules do against this kind of special interest interventions.

I would also—

Chairman BARR. My time has expired on that so I am going to have to cut you off there. Thank you for the testimony.

The Chair now recognizes the distinguished ranking member, Congresswoman Gwen Moore, for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman.

As I expected, this is a tremendous panel, a tremendous knowledge base, and I appreciate the witnesses for being here.

I am just feeling a little bit puzzled and confused because this hearing is talking about the supervisory responsibilities of the Fed and setting monetary policy and discussions about the independence of the Fed. And it is not clear to me how subjecting them to the appropriations process makes them more independent. I have meetings in my office all the time with bankers who—people who want us to do this or to do that. And if you can get the ear of whomever is in the Majority at any given time, and the appropriators, then you can wield your weight. So it is not really clear to me how subjecting them to the appropriations process makes them independent. It is kind of oxymoronic.

Wouldn't you agree with that, Dr. Cecchetti?

Mr. CECCHETTI. Yes, I would. I think that—

Ms. MOORE. And please give us the examples you weren't able to give us during your short testimony about how this works.

Mr. CECCHETTI. Yes, there is a set of very straightforward examples. First of all, let my start by saying that one of the Basel Committee's core principles for effective supervision is independence of the supervisors, including independent budgetary authority. I agree with you that it is very difficult to understand how giving politicians the control of budget is a way of improving people's independence.

I do agree, however, that in a Congressional, in a democratic process with the Congress, that it is your role to give objectives to independent authorities and then to hold them accountable for meeting those objectives.

The examples that I would point to would be primarily—there are two examples that I would point to domestically and several internationally. So the Federal Home Loan Banks were subjected to the appropriations process, and we ended up with the savings and loan crisis. OFHEO was subjected to the appropriations process, and we ended up with Fannie Mae and Freddie Mac on the government's—as being in conservatorship.

If I look internationally, I can point to the cases in Korea, Indonesia where the crises in the late 1990s occurred, and those were crises that occurred as a consequence of supervision being political. And, finally, I would say—

Ms. MOORE. How about Zimbabwe?

Mr. CECCHETTI. Zimbabwe has even bigger problems. They don't have independent monetary policy either. So I think that these—in most of these other examples, we at least independent monetary—

Ms. MOORE. Let me ask you this follow-up question. Unless I am hearing wrong, it almost sounds to me that people are challenging the role of central banks globally. If we are suggesting a model where we create some new ghost agency that does the supervision versus our central banks, what are we proposing to model for the rest of the world, and how would this work? Central banks typically have the credibility because they are independent—can you just weigh in on that?

Mr. CECCHETTI. Yes, I think that is an extremely good point. And I think that—one of the things that I would say is that the lender—I emphasized in my comments and you did as well in your introduction about the lender-of-last-resort function. I think the lender-of-last-resort function relies extremely heavily on supervisory information, on the information about the safety and soundness of an institution and about the quality of the assets that it has on its balance sheet. If someone else is doing that, then what that means is that you are going to have the lending being done outside the central banks. So, as you point out, you would need to create a shadow central bank somehow. And I can't imagine having a second central bank.

Ms. MOORE. One last question in my remaining seconds here that is a source of confusion for me. If we are pushing for independence of the bank—I keep hearing this notion that we need to have some sort of monetary rule. We had Dr. Taylor here, for example. How does having some kind of rule square with a bank being independent?

Mr. CECCHETTI. I think we are out of time, but the answer is it doesn't really square with that. And what we need is an objective that is set by you, the Congress, and then accountability for meeting that objective.

Ms. MOORE. Thank you for your indulgence and thank you.

Chairman BARR. The gentlelady's time has expired.

The Chair now recognizes the chairman of the Financial Institutions and Consumer Credit Subcommittee, Mr. Luetkemeyer, for 5 minutes.

Chairman LUETKEMEYER. Thank you, Mr. Chairman.

Before I begin my questioning, I would like to recognize that we are missing a few of our colleagues today. Some, like Mr. Posey and Mr. Ross, are home in Florida dealing with the aftermath of Hurricane Irma. Our thoughts are with them and all those impacted by not only Irma but Hurricane Harvey as well.

Our prayers are also with our friend and colleague, Barry Loudermilk, who was injured in a car accident early this morning. Both Congressman Loudermilk and his wife were transported to the hospital with non-life-threatening injuries and have been released. We will keep both of them in our thoughts, and pray for a speedy recovery for both Barry and his wife, Desiree.

As we can see, life goes on, but life is affected, and it is very, very important. As important as this hearing is, keep it in perspective.

Thank you, gentlemen, for being here today. It is certainly an honor to be able to discuss with you some concerns and some information we would like to get from you with regards to Fed regulation and monetary policy.

Mr. Sivon, last month, I sent a letter to Chair Yellen expressing concern over the FBO rule and the impact it would have, not only on foreign banks in the United States but also on U.S. banks operating internationally. We are on the cusp of seeing capital unnecessarily ring-fenced across the globe. Does that really contribute to global financial security? As a follow-up, is there any argument to be made that the Fed's actions have dampened the global economy?

Mr. SIVON. Thank you, Congressman.

In my testimony, I expressed that one of the major concerns of the Roundtable is a lack of coordination and cooperation here domestically among the various Federal financial regulatory agencies. That applies globally as well. And so the issue that you have raised is illustrative of the fact that there is a lack of sufficient coordination among international regulators that is leading to some consequences, and one of those consequences is ring-fencing, where institutions are asked to trap certain assets and capital in certain locations and then do not have the ability and flexibility to move those as business needs.

Chairman LUETKEMEYER. And in your judgement, I assume you believe that does affect the global economy?

Mr. SIVON. Yes, I do, and I would suggest that there is a need for some kind of overarching principles that international regulators, including the Fed, could agree upon to avoid that type of consequence.

Chairman LUETKEMEYER. You talked about the coordination not only globally, but you also mentioned within our country here. And one of the things—I point to the Treasury report recently put out back in, I think it was June. And in the back of the report here, it has a lot of recommendations, and one of them deals with trying to stop the overlap of regulations, to find more coordination between all the different regulatory agencies. And I guess in here, it talks—it lists the agency that it should be applicable to, and it has gotten the Fed in a lot of these situations. Have you seen the report? And do you believe that this is a pretty good synopsis of what needs to transpire to improve our financial structure?

Mr. SIVON. Yes, sir. We have looked at that report. FSR submitted its own set of recommendations to Treasury as they prepared that report. And many of our recommendations in fact are reflected in the final report. We do think there is a need for greater coordination among the regulators. And one of the specific suggestions that we have in the testimony today is that Congress could adopt some overarching principles to guide the regulators in their separate missions. The core principles that were put out in the Executive Order on financial stability would provide some guidance for them.

Chairman LUETKEMEYER. Our good friend, the ranking member, seems to worry about the independence of the regulators. I can tell you, being a former regulator, there is no reason for them not to have some oversight as well. Everybody needs to have oversight. And regulators need to have oversight as well. I think it is important.

You also made a comment in your testimony with regards to systemically important financial institutions and indicated that you preferred a risk-based assessment model versus a threshold. Could you elaborate just for a few seconds?

Mr. SIVON. Yes, I would be happy to. In fact, FSR specifically supports the legislation that you introduced that would provide for the designation of systemically important institutions through some type of risk methodology rather than a simple asset threshold. We think that is a more constructive and tailored approach than what exists today.

Chairman LUETKEMEYER. Very quickly, you also talked about CECL. Could you elaborate on it just a little bit and explain what it is and your thoughts?

Mr. SIVON. CECL was a fundamental accounting change that changes the way banks have set up reserves for the past 40 years. Previously, banks have, and today they still set up reserves based on the probability of a loss, and then when the loss occurs, they will book the reserve.

Chairman LUETKEMEYER. How does that affect the monetary policy?

Mr. SIVON. Let me just finish with what CECL does. What CECL does is, it says: You have to put up your reserve at the beginning of the loan. You have to estimate where the economy is going, forecast then the amount to put into your reserve.

Our concern is that CECL doesn't hit monetary policy as much as it hits capital requirements. We think that what this does is it creates the loss reserve to be the equivalent of capital, and so the loss reserve, in our opinion, should get tier 1 capital treatment under the capital rules.

Chairman LUETKEMEYER. So you think one of the tools for being a banker today is having a crystal ball?

Mr. SIVON. It is very difficult to predict the future.

Chairman LUETKEMEYER. That would seem to be the approach. Thank you very much. My time has expired.

Chairman BARR. The gentleman's time has expired.

The Chair now recognizes the ranking member of the Financial Institutions Subcommittee, Mr. Clay from Missouri.

Mr. CLAY. Thank you, Mr. Chairman.

Dr. Cecchetti, as you know, the Dodd-Frank Act, among other things, significantly enhanced the macroprudential responsibilities of the Federal Reserve. In testimony by former Vice Chairman Donald Kohn before this committee back in 2009, Vice Chairman Kohn wrote, "The Federal Reserve's monetary policy objectives are closely aligned with those of minimizing systemic risk. To the extent that the proposed new regulatory framework would contribute to greater financial stability, it should improve the ability of monetary policy to achieve maximum employment and stable prices."

Do you agree with Dr. Kohn's assessment?

Mr. CECCHETTI. I do agree with his assessment. I think that this is true for several reasons. The first one is that financial stability is necessarily the basis for stability in the entire economic system. And so, if it is the case that the monetary policy is to achieve its mandated objectives of stable prices and maximum sustainable employment, then financial stability is a foundation for that.

The second thing that I would say is that, if it is the case that the financial system becomes unstable and monetary policy needs to react to that financial instability, it takes away from its ability to do its primary job. And I think what that means is that there is really another set of tools that we need. And this is why it is that many people have focused on trying to generate tools that would ensure financial stability and allow interest rates especially to be the instrument that is used for price stability and maximum sustainable growth.

Mr. CLAY. And if you had the Federal Reserve and its leadership in one of your courses at the university, what grade would you give them for the past 4 or 5 years? How have they performed?

Mr. CECCHETTI. I think they have performed extremely well. You have to take into account that they did it in real time. Maybe, in hindsight, we could give them an A-minus, but if we had to grade them along the way, we would give them an A.

Mr. CLAY. Mr. Chairman, that is a pretty good grade from what I know about school and educating people.

Let me ask all of the witnesses: In addition to strengthening the capital positions of the Nation's banks, can each of you comment on how the collection of a standardized data set from the largest financial institutions in the U.S. is likely to help inform the Fed's various policymaking roles, including its supervisory and monetary policy function?

Starting with you, Dr. Calomiris, 30 seconds.

Mr. CALOMIRIS. Yes. That's an interesting question. I have actually been pointing to some deficiencies in the data that is being collected and used that I think should be remedied. The most obvious one is, for example, Fed stress tests are currently based on Y–14 and Y–9 data, which are pretty irrelevant for stress test purposes. They should be collecting information based on the managerial accounting of the bank, which would allow them to really understand the bank as a business. They don't do that.

Mr. CLAY. Dr. Cecchetti?

Mr. CECCHETTI. I think the Fed is the guardian of financial stability and needs to be able to measure aggregate systemic risk, and to judge how it is distributed in the financial system. And this requires, in my view, access to intermediaries' exposure information, which is more than we are getting right now. All we have is accounting of assets and liabilities, primarily in some derivatives. The degree to which they are going to be able to transmit shocks, so we need to be able to create network models of how banks are related to each other. This is extremely detailed, and I think it would be very valuable.

Mr. CLAY. Thank you.

Mr. Sivon, how would data collection—

Mr. SIVON. As Professor Calomiris indicates, the Fed stress tests today are based on FRY–14 data that is collected. And we have some concerns about the manner in which—while the Fed is—and the FSR have had a nice dialogue on the manner in which it is collected, we do have some concerns that the monthly reports are not really needed and that institutions need some additional time to implement changes in those reporting requirements.

We would also like to see the release of some of that data on aggregated basis.

Mr. CLAY. Thank you.

My time is up. I yield back.

Chairman BARR. The gentleman's time has expired.

The Chair recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you.

Mr. Sivon, in your testimony, you brought up some of the challenges associated with the supplementary leverage ratio, or SLR, and how it is calculated. I share your concerns about this problem. I have introduced legislation, H.R. 2121, the Pension, Endowment, and Mutual Fund Access to Banking Act, to address this issue for custody banks. Many members of this committee are cosponsors of this bill. In your testimony, you wrote, "Banking regulators should revise the calculation of the supplementary leverage ratio to exclude risk-free assets from the calculation of a company's total assets for purposes of the ratio. This would include reserves held at the Federal Reserve, cash, and Treasury securities."

As you may know, the Treasury Department's recent report on banks and credit unions also endorses this idea. Governor Powell and Chair Yellen have also expressed openness to this concept. Why do you believe that excluding risk-free assets, like cash held at central banks, from SRL makes sense?

Mr. SIVON. First of all, FSR supports your legislation and would like to see it expanded to cover all types of banks, not just custody banks, because we do think it makes sense. It would free up some assets that could then be put into more productive use. These are risk-free assets that, in our opinion, do not need to be counted as part of the leverage ratio.

Mr. ROTHFUS. Is there a specific impact for custody banks with respect to this?

Mr. SIVON. It poses a special issue for custody banks because that is the very nature of those institutions. They are holding a lot of deposits, and so they place them at the Fed for security purposes.

Mr. ROTHFUS. Dr. Calomiris, as you know, Professor Cecchetti takes a very different view of the extent and benefits of interaction between monetary policy and supervisory and regulatory functions at the central bank. In his testimony, he writes that, "a supervisory function is essential for effective and efficient execution of core central bank functions."

However, in your testimony, you assert, "There is no evidence of any synergy between monetary and regulatory policy." Why do you take a different view from the professor?

Mr. CALOMIRIS. Again, I think language is very important. People often confound the informational or examination with the regulatory role. Regulation is setting the rules. There is absolutely no connection between making law and doing monetary policy. There is a lot of connection between having an ongoing access to examination to participate in examinations. Again, this was exactly the distinction that was made very clear in the 2008 Treasury White Paper, and I support that distinction. So I think there is a little bit of confounding of language here.

Mr. ROTHFUS. If I could go back to Mr. Sivon, in your testimony, you suggested that an assessment of the impact of the current expected credit loss, or CECL, accounting standard on lending and economic growth should be conducted. What impacts do you anticipate as this standard is implemented?

Mr. SIVON. As I mentioned, the new standard requires institutions to forecast forward where the economy may go and set up at a reserve. Needless to say, that becomes much more difficult when you get into longer-term loans, such as a 30-year mortgage. So we are concerned that it could have an impact in pulling—causing institutions to make fewer mortgage loans or maybe fewer small business loans. We think one way to offset this is to give institutions credit for this reserve as part of capital.

Mr. ROTHFUS. If I could go back to Dr. Calomiris. This didn't jump out at me from your testimony, but I am curious about it, and that has to do with the Fed's balance sheet, which is, frankly, a consequence of the Fed's unconventional monetary policy. Does that balance sheet raise any conflict of interest with respect to its regulatory side of work, and how?

Mr. CALOMIRIS. Yes. There are multiple conflicts of interest that have come from the new Fed powers that the Fed has taken on in the last several years. One obvious one that is actually related to the supplementary leverage requirement is that the Fed has become a competitor in the repo market. And it was, in fact, a strange coincidence that the supplementary leverage requirement rule was passed at the exact same time that the Fed entered—which applied to repos—was passed at exactly the same time that the Fed became a competitor in that market. And the Fed profited from that rule.

Now I am not saying that the Fed did it only to profit, but there is no question that there was a clear conflict of interest.

Mr. ROTHFUS. Does that have anything to do with the nature of the assets in the Fed's balance sheet, Treasuries and GSEs—GSE notes?

Mr. CALOMIRIS. This has to do with the repo function that the Fed has entered.

With respect to the assets, there is a different conflict.

Mr. ROTHFUS. What is that?

Mr. CALOMIRIS. And that is, mortgage-backed securities that the Fed is holding, as you raise interest rates, if the Fed sells those securities, it will experience capital losses, which have political consequences for the Fed through their ramifications for the Fed's contribution to the budget deficit. They are extremely worried about that. So that could actually keep them from selling off mortgage-backed securities as quickly as they might otherwise. So these are the reasons why it is good to have a monetary authority that is not doing fiscal or regulatory policy.

Mr. ROTHFUS. I yield back.

Chairman BARR. The gentleman's time has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for a word before his time begins.

Mr. SCOTT. Sure. Thank you very much.

I, too, want to join with my Republican colleagues and certainly from this side of the aisle in wishing a speedy recovery to our good friend, Congressman Loudermilk. Congressman Loudermilk, as we know, was in a car accident. The car flipped over 2 or 3 times. He was en route up from, and the accident occurred near, Knoxville, Tennessee, and they have been flown back to Atlanta for further medical treatment. So we will get a report on that.

And this is just the second time in a matter of a short period of time that very near-death incidents have happened. As you will recall, he was there on the ball field when our Republican colleague, Steve Scalise, was shot. So I just ask everybody that we join in a prayer for him and wish him a very speedy recovery. And thank you for giving me that time.

Chairman BARR. Thank you.

Mr. SCOTT. Barry Loudermilk and I not only share—

Ms. MOORE. I would love to associate myself with the comments of Members on both sides of the aisle and make it part of the record that we are prayerful during this hearing.

Mr. SCOTT. Thank you very much. What I wanted to say was in addition, it is very important that Barry Loudermilk and I not only serve Georgia together, but we share counties together. We share Cobb County together. And so we work very closely on very important issues for our joint constituencies.

Thank you, Mr. Chairman.

I have been sitting here listening to this debate, and it called to my mind the great words of—we had a great many Founding Fathers, and none more valuable or greater than the great Alexander Hamilton. And it was Hamilton who said that a strong centralized national banking system shines at its most brilliant in a time of national crisis.

And that is what happened when we suffered the Wall Street bailout situation, and we were very fortunate to have that strong national banking system there. And we responded by establishing Dodd-Frank. And in that we were able, because we had, which was represented by the Federal Reserve, the apparatus there. And we put stress testing there. And it surprises me that some of my Republican colleagues might not be as mindful of how that benefitted us.

So, Dr. Cecchetti, what do you make of all this? It is my understanding that the Federal Reserve is not only doing a great job with stress testing, but it is because of that that our banking system is flourishing now.

Mr. CECCHETTI. Yes, thank you.

Let me just start, your colleague Congressman Clay asked me to grade the Federal Reserve only over the last 4 or 5 years. If I were to grade them from 2007, 2008, 2009, I would have given them an A-plus. And that is not unrelated to your question, because stress tests grew out of the crisis.

Stress tests came in the winter and spring of 2009 when the banking system was on the verge of collapse. And what happened was that by stress testing the banks, what the Federal Reserve did was it made everybody more confident that those banks were healthy. And so I think that it is absolutely essential.

Stress testing, which we discovered then by accident essentially as a crisis management tool, I think has now become the most important crisis mitigation tool and the tool that we use to ensure the resilience of the financial system more broadly.

Mr. SCOTT. Yes. And Hamilton went on to say that the greatness of this system is that it had the power, it has the authority, and it is free from persuasive, divisive politics. And that is why it is so important to have this away from the regular appropriations process for their funding.

Now, my staff tells me that the Fed has hundreds of Ph.D. economists who constantly are combing over data so that talented folks like Chair Yellen can make informed decisions, and her predecessors, and people will follow her.

So let me ask you about this idea of how important it is to keep the Fed independent away from what Hamilton refers to as this political persuasiveness and division?

Mr. CECCHETTI. I think it is absolutely essential. I think what is essential is that monetary policy and supervision both be done by people who can have long horizons, that they not be under the influence of short-term political pressures or those of constituencies that would want them to behave differently from what is in the long-term interest.

My view of this is that if we are to minimize the cost to taxpayers in the long run we need to make them independent, accountable to all of you surely for meeting their objectives, but independent in terms of their daily actions and in terms of the budgets to get their work done.

Mr. SCOTT. Right. And you mentioned the key word. It is who determines their budget, who determines their money. As the guy said in the great movie, "Follow the money." That is what determines your power and authority.

And I thank you for your comments there on how important it is to keep the funding in an independent way. Thank you, sir.

Chairman BARR. The gentleman's time has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank each of you for joining us today.

Just a comment in reference to my good friend Mr. Scott's perspective on the net effect of the regulatory policy from the Fed as a result of the Dodd-Frank bill. In North Carolina, we have lost 50 percent of our banks since 2010 because of the compliance requirements. And of course that has resulted in less capital and credit for small businesses so important for our economy.

Mr. Sivon, the Volcker Rule with its immense complexities ensures full employment, it appears to me, for the Washington lawyers and consultants and bureaucrats, but it continues to really harm others who are in small and medium-sized companies that aren't able to expand their businesses.

In your testimony you stated and suggested that the Volcker Rule would "impair liquidity in the Nation's capital markets, which as a consequence would force business to face higher borrowing costs, resulting in less economic activity and translating into fewer jobs."

Having said that, do you believe this still to be a valid concern? And specifically, what actions should Congress take to remedy this situation and help these businesses ensure full economic opportunity?

Mr. SIVON. Thank you, Congressman.

When the rule was contemplated, there were concerns that it could have some impact on liquidity, and recent studies are starting to bear that out. In fact, studies by the Federal Reserve itself have started to bear that out.

So we recommend that the rule be revisited. We are not alone in making this recommendation. The agencies themselves and the Treasury Department are starting to acknowledge that it is overly complex and there could be some improvements.

In my own practice I have helped a number of mid-sized banks develop their compliance programs for this rule, and what that exercise turns out to be is a demonstration that they are not engaged in proprietary trading, they are not making investments, so it becomes proving the negative.

Clearly, there is a category of institutions that this rule should not apply to, the scope of the prohibitions could be narrowed, the compliance requirements could be more streamlined.

Mr. PITTENGER. What role then should the Fed play in trying to implement any changes?

Mr. SIVON. The Fed is one of the five agencies that are responsible for writing this rule. So the Fed could coordinate with the other agencies in helping to streamline and address these issues.

Mr. PITTENGER. Thank you.

Mr. Calomiris, as you are well-aware, the Fed was established more than 100 years ago. According to the Board of Governors website, it says that it was established to provide a safer, more flexible, and more stable monetary and financial system. Yet the research suggests that the U.S. has been the most financially unstable developed economy in the world for two centuries.

As you know, Dr. Calomiris, Dodd-Frank gave the Fed a prominent role in the prudential regulation of our financial system. Should we believe that this time is different, that we finally found the optimal regulatory structure for a crisis-prone financial system, or is the new regulatory structure the same as the old one, fragile by design?

Mr. CALOMIRIS. I don't think that it is very promising looking forward. I agree with my colleagues here who have said the banking system right now is more stable than it was before. That is not really the interesting question. The interesting question is, when we go through the next unstable period, will these regulations work better than the last ones? And I think it is pretty clear that they won't.

I have just completed a book that I know all of you have because I made sure you all got a copy explaining why I don't think it is going to work.

And that also underlines my point that this shouldn't just be a discussion about deregulation, this should be a discussion about strengthening regulations that are not credible. And I would say that the implementation of Dodd-Frank is not very credible.

We are already seeing mortgage markets looking very similar to what they were doing in the late 1990s and early 2000s. That is the result of government decisions, FHA decisions, FHFA decisions. These were political decisions. They are putting us back into the same direction.

We saw the QM and the QRM standard, because they were given to the regulatory agencies to decide the details of, we saw those being whittled away. And we saw, of course, what Barney Frank has bemoaned as the loophole that ate the standard.

So I think that we have a lot of reasons not to be very confident.

Mr. PITTENGER. Thank you.

My time has, unfortunately, expired. Thank you very much.

Mr. CALOMIRIS. I'm sorry if I went on too long.

Mr. PITTENGER. I appreciate your testimony.

Chairman BARR. The time of the gentleman has expired.

The Chair recognizes the gentleman from Illinois, Mr. Foster.

Mr. FOSTER. Thank you, Mr. Chairman.

And thank you to our witnesses.

There have been two great financial crises, I guess, in our lifetime: the 2008 crisis; and the savings and loan crisis. In which one of these did the taxpayer have to write a bigger check? Anyone who wants to answer it? Just roughly?

Mr. CALOMIRIS. The first one.

Mr. FOSTER. That is my impression, that it was the check was about 2 percent of GDP, right?

Mr. CALOMIRIS. A little bit more. But it is a tough one because if you are asking write a check, that is a complicated question to answer. The total exposure of the taxpayer, potential loss exposure, was greater in the second crisis, but the actual—

Mr. FOSTER. Potential, but the actual losses were higher. I think they were—the nominal losses at least were near zero—

Mr. CALOMIRIS. I agree with that, yes.

Mr. FOSTER. So I think that is a significant point. And I am trying to get back to your point, Dr. Cecchetti, about what we are hearing here is that the solution to our problems is to subject regulators to the appropriations process, which is something you pointed out had been done to the regulators of the S&L. And we are also talking about the crosstalk between monetary policy and regulation.

And it is my sort of simpleminded understanding of the S&L crisis is it was a bunch of smaller institutions getting on the wrong side of an interest rate bet, and then when the Fed made a big move in monetary policy they were in big trouble. And it was the lack of any communication between the regulators and understanding what sort of stress that would put the regulated institutions under when the Fed made a big interest rate move that actually was the driving mechanism. Of course it spiraled into fraud and everything else.

But I was just wondering, is that a fair evaluation of how useful subjecting regulators to the appropriations is?

Mr. CECCHETTI. I believe that it is. And let me just say that I think you have exactly the right pathology in mind, which is to say that interest rate increases generally harm bank profitability and bank equity positions.

It is important, therefore, for the people who are contemplating those increases to understand what their overall impact is likely to be. They are going to be in the best position also to ensure that when they do raise interest rates, which they will ultimately have to do under circumstances in order to ensure that prices remain stable and that growth remains stable, that they understand what the consequences of those actions are going to be at a relatively detailed level.

Mr. FOSTER. And that had there been better communication between regulators and monetary policy actually would have been our best shot at preventing that largest taxpayer bailout of history in the savings and loan crisis.

Mr. CECCHETTI. I am not sure I would go quite that far. But I do believe that what was missing, especially in the last crisis, was having someone who was clearly responsible for the financial system as a whole and especially for the largest, say, three or four dozen financial intermediaries that are systemic where any one of them failing had large consequences for the system as a whole.

Mr. FOSTER. Okay. Thank you.

And, Dr. Calomiris, you have written extensively on contingent capital, which you are aware I am a big fan of as a mechanism, a market-based mechanism to make sure that it is not the taxpayer who is left holding the bag.

Could you just say a little bit about what you think the experience has been internationally with using these and what the prospects should be for avoiding future bank bailouts?

Mr. CALOMIRIS. Very quickly, the right instrument that I have been proposing has never been created yet. What we do know, however, is that the demand for contingent capital-type instruments has turned out to be very high by ultimate investors, so I think that is the evidence that is the most promising.

What we also know, though, is that we have created this total loss-absorbing capital concept, which the contingent capital could be used now in the context of that concept as the form required at the bank holding company. But it has to be required in a much larger amount than is currently present. So I think we have a lot of inadequacies that the contingent capital could help.

Mr. FOSTER. But there is also an important difference here, that the TLAC triggers that insolvency not violation of capital requirements.

Mr. CALOMIRIS. Exactly.

Mr. FOSTER. And so a market-based instrument that warns the banks two steps back from the cliff rather than at the point of insolvency has real merit.

Mr. CALOMIRIS. That is exactly right. And I think that is the essence of why this is so important, because I don't have confidence in the FDIC's ability to resolve these very large institutions, despite what they say under Title II. So we have to keep them far away from that point so we don't test that.

Mr. FOSTER. Thank you, and keep on this subject. I am a big fan.

Chairman BARR. The gentleman's time has expired.

The Chair now recognizes the gentleman from Colorado, Mr. Tipton.

Mr. TIPTON. Thank you, Mr. Chairman.

And I thank the panel for taking the time to be here.

Mr. Sivon, I would like to return back to a question, and maybe get a little more comment from you, that Chairman Luetkemeyer had raised in regards to rules and regulations and the overlaps that we have had.

We sent a letter to Secretary Mnuchin, 31 members of this committee, asking him in his capacity regarding the FSOC to be able to address rule and regulation overlap, to be able to streamline some of those processes. We have had Chair Yellen before this committee on numerous occasions, also noting that regulatory policy does have a trickle-down effect that is impacting smaller institutions, as well.

Can you maybe speak a little bit to some of the costs that are going to be associated with having that duplicative overlapping regulatory policy and how that impacts people literally at home?

Mr. SIVON. Yes, thank you. It is a major issue for the members of the roundtable, which are larger institutions. But you are absolutely correct that there is a trickle-down effect. Even though rules may be tailored, they are often applied to institutions below the specific rule.

Some examples. Today, institutions have to prepare resolution plans for a holding company. They also have to prepare resolution plans at the individual bank level. Some recovery planning is required by some regulators, which is a plan that before you get into a failing situation. There are duplicating requirements on risk management standards that the OCC and the Fed have put out.

So there are examples of instances where we are quite concerned that the agencies are not coordinating as much as they should be. FSOC could play a role here as an organization where all these agencies do sit, and maybe in the new Administration it will play more of a coordinating role.

Mr. TIPTON. Thanks. I appreciate that. I think that is a lot of the challenge, particularly at the community bank level, that we are seeing, our smaller institutions. Best practices. It may not be theoretically applicable to you, but indeed it becomes applicable to you, and that tends to flow down the list.

And I just had an opportunity during the August break to be able to visit with a lot of our community banks, and I think a number of them would actually be applauding you when you are saying make the loan loss reserves Tier I capital. You used to think of this as something separate and unto itself to be able to deal with it, but it is now impacting that ability really to be able to make some loans and to be able to help our folks at home to be able to grow the economy.

Would you maybe talk a little bit more—I thought it was interesting when you were talking about some of the modeling on the stress tests, to be able to reveal some more information so that you our banks—we understand we don't want anybody to be able to game the system. But would you maybe speak to that just a bit more?

Mr. SIVON. Yes. I would agree with others on the panel that stress testing is one of the more important reforms that has been put in place since the crisis. And, in fact, if you look at the results of the latest stress tests, they do demonstrate that large institutions could survive a crisis of worse magnitude than we went through in 2008.

The problem that we see with the manner in which the stress tests are operated today, though, is the models that the board maintains are not shared, they are not transparent with the industry. So you have bankers who are trying to estimate what the board's model may show and modifying their loan activity to try to meet that standard, whereas that may not be the most appropriate manner in which they should be engaging in their particular community given their risk profile and the market in which they operate.

So we think there is a little disconnect between the lack of transparency under the current structure.

Mr. TIPTON. Thank you.

And, Dr. Calomiris, I would like to maybe just return a little bit to the ability to be able to use a little bit of the power of the purse, the appropriations process, in terms of some questions that have been asked in terms of making the Fed actually more accountable.

When we look at 15 percent of the U.S. mortgage market securities are currently held in the Fed, is that going to impact some of theirs? Is there an appropriate way or would using that monetary policy be negative?

Mr. CALOMIRIS. I am very worried about the Fed keeping those on its balance sheet. And I support a recommendation, which I also have made a long time ago, and that Charles Plosser has also been pushing, for us to engage in a swap between the Treasury and the Fed, to swap those for Treasury securities so that we get the Fed out of the mortgage business.

And that is also an inappropriate fiscal intervention. The Fed is clearly intending to affect the relative cost of particular financial instruments. That is not monetary policy.

Mr. TIPTON. Thank you very much, Mr. Chairman. The time has expired. I yield back.

Chairman LUETKEMEYER [presiding]. The gentleman yields back. We are playing musical chairmen here today, so I will be chairing for a little bit, for the rest of the hearing.

So with that, we also have an important moment here. The gentleman from Indiana is going to be recognized to question for 5 minutes. But I understand it is a very, very important day in his life.

Happy birthday. Is that correct, sir?

Mr. HOLLINGSWORTH. Yes, that is correct. Thank you. Very, very important may be overstating it.

Chairman LUETKEMEYER. It is very important, very important.

Mr. HOLLINGSWORTH. I am happy to make another milestone.

Chairman LUETKEMEYER. Older and wiser. There you go.

The gentleman is recognized for 5 minutes.

Mr. HOLLINGSWORTH. Good afternoon, gentlemen. I really appreciate you taking the opportunity to come talk to us today. And so far it has proven enthralling, I can tell you. And for the dozens of my constituents back home watching this, it is indeed enthralling for them, I am sure, right?

But I wanted to come back to something because I have heard it implied or even explicitly stated a few times, that the lack of a crisis in the last 9 years is somehow evidence that this extra regulatory burden will forever and always keep us safe from a crisis instead of some recognition that by the same logic the fact that we had regulators and regulations before the last crisis seems to be some evidence that regulation, and especially by edict out of D.C., instead of enabling and empowering lenders to be able to pursue their own business models, it might in fact be one of the root causes for some of the instability.

And I would love it if Dr. Calomiris would comment on that.

Mr. CALOMIRIS. There are so many pieces to it. Of course, I wrote a book that went through that in some detail.

But it is important to remember that as we are worried about too-big-to-fail institutions, we are running up inordinate risks having to do with the mortgage market, that the Fed was the institution that first of all was managing the merger process that created too-big-to-fail institutions, and it was the Fed that was also managing the prudential regulatory process that decided whether they had adequate capital. And I would say the Fed was extremely politicized.

Mr. HOLLINGSWORTH. Right.

Mr. CALOMIRIS. And that its extreme politicization led it to approve of mergers in a way that created mortgage risk and then therefore could not set capital requirements that would have created adequate capital.

So that was, to my way of thinking, probably the single best example of the kinds of problems that come from a politicized regulator that is a central bank.

Mr. HOLLINGSWORTH. One of the deep challenges I have—and again, my statistics is rusty—but the use of the counterfactual here, somehow saying because we have not had a crisis that we are okay. But what we haven't talked about is the tremendous costs on the U.S. economy of the misallocation of capital across it because of government intervention, government distortion, and excessively burdensome government regulation, which continues to misallocate capital and not get it in the hands of those that could most productively use it, and the economy has suffered because of that. People back home have suffered because of that. And I would love it if you would comment a little bit on that.

Mr. CALOMIRIS. The most obvious area has been small business lending, especially because small banks have a lot to do with small business lending, and small banks have been really hit a lot by the overhead costs of the regulatory burden. That is one part of it.

Mr. HOLLINGSWORTH. And just what I hear from my small bankers in the community is what they say is: We have been essentially forced to combine because the regulatory burden is so heavy and that fixed cost is so heavy we have to amortize that over more and more customers, more and more loans, more and more products, and so we have combined and gotten larger. And thus, they find themselves less capable of serving the communities and find themselves more and more, in their feeling, in servitude of a bureaucracy in D.C. instead of focusing on enabling and empowering their customers.

Mr. CALOMIRIS. It shows in all the statistics I have quoted in my various work. One thing that I would also point out is we are going to great lengths through a variety of measures to push mortgages rather than small business lending, is what small banks do.

Mr. HOLLINGSWORTH. Right.

Mr. CALOMIRIS. And so it is not just that small banks have been hurt, it is also that if we actually required banks to be more diversified across their lending we would help small businesses quite a lot.

Mr. HOLLINGSWORTH. Indeed.

And, Mr. Sivon, I wanted to ask you specifically about a bill that I have recently introduced. This bill, H.R. 3179, the Transparency and Accountability for Business Standards Act, is really simple. It is about harmonizing regulation across jurisdictions. And the fact is that the United States has gold-plated many of the standards coming back from overseas. And I wondered if you could talk a little bit about the global competitiveness of U.S. institutions in the face of a heavier regulatory burden here at home than others may face in other jurisdictions.

Mr. SIVON. Thank you, Congressman. It is one of the issues highlighted in our testimony. We do think that the layering on of additional requirements for the larger U.S. institutions does raise competitive issues for them in global markets. And the legislation that you have introduced provides for the regulators to do a cost-benefit analysis before imposing that kind of a standard.

We strongly support that. We think the idea of cost-benefit analysis makes sense there as well as in other regulations that the agencies are proposing.

Mr. HOLLINGSWORTH. So the net-net is, when I think about the regulatory burden in this country, the misallocation of capital is costing opportunities for higher economic growth, for people to realize meaningful wages. And then in addition, that regulatory burden is costing U.S. companies competitiveness around the world to be able to export some of the great things that we have developed here to other countries.

And with that, I will yield back, sir.

Chairman LUETKEMEYER. The gentleman's time has expired.

We now go to the gentleman from Minnesota, Mr. Emmer, who is recognized for 5 minutes.

Mr. EMMER. Thank you very much, and thanks to the panel for being here.

I just don't even know where to start. So much of this has been covered. It is a very interesting discussion. But I think I want to start with Dr. Calomiris.

You had talked about one of the reforms being budgeting authority, having more oversight on budgeting authority. What about the argument that we hear constantly, and I think Dr. Cecchetti made this argument at some point, that this would impact the Federal Reserve's independence, putting their budget under the supervision of Congress, for instance? How would you respond to that?

Mr. CALOMIRIS. I think the important first step is to ask, when we talk about Fed independence, what are we talking about? Independence in the literature for decades has always meant independent of special interest pressures, independent of short-term pressures coming from the Administration. It has never, ever meant that laws that the Fed administers should be made independently of the United States Congress.

So I just want to be clear, when I use the word, "independence," I don't think that it is consistent with our Constitution to think that the Fed should be writing regulations that are not overseen by the U.S. Congress. I think that is a very radical and new idea that seems to me to be just wrong.

So the question then is, well, what is the role of budgetary discipline? Congress under the Constitution is the only agency, is the only institution that is supposed to be sending funds for whatever purpose in the government. So I don't really understand how you can read the Constitution and find this authority for the Fed to have a blank check to spend money any way it wants.

Mr. EMMER. Thank you.

Dr. Cecchetti, you had testified, and I wrote it down, early this afternoon that you need to have an objective and then there need to be guidelines on how to get to that objective. How is that different from having a rule in place which is in effect a guideline? I think the proposal from this Congress or this committee has been, one of the proposals, to put a rule in place so that at least people in the public know what to expect. But it doesn't have to be followed, and if it is not followed then it would require an explanation as to why we are not following it. How is that different?

Mr. HUIZENGA. I am so sorry, but would the gentleman yield for just a second?

Mr. EMMER. Absolutely.

Mr. HUIZENGA. As the author of the FORM Act, and I know Chairman Barr has been working on this, we actually had said that the Fed could make up their own guideline and just have it out there and then explain when they were going to deviate from that. So that was not even anything that we on this panel or the

House or the Senate or anybody else would put forward, it would actually be a guideline created by the Fed and measure themselves.

So I yield back.

Mr. EMMER. Great context. How is that different from what you said?

Mr. CECCHETTI. So what I was trying to say is that I view the job of the Congress as to set the objectives and to hold the Federal Reserve accountable for meeting those objectives. I do not believe that it is worthwhile for the Congress to be involved directly in setting policy.

Mr. EMMER. But actually, to interrupt, because we are going to run out of time, that is exactly what my colleague just said that they were proposing, is go ahead and set the objective, you do the policy so all of us know what it is, and then you have the guidelines, the policy guidelines and you explain. It sounds to me, sir, as though we actually agree on this.

I have to go back with the limited time I have left to Dr. Calomiris, because I have some concerns with this conflict of interest and the politicizing of the Federal Reserve. We have lost so many community banks, family-owned community banks and credit unions over the last 7 years since Dodd-Frank was in existence, and, in fact, it started even before that, but it has been accelerated in the last 7 years.

And it seems as though, looking at it and reading your testimony, listening to you here today, and perhaps your colleague might weigh in as well, in order to exist with this regulatory function and the monetary policy function you have to have a lot of resources in order to exist, and we are not creating new banks. Is there a favoritism towards the larger institutions?

Mr. CALOMIRIS. I just have a new volume coming out that I am editing on this. And some of the rules are hitting the large institutions, of course. Some of the rules are hitting the small institutions. The main problem with the small institutions is, how do you spread the overhead from having to comply with these things over a small balance sheet? And I think that is why it just becomes existential for them.

Chairman LUETKEMEYER. The gentleman's time has expired.

The gentleman from Arkansas, Mr. Hill, is recognized for 5 minutes.

Mr. HILL. I thank the chairman. I thank both chairmen for this interesting topic, to continue our exploration of the Fed and the role of the Fed both in monetary policy and in regulatory policy. And I am sorry I have been in and out today. It is one of those days on Capitol Hill.

I would like to talk and follow up with my friend from Indiana's comments about misallocation of capital and get your views just from a little different perspective. Obviously market prices provide a lot of information to market participants. And you have had the Fed really over the last few years be unprecedented in sustained decline of zero interest rates, plus doubling down with QE1, QE2, QE3.

And we have the third most expensive S&P 500 now in history. Only 1997 to 2001 and 1929 exceed the price earnings multiple on the S&P 500 right now. And we have historically low cap rates for long-tailed commercial real estate properties, for example. And I think at the last count something like $13 trillion of sovereign debt is at a negative yield.

So these are clearly unprecedented times.

But one of the key components of that was back in 2012 the Fed established an inflation target of 2 percent, which we have not hit. And I wonder if that calls into question whether they should even have set such a target if they can't hit it. I think Gary Shilling said, and I am paraphrasing, if you can't hit a target, maybe we need to question our authority to even try to do that.

So I am interested in your views on that inflation target. Should that be maintained or should we, as we normalize the balance sheet or attempt to, also let that go by the wayside as a test for the last years? Each of you, if you would comment on that, please?

Mr. CALOMIRIS. I will be quick. I would have preferred a 1 percent target rather than a 2 percent target, which is the one Alan Greenspan, as I read it, suggested in 2006. But now that they have stated the 2 percent target, I think it is important that it not be subject to change. I think that they need to stick with it because they have now said that that is their long-run target. That should be subject, of course, to your approval, but I think that it is a good idea to stick with it.

I also don't agree with people who say the Fed has undershot its target, because this is a long-run target. It is not clear yet whether being at 1.5 percent for current inflation means that they are pursuing policies that are long run below the target. So I don't think that we want to be too critical of the Fed for coming in at 1.5 rather than at 2.

Mr. HILL. I just want to add one nuance to that. At 1.7 percent, should we just declare victory and say we have hit 2 percent if it is going to not let us take other policy decisions in the monetary policy arena surrounding the balance sheet that maybe we should because it is just one factor considered, not the only factor?

Mr. CALOMIRIS. So just very quickly, monetary policy remains accommodative. In real English what that means is monetary policy is still pushing toward going to a higher rate of price growth. And that is appropriate given that the Fed has a 2 percent objective. I think it should be less accommodative than it is.

So I think the Fed is basically doing behavior that is so far consistent with a 2 percent policy objective, and I think that we shouldn't beat them up too much.

Mr. CECCHETTI. I agree with my esteemed colleague that 2 percent, now that you have it, I think you have to keep it. If you start changing it then everybody is going to wonder when you are going to change it.

And the most important thing, I think, for all of us and for individuals, for small businesses, for households, for investors is that they be able to have some security in what inflation will be over the long run. And in this I think Dr. Calomiris and I completely agree that these modest deviations over relatively short periods of time are not a problem.

Mr. HILL. Mr. Sivon, quickly, sir?

Mr. SIVON. On monetary policy, the members of the FSR will operate in any interest rate environment.

Mr. HILL. Thank you, Mr. Chairman. I yield back.

Chairman BARR. The gentleman's time has expired.

The gentleman from California, Mr. Royce, is recognized for 5 minutes.

Mr. ROYCE. Thank you very much, Mr. Chairman.

Dr. Calomiris, as you may know, I have spent a lot of time concerned about the drug of leverage, as you referred to it. In fact, when the House considered GSE reform back in legislation in 2005, I introduced an amendment to give the regulator the authority to curtail the systemic risk posed by Fannie and Freddie's portfolio. The regulator would have had the ability to deleverage those portfolios.

That amendment was defeated by a large margin, leaving the underlying legislation incapable of curtailing the risk exposure from these portfolios. The opponents of my amendment on both sides of the aisle claimed Fannie and Freddie posed no threat to the financial markets and that systemic risk was, in one of these debates I remember here, a theoretical term.

In reality the opposition was looking to preserve the status quo. They were looking to allow Fannie and Freddie to grow at a very alarming rate without any meaningful constraints, and I would add without any oversight from this institution.

You have said we need the political courage to give up the drug. Do you think we have learned from that crisis? Have we brought transparency to the GSEs and the Federal Reserve and the role they play in terms of subsidizing our housing markets, do people really understand that, or is the moral hazard that I pointed out then still in play today?

Mr. CALOMIRIS. It has gotten worse. So let me remind you that as soon as Mr. DeMarco was replaced by Mr. Watt, one of the first things Mr. Watt did was to lower the downpayment requirements for GSE mortgages from 5 percent to 3 percent. Five percent is way too low. Three percent is unbelievably low. The FHA also cut insurance premiums.

Has the FSOC, who is supposed to be looking for systemic risk, ever used the word, "mortgage" or the words, "real estate" in any of their discussions? Almost none. Why? The Secretary of the Treasury is the head of the FSOC, so why would the Administration that appointed Mr. Watt then also say that Mr. Watt just created risk. They wouldn't, right?

So the problem is the FSOC is politicized and is not going to be honest about mortgage risk. And it is currently a threat. It is going to get worse.

Mr. ROYCE. Let me ask Mr. Sivon a question, because you are someone who has opined on insurance regulation for many years.

Could you take a minute or 2 to describe how we ended up where we are today? Because this is no longer a discussion about State versus Federal regulation. It is now a discussion about layered regulation. That is the difference. The Federal Reserve now plays a pronounced role in this regulation.

And I can think of some of the possible positives from the outcome. You could argue that maybe now on the monetary policy side the Fed better understands the impact prolonged low interest rates have on life insurers trying to plan for the long term. That is a positive. But on the regulatory side, it is unclear what the proper role for the Fed is in the future. So I offer you the floor here with the remaining minutes.

Mr. SIVON. One of the major changes in the Dodd-Frank Act was to give the Fed regulatory and supervisory authority over a number of insurance companies. In fairness to them, I think they have been moving slowly in the manner in which they have been exercising that authority.

On the other hand, as I noted in my testimony, we think it is very important for the agency to appreciate the distinction between the business of insurance and the business of banking, and some of the supervisory policy statements that they have put out have been more aimed at banking than recognizing the distinct issues that an insurance company faces.

The most recent action that they took last year was to propose capital standards for the insurers that they regulate. They proposed two alternative standards: one called the consolidated approach for the very largest insurers that they regulate; and another called a building block approach for the savings and loan holding companies that are owned by insurance companies.

The building block approach is based upon State insurance regulation. And so it is our strong view that as the Fed moves forward in regulating capital requirements for the insurers that it regulates it doesn't layer on yet a new type of capital requirement, but look to what the States have done and build on this building block approach for capital requirements for insurance companies.

Mr. ROYCE. Thank you very much.

And I thank you again, Mr. Chairman, and I thank our witnesses.

Chairman LUETKEMEYER. The gentleman's time has expired.

We have a situation where we are truly enthralled by your expertise today, and we have another round of questions that we would like to ask if you guys have some time. We would like to impose on you to be able to do that. Or do you guys have some other places to go shortly? No? Okay.

Otherwise, we would like to start a second round, and we will start with the gentleman who is the chairman of the Oversight Subcommittee, the gentleman from Kentucky, Mr. Barr.

Chairman BARR. Thank you, Mr. Chairman.

And I appreciate the indulgence of our witnesses. We appreciate the very interesting exchange of ideas here today. What I have heard from all of the witnesses is a general agreement that Fed independence, a Fed free from politicization is a goal that we share.

But I think a strong argument can be made that the Fed's aggressive implementation of the Dodd-Frank Act, that their zealous supervisory activities, their overregulation arguably, that that has, in fact, diminished economic growth, that that has undermined credit availability in capital formation, and that that process, that process of being engaged in the regulatory supervisory process, has actually induced the Fed to pursue a radically unconventional and accommodative monetary policy to offset the growth-destroying effects of the regulatory policies.

And that obviously, that monetary policy has distorted financial asset values. It has discouraged financial capital from freely engaging in its most promising opportunities. And witnesses in this committee, in this subcommittee, have expressed concern about the Fed's balance sheet stepping out of what is necessary for the conduct of monetary policy and obviously into unprecedented unchartered credit policy.

So the point I am trying to make is that this conduct, I would submit, does not really look like a government agency free of politics. That to me looks like a government agency that is totally politicized. And so I invite your feedback on that observation.

Dr. Calomiris?

Mr. CALOMIRIS. I think that it is true. It is inevitable. When you get into things like mortgage-backed securities markets and you are making changes in relative interest rates for different financial instruments, that is what we economists call fiscal policy. That is a decision to subsidize some kinds of uses of funds at the expense of others.

So when you get engaged in that, just like any political institution, you become a political institution and you become a lightning rod for influence. This is one of the reasons why monetary policy just has to stay away from those kinds of things.

Chairman BARR. Just to follow up to your answer there, and I want to hear from the other witnesses on that, but I think you have made the point, Dr. Calomiris, that as an owner of over 15 percent of U.S. mortgage market securities, the Fed's monetary policymakers are quite conflicted when it comes to interest rate policy.

Mr. CALOMIRIS. That is right.

I also just want to say I think your analysis of the motivation of the Fed is right, that the Fed having been part of the problem of creating the growth slowdown has actually tried to do things to try to prop things up. It is not working very well. And Marco DiMaggio, my former colleague, his study found that the only part of QE that really had a positive effect of QE2 and QE3 was the mortgage-backed security part.

Chairman BARR. Dr. Cecchetti, I do want to give you an opportunity to respond. And as you respond, could you also address the testimony that you offered earlier that the job of the Congress is to set objectives and hold the Fed accountable? But how do you hold, how does Congress hold the Fed accountable on rulemaking if they are completely immune from the meaningful oversight of the appropriations process?

Mr. CECCHETTI. I believe that you can hold them accountable with—let me start with your first points. I think there are two points.

First of all, on the mortgages, I think that many people, including me, are uncomfortable with the fact that the Federal Reserve owns so many mortgages, the mortgage-backed securities. But these were purchased as the Fed was trying to support the mortgage market during a collapse, and I think that they will let those run off as soon as they practically can.

On the issue of stringent capital requirements, I think it is important to understand that capital requirements facilitate lending. Strong banks lend. Banks that have strong underlying capital positions are lending, and they are doing it now, and I think that that is a very, very important thing that I hope that everybody appreciates.

There is an issue which has come up a number of times which I will comment very briefly on, and that is that I think there is also broad agreement that a $1 trillion bank and a $1 billion bank should not be treated identically. And the question then is how do you change that treatment?

Chairman BARR. I yield back.

Chairman LUETKEMEYER. The gentleman's time has expired.

We now go to the ranking member of the Financial Institutions Subcommittee, the gentleman from Missouri, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

And, Dr. Cecchetti, the outlook of the economy, including whether financial conditions are likely to lead to faster or slower future growth, has a significant impact on both inflation and employment. Given this, can you talk about how the information that the Fed learns through its supervision of the financial system would inform and enhance the Fed's outlook on how it may need to adjust its monetary policy stance in order to achieve its statutory full employment and price stability objectives?

Mr. CECCHETTI. Yes, Congressman, I would be happy to.

The Federal Reserve's interest rate actions operate through the banking system. So it is essential when they set their interest rate to know what it is that the banking system is doing.

The information that the Federal Reserve has access to today prior to making those decisions includes information about individual borrowers and individual lenders. They know about the size of loans, they know who it is that is doing the borrowing, and they know what the terms are of those loans. They use that information—aggregating it, obviously—in a way that then informs them on how it is they need to set their policy in order to ensure that the easing or tightening of the policy has the desired impact.

Mr. CLAY. And to what extent does the Fed's forecasting function tend to rely on analysis of supervisory data?

Mr. CECCHETTI. I think the answer to that is that we are going to know more and more about that over the next few years.

As Dr. Calomiris pointed out, the Federal Reserve as part of its accountability mechanism releases transcripts of the Federal Open Market Committee meetings with a 5-year lag. So right now we don't actually have access to the discussions and the meetings for the past 5 years, but my understanding from speaking to some people inside of the Federal Reserve is that the kind of information that we are describing here now has found its way in that time period, because it hasn't been collected in a consolidated and consistent way until the last few years, that it is now finding its way into those decisions and into those discussions.

Mr. CLAY. Thank you for that.

And, Dr. Calomiris, considering the performance of the U.S. economy over the last year, do you think the Federal Reserve has made the correct moves as far as being able to lower unemployment and the strong market indicators that we see now? Do you give them any credit for that performance?

Mr. CALOMIRIS. Absolutely. As I said, I think we are below our long-run inflation target. I think that according to the Fed's own measures, though, of unemployment, it has been a moving target. So the Fed doesn't really have a very good sense of what the long-term right level of unemployment is, and that has been one of the things we have been learning.

So it has been a tough job. I think that qualitatively they have done a fair job. My friend, Mr. Cecchetti, is an easier grader than I am. But I would say that they have done a decent job under a circumstance of extreme uncertainty about the long-run unemployment rate.

Mr. CLAY. Thank you for your response.

I would prefer to take a course from Dr. Cecchetti, I think.

And with that, Mr. Chairman, I yield back.

Chairman LUETKEMEYER. The gentleman from Missouri yields back the balance of his time. As the gentleman who actually got an A or two in school, we are okay with either one of these guys. I think we could make it work.

With that, we go to the gentleman from Indiana, Mr. Hollingsworth, for 5 minutes.

Mr. HOLLINGSWORTH. I really appreciate the testimony again, and thank you for being here.

So one of the things that was said a few minutes ago was that strong banks make loans, and I don't doubt that loan growth hasn't been zero, but it certainly hasn't been as robust as it otherwise would be.

When we look back at prior recessions and loan growth post-recessions, we have continued to see this one lags back behind by many, many dozens of statistics and measures, and that is a real challenge.

It is a real challenge because capital formation out in especially where I come from, in the heartland, is really, really poor, and we have to fix that.

So that is one thing that I talk a lot about, which is kind of the wet blanket effect of all of these regulations.

The other thing, which isn't talked about as much but I have been pushing really hard, is the effect on bank balance sheets of these many intrusive regulations. And let me tell you what I think I mean, which is the more and more that we develop a higher and higher regulatory threshold in a variety of different areas, the more and more we force institutions to look more and more similar to each other. By government saying we are going to weight these and not these, we are pushing banks into a corner.

And you have to be really careful when you line banks up like that because you better hope you got everything right, because now you have lined them up to where the moment there is an issue it is a very quick transmission from institution to other institutions because their balance sheet looks very familiar.

What I fundamentally believe is that robustness and resiliency are emergent qualities from a system, not qualities that can be demanded by fiat.

And so Mr. Sivon had talked about this a little bit earlier, just allowing for diversity of businesses to exist within the financial landscape and a diversity of business models. And I wondered if you might touch on that again and talk about how maybe a resilient, robust system, one that can withstand shocks, probably derives from that diversity of business models, risks, and profiles.

Mr. SIVON. Yes. Thank you. Clearly, the system is stable today in part because of many of the steps that have been taken by the industry and regulators and Congress.

Our view is that we probably have some excess capital and some excess liquidity requirements today that could be put to more productive use and help economic growth. And that is the nature of the recommendations that we make in our testimony in terms of adjusting the capital requirements and the liquidity rule and the Volcker Rule and the supplemental leverage ratio and so on. There are quite a number of changes that could be done in a fine-tuning way to help economic growth.

Mr. HOLLINGSWORTH. Dr. Calomiris, could you comment?

Mr. CALOMIRIS. I will, like a broken record, just point out that it can't possibly be a good thing that, putting aside the largest banks, that the banks throughout our country have about three-quarters of their loans in real estate.

When you are asking, are we in a situation that is going to be resilient, when all those balance sheets are basically lending to one sector that is very correlated with the business cycle and has a very hard time selling assets during a downturn, how are we dealing with systemic risk? I think it is kind of a joke.

Mr. HOLLINGSWORTH. Dr. Cecchetti?

Mr. CECCHETTI. Two quick comments.

First of all, I think it would be very difficult to disagree with your comment about the need for what I would call a diverse ecology in the financial system in order to ensure its resilience. I think that is absolutely, absolutely essential. And to the extent that the regulatory environment is overly constraining in certain ways, it will decrease that diversity and reduce the resilience.

I would, however, want to comment on the issue of the lending levels. I think that we did not come into the crisis with levels of debt that were sustainable. And so the fact that levels of debt today are lower and that growth rates during the recovery have been lower than those in previous recoveries I think is something that we should not be terribly upset about.

The distribution of those loans is a separate issue, as my colleague just described. And so I might—I would agree that if all you are doing again is lending to real estate, that that is an issue.

Mr. HOLLINGSWORTH. I certainty understand that perspective, but back home in Indiana there are a lot of people who feel like it is something to be upset about.

And the lack of loan growth, and especially loan growth to the incremental individual who might be on the bubble of creditworthiness but is trying to start that business, trying to make a difference, trying to build a better financial future for themselves, to them the lack of loan growth or credit growth or credit availability has been a real challenge, and they feel like it is being more and more directed by bureaucrats in a fashion towards others and not towards empowering them across the heartland.

And with that, I will yield back, Mr. Chairman.

Chairman BARR. The gentleman's time has expired.

The gentleman from Georgia, Mr. Scott, is recognized for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Cecchetti, it seems to me that some of my Republican friends want to strip the Fed of its supervisory and regulatory functions and leave the Fed, in my opinion, and I want your opinion on this, wouldn't that leave the Fed ill-equipped to be able to judge the conditions of the financial institutions that they are in business to do? Wouldn't that make it very difficult, particularly when the Fed has a role of being the lender of last resort?

Mr. CECCHETTI. I certainly believe that. Making a loan to a bank—for the central bank to make a loan to a bank I think is a very important financial stability tool. At the same time it is extremely important that the central bank, the Federal Reserve, not make a loan to an insolvent bank. You cannot be in the business of lending money to people who are already bankrupt.

Mr. SCOTT. Right.

Mr. CECCHETTI. There are many reasons for that. The first one is that is basically a bailout. The second one is that you are subordinating existing debt holders. Because the Federal Reserve is going to require collateral, it is going to come in senior to everybody else that is out there.

The second thing you are going to do is you are going to make the cleanup more costly.

And the third thing is that if you make loans to bankrupt institutions, what is going to happen is that people are going to come to know that you make loans to bankrupt institutions, and then others are going to assume that if you go for a loan you are bankrupt, and nobody is going to want to go for a loan, so it is going to be very stigmatizing.

So I think that the only way to ensure that the Federal Reserve or any central bank does not make loans to insolvent institutions, to bankrupt institutions, is to have supervisory information, because you need things that are very, very current, and you need people who you can trust providing you with that information.

Mr. SCOTT. And it seems to me that they want to take it away from the Fed and put it to some outside entity. What outside entity are they talking about?

Mr. CECCHETTI. I think you would have to create a new one. Either that or you are going to have to combine the Federal Reserve's supervisory and regulatory authority with an existing agency, and I don't see anyone suggesting that. But I don't see how you could do it.

Mr. CALOMIRIS. There are many ways to do it. Let me remind you that in 2009 Senator Dodd, that was his vision of how we should have crafted the Dodd-Frank Act, and I agree with that. I think we should have gone in that direction.

Furthermore, that the 2008 Treasury Blueprint that I keep referring to specifically made the same distinction. It seems like Professor Cecchetti and I are sort of in agreement, because the key point is you want the lender of last resort and the monetary authority to have continuous unfettered access to all information and to participate actively in the examination process, that aspect of supervision.

But you don't need them to be deciding who gets to merge and who doesn't. You don't need them to be setting laws down. It is a different function.

Mr. SCOTT. But it just seems to me that if you are the lender of last resort and that power and authority rests with you, you are the fulcrum of the welfare of the entire economy. But if you take away that ability to give it to an outside source, that really is a mystery. You just can't pluck it out the air here and give it to it. I would think it would be devastating turbulence to our whole economy.

Mr. CECCHETTI. I think that I am not the historian that Dr. Calomiris is, but I will say that the Federal Reserve was started in 1914 by the Congress in order to actually do this. And so it is hard for me to see how you would organize this in a different way.

Mr. SCOTT. Let me just ask you on the appropriations process, Mr. Cecchetti, what will subjecting the Fed's nonmonetary functions to the appropriations process, in your opinion, do to the economy?

Mr. CECCHETTI. I think it would be bad, but I think you have run out of time.

Mr. SCOTT. You did say it—

Mr. CECCHETTI. It would be bad. I think it would not serve us well.

Mr. SCOTT. All right. Thank you.

Chairman LUETKEMEYER. The gentleman's time has expired.

The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you, again.

One of the issues in the inflation target is whether we actually measure inflation properly. I guess Larry Summers and others have been going around giving talks that we are making a bad mistake in how we—one simple example that everyone points out is this supercomputer in my hand here is the equivalent to a couple-million-dollar Cray-1 supercomputer. And so everyone in my family can now afford their own private supercomputer that used to cost a million dollars in 1970 dollars.

And so we are not doing inflation—or Wikipedia. Every middle-class family used to put 500 bucks down into World Book Encyclopedias for their children that they now get for free or essentially free.

And so that especially in items having to do with the digital economy, it is not at all clear we are doing inflation right. And if you look at people's leisure time, it is going more and more into free things on the internet that we used to pay a lot for. Just a long list of these things.

And you can make a case that we are badly mismeasuring inflation. If that is true, it has real implications for monetary policy.

And I was wondering what your attitude is on this part of the debate, because the digitalization of our economy is accelerating, and this is going to be more important in the future.

Anyone?

Mr. CECCHETTI. We are trying to pass this around.

I think this is an extremely difficult question. And my own view is that these problems have existed to one degree or another for a very long time. Television is very much like some aspects of the internet. So television comes on in the 1950s and provides us with free television in exchange for advertising.

Google provides us with free lots of things in exchange for advertising, which then the advertising, of course, costs get impounded into the costs of all of the other products that we have, that we purchase.

So the question is whether or not that has gotten materially worse. I love my supercomputer in my pocket, as well, and I use it quite a lot, and it is it is much more than a—I would have put the price at more like $30 million in 1970 dollars than $1 million. It is a lot.

But I think that are we today worse than we were, say, during the time there was the Boskin Commission in the 1990s that estimated the bias in the Consumer Price Index at roughly 1 percentage point per year. One percentage point seems to me to be a reasonable number. That means that actual inflation is closer to 1 than—when it reads 2 it is closer to 1.

Mr. FOSTER. That has real implications, for example, politically where there is a narrative that real wages have not gone up in the last generation. And if you change that by 1 percent, that is a big change in that narrative.

Mr. CECCHETTI. I agree with that completely. And the person whom I would point to as the biggest champion of that is actually Martin Feldstein, who I think normally testifies for your Republican colleagues.

Mr. FOSTER. Let's see. I guess there is a line of commenting actually that has been happening about the politicization of the Fed. I was just wondering when in the past have Presidents seen fit to appoint political operatives, campaign operatives and speechwriters, to Chair the Federal Reserve. I am only aware of that happening one time in my historical knowledge. Any other example than Chair Greenspan?

Mr. CALOMIRIS. I can't think of a—

Mr. FOSTER. Of a second example.

Mr. CALOMIRIS. Just to answer that more constructively, I don't think it is about the personalities or the backgrounds of the people as much as it is about the incentives of the institution.

Mr. FOSTER. I presume you have read Chair Greenspan's book, I take it you probably all have, and you see he talked in glowing terms about his experience as a campaign operative and also his sadness when George Herbert Walker Bush, George Bush, Sr., accused him of being responsible for George Bush, Sr.'s losing the election because he appropriately tightened credit at the wrong time.

Mr. CALOMIRIS. I know a little bit about that story if you want to hear about it.

Mr. FOSTER. Did he correctly report it, in your belief, in his book?

Mr. CALOMIRIS. So Nicholas Brady told me, and he told me because he knew I was a financial historian and he wanted the record to contain this, that Alan Greenspan had made a promise to him that he reneged on. And I think that was the nature, that, in fact, George Bush's promise to or willingness to consider tax increases was premised on that agreement.

That is how Washington works, which you know better than I. And so I think a lot of the bitterness had to do with the fact that President Bush actually made a concession on tax policy expecting the Fed to do something that they then backed out on.

Mr. FOSTER. I see. And is it fair to say, though, my last question, that for President Bush II, when he had the opportunity to tighten credit at a time that you could make a strong argument for, that he did not repeat his mistake?

Mr. CALOMIRIS. Which Bush are we talking about?

Mr. FOSTER. We are talking about Bush II and the question of whether keeping the housing bubble inflating potentially to influence the reelection of George Bush, Jr.

Mr. CALOMIRIS. I don't know whether that was part of the calculation.

Mr. FOSTER. Okay. Well, thank you. I appreciate it.

Chairman LUETKEMEYER. The gentleman's time has expired.

With that, we are going to wrap up the questioning. I have a few comments and a few questions here. So we will try and be brief here.

Mr. Sivon, all large banks have on-site examiners from the Federal Reserve. How have the Federal Reserve supervisory practices changed since the crisis? Have the supervisors been adequately transparent?

Mr. SIVON. Thank you, Congressman.

Chairman LUETKEMEYER. I know you represent a lot of big banks with the Financial Services Roundtable.

Mr. SIVON. Thank you, Congressman. It is true that the larger banks have on-site examiners.

I think, in fairness, the supervisory policies of all the agencies have tightened since the crisis, the Fed included. And where we are at this juncture and what our testimony is trying to indicate is that we are at a tipping point where we think that there could be some refinement both in regulation and in supervisory policy.

Chairman LUETKEMEYER. I have just a few thoughts here. We have had a very lengthy discussion today, and I don't want to drag this out any longer, but just a couple of little thoughts here with regards to some of the comments that were made and some of the testimony that we have heard.

I think, Mr. Sivon, you made the comment with regards to stress test models, and I am kind of concerned sometimes that the stress testing that is being done doesn't actually reflect a stressed or a situation that could actually occurred. That is my concern with some of the stress tests.

I know there are some difficulties in modeling because the Fed doesn't tell the banks how to do this. They are kind of doing it on a guesstimate way of going about it. But at the same time I am kind of concerned at the way the Fed's modeling on these things is going, that they are really not modeling a real situation that could actually occur in today's world, and that is a concern of mine.

Mr. SIVON. One of our recommendations to address that specific concern is that the Fed's stress test scenarios be put out for public comment so that they could be scrubbed and the Fed could benefit from that type of input from people on this panel.

Chairman LUETKEMEYER. Dr. Calomiris, do you have—

Mr. CALOMIRIS. I agree with that. I have a specific version of that, which I have proposed.

But I also want to come back to the point of the stress test. The stress test using the current data can't answer the question they want to answer. What they want to answer is, how will we be able to tell whether banks might be suddenly losing their economic value? That is what causes a crisis.

The failure of banks to be able to roll over their short-term debt and to be able to behave normally reflects a sudden loss of economic value. That is not going to be captured unless you model the creation of economic value. You can't model the loss of it.

Relying on book value of equity ratios and using the kind of data that are used in these financial reports simply cannot answer the question.

So I would say that stress tests are close to useless as a forecasting tool for the sudden loss of economic value, and I don't believe the scenarios are very meaningful. So I do think currently they are not helpful, but they are currently for most of the banks the binding constraint on capital. So I think that is very troubling.

I am a big fan of stress tests as an idea, but the current procedures have the secrecy problem, which is unaccountability, and therefore bad modeling is quite likely. But even more deeply, conceptually they are just not addressing the right question, and they don't have the data to address them.

Mr. CECCHETTI. I would just like to be the defender of what is going on today. I believe that the Federal Reserve is doing a reasonable job of this. I think they are trying to improve every day that they go to work to do a better job. I think they are trying to do that both on the modeling side, the scenario side, and on the side of the data that is being collected.

What I would say is that I think we want to be very, very wary of transparency on the scenarios and on the models. I think that the idea that people are going to game the system is a very real one and that we want to guard against that.

Chairman LUETKEMEYER. It is interesting, because in this very committee, in that far corner over to the left, we had a stack of paper to represent 20,000 pages, what is sometimes a small stress test for some of these institutions, and it took up that whole table and then some. And yet, I don't know that anybody even reads it when it gets to the Fed.

And so as a former regulator, the Fed already has all this information. This is one of my concerns with the stress tests. To me it is an exercise where they don't seem to be willing to do their job, which is to assess risk themselves. The Fed does its own systemic risk analysis for all those institutions, yet I am not sure why we need a stress test. It is done by the bank itself, which seems to be a game of "gotcha." Am I wrong?

Mr. CALOMIRIS. If it were done properly the stress test could answer questions, a well-posed question: In the event that these things happened, would you suffer a very large sudden loss of value?

So I think it does have a function that is unique. I am not against stress tests as an exercise. I just don't think they are currently ready for primetime.

Chairman LUETKEMEYER. My time has expired here, so we need to move on. I will let you gentlemen get home. And again, thank you for your expertise and your willingness to be with us and share your knowledge today. It has been a great hearing.

And I thank the chairman of the Oversight and Investigations Subcommittee, Mr. Barr, for all his hard work and participation in putting this together and his great comments.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, this hearing is adjourned.

[Whereupon, at 4:15 p.m., the hearing was adjourned.]

A P P E N D I X

September 12, 2017

Reforming and Depoliticizing the Federal Reserve

Testimony of Charles W. Calomiris
Before the U.S. House of Representatives
Subcommittee on Financial Institutions and Consumer Credit
and Subcommittee on Monetary Policy and Trade
of the Committee on Financial Services

September 12, 2017

The Federal Reserve is now more politicized than it has been at any time in its history, and consequently it is also less independent in its actions than at any time in its history, with the exception of the years 1936-1951 when it lacked effective monetary policy authority.

The Fed's leadership argues that the accumulation of a variety of discretionary powers enhances its effectiveness and independence, but history and logic tell a different story. As the Fed accumulates more and bigger political lightning rods of discretionary power – often through its own active lobbying for increased power, as during the aftermath of the 2007-2009 crisis – the Fed finds itself increasingly politicized, and less independent, both in the realm of monetary policy and in regulatory and supervisory actions.

The Fed's discretionary powers – which now encompass monetary, fiscal, regulatory, and supervisory matters on a grand scale – have been growing over the past decades and today are greater than ever. With that discretionary power inevitably comes attacks by special interests seeking to manipulate those powers. The Fed finds itself making political deals with special interests and their representatives largely as a result of its burgeoning discretion. Examples of how this has affected regulatory policy include the politicization of CRA enforcement and bank merger deals in the 1990s and 2000s, which also led the Fed to fail in its job as prudential regulator of risk prior to the crisis, and the disgraceful complicity of the Fed in "Operation Chokepoint" in recent years.

Fed leaders intent on preserving their discretionary power wrongly argue that unlimited flexibility helps them to be more effective. They resist proposed clarification of their mandates or requirements that they follow clear rules when crafting policy despite the compelling economic arguments in favor of those proposals. It is downright unseemly to see Fed leaders go to great pains to defend the status quo of vague and unaccountable mandates placed on their actions. They resist and mischaracterize the proposed establishment of a flexible, rule-based system to enhance Fed monetary policy accountability, as they actively seek new authorities to make and enforce financial regulations without adhering to formal rule making procedures or seeking Congressional approval. They actively and successfully resisted efforts (like those of Senator Dodd in 2009) to transfer powers from the Fed to other less conflicted regulatory entities that might operate more independently.

Fed leaders defending their power also offer distorted and self-interested opinions about important public policy questions, while pretending that their opinions should be viewed as unbiased professional analysis. Fed Chair Janet Yellen's August 2017 Jackson Hole speech was a prime example. It was a full-throated defense of the status quo of financial regulation, and the Fed's status as financial regulator in chief. But Chair Yellen ignored scores of studies that contradict her narrative of the goldilocks status quo. For a literature review, see my May 2017 book, *Reforming Financial Regulation After Dodd-Frank* (Calomiris 2017a), and the forthcoming special issue of the *Journal of Financial Intermediation* containing original empirical studies of regulatory problems arising from post-crisis regulatory policies. Many of the studies she ignored were written by economists working at the Federal Reserve Board, the various Federal Reserve Banks, and the Office for Financial Research, as well as by top academic researchers. Don't be fooled by her charade. Financial regulatory policy is unbalanced, unlikely to prove effective in achieving its objectives, and fails to meet basic standards of due process for a democracy operating under the rule of law.

The core problem that must be addressed is the absence of clear rules guiding the procedures followed by the Fed when setting monetary policy or adopting regulations or supervisory practices. Basing decisions on such rules – which could be designed to be flexible and to change as needed over time – would ensure greater effectiveness and accountability of monetary policy and regulatory policy, and enhance Fed independence. As I explained in my April 4, 2017 testimony before this committee (Calomiris 2017b), "paradoxically, unlimited Fed discretion does not result in greater independence of action because unlimited discretion invites political interference." Fed independence is best achieved by imposing discipline on the process of monetary and regulatory policies in a way that sets clear objectives for both sets of policies and enhances accountability with respect to achieving those objectives.

As I show in Calomiris (2013), which I attach as an exhibit to this report, in the absence of clear rules, pressures on policy makers tend to make them cede ground to special interests, and they do so in a myopic way, reflecting current political pressures of special interests rather than long-run public interests. For example, when monetary authority is not delegated to an independent central bank acting under clear rules that limit special interest pressures, elected officials and others can pressure central bankers to print money in lieu of taxes to pay for election-year concessions to powerful constituents. The existence of clear mandates and the requirement that clear rules be enunciated and followed insulates the central bank from those sorts of undesirable short-term pressures. The same logic that explains the desirability of rules-based independent monetary policy also applies to regulatory policy. Bank regulation should be vested in an accountable agency that follows rules established by Congress and is subject to Congressional budgetary discipline.

In April, I testified about the appropriate way to structure Fed monetary policy using a flexible rules-based approach, and I also discussed a variety of other changes in the governance structure of the Fed that would enhance the diversity of thinking, quality of analysis, accountability and independence of monetary policy.

In that testimony I made several recommendations to address the need to reduce existing conflicts of interest in Fed powers and responsibilities that are distorting monetary and regulatory policy decision making, and I proposed some budgetary reforms that would prevent the use of Fed revenues for fiscal policy actions not controlled by Congress. I will not repeat all those arguments here, but instead focus here on alternative measures – which are less ambitious than my proposal to implement the 2008 Treasury Blueprint for regulatory restructuring to remove the Fed from day-to-day regulation and supervision, and therefore, perhaps easier to accomplish.

I reiterate that, in my opinion, the ideal set of reforms would establish clear rules to guide both monetary policy and regulatory policy, would avoid undesirable conflicts of interest by placing day-to-day regulatory and supervisory authority in an agency other than the Fed, and would establish administrative and budgetary discipline over the process of regulation and supervision.

Fed leaders often claim that their role as lender of last resort requires them to maintain regulatory and supervisory authority over banks. That is a fatuous argument. Despite Fed officials' defenses of their growing regulatory powers by arguing for synergies between monetary and regulatory policies, there is no evidence of any synergy between monetary and regulatory policy. Vincent Reinhart (2009), a former high-level Fed official, has questioned the Fed leaders' arguments in favor of such synergies: "There is an easily verifiable test. The arm of the Fed that sets monetary policy, the Federal Open Market Committee (FOMC), has scrupulously kept transcripts of its meetings over the decades. (I should know, as I was the FOMC secretary for a time.)....If the FOMC made materially better decisions because of the Fed's role in supervision, there should be instances of informed discussion of the linkages.

Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that historical resource. I don't think they will be able to do so." The information needed by the lender of last resort pertains to examinations and is unrelated to day-to-day regulatory or supervisory power. As the 2008 Treasury blueprint noted, the Fed could participate in examinations, as needed, without having to craft regulations and be responsible for day-to-day supervision.

The history of growing Fed involvement in the regulation and supervision of banks did not result from a perceived synergy between monetary and regulatory policy but rather because of accidents of history that made it more expedient to locate new powers in the Fed (Calomiris 2013). In the 1930s, the Fed was given new regulatory powers because it happened to have been collecting information that turned out to be relevant to new regulatory mandates. More recently, Administrations and Congresses have vested power in the Fed precisely because doing so made it more likely that the Fed would respond to certain favored special interests. For example, the "third way" espoused by the Clinton Administration explicitly depended on the Fed to apply pressure on banks to grant concessions to special interests that the Administration favored as part of the bank regulatory approvals (Calomiris and Haber 2014, Chapter 7). Fed officials welcomed new power because they saw additional regulatory power as a means of insulating monetary policy from political pressures by giving concessions to special interests on regulatory policy.

Despite the advantages of avoiding such conflicts by removing regulatory policy from the Fed, a less drastic set of reforms could accomplish a great deal of improvement. Specifically, if it were possible to establish clear rules governing both monetary and regulatory policy and impose administrative and budgetary discipline on the process of regulation, then even if regulatory and supervisory powers remained vested in the Fed, the problems associated with Fed conflicts and politicization would be substantially reduced. Clear rules and procedures establishing budgetary and administrative discipline would make the location of regulatory authority less important.

Budgetary and administrative discipline over regulation should ensure that Congress retains its Constitutional authority to make laws and control government spending. Not only would such discipline restore the intent of our Constitution, it would also result in many practical advantages. Requiring Congress to weigh the social costs and benefits that arise in regulation likely would limit special interest manipulation of regulatory discretion after regulations are passed through pressures applied to regulators (see Gordon and Rosenthal 2017 for a discussion of how delegation to regulatory discretion undermined the risk-limiting provisions of the Dodd-Frank Act with respect to the mortgage market). Most importantly, to improve and depoliticize regulation, Congress must establish clear rules that limit the use of unaccountable discretion, must establish budgetary authority for regulatory implementation, and must limit the abusive reliance on "guidance" in regulatory actions by requiring a much greater reliance on formal rule making consistent with the Administrative Procedures Act. If this were done alongside the establishment of a flexible monetary policy rule, that would go a long way toward restoring balance in the regulatory process, while also depoliticizing the Fed and ensuring the accountability of monetary and regulatory policy.

The Fed will not improve itself without action by Congress to require rules-based behavior, to restore proper Congressional budgetary authority over regulatory matters, and to require adherence to due process in regulation. As Reinhart (2012) explains, the Fed avoids creating clear rules because it lacks an incentive to do so. Reinhart shows that this is a consequence of three factors, which Reinhart labels "ambiguity" (of its mandate), "diversity" (a lack of agreement about what its goals should be, given that ambiguity of mandate), and "democracy" (the fact that the FOMC is a collection of different people). Only by clarifying the goals of the Fed and requiring it to work within clear rules can regulatory and monetary policy be improved to make those policies focus on long-run objectives, avoid short-run politicization, ensure appropriate balance and due process in regulation and supervision, and become accountable to the will of the people.

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APPENDIX TO TESTIMONY

How To Promote Fed Independence:

Perspectives from Political Economy and US History

Charles W. Calomiris*

March 11, 2013

Parts of this paper borrow heavily from joint work with Stephen Haber (Fragile By Design: Banking Crises, Scarce Credit and Political Bargains, Princeton University Press, forthcoming). For helpful discussions, I thank Stephen Haber, Marvin Goodfriend, Allan Meltzer, David Wheelock, Geoffrey Wood, and Larry Wall.

I. Introduction

Practically everyone can agree that central bank independence is desirable, within the confines of a clear mandate to guide central bankers, which ensures their accountability to their citizens. Yet differences persist about the answers to five fundamental questions about central bank independence and the mandates within which that independence is expressed. What is the precise meaning of independence? On what does its existence depend? Why is it desirable? How independent is the current Federal Reserve System (Fed), and how independent has it been over its hundred year history? What could be done to enhance Fed independence by improving the current mandate within which the Fed operates?

These five questions have been present constantly in policy debates about the institutional design of central banks, especially since Milton Friedman's classic 1962 article addressing them.[1] Yet despite many decades of thinking, a working definition of Fed independence remains elusive, judgments differ about its extent and feasibility, and policy advocates continue to advocate very different kinds of rules for improving Fed independence.

In this article, I show that convincing answers to the five fundamental questions about Fed independence must begin by recognizing the status of the Fed within American democracy. As a matter of the logic of political economy, that means not only identifying the momentary statutory powers of

[1] Friedman (1962) considers three possibilities: a fully discretionary, independent central bank, a commodity standard, and a monetary rule. Friedman argues that the most desirable of these is a monetary rule. I conceive of a more flexible arrangement than a rule: one in which the central bank has a clear statutory mandate or explicit rule (e.g., a Taylor Rule) that it commits to follow, but it can deviate from the rule. I recognize, following Capie and Wood (2012), and in the spirit of Meltzer (2012), that inflexible rules are not credible, especially in the presence of financial crises. Thus, I favor a "comply-and-explain" regime, in which departures from the rule are clearly announced and explained. The central bank describes why it is deviating from the rule, and commits to do so rarely. The leadership of the central bank, therefore, bears significant personal reputational risk if the supposed reasons for the deviation from the rule are considered to have been inappropriate, on the basis of hindsight. One could make this personal responsibility explicit by requiring that the terms of all Governors and Presidents would come up for renewal two years after they deviated from the rule, which would put discourage departure from the rule unless the circumstances clearly warranted it.

the Fed, but analyzing how alterations in those powers arise. All political constructs – including the Fed – are the result of a political bargaining process. Independence is impossible to define without considering the process through which power is delegated or withdrawn.

When considering the political bargains that give rise to changes in Fed powers, it is crucial to consider decisions to *combine different authorities* within the Fed. The *combination of authorities* given to the Fed has been important in shaping the independence with which the Fed implements each aspect of its authority. It can be very misleading to focus – as many scholars do – only on the monetary powers that have been delegated to the Fed. Deciding what combination of powers to allocate to the Fed has been an important part of the political bargain affecting Fed independence. The range of the Fed's powers has not been constant over time, and changes in powers can have important implications for changes in the degree of Fed independence. Nor are changes over time in independence uniform across the various types of authority wielded by the Fed (which we will divide into monetary policy and regulatory policy powers). In the context of contemporary Fed actions, I define monetary policy as consisting of open market operations that expand or contract high-powered money (bank reserves plus currency) by buying or selling short-term Treasury securities, or that affect low-powered money through changes in properly bank reserve requirements.[2] The relationship between the extent of Fed power and Fed independence is not straightforward. In particular, it is not true that increased power always

[2] I do not consider Fed "credit" powers in this essay. By credit powers, I mean fiscal activities of the Fed related to the absorption of credit risk through lending and the purchases of risky securities. As Goodfriend (2011, 2012) notes, such powers are an inappropriate circumvention of proper procedures for appropriating funds in a democracy, which should be the purview of Congress and the Administration, not the central bank. These Fed powers became especially important in the recent crisis. Delegation of regulatory powers can have a similarly fiscal aspect, as I will show in the discussion of regulatory policy. I include reserve requirements in my definition of monetary policy. I recognize that this is a controversial definition. Reserve requirements that pay interest below the market (fed funds) interest rate on required balances constitute a tax on banks. Although Fed reserve requirements currently do not pay fed funds rates as a matter of policy, I propose that they should (as discussed further below). I do not explore credit policy for two reasons. First, others, especially Goodfriend (2011, 2012), have already commented on these issues at length. Second, considering the possible means for creating a credit policy authority separate from the Fed to deal with emergency subsidization of credit risk during a crisis would require a lengthy treatment.

produces greater independence. Increases in powers can result in reduced independence along some dimensions and increased independence along other dimensions.

A convincing treatment of the logic and history of Fed independence could be the subject of a lengthy book. In this article, my ambitions are more modest. I construct a working definition of Fed independence that reflects the realities of American democracy – one that is informed by Fed history, and that takes account of the interactions among the various aspects of Fed power in affecting the extent of policy independence. I structure the discussion by first summarizing the argument of the paper in the form of eight sets of propositions, in Section II, which together address the fundamental questions about Fed independence that I posed in the first paragraph. More detailed evidence in support of those propositions is provided in Sections III and IV. Section V concludes.

II. Eight Sets of Propositions about Fed Independence

Proposition 1: Independence of authority of any agency is usefully defined as the ability to act, within the confines of a mandate, on the basis of judgment, and to do so with an expectation of impunity. An expectation of impunity is crucial to the existence of independence. An independent authority is independent not simply by virtue of the granting of de jure authority at a moment in time, but also by virtue of its reasonable expectation that the delegation of power will not be withdrawn as a consequence of undertaking legitimately independent decisions (that is, decisions that are made according to due process and within the confines of the entity's statutory mandate).

Proposition 2: The de jure granting of independent authority does not itself guarantee legitimate independent action. Legitimate central bank independence, as a behavioral reality, "generally requires" that four separate conditions must all be satisfied: (i) the presence of a clear statutory mandate (otherwise there is no way to gauge legitimacy – that is, to see whether the mandate has been exceeded), (ii) the granting of statutory power for independent action within the constraints of the mandate, (iii) expected statutory authority persistence (a reasonable expectation that the exertion of independent authority within the confines of the preexisting mandate will not result in a change in the mandate),[3] and (iv) central bank leadership that is desirous of acting independently. It is possible for a central bank to gain legitimate independence without one or more of these requirements (by virtue of exceptional leadership, successful policies, and spontaneous public approval), but this is unlikely.

Proposition 3: Independence is desirable because it constrains the ability of elected officials to make policy decisions. Presumably, the potential value of such constraints revolves around two aspects of political decisions in a democracy, which may be considered undesirable in economic policy making: myopia and logrolling. Myopia refers to the tendency of elected officials to sacrifice long-term objectives in order to retain their political power via reelection. Logrolling (mutual back-scratching among vested interests) makes it possible that policy choices that would benefit everyone may not be chosen because they are not a top priority of any powerful special interest. A political bargain that cobbles together a voting majority by making a concession to each member of its coalition will avoid supporting some desirable economic policies, especially if those policies make it harder to fulfill the top priorities of the various special interests that support the coalition.

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[3] Consider an illustration of this point from the history of the Supreme Court. Under the Constitution, Supreme Court Justices serve for life. Lifetime tenure by itself would mean little if the Congress could act to amend the law to shorten the tenure of federal judges. The fact that it would require a Constitutional amendment to alter their tenure contributes to the Court's independence. Similarly, the fact that under current law, the number of Justices is limited to nine is important, as it limits the ability of Congress and the Administration to pack the court with new appointments to push through a point of view (for example, this was done by President Grant to achieve an outcome with respect to the constitutionality of inflationary legal tender laws in the 1870s, and President Roosevelt threatened this action in the 1930s during his battle with the Court). The nine-Justice limit, however, is arguably less potent a protection of independence than lifetime tenure because it is more easily reversed (it is a matter of statute, not the Constitution).

For example, as the result of myopia and logrolling, if monetary authority is not delegated to an independent central bank, elected officials may choose to print a large amount of money (rather than increase taxes, which would run afoul of one or more powerful constituents affected by that tax) to pay for election-year grants to some of their most powerful constituents. Elected officials may choose to do so despite the consequences of inflation in the future.

Monetary policy is an ideal candidate for delegation to a central bank precisely because the costs of incremental decisions to inflate are small and widely distributed in the population, and because they tend to arise with a lag. Problems of myopia and logrolling – which are especially pronounced in populist democracies like that of the United States – will therefore tend to benefit from delegation of monetary policy to a truly independent central bank. (Of course, myopia and logrolling may also make it far less likely that populist democracies will choose to create truly independent central banks in the first place – a problem to which I will return.)

Even a truly independent central bank may not choose to adhere to monetary policies that are in the interest of its citizens, however, for one of three possible reasons: (1) The central bank may choose objectives that are contrary to the public interest, either because of its freedom to dictate objectives, or because it is under the pressure of particular political factions. (2) Even in the absence of political factions, without a constraining mandate that requires the central bank to adhere to particular long-term objectives, it may make policy choices that are popular on a moment-to-moment basis, but that are contrary to the public interest because of a time inconsistency problem (Kydland and Prescott 1977). (3) The central bank may be incompetent in exercising its discretionary authority. Thus independence by itself, in the absence of a constraining mandate that guides policy objective and a competent agency, is no guarantee of desirable policy.

The same logic that explains the desirability of independent monetary policy also applies to regulatory policy, and explains why bank regulation is also a candidate for delegation to a truly independent agency (not necessarily the central bank). Regulation (most obviously, selective relaxation of entry barriers) can also be used to serve vested interests at the expense of the general populations. Entry barriers in fact have been used in precisely this way throughout U.S. banking history. Thus, if an independent regulatory agency can be established, it could conceivably produce decisions that are not influenced by myopia and logrolling.

Proposition 4: Unfortunately, for most of Fed history, with respect to both of its main categories of authority (monetary policy and regulatory policy), one or more of the four necessary conditions for independent behavior has been absent. As a consequence, it has been rare for the Fed to act independently. Independence has been rare in monetary policy; the only eras in which independent action in monetary policy was clearly evident were 1921-1933 and 1979-2006 (comprising less than half of the Fed's history). In the area of regulatory policy, an area of Fed authority that has become increasingly important since the 1980s, Fed policy has been much more politicized. The variation over time in the extent of Fed independence is not associated with statutory changes in the Federal Reserve Act, but rather with changes in the economic and political circumstances in which the Fed acted, and with its leadership.

Proposition 5: The greater politicization of regulatory policy, in comparison with monetary policy, reflects political trends that favored their use as hidden tax-and-transfer policy tools, especially beginning in the 1990s, as part of the "third way" policy approach of the Clinton Administration, which sought to use financial system regulation to achieve objectives that it could not achieve through the normal appropriations process. Fed leadership did not resist that trend, but rather, embraced its newfound powers and vocally sought to obtain increasing regulatory authority, which it did obtain in the 1990s and subsequently.

The leadership of the Fed has always given greatest priority to obtaining and preserving independence with respect to monetary policy. The Fed's quest for increased regulatory authority, and its willingness to act as a political intermediary with respect to the uses of regulatory policy, may be seen as an attempt to enhance and preserve the Fed's monetary policy autonomy. Because the Fed's leadership gives greatest priority to preserving and enhancing its monetary policy independence, delegating enhanced decision making powers in the area of regulatory policy to the Fed tends to encourage political tradeoffs that result in *relatively less independent regulatory policy, but relatively more independent monetary policy*. This likely has been anticipated in the political bargains that have allocated regulatory policy authority over the past three decades; the increasing breadth of powers granted to the Fed, therefore, can be seen as the outcome of a political bargain trading off of one aspect of Fed independence for another.

In the area of regulatory policy, the Fed has generally been willing to act as a compliant intermediary to implement the political bargains hashed out by Congress and the Administration – including bargains that used regulatory policy as a hidden form of fiscal policy. There are many examples of this phenomenon, but the most obvious and socially costly example was the Fed's oversight of bank mergers during the 1990s and 2000s. The Fed's intermediation of the grand political bargain with respect to bank mergers during that era was likely a greater contributor to the crisis of 2007-2009 than the Fed's frequently criticized departure from the Taylor Rule in 2002-2005. One interpretation of the Fed's desire to obtain regulatory power and acted its willingness to act as an intermediary of politicized regulation is that doing so is perceived as helping to preserve its monetary policy independence.

Proposition 6: Even in the area of monetary policy, greater Fed independence generally has not produced better policy outcomes; indeed, times of relatively great independence have been associated with all three of the major errors of monetary policy in the United States during the Fed's history (the Great Depression of 1929-1933, the Great Inflation of 1965-1979, and the loose-money prelude to the subprime crisis of 2002-2005).

The Great Inflation of the 1960s and 1970s is mainly attributable to the limits on independent action by the Fed during that period, owing to a combination of political pressures on the Fed to monetize government debt in the 1960s and 1970s and to the political agenda of Fed leaders during that time. Nevertheless, to the extent that Fed leadership enjoyed independence during that era, its adherence to simple Keynesian Phillips Curve analysis encouraged the tolerance for accelerating inflation; thus, even in the absence of politicized choices, flawed thinking about monetary policy likely would have produced an inflationary acceleration.

With respect to the other two major monetary policy errors during Fed history – the monetary contraction of 1929-1933 and the monetary expansion of 2002-2005 – it is important to recognize that Fed independence was at its peak during those periods. In the first case, the Fed's discretionary errors were attributable to its pursuit of a flawed policy rule, which combined adherence to the "real bills doctrine" (a monetary policy doctrine with no current adherents) and money illusion (the failure to distinguish between nominal and real interest rates). In the 2002-2005 period, the Fed's errors reflected a willingness to depart from its Taylor Rule behavior in the interest of avoiding the short-term downside risk of a recession.

The tendency to make important errors in discretionary judgment during these three eras of monetary policy would have been substantially circumscribed if the Fed had faced a clearer mandate to ensure price stability, or if it had adopted a transparent rule as its interpretation of its unclear mandate.

Either of these options would have constrained the latitude of policy makers by forcing them to articulate a long-term rule for monetary policy (e.g., a Taylor Rule), which would have required them to articulate a long-term objective for policy and explain any departures from it. Thus, the adoption of a clearer statutory mandate, or of a rule-based interpretation of the existing mandate, would not only have increased Fed independence (by insulating the Fed against political pressure – see Proposition 2), it would also have improved the outcomes resulting from the wielding of independent authority. This logic is especially relevant now, as the risks to the erosion of Fed independence going forward are substantial, and as the recent QE policy experiment has removed any semblance of adherence to a Taylor Rule, or any other rule, from monetary policy.

Proposition 7: The Fed's leadership tends to exaggerate the independence of the Fed, while seeking unfettered discretionary authority and resisting rule-based mandates that would increase Fed accountability. These actions do not foster legitimate independence, or maximize the benefits of independence that is achieved. They may reflect, in part, the increasing dominance of professionally trained macroeconomists in the leadership and staffs of the Fed. With some important exceptions, Fed leaders and economists increasingly have become professionally trained macroeconomists. The majority of them have been schooled in highly simplified models of monetary policy, and they tend to place too much faith in the latest versions of these faddish and unrealistic models, perhaps because doing so reinforces their credentials as policy experts and improves their career prospects. There is, of course, nothing wrong with using simplified and formal models as heuristic devices for honing one's reasoning. But one should not pretend that those models can serve as the basis for confident judgments about the consequences of discretionary actions.[4]

[4] As Meltzer (2012) notes: "Recently, the Board staff and principal members used a model based on Woodford's (2003) elegant modeling. This, too, is deficient. In the model, money and credit do not matter for monetary policy. And prices of assets are not part of the transmission mechanism. Only short-term interest rates and rational expectations are relevant. How could we have a credit crisis? Could anyone believe that the decline in housing

The bias toward undisciplined discretion encourages a resistance within the Fed to clearer, rules-based limits on the exercise of Fed discretion. That resistance to rules – while often pursued in the name of promoting Fed independence – actually makes legitimate Fed independence much less likely (Proposition 2), and also makes the exercise of Fed discretionary authority more prone to error.

Furthermore, the emphasis on many years of training in highly technical macroeconomic modeling generally results in pervasive ignorance about history or about the Fed's role in regulatory policy. This ignorance contributes to a lack of interest in and understanding of the Fed's uses of regulatory policy tools, and aggravates the Fed's willingness to allow political pressures to determine regulatory policy outcomes.

Proposition 8: To promote independence along both dimensions of economic policy (monetary and regulatory) two sorts of policy reforms are required: (i) separation of authority over the two areas into two distinct agencies (to avoid tradeoffs that reduce independence of regulatory policy), and (ii) the establishment of clear mandates and accountability procedures for each category of policy. In particular, with respect to monetary policy, the Fed's mandate should be expressed in the form of a "comply or explain" rule (e.g., a Taylor Rule, or some other similar rule) that would make clear the objectives of monetary policy, and thus *permit* and *require* greater accountability. These policy actions would substantially increase the likelihood that the four necessary conditions of policy independence would hold, and thus would promote greater independence of policy.

I do not attempt to "prove" these eight complex and controversial propositions in this article. Rather, as a first step, I present them as an interpretive narrative to stimulate discussion and debate.

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prices was a rational expected response to policy? I find it incredible that a central bank ignores changes in money and credit. Simply put, that is a mistake that not only ignores much that economists have learned about monetary economics from analysis and history. No less surprising is the total neglect of the role of asset prices in the transmission mechanism of monetary impulses. Earlier work by Brunner and Meltzer (1993) and by Tobin (1969) did not neglect asset prices or credit."

They reflect my understanding of the logic of political bargaining and a much broader historical narrative of politics, banking and central banking in the United States (see, for example, Meltzer 2003, 2009, 2010, Calomiris and Haber 2013). Neither do I claim originality for any of these ideas. Since Milton Friedman's classic work on these problems, many other scholars have made similar arguments to those contained in the eight sets of propositions, although I do not believe that any previous study has integrated all of these various propositions.

III. The Logic of Central Bank Independence and the Monetary Policy History of the Fed

In what sense is any government entity (hereafter referred to as an "agency") within a democracy "independent"? Clearly, independent action is not usefully defined to be synonymous with tyrannical action. To be legitimate within a democracy, independent action must occur within the confines of Constitutional and statutory mandates that define the purposes of independent action. Furthermore, in pursuit of those mandates, the independent agency also must follow proper procedures, consistent with democratic oversight and accountability, and adherence to the rule of law.

It follows, therefore, that statutory authority that delegates decision making responsibility is necessary for legitimate independence to exist. But it is not sufficient. For example, if an agency knows that the delegation of authority will be withdrawn unless a particular outcome is chosen by the agency, then that agency is not truly independent in its actions. Unless an agency can act with impunity – so long as the agency's actions conform to the mandates that define its purposes and the required procedures that govern its deliberations – the agency cannot be independent.

In order to act with the impunity necessary to foster true independence, the statutory mandate of the agency must be clear. A lack of clarity in the mandate makes it hard to tell when the central bank is achieving its goals and when it is not. An unclear mandate therefore makes it harder to hold the agency accountable for doing what it is supposed to do (thereby ceding too much authority to the agency to pursue its own goals). Just as bad, an unclear mandate makes the agency a target for politically motivated attacks that can threaten its independence.

These principles are illustrated well by the monetary policy history of the Fed, which is replete with examples of how statutory delegation of authority to the Fed has not been sufficient to ensure its true independence. Indeed, de jure and de facto independence have not been closely associated over time, and sometimes have moved in the opposite direction over time (see also Taylor 2013). The Banking Act of 1935, which restructured the Federal Reserve System, made the Fed more politically responsive by centralizing authority and increasing the power of government appointees within the Fed. But this restructuring had little immediate effect on Fed policy or independence because of the effective substitution of Treasury authority over monetary policy until 1951. The creation of the so-called dual mandate for the Fed in 1977 (which was really a triple mandate requiring the Fed to maintain price stability, maximum employment, and interest rate stability, without defining priorities or weights across these often competing objectives) might have been expected to make the Fed less independent. The creation of multiple, unclear and conflicting mandates might have contributed to the politicization of the Fed. As we will see, however, it coincided roughly with the beginning of an era of high de facto Fed independence.

World War I

Most of the changes in the extent of Fed monetary policy independence had nothing to do with statutory changes. The first meaningful change – which reduced Fed independence – came with World War I. The Fed was established in 1913 on the basis of the "real bills doctrine" (the view that bills related to trade should be the exclusive asset bought and sold or held as collateral against loans to member banks). Government debt was excluded as collateral from Fed discounting operations to ensure that the Fed did not act as a source of funding to the government. Importantly, the Fed's charter required it to maintain gold convertibility, which substantially circumscribed its actions. The Fed's initial structure – which gave primary authority to its Reserve Banks, which were owned and controlled by the Fed member banks in their respective districts – also limited the extent to which political pressures could control Fed actions.

Under the pressures of World War I's financial challenges, however, the Fed began to become an important partner in assisting the U.S. government to market its debts. In 1917, reserve requirements were reduced to permit expanded credit to finance the war (Meltzer 2003, p. 79, footnote 31). And collateral rules for Federal Reserve note issues were relaxed in 1917: the total amount of collateral was reduced, and perhaps more importantly, promissory notes of member banks secured by government bonds could be used as collateral for the notes (Meltzer 2003, p. 89).[5] At the end of World War I, in the interest of boosting demand for outstanding Treasury debts, the Fed also reduced its discount rate for loans collateralized by Treasury securities.

The accommodation policies of World War I had long-term effects. The discount rate reduction led the Fed to abandon its "penalty" rate policy for targeting the discount rate, which had been one of its core founding principles (Meltzer 2003, pp. 73, 86).[6] This change subverted the Fed founders' intent that the Fed would use a penalty discount rate as its primary tool of managing the cyclical and seasonal availability of credit in the money market. More broadly, the World War I precedent of making the Fed subservient to the interests of marketing Treasury debt not only produced the short-term inflationary

[5] Despite the real bills doctrine, the Fed always had the ability to purchase government securities as part of its open market operations. The extent of such purchases were constrained, however, by the need to maintain gold convertibility, by the rules governing the gold backing for Federal Reserve notes, and by the dominant role of discounting in the Fed's balance sheet prior to 1932.

[6] There have been moments when the discount rate was above the market rate, but that was not part of a consistent policy rule implemented to achieve that outcome.

binge of 1917-1920 (Meltzer 2003, pp. 90-107), it also set the stage for subsequent changes that eventually made the Federal Reserve a fiscal instrument of the U.S. Treasury.

The Great Depression

Those changes were completed during the 1930s, in reaction to the political upheaval that accompanied the Great Depression. First, in the 1932 Glass-Steagall Act, a temporary measure that was later made permanent, the Fed was permitted the use of Treasury securities as collateral for Federal Reserve note issues (Calomiris and Wheelock 1998, Meltzer 2003, pp. 358, 417-418, Calomiris 2013). In March 1933, the United States left the gold standard, freeing monetary policy from its constraining price level anchor. In 1934, the Treasury gained substantial new monetary powers through the Gold Reserve Act of 1934 and the Silver Purchase Act of 1934 (see Calomiris and Wheelock 1998), which meant that it could exert separate control of monetary policy, if it so desired. In 1935, the Fed was restructured to centralize its policy actions in the Board of Governors, which was the part of the system whose leaders were government appointees (Calomiris and Wheelock 1998, Meltzer 2003).

The Fed is regarded as having operated reasonably independently in setting its monetary policy from about 1923 until 1932 (before the political backlash of the Depression eliminated many of the constraints that had insulated the Fed from political manipulation). After 1933, however, control over monetary policy was effectively transferred to the U.S. Treasury, not as the result of statutory changes with regard to Fed powers, but rather by creating new policy options for the Treasury to offset Fed actions through its new monetary powers created in 1934. After 1933, the Fed's balance sheet was small compared to the new monetary issuance powers that had been granted to the U.S. Treasury in 1934. Any attempt to tighten monetary policy by shrinking its balance sheet would have simply been undone by a Treasury policy of monetary expansion (Calomiris and Wheelock 1998). As Edwin Kemmerer (1934) lamented, "...the Federal Reserve would be powerless to control the market in the face of the operations of the Treasury Department with its new two billion dollar stabilization fund. These operations will of necessity dominate the situation." Secretary of the Treasury Morgenthau mused about his ability to control monetary policy through the threat of using his new powers in his diary, where he noted that this arrangement also would allow him to escape blame for mistakes in policy because the Fed would be incorrectly regarded as in charge of monetary policy.

The 1951 Accord and the Great Inflation

In 1951, the famous Treasury-Fed Accord led to what is widely regarded as the re-establishment of Fed independence. It is noteworthy that there was no statutory change associated with the Accord, but rather an agreement between the Fed and the Truman Administration that the Fed could now engage in monetary policy rather than simply pegging interest rates on government debt under Treasury instruction. This new arrangement reflected an important fact: the Fed's balance sheet had grown so much due to its monetization of government debt during World War II that the Fed's ability to contract now was far in excess of the Treasury's monetary powers to expand, implying that the Fed would be able to win any prospective game of chicken with the Treasury over the setting of the money supply.

After the 1951 Accord, the Fed operated somewhat independently of the Treasury, but not completely so. Its "even keel" policies specifically intended to stabilize markets during Treasury debt offerings. Additionally, the Fed sometimes acted specifically at the behest of the Treasury to support special funding needs. Critics of the Fed that sought greater independence – like Senator Paul Douglas – withheld support for Martin's reappointment as Fed Chairman in 1956 (Meltzer 2010, pp. 132-3). These critics pointed to the main brake on Fed independence since 1951: the willingness of Fed leadership to act independently. That lack of willingness to act independently sometimes reflected political threats. In the 1950s, a longtime critic of the Fed, Rep. Wright Patman (Texas) constantly offered proposals to reform the Fed, restructure it, and audit it. One of his proposals, in January 1955, would have required the Fed to "support the price of United States Government securities at par" (Meltzer 2010, p. 226).

Political pressures on the Fed became intense in 1967 under the combined fiscal pressures of financing the Viet Nam War and the Great Society. Under heavy lobbying by the Secretary of Treasury and prominent members of Congress, in July of 1967 the Fed Board denied requests by the Federal Reserve Banks to hike their discount rates. As Meltzer (2010, p. 511) put it: "Coordination [with the Treasury] now dominated independence for many at the Federal Reserve, so political concerns dominated economics." In August, in an attempt to limit interest rate increases, Congress also proposed legislation limiting interest rates on time deposits, and increasing reserve requirements on time deposits. The Fed Board negotiated with members of Congress to withdraw the bill in exchange for its commitment to use its judgment as necessary to achieve the desired result. In other words, the Fed traded explicit limits on its independence for implicit ones. The implicit threats of government action to curb Fed powers if the Fed hiked interest rates were an important contributor to the acceleration of inflation during the 1960s. The Fed's commitment to keep interest rates low constituted a commitment to monetize booming government deficits. Meltzer (2010, pp. 527-29) lists four main errors by the Fed that contributed to the acceleration of inflation in the 1960s, and the first of these was that "the Federal Reserve tried to coordinate policy with the administration and persisted in doing so long after it became a serious impediment to carrying out its responsibilities. Even when Martin recognized that a tax increase was unlikely, he resisted even mild steps toward restriction...Coordination was the enemy of central bank independence..." (p. 527).

As inflation accelerated in the late 1960s, an important contributor to the lack of willingness of Fed leadership to act independently was that lack of desire to do so. This reflected political preferences that led Chairman Arthur Burns to put loyalty to the Nixon administration above the pursuit of proper policy objectives. As Meltzer (2009) shows, Arthur Burns, in particular, was so loyal to President Nixon that he served the interests of Nixon's electoral ambitions, despite the consequences for rising inflation.

Central to the limits on Fed independence that came from both political threats and misplaced loyalties was the lack of statutory clarity about the objectives of monetary policy. That lack of clarity avoided accountability of the right kind – which would have been so useful to constrain Arthur Burns' willingness to allow inflation to accelerate. It also encouraged political attacks. Because any Fed critic was free to point to some shortcoming in the economy related to the long list of ill-defined Fed policy objectives, it was very hard for the Fed to defend itself against political attack. If the Fed had been given the single, overarching objective of ensuring price stability (like the Bank of England and the European Central Bank have been given), or had been given a more complicated, but clear, rule to follow (e.g., a parameterized Taylor Rule with a clearly specified long-run target rate of inflation) then the Fed would have been able to defend itself against attacks by referring to its compliance with its statutory mission. In the event, however, critics were free to attack the Fed along any dimension they chose, and could point to evidence that this dimension was part of the Fed's ill-defined mandate. Once freed from the constraint of adherence to the gold standard, and the nominal anchoring that this entailed, it was almost inevitable that an era of high fiscal deficits would produce monetary accommodation and high inflation. The absence of a clear mandate, made it virtually impossible to even define Fed independence (which is properly defined as latitude to act to achieve a specified goal), or to distinguish it from Fed diktat, or to objectively evaluate Fed performance in order to defend the Fed's record. In short, the absence of a clear mandate made legitimate independence very difficult to achieve.

Volcker, Greenspan, and the Great Moderation

But not impossible, as Paul Volcker would soon demonstrate. There is no doubt that Paul Volcker brought a different brand of leadership – and a clear commitment to independence – to the Fed when he assumed its leadership. But this change did not occur in a vacuum. High inflation had a silver lining: it was very unpopular. When Paul Volcker agreed to take on the job of Fed Chairman, he made it clear to Jimmy Carter before he was appointed that he would aggressively fight inflation, and that the consequences would not always be pleasant. President Carter supported his nomination in spite of (or perhaps because of) that commitment.

Volcker's commitment to beat back inflation, and his new brand of leadership, instilled a new culture of independence at the Fed, one that celebrated courage and a new commitment to the medium- and long-term objective of price stability, and which sought to enhance and preserve monetary policy independence against momentary political influences. There was no better proof of the Fed's new independence than the economic decline of 1979-1982. The Fed did not deny its role in producing tough economic times; instead, it argued for the necessity of maintaining its commitment despite those costs.

Volcker's relationship with Fed staff, however, could be a bit rocky. He was not impressed by formal modeling or by opinions based on the latest macroeconomic fads -- whether from "saltwater" or "freshwater" macroeconomists. And although he branded his policy approach "pragmatic monetarism" neither did he subscribe to the views of the academic monetarist camp. As it turned out, Volcker's lack of interest in the modeling vanities of economists served him well. As Allan Meltzer (2012) put it:

> From the mid-1970s to the early 1980s, the Federal Reserve inflation forecast was below actual inflation for 16 consecutive quarters. The staff used the Phillips Curve to forecast inflation. There is considerable research showing that Phillips Curve forecasts are unreliable...When Paul Volcker became chairman of the Board of Governors, he told staff that their inflation forecasts were inaccurate. He repeated the message publicly and in Congressional testimony....Paul Volcker not only rejected use of the Phillips Curve, he developed and promoted what I call the anti-Phillips Curve. Unlike the staff approach relying on quarterly data, Volcker emphasized longer term responses. His approach, based on empirical observations, was that during the 1970s, inflation and real growth or the unemployment rate rose and fell together. There was no tradeoff in the longer period. In a television program as early as 1979, shortly after announcing his new policy procedure of targeting reserve growth and allowing interest rates to be set in the market, he was asked what he would do when unemployment rose and how policy reduced

inflation. His reply cited the co-movement for the 1970s when employment rates and inflation rose together. He predicted that they would fall together under his policy. They did. His prediction was correct.

Alan Greenspan was able to build on Volcker's achievements, both because of his own commitment to similar principles, and because the strong growth and low inflation enjoyed during the Great Moderation of 1986-2003 seemed to vindicate the short-term sacrifices made during the Volcker years. Greenspan, like Volcker, did not passively accept the views of his staff. "As chairman, Alan Greenspan told the staff that he did not find their inflation forecasts useful. Like Volcker, he explicitly rejected the Phillips Curve" (Meltzer 2012). Greenspan's success in out-forecasting the models became legendary. He became the "maestro." The Fed's credibility, and its chairman's, was never greater. This mattered for enhancing Fed independence. Although political pot shots from Congress continued, the record of success insulated the Fed from any serious attacks on its monetary policy independence.

Off the Rails, Again

Unfortunately, from 2002 to 2005, the Fed decided to make use of its high degree of independence to pursue an unusually expansionary monetary policy. In doing so, it departed from its prior adherence to something approximating a Taylor Rule with a roughly 1-2% long-run inflation target. Over the course of these four years, the fed funds rates was maintained at levels that averaged more than 2 percentage points below the "warranted" fed funds rate that was consistent with adherence to the Taylor Rule. This was also the only four-year period in postwar history (other than the late 1970s) that saw a persistently negative real fed funds rate. This pattern, unfortunately, demonstrated that independence – when not guided by clear, rules-based mandates – may have costs as well as benefits.

As in the high-independence period of 1929-1933, and the somewhat independent era of 1951-1979, Fed policy in 2002-2005 reflected beliefs about monetary policy that were soon discredited. In the two earlier periods, adherence to the real bills doctrine (in the form of the Riefler-Burgess doctrine), and a lack of understanding of the relationship between nominal interest rates and inflation, were central to the errors of the Fed in the two earlier periods (Brunner and Meltzer 1964, 1968, Wheelock 1991, Meltzer 2003, 2010). In the case of the 1960s and 1970s, another contributor to accelerating inflation was the belief in a simple Keynesian Phillips Curve (Meltzer 2009, 2010). In the 2000s, it is harder to identify precisely the ideological source of the Fed's decision to depart so dramatically from the Taylor Rule. That decision seems to have reflected concerns about oil prices and other very short-term concerns that were seen as downside risks for the economy. Governor Frederic Mishkin, in particular, was vocal in defending the departure from the Taylor Rule to protect against short-term downside risk.

Many critics, including Taylor (2010, 2011, 2012, 2013), have attributed much of the problem in the recent financial crisis to the impact of loose monetary policy on financial and economic overheating in the years leading up to the subprime bust. That view may somewhat exaggerate the role of monetary policy in the recent crisis because it places too little weight on micro-economic distortions produced by government policies that drove the decline in mortgage underwriting standards during the 1990s and 2000s (Pinto 2011, Wallison 2011, Calomiris and Haber 2013), but there is no doubt that loose monetary policy contributed substantially to the narrowing of credit risk spreads and to increases in the prices of real estate and common stock. The literature documenting the recent effects of expansionary monetary policy on risk spreads and risky asset pricing is now quite large, and includes Dell'Ariccia, Igan and Laeven (2008), Jimenez, Ongena, Peydro-Alcalde and Saurina (2007), Mendoza and Terrones (2008), and Bekaert, Hoerova and Lo Duca (2010).

What If Monetary Policy Had Been Given a Clear Mandate?

The important role of Fed discretion in contributing to the three major monetary policy errors of the past century illustrates another important benefit of establishing a clear mandate to guide Fed policy. In the presence of a clear mandate, Fed officials would have had to explicitly defend their purposeful departures from an explicit, publicly disclosed rule (e.g., the Taylor Rule), rather than simply make vague pronouncements about changes in beliefs, discussed in the absence of any explicit commitment to a rule. The burden of proof would have been on the use of discretion, and this would increase the adverse personal consequences of employing discretion counterproductively. In the presence of a rule, and the greater accountability that it would bring, not only would legitimate independent monetary policy be more achievable, independence would produce better outcomes by giving less latitude to faddish ideas or personal proclivities, which history has shown have a very poor track record in monetary policy.

Monetary Policy Independence at Risk?

Once one recognizes the key role of economic and political events in shaping the extent of de facto Fed independence, the prospects for preserving the current degree of monetary policy independence under the status quo are very bleak. It is not clear how much the Fed's recent actions (particularly QE2, Operation Twist 2, QE3, and the unprecedented use of very specific forward guidance) reflect politicization of the Fed leadership. Did the Fed pursue these measures under political pressure, or perhaps to limit political pressure by appearing to do something in the face of high and persisting rates of unemployment? It is hard to say, but these actions clearly have created objective grounds for worrying about the ability of the Fed to maintain its monetary policy independence in the future.

The key risk that monetary policy poses to the economy now is the possibility that the Fed will be too slow to contract the supply of money and credit once the economy returns to normal. A normal economy will see the money multiplier grow substantially. Unless the Fed contracts its balance sheet or increases required reserves substantially to keep the money multiplier from rising, the return to normal will imply substantial price inflation. Why might the Fed fail to respond by contracting its balance sheet or raising reserve requirements? Because of the de facto political limits to its independence. What would produce political threats to contractionary monetary policy? There are five readily identifiable potential sources of trouble.

The first is the long-run risk of what has become known as "fiscal dominance" – pressures from deficit finance that effectively could constrain monetary policy's ability to tighten. In short, if the U.S. government issues more government debt than it can credibly commit to repay (which I will label an "unsustainably" large amount of debt), one of two things must occur: monetization of the debt or default. While it is true, in principle, that the Fed could refuse to monetize the unsustainable debt of the government and force it to default, in practice that would not happen. Congress and the Administration can always amend the Federal Reserve Act, as needed, to ensure that the Fed purchase sufficient government debt to avoid a default, and of course, they would have every incentive to do so if a recalcitrant Fed leadership failed to "voluntarily" monetize the government's unsustainable debt. The current path of government entitlement spending places the U.S. on a clearly unsustainable path. Absent significant entitlement reform, the U.S. government debt-to-GDP ratio will rise to clearly unsustainable levels within the next twenty years.

The second threat related to fiscal dominance is much more imminent. Whether or not the U.S. government eventually reduces its entitlement spending commitments, a decision to tighten monetary policy and drive up interest rates could imply significant increases in the government's deficit. As the economy recovers and long-term interest rates begin to rise (through a combination of expectations of higher real rates of interest, or of possible monetization of government debt) the interest costs of government debt held by the public will rise. A moderate rise of, say, two percentage points in interest rates could mean an increase in funding costs of roughly $100 billion. Furthermore, holding constant the interest rates on government debt, any shrinkage of the Fed's holdings of government debt as a means of monetary tightening would increase the federal deficit by shifting government debt from the "interest-free" category to the "interest-paying" category.[7] The large existing level of federal deficits, the prospects of sharp increases in interest rates from their historic lows, and the vast Fed holdings of government debt all imply significant risk that the Fed will feel severe pressure from some members of Congress and possibly from the Treasury to delay tightening in the interest of limiting the rise in deficits. Thus the inflationary monetization of government debt could occur long before the explosion of entitlement expenditures.

Third, a contraction of the Fed's balance sheet would require it to disgorge itself not only of government debt but also of mortgage-backed securities (MBS) which it has been buying in vast quantity for the past few years. Any attempt to reverse the flow and dump these into the private market will drive up MBS spreads, and hence mortgage rate spreads. The housing lobby (which is as strong as it is bipartisan) will waste no time appealing to its supporters in Congress and the Administration to pressure the Fed to slow any sales of MBS.

Fourth, in a rising interest rate environment, Fed sales of government bonds and MBS will cause it to incur large capital losses. The Fed does not mark its portfolio to market, but rather, recognizes losses as it sells assets. As interest rates rise, the prices of those assets will decline, and the implied losses could be quite large. A large amount of sales could render the Fed insolvent. Although, as a matter of economics, Fed insolvency on a book value basis is irrelevant to its ability to pursue monetary policy, a Fed insolvency would provide a golden political opportunity for Fed critics. Anticipating those political attacks, the Fed might prefer not to raise interest rates on excess reserves very aggressively.

A fifth problem that could discourage monetary tightening relates to another policy option – the use of interest payments on reserves – which in principle offers a means of tightening without shrinking

[7] Government debt owned by the Fed earns interest, but those interest payments are returned to the Treasury, net of Fed operating expenses.

the Fed's balance sheet. As the economy recovers, banks will want to expand their lending at prevailing interest rates. By paying high rates of interest on excess reserves, it is argued, the Fed can entice banks to maintain those reserves rather than lend them. This will keep the money multiplier from increasing, and thereby constrain the growth of money, credit, and prices without having to shrink the Fed's balance sheet. There are, however, two rather severe political problems that could arise in reaction to this policy. Given how much bankers are despised by a large segment of the public, and given that interest payments on reserves might have to be very high to convince banks to hold vast quantities of excess reserves, large interest payments payments to "fat cat banksters" is not likely to go over well in Congress or the Administration. Furthermore, similar to the effect of realized capital losses from selling assets, high interest payments on excess reserves would render the Fed insolvent on a book value basis.

There is a possible way out of these problems, namely a significant increase in the reserve requirement.[8] By requiring banks to hold reserves, the Fed would not have to pay a very high interest rate on them. Currently, the Fed pays zero interest on required reserves. This is inappropriate because setting requirements for the holding of zero-interest reserves is tax policy, which should be outside the purview of the central bank. A statutory change that would require the Fed to pay the short-term fed funds rate on required reserves (which would avoid imposing a large tax on an already weakened banking system) not only would be desirable as a long-run policy change as a matter of limiting the Fed's powers, it would probably allow the Fed to prevent an acceleration in inflation without shrinking its balance sheet, paying high interest rates to "banksters" or imposing a huge new tax burden on banks. Not only would this policy make sense economically, it would also be less likely than the other approaches to inflation prevention to create political hazards for the Fed. Perhaps surprisingly, Fed

[8] Some Fed officials have also advocated the use of reverse repos on a massive scale as a way to contract the effective balance sheet of the Fed without actually selling assets, at least for a period of time. Repos are a way to repeatedly lend securities without actually selling them, but in doing so, to reduce the effective size of the Fed's balance sheet. Given the scale of the transactions that would be required, and given the skepticism with which the reverse repo idea has been greeted by some market participants, it is highly uncertain whether this tool will be able to provide a means of preventing a surge in inflation.

officials thus far have shown no interest in this policy option.[9] Of course, even an increase in reserve requirements will imply some rising pressure on the fiscal deficit; payments on required reserves will reduce the amount of revenue the Fed can return to the U.S. Treasury.[10]

In summary, a combination of the current size of the Fed's balance sheet, its composition, the fiscal problems of the U.S. government, and the potential for sharp increases in interest rates over the next few years create significant risk of inflation. That risk of inflation, in large part, reflects the implications of these economic factors for the political challenges that the Fed will face if it chooses to tighten monetary policy to try to forestall an increase in inflation. As in the past, it is unlikely that the Fed's statutory powers will change. And, as in the past, the implicit or explicit threats to change the Fed's powers will likely be enough to undermine the Fed's commitment to independent action.

What specific form might these political threats take? The most obvious threat was illustrated by the comments of Former Congressman Barney Frank, who suggested altering the governance of the regional Feds to make their Presidents political appointees. One could also imagine changes that would dilute the voting role of the regional Presidents. It is widely believed that the Presidents tend to be the source of greatest independent actions within the Fed, precisely because they are appointed locally, through a process that gives weight to local business interests rather than the national political interests that determine the appointment of Governors. Clearly, politicians also understand this argument. One could argue that the mere suggestion of the possibility of such a change damages Fed independence by making Fed Presidents more circumspect in voicing their opposition to positions supported by Fed Governors. As the Grand Inquisitor (and presumably Barney Frank) was aware, sometimes you only need to "show them the instruments."

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[9] For a proposal along these lines, see Calomiris (2012).

[10] One issue to be considered is which deposits or debts reserves requirements would be held against. My view is that the base should be broad – total assets less common equity. This would prevent regulatory arbitrage through the redefinition of deposits as repos.

IV. Independence and the Fed's Regulatory Policy Powers

The authority of the Fed in performing its monetary function is well understood and often commented upon (e.g., the timing, membership, voting rules, and press releases related to FOMC meetings). The Fed's role in banking regulation, or more broadly in financial regulation, receives less attention, is not as well understood, and has been much more subject to change over time.

The Fed plays an important role as a regulatory policy advocate in Washington, as a writer of regulations, and as a supervisor. It also represents the United States at the Basel Committee, which sets international prudential regulatory standards for banks. These regulatory functions are performed by the Fed alongside many other (sometimes "competing") financial regulators – the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the state banking and insurance authorities, as well as the courts. This is an activity that increasingly occupies a great deal of time and energy at the Fed – especially since the 1980s – as the structure and rules of the financial regulation game have changed dramatically and much more frequently in the U.S. over the past three decades than the structure and rules for monetary policy. The Fed has taken on a newly dominant role as a regulator – one that has important implications for the future of Fed independence.

Modest Beginnings

From the beginning, the Federal Reserve Banks played a regulatory role, but that role began very modestly, became significant after the Great Depression, and expanded dramatically in the last two decades of the 20th century and beyond. For Fed member banks that are state-chartered (rather than nationally chartered) the Fed has always been the primary federal supervisory and regulatory authority, and it shares regulatory and supervisory authority over state-chartered banks with the relevant states' chartering authorities. The Federal Reserve Board was given significant nationwide regulatory authority for the first time in the Banking Act of 1933, and its authority was then expanded as the regulator of bank holding companies under the Bank Holding Company Act of 1956.

The initial limits on the Fed's role as a regulator reflected the unit banking structure of the U.S. banking system, in which both nationally chartered and state-chartered banks were restricted to operate in only one state, and typically were required to maintain only one banking office. Given the absence of a national system of banks there was little obvious need for a national regulator or supervisor of banks. Indeed, the Fed itself was a highly decentralized system, with control residing mainly in the twelve Reserve Banks, at least until the 1933 and 1935 Acts. Furthermore, the Fed was not itself a chartering authority, and Fed membership was voluntary (indeed, for much of the 20th century, most U.S. banks were not Fed member banks). Finally, the Federal Reserve Banks were owned and controlled by their members. Under these circumstances, not surprisingly, the Federal Reserve System was given little regulatory authority and showed little ambition to impose regulatory constraints on its members. Indeed, the creation of the Fed itself was only possible as the result of some rather significant deregulation. Prior to 1913, national banks were prohibited from lending against real estate.[11] In order to secure political support for the Federal Reserve Act, especially in agriculture-dominated areas, the Act specifically permitted member banks (including national banks) to lend against real estate.

The Great Depression

This changed as a result of the Great Depression. The political fallout for banks from the Great Depression was extreme. It was also extremely misguided. Economic historians now agree that the

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[11] National banks evaded this regulation by lending without collateral and then accepting real estate collateral after the fact as part of an ongoing negotiation with the borrower. Nonetheless, this restriction did lead to significantly less lending against real estate by national banks than by state-chartered banks (for a more complete discussion, see Calomiris and Carlson 2013).

primary causes of financial and economic distress during the Depression were traceable to a combination of misguided monetary policy targeting rules based on "real bills doctrine" thinking and the fragile unit banking structure of the U.S. banking system. Unfortunately, however, the regulatory policy changes relating to banks were based on a very different view, namely that bank consolidation and banks' involvement in securities markets (both of which had been pronounced during the 1920s) had caused the collapse of the banking system. Although this view is demonstrably false it nonetheless formed the basis for the ill-conceived banking reforms of the 1930s (Calomiris 2010). Ironically, those reforms were consciously designed by Messrs. Glass and Steagall (who were, respectively, the principal defenders of the real bills doctrine and unit banking in Congress) to strengthen the regulatory commitment to the real bills doctrine and unit banking.

The principal banking reforms included the separation of commercial and investment banking, interest rate limits on deposits, the creation of Federal Deposit Insurance, and a variety of measures designed to limit the expansion of banking "groups." Glass was the champion of the first two sets of measures, and Steagall was the champion of the second two. These measures were not universally welcomed by informed policy makers, but opponents were unable to counter the strong public support for these measures, which reflected, in part, the highly publicized Pecora Hearings, which attacked Wall Street bankers. In particular, although the President Roosevelt, the Fed, the Treasury Secretary, and Senator Glass all opposed deposit insurance as a destabilizing measure, Representative Steagall was able to push it through on a tide of public support.[12] Glass focused his attention on measures designed to insulate the banking system from securities markets by prohibiting connections between banks and securities related affiliates, limiting lending against securities, and limiting bank lending to affiliates.

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[12] The opposition to deposit insurance reflected the disastrous experience with eight states' deposit insurance experiments, all of which collapsed in the 1920s. For more discussion of the views on deposit insurance and the politics and economics that underlay them, see Golembe (1960), Calomiris (1989, 1990, 1992), Flood (1991), Patrick (1993), Calomiris and White (1994), Calomiris (2010), and Calomiris and Haber (2013).

Interest rate limits were primarily advocated as a means of undermining the interbank deposit market, which had the effect of concentrating funds in New York City banks, which were often used for securities lending. Deposit insurance and limits on banking groups, advocated by Steagall and other unit banking supporters, were designed to protect unit banks from competition.[13] Deposit interest rate ceilings were also motivated as a limit to competition.

The architects of the 1933 reforms needed someone to enforce these new arrangements and there was no practical alternative to the Federal Reserve Board. Who else had sufficient informational access, through the Fed member banks, to monitor the nationwide and international network of banking relationships. Such monitoring was essential for the enforcement of the separation of commercial and investment banking and the new limits on group control of banks, as well as enforcement of Clayton Act limits on interlocking directorships (which would take effect in 1934, and become part of what would become known as Regulation L). The Board played a central role in defining what constituted an affiliate for purpose of the various statutory limits, as well as for examining banks and affiliates to determine whether they were in violation of the various new rules on securities activities, group control, or interlocking directorates. It was also charged with setting margin requirements on securities loans.

It is noteworthy that this new delegation of regulatory responsibilities to the Fed occurred in the context of a highly volatile political environment with respect to controversies over the reform of monetary policy. The 1932 Act had already required the Fed to make use of government securities as collateral for its discounting. Soon the 1934 Gold and Silver Acts would effectively substitute Treasury control of monetary policy for Fed control, and the 1935 Act would centralize Fed power and give

[13] Limits on branching prevented consolidation via that channel, but "group" banking (control of multiple banks by a common company) or "chain" banking (control of multiple banks by a common group of shareholders) could circumvent such limits to some extent by allowing a group of investors or a bank to purchase stock in multiple banking organizations. The 1933 Act and the Clayton Act made this more difficult by limiting the voting rights and corporate governance structures of groups.

greater weight to the politically appointed Board of Governors. The Fed did not support all aspects of the reforms that were remaking its world (for example, the Fed Board opposed the creation of deposit insurance, and the use of government securities as collateral for discounting was anathema to real bills thinking), but the Fed was not in a position to push back the political tide that was fundamentally reshaping the monetary and regulatory rules. All it could do was accept those new rules, roll with the punches, and try to maintain and competently execute whatever authority was left to it.

The Fed's stock was not very high in Washington in the mid 1930s, which may also explain why the Fed was not the institution charged with overseeing the government's main policy changes toward banks. The creation of the Federal Deposit Insurance Corporation (FDIC) and the creation of the Reconstruction Finance Corporation (RFC) meant that two new powerful banking regulators would now operate as parallel organizations to the Fed with their own distinct authorities. Furthermore, it was these two institutions that were given primary responsibility for examining banks in 1933-1934 to determine which would reopen, which would reopen with RFC assistance, and which would be shut permanently. The Fed's regulatory role was primarily as a "preventative" regulator charged with preventing the mixing of commercial and investment banking, excessive lending against securities, and any backdoor consolidation of the banking system via banking groups.

Five Post-Depression Decades of Narrow, Fragmented Banking

The Bank Holding Company Act of 1956 (further extended in 1970 to apply to single-bank holding companies) created further limits regarding the entities that could control banks, and expanded the authority of the Federal Reserve Board in its oversight of the parties in control of banks. Any entity assuming control of a bank had to receive the approval of the Fed Board. The Holding Company Act also gave the Board authority to prevent changes in control that would lead to the control of banks by entities that were involved in non-banking activities (the so-called separation of banking and commerce).[14]

In 1960 and 1966, in reaction to an increase in bank merger activity during the 1950s, and under the continuing pressure of unit bank lobbying (especially, the Independent Bankers Association), Congress enacted legislation (the Bank Merger Act) intended to limit mergers among banks. Bank regulators, including the Federal Reserve Board, now had to consider the competitive consequences of mergers before approving them. Although promoted as a measure to ensure competition, in fact these measures are better understood as measures designed to preserve the market power of inefficient unit banks by limiting the ability of successful banks to grow.[15]

As this brief review makes clear, from 1933 to 1980, the dominant trend in banking regulation, and the role of the Fed and other bank regulators during that period, revolved around the restrictions on bank consolidation and the range of banking activities. Consistent with this trend, virtually no relaxation of branching restrictions occurred, either at the state or federal level, during this period.

Deregulation of Branching and Underwriting Activities after 1980

After 1980, there was a dramatic reversal in banking regulation with respect to consolidation and bank powers (see Figure 1, taken from Calomiris and Haber 2013, Chapter 6). The relaxation of branching barriers took the form of state-level policies (often as part of regional interstate agreements), as well as federal legislation. This coincided with an unprecedented merger wave in banking, and a dramatic expansion of banks' powers, culminating in the Gramm-Leach-Bliley Act of 1999.

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[14] For a review of these Acts, see Carnell, Macey and Miller (2009). The approval of individuals to take controlling interests in a bank – based on the considerations of character, the nature of his/her business dealings, and competitiveness concerns – was required under the Change in Bank Control Act of 1978.

[15] For a review of the legislative history, political economy, and enforcement of these statutes, see Klebaner (1967), Traber (1969), Shull and Horvitz (1971), and Carey (1975). For a summary of their content, see Carnell, Macey and Miller (2009).

What caused this dramatic reversal? As Calomiris and Haber (2013) discuss, five forces worked to undo the sway of the unit banker-agrarian populist coalition. The first was demographic: during the 20th century, the United States was transformed from a predominantly rural to a predominantly urban country, which meant that voting power shifted away from rural interests – which had generally been supportive of unit banking – toward America's cities. As of 1900, 45.8 million Americans lived in rural areas, compared to 30.2 million in cities and towns with more than 2,500 inhabitants. By 1940 the number living in cities or towns had grown to 74.4 million, compared to 57.2 million rural inhabitants. After World War II, the urban population share took off; by 1970, 133.4 million Americans lived in locations with more than 2,500 inhabitants, compared to 69.8 million living in rural areas.[16]

The second force was technological progress that eroded the ability of banks to extract rents from borrowers and depositors. With respect to borrowers, beginning in the 1970s, the computer revolution drove down the cost of information storage and retrieval, allowing prospective lenders anywhere in the country to assess a borrower's credit-worthiness reasonably well without having to rely as much on "soft information" that could only be obtained locally. With respect to depositors, technology also spurred much greater competition, especially via networked automated teller machines (ATMs that are linked via computer). The networked ATM was patented in 1974, and it was only two years before unit bankers started filing cases in both federal and state courts seeking to block their proliferation. One of those cases, *Independent Bankers Association of New York State v. Marine Midland Bank*, ultimately wound its way to the Supreme Court, which in 1985 ruled that an ATM was not a bank branch, thereby eviscerating state laws that set limits on banks with branch networks.[17]

The third influence was accelerating price inflation in the 1960s and 1970s, which spurred disintermediation from the regulated banking system, and created the first of the post-1960 "shadow

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[16] These figures are from Calomiris and Haber (2013), Chapter 6.
[17] Calomiris and Haber (2013), Chapter 6.

banking systems" of relatively unregulated finance companies and money market mutual funds. Regulation Q limited the interest rate that could be paid on bank deposits. As inflation and nominal market rates of interest rose, the real interest rate payable on regulated deposits became increasingly negative, making it hard for banks to attract deposits. Instead, institutional depositors increasingly began to put their money into commercial paper. Households soon followed institutional depositors as "money market mutual funds" began to allow customers to write checks against their portfolios of treasury bills and commercial paper.

As technological change and inflation spurred the growth of alternatives to regulated banking, and produced declines in the domestic "core" deposit and loan market shares of regulated banks, a fourth worrying factor reared its head. U.S. banks – which were relatively small and constrained in their geographic reach and permissible product lines, compared with the banks of other developed countries – were losing global market share. Large foreign banks were even making inroads into U.S. markets by building relationships with large U.S. corporations. The Fed and many U.S. politicians became advocates of the deregulation of interest rate ceilings, the removal of branching restrictions, and the elimination of limits on bank powers (especially the limits on corporate securities underwriting by banks), all as a means of allowing U.S. banks to compete with their foreign counterparts. For example, consider Alan Greenspan (1988):

> The ability of banks to continue to hold their positions by operating on the margins of customer services is limited. Existing constraints, in conjunction with the continued undermining of the bank franchise by the new technology, are likely to limit the future profitability of banking...If the aforementioned trends continue, banking will contract either relatively or absolutely.

Greenspan (1990) went on to argue:

> In an environment of global competition, rapid financial innovation, and technological change, bankers understandably feel that the old portfolio and affiliate rules and the constraints on permissible activities of affiliates are no longer meaningful and likely to result in shrinking the banking system.

The fifth force driving reform of banking regulation was a wave of banking distress in the 1980s, which set into motion a political movement in favor of bank consolidation. The 1980s saw an unusual confluence of shocks affecting banks. The spike in interest rates in the early 1980s caused banks and thrifts (savings and loan associations, or S&Ls) with large exposures to real estate loans (which paid fixed interest rates) to suffer major losses.[18] Agricultural price collapses in the early 1980s caused many small, rural banks to fail.[19] Oil and gas price collapses in the early 1980s wiped out many banks in Texas and Oklahoma.[20] The revocation of the tax laws governing accelerated depreciation for commercial real estate transactions caused major declines in the commercial real estate market in the northeast, negatively affecting the banks that lent in this market. Evidence that banks had contributed to the size of their losses through aggressive risk taking and abuse of the protection afforded by deposit insurance and access to the Fed's discount window, sometimes after they were already deeply insolvent, further galvanized opposition to preserving the status quo.[21]

The extreme banking distress of the 1980s even encouraged many unit bankers, as well as bank borrowers, and government officials, to favor the relaxation of branching restrictions. A unit banker facing the failure of his bank saw acquisition by a branching bank as a way to exit with some stock wealth and perhaps even a job in the new bank, a desirable alternative to losing everything. The borrowers at failing unit banks saw the branching banks that were willing to buy weak banks as a crucial source of funding. For the FDIC and federal government officials, the big banks willing to acquire small failing banks reduced the costs of paying off failed banks depositors. For state governments, the new bank entrants were a welcome means of restoring local economic growth.

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[18] See, for example, Barth, Bartholomew and Labich (1989) and Wheelock (2006).
[19] See Calomiris, Hubbard, and Stock (1986).
[20] See Horvitz (1991).
[21] See Barth, Bartholomew and Labich (1989), Brewer and Mondschean (1991), White (1991), Brewer (1995), Gilbert (1994), and Schwartz (1992).

As Calomiris and Haber (2013) show, just as had occurred in 1907 and in the Great Depression, a financial crisis exposed the inherent instability of financial institutions that could not diversify risk by pooling the risks of different regions, and that could not respond to difficulties by shifting resources across branches of an interconnected network. But this time regulators and politicians saw an advantage in permitting large banks to acquire failing banks in exchange for limiting the cost of those failed banks to the FDIC. From 1979 to 1990, 15 states relaxed their branching restrictions.[22] Many states also permitted their banks to be acquired by large, out-of-state banks, many of which hailed from states like North Carolina, Ohio, and California, which had long permitted within-state branching.

A major blow to the state laws that prohibited interstate branching came in 1982, when Congress, in response to the Savings and Loan crisis, amended the Bank Holding Company Act of 1956 to allow failed banks to be acquired by any bank holding company, regardless of state laws. This induced many states to enter into regional or national reciprocal arrangements whereby their banks could be merged (not just purchased by a holding company) with banks from another state. Between 1984 and 1988, 38 states joined one of these reciprocal arrangements.[23] Banks operating national branching networks accounted for only ten percent of the U.S. banking system in the early 1980s. By the mid-1990s, they accounted for more than 70 percent.[24] The final blow to the unit banks came in 1994, when Congress codified the process that had been taking place at the state level by passing the Riegle-Neal Interstate Banking and Branching Efficiency Act. Banks could now branch both within states and across state lines.

The consolidation of banking was also accompanied by an expansion of the permissible activities of bank holding companies into securities underwriting and insurance. The expansion into underwriting occurred in several discrete stages over the period 1987-1999, beginning with the Fed's discretionary

[22] Calomiris (2000).
[23] Kroszner and Strahan (1999).
[24] Calomiris (2010).

decision in 1987 to allow small inroads by bank holding companies into investment banking. The initial opening resulted from a Supreme Court change in the 1980s, which suggested that the Court would adopt a more limited interpretation of the Glass-Steagall restrictions on mixing investment banking and commercial banking, thus opening the door to some investment banking by commercial banks. Limitations were relaxed slowly, however, and many so-called "firewalls" were established initially to isolate investment banking affiliates' underwriting activities from the activities of the core banking enterprise. The first investment banking (Section 20) affiliates were established in 1987. There was a further relaxation of the extent of activity by these affiliates in 1989. In 1997, the Fed eliminated firewalls that it had established to keep the operations of Section 20 affiliates separate from the other operations of the bank (Phillips 1997). Ultimately, in 1999, Gramm-Leach-Bliley eliminated any restrictions on the amount of investment banking activities in commercial banks. Over time, the Fed and other advocates of change were able to build the case that the fears of some policy makers about conflicts of interest arising from the combination of investment and commercial banking were ill-founded, and that the presumed benefits from the combination were real.

Gradual changes created a favorable track record, which laid the groundwork for the Administration's and Congress's willingness to eliminate virtually all financial activity restrictions on the newly created "financial holding companies" entirely in 1999 (a policy change the Fed actively advocated in the 1990s).

Political support for the relaxation of activity limits, as in the case of consolidation, reflected the declining global position of U.S. banks. By the mid-1980s, U.S. banks had declined in international importance and profitability. Large U.S. banks had made significant profits in the growing areas of credit card lending and private equity investing, and without those profits the losses from nonperforming loans, sovereign defaults, and increasing competition and deposit disintermediation would have placed most large banks into extreme difficulties (ironically, equity investing by a handful of the largest banks was underway on a large scale long before debt or equity underwriting was permitted).

Evidence from numerous academic studies that it makes sense to combine commercial banking and securities underwriting within the same financial intermediary supported the elimination of the regulatory barrier between the two. There is now a huge literature showing, in theory and in practice, that it can be beneficial for bank customers to permit banks to engage in underwriting of corporate debt and equity (see the summary in Calomiris and Pornrojnangkool 2009). In essence, savings of information production costs lie at the heart of this policy. The historical prohibition on combining commercial banking and investment banking had been based on faulty premises and a lack of evidence, and this became increasingly apparent during the 1990s.

The growth in the market shares of commercial banks in investment banking in the 1990s and 2000s was dramatic. As of 1992, only 10 percent of corporate debt and less than one percent of corporate equity flotations were underwritten either solely or jointly by commercial banks. By 2002, 66 percent of corporate debt and 36 percent of corporate equity flotations were underwritten either solely or jointly by commercial banks (Calomiris and Pornrojnangkool 2009).

The Role of the Fed

It was during the period of consolidation and the expansion of bank powers that the Fed became *the* dominant supervisor and regulator of banks, and later of the entire financial system. This expansion of Fed power reflected various influences – including the perception of the Fed as both an institution full of highly competent, knowledgeable, and reputable people. But there was more to the story than that. The Fed was also a savvy political intermediary.

On the surface, the deregulation of banking was a technical issue, decided on its merits as a matter of economics, and the Fed played an important role as an honest broker of information, helping to inform policy makers, and thereby helping them to achieve a rationalization of the structure of the banking system. But there was more to the political decisions shaping deregulation than "efficiency" concerns, and there was more to the Fed's role than its provision of information to policy makers. The Fed also was a political player in the deeper drama that permitted and shaped deregulation – what Calomiris and Haber (2013) call the Game of Bank Bargains. Deregulation was a political deal. The Fed was both an intermediary that helped to enforce the political bargains shaping the banking system, and itself a party to those bargains. Most importantly, the expansion of Fed power reflected the Fed's willingness to ally itself with the dominant coalition that controlled how consolidation of the banking system would occur.

In this regard, it is instructive to note that the Fed initially did not welcome the consolidation of banking. It did so only after consolidation was well underway and regarded as politically safe to support. Hawke (1988) summarizes the Volcker Fed's attitude toward relaxation of branching laws:

> The Federal Reserve under Volcker was largely a bystander in this profound change in the structure of American banking. While Volcker consistently supported very limited intrusions into state authority to facilitate the interstate takeover of large failing and failed banks, his Board did nothing whatsoever to encourage broader interstate banking. On the contrary, in its grudging and suspicious treatment of the desires of banking organizations to acquire thrifts; in its response to such developments as "stake-out" investments – nonvoting equity investments in banks by bank holding companies not yet permitted to make full-scale acquisitions in the target bank's state; and in its pinched and niggling approvals of requests by bank holding companies to use nonbank banks as a means of interstate expansion, the Board seemed to view itself as the little Dutch boy of interstate banking, with a duty to plug each supposed leak in the dike as it appeared. Its perverse attitude was exemplified by its treatment of the credit-card bank "usury haven" cases.

Why the change in Fed advocacy on branching? Given the tectonic economic shifts that favored consolidation, the political landscape in Congress regarding branching changed completely in the late 1980s. Consequently, the Fed's advocacy reflected, and lagged behind, a broader political movement throughout the country. The Fed advocated consolidation only after it was clear that doing so did not threaten to cause it little difficulty with Congress or the Administration.[25]

Can one identify a "philosophy of regulation" that underlay the regulatory advocacy of the Fed and Chairman Greenspan after 1987. Did the Greenspan Fed have a point of view on regulatory matters? I will show that, although the Fed's advocacy on various matters may appear somewhat contradictory, or at least, philosophically heterodox, the Fed has behaved in a manner that is remarkably predictable, once one takes account of the political arena in which both regulatory and monetary policy are made.

The Greenspan years did not illustrate a pure economic philosophy of financial regulation, but rather a politico-economic philosophy, which one might term "pragmatic and political-bargain-based deregulation." I would not argue that Chairman Greenspan's regulatory advocacy was optimal, either from the unconstrained standpoint of an ideal regulatory system, or from the constrained (realistic)

[25] There is no doubt that Chairman Greenspan was an active proponent of branching deregulation (see Greenspan 1988, 1990, 1997a-e, 1998, 1999, 2001). On May 3, 1997, for example, in a speech before the Conference of State Bank Supervisors, he advocated Congressional action to place state banks on an equal footing with national banks with respect to the permissible activities of branches located outside the state in which their headquarters are located. Advocates of eliminating branching restrictions, including myself, have long pointed to the gains from greater competitiveness and greater diversification of risk that comes from permitting banks to branch freely. It is noteworthy that Chairman Greenspan's May 1997 speech was directed toward enhancing the scope and powers of state-chartered bank branches. That is, his recommendation would have increased the importance of the regional Feds relative to the OCC as regulators of banks (as opposed to holding companies). One of the concerns that Fed officials had about bank branching, which the Chairman recognized in his testimony before the Congress on June 17, 1998, was that interstate branching was expected to "induce shifts from state to national bank charters, reducing the Fed's supervisory role." Improving the powers of state-chartered branches would have offset some of those expected defections. In his June 1998 testimony, Chairman Greenspan argued that the Board of Governors' position in support of interstate branching was a piece of evidence that directly contradicted theories of Fed advocacy that emphasized political turf battles. He pointed with some pride to the fact that the Board of Governors supported interstate branching despite its anticipated effect of inducing shifts toward the national banking system. But that argument is not convincing for two reasons. First, the Fed Board, as opposed to the regional Feds, regulates bank holding companies. Interstate banking, by enhancing the size and scope of bank holding companies, and by ushering in the era of universal banking, set the stage for the shift in regulatory power away from both the OCC and the regional Feds and toward the Federal Reserve Board, and Chairman Greenspan was already advocating such a shift in authority toward the Board alongside his support for interstate branching. Second, the Fed's advocacy algorithm takes into account the interests of its strongest political allies, the big banks, who surely stood to gain greatly from interstate banking. Thus, despite the possibility of local charter switching toward national banks, interstate branching was a predictable big win for enhancing the power of the Federal Reserve Board.

standpoint of what is possible in the real world. My goal is not to highlight errors so much as to make the positive claim that there is a fairly straightforward logic implicit in the Fed's regulatory advocacy, a fairly simple algorithm of advocacy. To understand its logic, one must begin with an understanding of the Fed as a political player in the Washington drama, as a creature of the federal government subject to its oversight, as a competitor with other regulators for influence within the financial services industry and within the political realm, and as a prioritizing agent that decides which battles (monetary or regulatory) to fight when, and how hard.

To explain the reversal in Fed advocacy of deregulation in some areas, but not in others, Calomiris (2006) categorizes financial regulatory issues into four categories, according to his interpretation of the Fed's actions and the dominant motives for those actions: one category is labeled "Fed advocacy of beneficial deregulation," and three other categories include cases where the Fed has opposed beneficial regulatory policies, which he attributes to three reasons: "Too politically hot to handle," or "Not in the interest of the big banks," or a "Fed regulatory power play" to boost its own political influence.[26] His proposed regulatory advocacy algorithm for the Fed is fairly simple: the Fed

[26] The growth of commercial bank involvement in underwriting created a regulatory turf battle in the mid-1990s between the Fed and the OCC. The OCC sought to allow national banks (for which it is the primary regulator) to underwrite securities through bank subsidiaries (which the OCC regulated) rather than through affiliates of the bank (subsidiaries of the bank holding company, which were regulated by the Fed). Ultimately, despite Fed opposition, the Gramm-Leach-Bliley Act did permit bank subsidiaries to engage in underwriting and most other activities in which affiliates are permitted to engage. The Fed opposed this proposal on the grounds that there was a possibility of conflict and a risk of bank instability arising from underwriting occurring within bank subsidiaries. Chairman Greenspan testified in Congress on April 28, 1999 that allowing investment banking to occur in bank subsidiaries "would be especially risky." This argument is hard to fathom (indeed, if anything, the opposite should be true, since some problems of asset substitution risk cannot occur between banks and their subsidiaries, but can occur between banks and their affiliates). It was a pure Fed power play. One of Chairman Greenspan's great rhetorical skills, which this and many other cases where he opposed deregulation illustrate, is to shift the burden of proof to suit his argument. When he advocated deregulation (as in the case of expanding underwriting powers via affiliates), he argued that there was no clear evidence that deregulation would cause harm. When he opposed deregulation, he argued that there was no clear evidence that deregulation would *not* cause harm. In the case of permitting underwriting, he used gradualism to compromise with worrisome critics, and build a record of performance on which to base further relaxation of constraints. But he did not advocate gradualism and experimentation as a means to overcome uncertainties on the party of policy makers in other areas (notably, with respect to permitting underwriting in subsidiaries, or as discussed below, with respect to allowing commercial firms to provide financial services). Chairman Greenspan knew how to overcome Congressional fears of change

supported consolidation and activities deregulation because doing so did not (1) stir up significant political opposition to the Fed within Congress or the Administration, which might threaten its monetary policy independence, (2) harm the large commercial banks (who were key allies of the Fed in some of its political battles in Washington), or (3) undermine the Fed's competitive position vis a vis other regulators.

Furthermore, Calomiris (2006) argues that these three constraints (opposition by politicians, opposition by big banks, and erosion of Fed regulatory power) led the Fed not only to fail to support some beneficial regulatory changes (e.g., allowing financial holding companies to actively compete in real estate brokerage, reining in the growth of Fannie Mae and Freddie Mac during the 1990s, and requiring banks to expand and improve their capital requirements), but to actively support a very harmful approach to bank consolidation.[27]

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when he wanted to, and he also knew how to use Congress's fear of change as a tool to limit deregulation. Which Congressman would want to bear the responsibility of having ignored Alan Greenspan's warning? Fortunately, in the case of the debate over subs vs. affiliates, those tactics did not win the day.

[27] With respect to Fannie and Freddie, the political landscape started to change dramatically around the middle of 2000. At that time, Congressmen Richard Baker (who occupies a "safe seat" in Louisiana, who has what appears to be a sincere philosophical opposition to the risks and costs posed by the GSEs, and who also may have been searching for an issue of national importance to call his own) began a campaign to bring to light the various GSE abuses. Magazines started to publicize the networks of GSE political connections, and the large amounts of compensation earned by GSE executives (and their lack of banking skills, but strong backgrounds in lobbying). Unseemly power plays and Congressional arm twisting by the GSEs over modest proposed reforms of their capital standards encouraged more scrutiny and opposition, which came from all parts of the political spectrum. And the recent accounting scandals added further fuel to the fire. The White House became particularly interested in GSE reform after 2003, as the result of the accounting scandals. The growing chorus of academic and political opposition to the GSEs, coupled with the strong push from the large banks, and the new shift in the Administration and Congress away from supporting the GSE status quo seems to have tipped the balance for Chairman Greenspan. For the past several years, he has been a vocal advocate of GSE reform. On May 19, 2000, he sent an open letter (Greenspan 2000) to Chairman Baker, pointing out the risks and costs inherent in the GSEs and supporting the case for reform. Subsequent remarks by Chairman Greenspan have elaborated on his initial May 2000 letter (most recently in his April 6, 2005 testimony to the Senate Banking Committee – Greenspan 2005), and open season on the GSEs has been declared for Fed researchers, who had long been chomping at that bit. Now Chairman Greenspan is practically leading the charge for GSE reform. Thus, a regulatory reform that started off as "too hot to handle" became transformed (as in the fairy tale) to be "just right."

Most importantly, Calomiris (2006) and Calomiris and Haber (2013) argue that the Fed did not prevent undesirably anticompetitive bank mergers, and also that it failed to act properly as a prudential regulator of merging banks, especially with respect to *identifying and constraining the mounting risks that banks took on as part of their contractual agreements with activist organizations (which enjoyed powerful political support in the government), as a means of gaining support for proposed mergers*. These two failings were two sides of the same political bargain: the bank merger wave, at its heart, was a political bargain to create rents (by creating market power) and to distribute those rents among politically powerful entities (mega banks and power urban activist organizations). The Fed was a willing intermediary of this bargain, and its willingness to play that role was rewarded with increased regulatory power, and with its increasingly unthreatened monetary policy independence. But the social costs of that bargain were large.

The Fed's as Intermediary of the Megabanks-Urban Activists Merger Bargain

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, by knocking down the last barriers to interstate banking, marked the demise of the unlikely political coalition between unit bankers and agrarian populists that had dominated banking policy for over a century and a half (Calomiris and Haber 2013). It permitted a wave of mergers and acquisitions that created the megabanks that now have a branch in nearly every city or town in the United States. JP Morgan Chase was created out of the merger of no less than 37 banks, creating a megabank with more than 220,000 employees and $2 trillion in assets as of 2011. The Bank of America, which had initially been a California-based bank, merged with or acquired more than 50 other banks.[28]

The creation of the new megabanks generated tremendous profits for merging banks—from economies of scale, economies of scope, the potential for market power, and too-big-to-fail government

[28]Calomiris and Haber (2013), Chapter 7.

protection. Political actions that create profit also create new opportunities for deciding how to divide them. Calomiris and Haber (2013) show that, in the new U.S. Game of Bank Bargains defined by branching deregulation, populist politics continued to play a role in determining the allocation of profits, although the center of populist power had shifted from rural to urban areas.

Each merger and acquisition required approval from regulators, most particularly from the Federal Reserve Board. The process of approval required that banks show that they had been good citizens of the communities in which they operated, and this fact provided a source of leverage for activist groups, such as the Association of Community Organizations for Reform Now (ACORN), who could block or delay a merger by claiming that the banks were not in compliance with the Community Reinvestment Act of 1977. What had been a largely moribund piece of legislation now became a very valuable chip in the Game of Bank Bargains, which perhaps explains why the Act was revised eight times once the merger wave got underway, each revision usually increasing its stringency. Bankers seeking to become nationwide enterprises had to ally with activist groups to obtain their political blessing. In exchange, the activist groups obtained contractual guarantees from the would-be merging banks to direct mortgage and other credit, as well as cash contributions, to themselves and their constituents.

The incentives to become a megabank were multiple. Potential advantages included diversification, the ability to spread overhead costs over a larger operation, economies of scope (a large bank could afford to provide a broader range of products and services). Additional potential advantages of becoming a mega-bank was were the potential for obtaining market power and the potential implicit subsidy of too-big-to-fail protection.

The Federal Reserve Board had the key decision making authority over mergers, as the regulator of bank holding companies, but other bank regulators and the Justice Department also could weigh in to oppose mergers, if they chose to do so. There were several criteria that could be used to block approval of a bank merger. First, an acquiring bank had to be financially strong. Second, the merged bank could not have excessive market power. This was not much of a constraint, because the Fed typically assessed market power by looking at a merged bank's deposit market share, rather than its ability to set prices in credit markets.

The Fleet Financial-BankBoston merger of 1999 is a telling example: by combining the only two New England banks of significant size it created a megabank that could set prices for business borrowers. Mid-sized businesses that were too big to borrow from the remaining small, local banks, and too small to be able to borrow in global markets, were particularly affected. Not only did they object to the merger on these grounds, the Mayor of Boston and the Attorney General of Massachusetts did as well. All to no avail: the Fed approved the merger, and interest spreads for business borrowers rose by a full percentage point.[29]

The third criterion by which a merger could be blocked was "good citizenship" (as regulated under the CRA) and Calomiris and Haber (2013) show that, unlike market power, this was indeed a binding constraint. The language of the CRA focuses on making sure that banks serve their local communities, but this largely translated into ensuring that low-income urban communities with minority populations were not subjected to discrimination in lending. The early years of the CRA do not appear to have produced much in the way of results: as Figure 2, taken from Calomiris and Haber (2013) Chapter 7, shows, from 1977 to 1992, only $43 billion in CRA commitments by banks had been announced, and almost all of that occurred after 1989. As of 1995, however, revisions to the CRA meant that banks faced adverse consequences for running afoul of federal government bank supervisors who monitored and rated their CRA compliance. As President Clinton boasted in a July 1999 speech, "[CRA]

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[29] Calomiris and Haber (2013), Chapter 7.

was pretty well moribund until we took office. Over 95 percent of the community investment...made in the 22 years of that law have been made in the six and a half years that I've been in office."[30]

Clinton embraced the idea of CRA commitments as part of his more general belief in a "third way" to promote the economic well-being of disadvantaged Americans without harming other individuals or business interests. This "third" approach stood in contrast to either a laissez-faire approach or a traditional tax and transfer approach to public policy.

Why did banks care about their CRA ratings? Banks could receive a range of CRA "grades"—Outstanding, Satisfactory, Needs to Improve, and Substantial Noncompliance—and these depended on the degree to which a bank was serving the needs of the low-income and minority groups in the communities where it operated. The main penalty for getting a weak rating was that it could potentially scuttle a bank merger on the basis of "bad citizenship." A bank that was not pursuing an aggressive strategy of mergers and acquisitions did not, therefore, need to pay much attention to its CRA rating. A bank with big ambitions to grow, however, needed to a good rating from CRA.

A bank that wanted to expand through a strategy of mergers and acquisitions faced a strategic choice: it could either create its own CRA lending program or it could enlist community activist groups as partners in creating a joint CRA lending program. The advantage of the former was that the bank retained control of decision-making about the allocation of the CRA loans. The advantage of the latter was that the bank could enlist the support of community activist groups for its merger and acquisition activities, in exchange for which it effectively gave up control over the CRA portfolio. That is, the partnership between banks and activist groups aligned the incentives of activist groups with the bank, so that the activist groups would testify on behalf of a merging bank about its commitment to good citizenship.

[30] Calomiris and Haber (2013), Chapter 7.

Of course, a formal partnership agreement with a bank was a welcome source of fee income and power for the activist groups. At least to judge from the merger of Fleet Financial and BankBoston, a bank-run program was cause for activists to oppose a merger. As the transcript of the Fed hearing for that merger makes clear, a coalition of Massachusetts activist groups testified against the merger because Fleet-BankBoston had committed $14.6 billion to CRA lending, but refused to continue Fleet's CRA partnership with ACORN. Fleet-BankBoston, anticipating this opposition, actually paid the travel expenses of out-of-state activist groups in order to testify on the bank's behalf.[31]

It was, therefore, often in a bank's interest to enter into an explicit partnership with an activist group in advance of a Fed hearing, rather than running its own CRA credit program. Some critics of the CRA described those deals as a form of "legalized extortion."[32] Regardless of the words used to describe them, the deals struck by banks and activist groups were a predictable outcome of the situation at hand. Banks had every incentive to merge: they could capture scale economies in administration, diversify risk, obtain market power, and perhaps grow large enough to obtain too-big-to-fail protection. Activist groups had every incentive to threaten to show up at Fed hearings to complain that a bank involved in a merger was not a good citizen: their organizations would prosper as the result of the CRA agreements that they negotiated, and their constituents would enjoy increased access to credit. Given the existence of the CRA, both sides had incentives to strike a deal, because failure to do so meant that the bank merger might be blocked, thereby forcing the bank to forego the opportunity to increase its profits and forcing the activist group to forego the opportunity to serve its members and increase the resources at its disposal. The politicians whose policies made these deals possible saw no reason to get in the way of them. As President Clinton proudly proclaimed in a 1999 speech, the banking reform legislation of that

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[31] Calomiris and Haber (2013), Chapter 7.
[32] Calomiris and Haber (2013), Chapter 7.

year "establishes the principles that, as we expand the powers of banks, we will expand the reach of the [Community Reinvestment] Act."[33]

There was nothing subtle about the manner in which the deals between merging banks and activist groups were arranged. In fact, an umbrella organization for activist groups, the National Community Reinvestment Coalition (NCRC), actually put together a 101-page guide on how to negotiate with banks that were in the process of merging. The NCRC guide did not shy away from encouraging activist organizations to take advantage of their leverage over a prospective bank merger: "When a lender desires to merge with another institution or open a branch, the lender must apply to the Federal Reserve Board and/or to its primary regulator for permission. If the lender has received low [sic] CRA rating, the federal agency reviewing the lender's application has the authority to delay, deny, or condition the lender's application."[34] The guide goes on to say: "Merger and acquisition activity presents significant opportunities for community groups to intervene in the approval process and raise CRA concerns and issues. Some banks are very desirous of Outstanding ratings so that they can present a clean reinvestment record to regulators when they ask for permission to merge....Activists should keep in mind that changes from Outstanding to Satisfactory ratings (and back again) is effective in leveraging reinvestment as well as changes from passing to failing ratings (and back again to passing). This is true regardless of whether the movement in ratings is the overall rating for the bank or a rating for particular geographical areas."[35]

The guide then explains how to affect a bank's grade: "...community organizations can offer written comments on a bank's CRA and fair lending performance when a bank has submitted an application to merge or acquire another bank or thrift. NCRC can assist community organizations in

[33] Calomiris and Haber (2013), Chapter 7.
[34] Calomiris and Haber (2013), Chapter 7.
[35] Calomiris and Haber (2013), Chapter 7.

preparing comments on merger applications."[36] Finally, the guide made clear that simply creating noise in a bank's merger application file could allow a group to leverage resources, even if the bank had been CRA compliant: "Timely comments can influence a bank's CRA rating by directing examiners to particular areas of strength or weakness in a bank's lending, investments, or services in low- and moderate-income neighborhoods.... Even changing a rating from Outstanding to Satisfactory in one state or one part of the exam can motivate a bank to increase the number of loans, investments, and services to low- and moderate-income communities."[37]

Activist groups were successful in negotiating many long-term contracts with banks, in which they received specific monetary and other commitments for their organizations. Calomiris and Haber (2013) show that between 1977 and 2007 there were no fewer than 376 such agreements, involving scores of groups. These agreements included a $760 million commitment from the Bank of New York to ACORN, an $8 billion agreement between Wachovia Bank and New Jersey Citizen Action, and a $70 billion agreement between the Bank of America and the California Reinvestment Coalition.[38] In return, the activist groups did not oppose the approval of those banks' pending mergers and acquisitions. Sometimes, they submitted documentation and testified *in support* of the merger. For example, when NationsBank merged with the Bank of America in 1998, creating the largest bank in the United States, with $525 billion in assets, the President of ACORN Housing, George Butts, testified at the Fed hearing on behalf of the merging banks.[39]

The commitments that activist organizations obtained from banks came in two forms. First, banks committed to supply mortgage and small business credit to borrowers identified by the activist organizations. As Calomiris and Haber (2013) show, over the period 1977-2007, these directed credit

[36] Calomiris and Haber (2013), Chapter 7.
[37] Calomiris and Haber (2013), Chapter 7.
[38] Calomiris and Haber (2013), Chapter 7.
[39] Calomiris and Haber (2013), Chapter 7.

commitments totaled \$867 billion, with almost all of that growth coming in the years after 1992. Banks also provided a second source of support to activist groups, by paying them fees for administering the directed credit programs into which they had entered or by making direct contributions to those groups. Between 1993 and 2008, for example, ACORN, received \$13.5 million from the Bank of America, \$9.5 million from JP Morgan-Chase, \$8.1 million from Citibank, \$7.4 million from HSBC, and \$1.4 million from Capital One. As of 2000, the U.S. Senate Banking Committee estimated that the total of such fees and contributions to all activist groups came to \$9.5 billion, which Calomiris and Haber (2013) regard as likely an understatement of the true amount.[40]

Had it not been for the CRA, banks would have made fewer and less risky loans in the 1990s and 2000s. A recent study, by Agarwal, Benmelech, Bergman and Seru (2013) compares the portfolios of banks in the six quarters prior to a CRA evaluation relative to the portfolios of other banks not slated for an evaluation, and finds that an impending a CRA examination caused banks to increase their lending by 5%, and increased the default risk of those banks mortgage loans by more than 15 percentage points.[41] This approach provides lower-bound estimates of both increased lending and increased levels of default risk resulting from the CRA. Another approach to measuring the impact of CRA compliance is to focus on the increase in the level of CRA commitments over time. This is the approach taken by Pinto (2011), who assumes, conservatively, that the CRA had no binding effects on bank lending until the Clinton Administration's CRA policy push. Under that assumption, Pinto concludes that, by 2007, there were

[40] Calomiris and Haber (2013), Chapter 7.

[41] Agarwal, Benmelech, Bergman and Seru (2012) summarize their results as follows: "We find that adherence to the act leads to riskier lending by banks: in the six quarters surrounding the CRA exams, lending is elevated on average by about 5 percent and these loans default about 15 percent more often....We note that our estimates do not provide an assessment of the full impact of the CRA. This is because we are examining the effect of CRA evaluations relative to a baseline of banks not undergoing an exam. To the extent that there are adjustment costs in changing lending behavior, this baseline level of lending behavior itself may be shifted toward catering to CRA compliance. Because our empirical strategy nets out the baseline effect, our estimates of CRA evaluations provide a lower bound to the actual impact of the Community Reinvestment Act. If adjustment costs in lending behavior are large and banks can't easily tilt their loan portfolio toward greater CRA compliance, the full impact of the CRA is potentially much greater than that estimated by the change in lending behavior around CRA exams."

$2.2 trillion dollars in CRA commitments that would not have been undertaken by banks voluntarily. In short, however its effects on lending are measured, CRA compliance had major effects on the amount and the riskiness of lending.

The trillions of dollars worth of CRA deals also had important consequences for the structure of the banking industry. The arrangements made by banks and activist groups did not just mean that the latter would not block mergers by the former; it meant that the latter, and their political allies, ironically, became *supporters* of something that one would think they should have opposed: limits on bank competition that favored mega-banks.

As Calomiris and Haber (2013) show, the partnership between megabanks and activist groups became even more ambitious as it drew in a third set of partners—Fannie Mae and Freddie Mac. Banks would not make limitless commitments to their activist partners: CRA loans implied higher levels of risk for the bank than more traditional mortgage loans. Thus, the activist groups used their political power in Washington to generate regulatory mandates on housing GSEs, which included the Federal National Mortgage Association (FNMA, commonly known as Fannie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC, commonly known as Freddie Mac), and the Federal Home Loan Banks (FHLBs). Fannie Mae and Freddie Mac, in particular, were required to repurchase mortgage loans that had been made to low income, urban, and minority constituencies. This change was a win-win for activist groups and mega-banks; more credit could be directed to targeted constituencies at less cost to the banks because the banks were now able to resell some of their CRA-related mortgages to a GSE on favorable terms.[42]

[42] Several books document the effects of Fannie Mae and Freddie Mac on the mortgage market leading up to the subprime crisis. In addition to Calomiris and Haber (2013), see Rajan (2010), Morgenson and Rosner (2011), Acharya, Richardson, van Nieuwerburgh, and White (2011), and Wallison (2011).

These government mandates on Fannie and Freddie were not vague statements of intent, they were specific targets; and in order to meet those targets Fannie and Freddie had little choice but to weaken their underwriting standards. By the mid-1990s, Fannie and Freddie were agreeing to purchase mortgages with downpayments of only three percent (instead of the 20 percent that had been the industry standard). Soon after they were buying mortgages with weak credit scores. By 2003, they were agreeing to purchase massive quantities of loans with no documentation of income (so called liar, or no-doc, loans). In exchange, they obtained valuable concessions from Congress, most particularly capital standards (minimum ratios of equity capital to assets) that were only 60 percent that of commercial banks holding similar loan portfolios. That is, the managers and shareholders of the GSEs joined the megabank-urban activist coalition. They became a crucial ingredient to the growth of the coalition's resources, a crucial part of the institutional glue that held the coalition together.

Weak underwriting standards were not an excludable good (or bad); they were available to *everyone*. Fannie and Freddie, by virtue of their size and their capacity to repurchase and securitize loans made by banks, set the standards for the entire industry. Thus, large swathes of the American middle class—whether they realized it or not—were soon pulled into this large bank-urban activist-GSE coalition by jumping on the easy credit bandwagon. This fact cannot be emphasized strongly enough: when Fannie and Freddie agreed to purchase loans that only had a three percent downpayment, no documentation of income or employment, and a far from perfect credit score they changed the risk calculus of large numbers of American families, not just the urban poor.

Calomiris and Haber (2013) note that one of the cruel ironies of the debasement of lending standards was that it was not a very efficient way to raise the living standards of the urban poor. Transferring income by distorting the incentives of bankers, the managers of GSEs, government agencies, and large swathes of the population through implicit housing subsidies contributed greatly to the Subprime crisis of 2007-09. That crisis likely undermined whatever short-run redistributive gains the subsidy programs achieved. A system of on-balance sheet tax and transfer programs might have been politically more difficult to implement, and therefore would have been of more modest scale, but it would have produced more positive outcomes in the long-run.

What the Fed Should Have Done in the 1990s and 2000s, and Why It Didn't Do It

In retrospect, it seems clear that the Fed would have better served the interests of the U.S. economy and banking system if it had not been so willing to approve many of the mega-mergers of the 1990s and 2000s, or the contracts between the megabanks and the community activists that coincided with those mergers. The Fed, as a competitiveness regulator, should have been more concerned about the creation of concentrations of market power (as during the merger of Fleet and BankBoston). The Fed, as a prudential regulator, should have been more concerned about the potentially destabilizing consequences of $4.5 trillion in contractual CRA merger-related commitments. The Fed should have recognized the systemic risks that these mergers and contracts, especially in combination with debased underwriting standards and GSE mandates. Clearly, the Fed had the authority to stop or reshape these mergers, to instruct banks not to enter into risky contractual commitments, or to require banks to maintain much higher capital ratios if they undertook such risks (which by itself would have discouraged some of the risk taking during the merger wave).

It is hard to prove why people or organizations make mistakes, but several facts no doubt contributed to the Fed's decisions not to be stricter in its regulation of mergers, competition or risk taking. The parties to the bargain between the megabanks and the activist organizations were extremely powerful politically, and closely allied with influential politicians in the Congress and the Administration, both during the Clinton years and during the George W. Bush presidency. Opposing this bargain would not have been easy for the Fed. Doing so would have risked the wrath not only of the big banks, but of the members of Congress and the Administration that had direct control of its authorities, both in the realm of regulatory policy and monetary policy. A Fed that would have decided to be tougher would also have risked losing its regulatory powers, and possibly a fair degree of its monetary policy independence, both of which depended on its friendly relationship with the Administration and Congress.

Neither the microeconomic regulation of mergers, nor the prudential regulation of banks, has ever been the Fed's top priority. Monetary policy is the top priority, and preserving monetary policy independence was the paramount objective of the Fed. Putting that monetary policy independence at risk to strike down the trillions of dollars of merger-related CRA contracts in the name of competition or systemic risk management would have been almost inconceivable as a political calculation. Furthermore, the Fed was involved in heated turf battles with other regulators. Fed opposition to the political bargain between the megabanks and the activists might simply have resulted in a loss of Fed regulatory authority rather than any change in regulatory outcome, as Congress and the Administration might have transferred authority over prudential regulation or merger approval to other parties.

Finally, the Fed's regulatory mandate was itself unclear because it involved multiple, conflicting objectives. On the one hand, the Fed was charged with preserving bank safety and soundness and competitiveness (already a complicated mandate); on the other hand, the Fed had to supervise bank compliance with the CRA, and was specifically required to measure banks' commitments to their communities and to take CRA compliance into account when considering mergers. If the Fed had taken a bold stand against the grand bargain between the megabanks and the activists, critics in Congress could have argued that it was failing to fulfill its mission, and used that argument to justify either a transfer in merger approval authority, or other changes in Fed authority.

In short, the best explanation for why the Fed failed to act properly is not that it was incompetent or corrupt, but that it had little choice but to comply. Of course, the political actors that made mergers possible and created the CRA amendments of the 1990s would have been aware of the political realities that constrained Fed action. Indeed, they would have depended upon them.

V. Policy Implications

The policy implications drawn from the above history and analysis are summarized in Section II's eight sets of Propositions. In closing, I expand on Proposition 8. To promote independence along both dimensions of economic policy (monetary and regulatory) two sorts of policy reforms are required: (i) separation of authority over the two areas into two distinct agencies (to avoid tradeoffs that reduce independence of regulatory policy), and (ii) the establishment of clear mandates and accountability procedures for each category of policy.

With respect to the first of these proposals, so long as the Fed is vested with both monetary and regulatory authority, it will fear political reprisals with respect to monetary independence from pursuing regulatory policies that run counter to the political bargains of influential politicians in Congress and the Administration. Separating regulatory and monetary authorities would ensure greater accountability of whichever agency is charged with each and would avoid political trading off between the two (Calomiris and Litan 2000). Just prior to the recent crisis, Secretary Paulson's working group on regulatory reform had released its findings suggesting the desirability of just such a change. Unfortunately, the political deals surrounding the crisis and the legislative response to it moved further in the direction of empowering the Fed as the primary regulatory of the financial system. Some supporters of this approach have claimed that it is necessary to do so to ensure that the Fed can monitor risks of the banks to which it lends. This is a fatuous argument. The Fed can and should retain full authority to examine all Fed member banks. That does not require the Fed to be a merger regulator, or a prudential regulator.

With respect to the establishment of clear mandates and accountability procedures for each category of policy, I would reiterate that without clear mandates, legitimate independence is nearly impossible to achieve. Furthermore, clear mandates limit undesirable discretion that results from inappropriately politicized leadership (the Burns problem) or the excessive confidence of economists in pursuit of intellectual fads (like the Riefler-Burgess doctrine, the Phillips Curve, or the DSGE framework).

On the regulatory front, on prudential grounds banks should be prohibited categorically from making contractual commitments with activist groups. The criteria for merger approval should be based on multiple objective criteria for measuring market power (not just deposit market shares), each of which must be satisfied for mergers to be permitted.

With respect to monetary policy, the Fed's mandate should be expressed in the form of a "comply or explain" rule (e.g., a Taylor Rule, or some other similar rule).[43] Such a rule would make clear the objectives of monetary policy, and thus *permit* and *require* greater accountability. The ironic and important truth is that constrained independence equals greater independence. The Fed currently is tasked with achieving four objectives: price stability, interest rate stability, maximum employment, and financial stability. There is no way to hold the Fed accountable for its monetary policy actions with this vague, multi-dimensional mandate. This invites politically motivated attacks that limit Fed independence, and also invites bad discretionary policy ideas.

It is not realistic to argue that the central bank could or should be bound by a rigid rule. As Capie and Wood (2012) point out, such rules almost never survive trying times. I favor a "comply-and-explain" regime, in which departures from the rule are clearly announced and explained. The central bank

[43] A Taylor Rule is not the only possibility. A nominal GDP growth rule tied to an inflation objective (which could be "reset" annually to avoid inflationary consequences from large supply shocks) is another possibility, which has the advantage relative to a Taylor Rule of not requiring an estimate of the natural rate of unemployment. If a Taylor Rule approach were chosen, the mandate would also have to set limits on the process governing the assumed natural rate of unemployment to avoid manipulation of the formula. For example, it might be set as a moving average of many (e.g., 20) years of lagged unemployment rates.

describes why it is deviating from the rule, and commits to do so rarely. The leadership of the central bank, therefore, bears significant personal reputational risk if the supposed reasons for the deviation from the rule are considered to have been inappropriate, on the basis of hindsight, or if it exceeds the permissible frequency of deviations from the rule. One could make this personal responsibility explicit, for example, by requiring that the terms of all Fed Governors and Presidents would come up for renewal two years after they deviated from the rule, which would put discourage departure from the rule unless the circumstances clearly warranted it.

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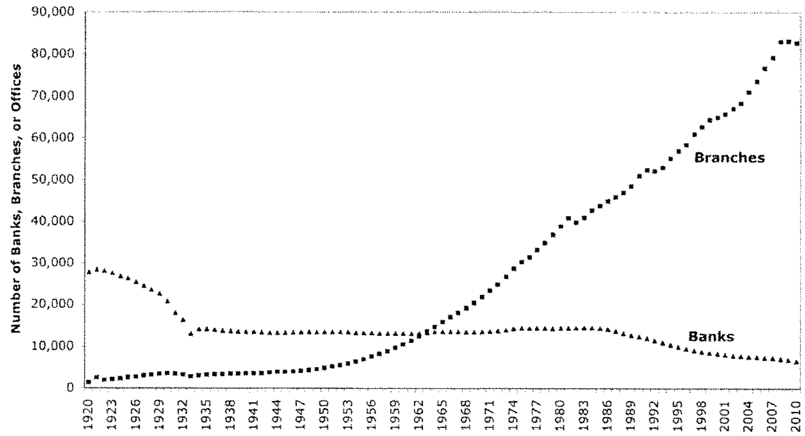
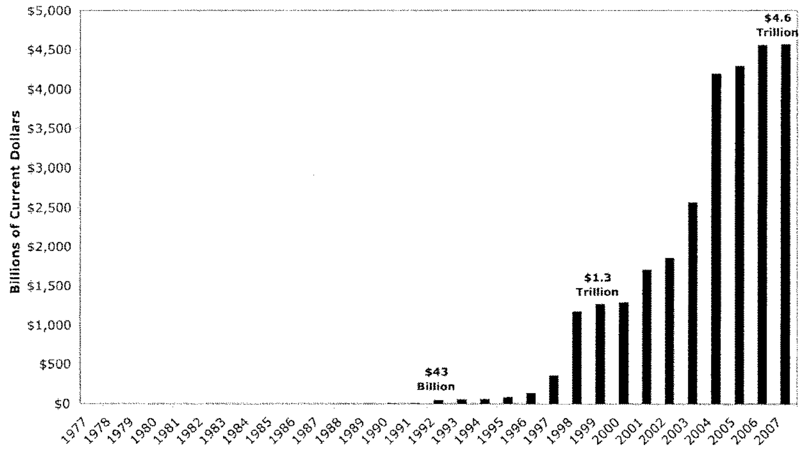
Figure 1
Number of Banks and Branches, 1920-2010



Source: Computed by Calomiris and Haber (2013), Chapter 6, from Federal Reserve, Banking and Monetary Statistics, p. 16, 297; Federal Deposit Insurance Corporation website, http://www2.fdic.gov/hsob/hsobRpt.asp

Figure 2
Cumulative CRA Commitments, 1977-2007



Source: Calomiris and Haber (2013), Chapter 7, computed from National Community Reinvestment Coalition, CRA Commitments data.

The Relationship between Prudential Supervision and Monetary Policy

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Testimony before the joint hearing of the
Subcommittee on Financial Institutions and Consumer Credit
Subcommittee on Monetary Policy and Trade
Committee on Financial Services
U.S. House of Representatives

September 12, 2017

Chairman Luetkemeyer, Chairman Barr, Ranking Member Clay, Ranking Member Moore, and distinguished members of the committee, thank you for inviting me to present my views on the relationship between prudential supervision and monetary policy.

The U.S. financial system is far more resilient today than it was a decade ago, and the likelihood of another system-wide crisis is now lower. As a consequence of post-crisis regulatory reforms, banks have more loss-absorbing equity capital than they had in 2007. They also face stringent liquidity requirements. And, the biggest among them must meet rigorous stress tests. This new environment ensures that all financial organizations, especially those that are large and complex, are much less likely to become a burden on the taxpayer.

It is important that we build on this progress. Regulations must remain sufficiently strict and supervisors must interpret and apply them rigorously. We also need appropriate governance. That is, we must organize the *regulation*, by which I mean the promulgation of the rules themselves, and the *supervision*, which is the monitoring of compliance with the rules, to ensure that the authorities can and will be able to do their jobs effectively.

Regulation and supervision are intimately connected, so it makes sense to house them in the same agency. Rules will always need refinement. Technological innovation and economic advances mean that the financial system is constantly evolving, and creative people find ways to skirt existing regulations. This all means that rules and their application require frequent adjustment. Who better to gather the information needed to improve the rules—to make them both less burdensome and more effective—than the supervisors enforcing them? This process of continuous improvement, where information from supervisors leads to regulatory enhancements, will be most efficient when the two groups are operating under the same roof.

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My comments today focus on *governance*, framing the discussion in terms of supervision, with the understanding that supervisors should also be regulators. I will address two related questions:

1) Should prudential supervision be an independent function, sheltered from day-to-day political influence with control of its own budget?
2) Should the central bank be a leading supervisor?

My answer to both of these questions is an unqualified yes. To do otherwise would put the financial system at risk of costly disaster.

Some preliminary remarks on monetary policy independence

> *"This administration will always support the political independence of the Federal Reserve Board."* President Ronald Reagan, February 18, 1982.[1]

Before getting to the specifics of my argument, I start with something that is uncontroversial: in adjusting the instruments that Congress authorizes them to use to achieve their statutory goals, central banks should be independent of short-run political pressures. Such *instrument independence* allows monetary policymakers to deliver lower inflation without sacrificing economic growth or employment over the long run.

The reason for this is straightforward: to be credible and successful in achieving their mandated objectives, monetary policymakers must have a long horizon. The impact of today's interest rate decision will not be felt for some time—several years, in many instances. Politicians realized decades ago that their time horizons are not long enough to deliver the best outcomes. The temptation to forsake long-term goals for short-term gains is just too strong. If people expect policymakers to pursue overly accommodative policies to achieve short-run objectives, the long-run goals of price stability and maximum sustainable growth will suffer.

Governments throughout the world solve this dilemma by delegating monetary policy responsibility to a separate, largely apolitical, institution with special expertise. To insulate these policymakers from daily political pressures, central bankers have control of their budgets and the authority to make irreversible operational decisions. By granting central bankers long terms, governments also enhance their credibility.

So, when it comes to monetary policy, there is broad agreement: to deliver price stability and maximum sustainable growth, central bank's operational decisions must be independent of political influence. At the same time, an independent central bank must act with sufficient transparency so that the government can hold policymakers accountable for achieving the legal mandate. In the United States, this is why the Federal Open Market Committee publishes its decisions, explains its actions, and faces public questioning about its efforts to secure price stability and maximum sustainable employment (or economic growth).

[1] Reagan, Ronald (1982). "The President's News Conference," February 18, in John T. Woolley and Gerhard Peters, eds. *The American Presidency Project*, website.

The need for independent prudential supervision

> *"To be effective, bank regulators and supervisors also require an appropriate degree of independence; in particular, the public must be confident that regulators' decisions about the soundness of specific institutions are not unduly influenced by political pressures or lobbying."*
> Federal Reserve Board Chairman Ben Bernanke, May 25, 2010.[2]

What about prudential supervision? Here the arguments for independence are remarkably similar to those for monetary policy. Strict bank supervision may result in unpopular limits on certain types of loans or even the closure of failing banks. Pressure from both bankers and their borrowers can lead to a delay in corrective action, fostering poor incentives and increasing the risk of larger problems down the road. Again, political interference may very well generate gains today, but the bill will come due tomorrow. Shelter from political influence, complete with budgetary control, allows supervisors to maintain a long-term view, giving them the credibility to enforce rigorous standards, promoting financial resilience and reducing public costs. As is the case with monetary policy, supervisors' actions are constrained by Congressional statute, combined with the appropriate mechanisms to ensure accountability.

While not all banks need a single supervisor, having one agency overseeing the most systemically risky intermediaries is key to avoiding a race to the bottom among multiple supervisors. This is exactly what happened in December 2006, when Countrywide Financial switched regulators from the Fed and Office of the Comptroller of the Currency to the less effective Office of Thrift Supervision.[3]

Experience in the United States and elsewhere shows how costly it can be when financial regulation and supervision are subject to political oversight. Domestically, two cases are instructive: the Federal Home Loan Bank (FHLB) system and the Office of Federal Housing Enterprise Oversight (OFHEO). In the first, as a result of being subjected to the congressional appropriations process, FHLB supervision of the savings and loan (S&L) industry allowed deep problems to fester. The eventual closing of over 1,000 institutions from 1986 to 1995 had a *direct* cost to taxpayers of roughly $250 billion in today's dollars.[4] (This ignores the large indirect costs arising from the failing S&Ls' misallocation of resources.)

Established in 1992, OFHEO supervised the Government-sponsored enterprises (GSEs)—Fannie Mae and Freddie Mac, the two mortgage giants that played key roles in the 2007-09 financial crisis. Their political influence weakened prudential oversight to the point where, for every $100 that they guaranteed, they were required to have only $0.45 in capital; and, for each $100 in mortgages they retained on their balance sheet, the capital requirement was only 2.5%.[5] In September 2008, with their slim capital buffer gone, the Treasury put the two GSEs into receivership, eventually providing $188 billion of taxpayer

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[2] Ben S. Bernanke, "Central Bank Independence, Transparency, and Accountability," speech at the Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo, Japan, May 25, 2010.
[3] See National Commission on the Causes of the Financial and Economic Crisis in the United States, *The Financial Crisis Inquiry Report*, Washington D.C.: U.S. Government Printing Office, January 2011, pg. 173-4.
[4] A description of the impact of the appropriations on supervision is in FDIC, "The Savings and Loan Crisis and its Relationship to Banking," Chapter 4 in *An Examination of the Banking Crises of the 1980s and Early 1990s*. For estimates of the costs, see Curry, Timothy and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," FDIC Banking Review, vol. 13, no. 2, 2000.
[5] See Viral V. Acharya, Matthew Richardson, Stijn van Nieuwerburgh and Lawrence J. White. *Guaranteed to Fail: Fannie Mae, Freddie Mac, and the Debacle of Mortgage Finance*. Princeton, N.J.: Princeton University Press, 2011.

support to keep them afloat. (Again, that leaves out the massive costs arising from the misallocation of resources resulting from the GSEs' behavior.)

Elsewhere in the world, examples of how political interference fueled costly financial crises with dire consequences are easy to come by. I mention two. The fact that Korean and Indonesian supervisors lacked independence clearly worsened the Asian Crisis of 1997-98. And, the political sensitivity of supervisors, especially with regard to real-estate related credit, surely exacerbated Japan's decades-long banking problems.[6]

So, logical reasoning, careful research and common sense all lead to the same conclusion: independent prudential supervisors provide the foundation for a resilient financial system. When supervisors are independent of political interference, complete with budgetary autonomy, the financial system is more stable and taxpayer costs are lower. For this reason, the Basel Committee on Banking Supervision's second Core Principle for Effective Banking Supervision is that supervisors possess operational independence and have budgetary processes that do not undermine their autonomy.[7]

Whether a government upholds this core principle (and others) affects the confidence people have in its financial system. With that in mind, the IMF incorporates the principle of supervisory independence into its Financial Sector Assessment Program, which evaluates the resilience of a country's financial system. Today, the vast majority of countries in the world meet this standard.

This leads to the inescapable conclusion: prudential supervision should be an independent function, housed in an entity with control of its own budget, insulated from day-to-day political influence, but acting transparently to ensure accountability.

Why the central bank should be a leading supervisor

> *"Monetary policy and concerns about the structure and condition of banks and the financial system more generally are inextricably intertwined. Other agencies, certainly including the Treasury, have legitimate interests in regulatory policy. But I do insist that neither monetary policy nor the financial system will be well served if our central bank is deprived from interest in, and influence over, the structure and performance of the financial system."*
> Paul A. Volcker, March 17, 2010.[8]

Should central banks be a leading supervisor, including supervising systemically important institutions? The answer is clearly yes. As the lender of last resort, as the monetary policy authority, and as the organization responsible for overseeing the health and stability of the overall financial system—what we could call a *systemic regulator*—the central bank needs to be a supervisor.[9]

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[6] For a discussion of these episodes, and others, see Marc Quintyn and Michael W. Taylor, "Should Financial Sector Regulators Be Independent?" IMF Economic Issues No. 32, 2004.
[7] Basel Committee on Banking Supervision, "Core Principles for Effective Banking Supervision," September 2012.
[8] Paul A. Volcker, "Testimony before the House Financial Services Committee," March 17, 2010.
[9] The Squam Lake Group advocates that the central bank should serve as the systemic regulator, making clear what that does and does not entail. See Squam Lake Group, "A Systemic Regulator for Financial Markets," in *Squam Lake Report*, Princeton, N.J.: Princeton University Press, 2010, Chapter 2.

The lender of last resort and prudential supervision

Recall that Congress created the Federal Reserve in 1913 in response to a series of banking panics. Financial instability after the Civil War resulted from the absence of a central bank to provide emergency loans to solvent institutions facing sudden deposit outflows. When depositors ran on a few banks, panic frequently spread. To promote stability, Congress authorized the Fed to serve as the lender of last resort—lending against good collateral to solvent institutions at a penalty rate.

Operating as the lender of last resort requires two pieces of information: (1) a determination of an institution's solvency, and; (2) a valuation of the collateral that is being posted to back the loan. Supervisors, with their intimate knowledge of the bank's operations, are the officials expected to have both of these.[10]

On the importance of solvency, there are three reasons that it is imperative a central bank *never* lend to bankrupt institutions. First, since the central bank will always require collateral, its loans further subordinate the bank's long-term creditors. It does this both by allowing short-term depositors to run and by inserting itself ahead of others in the queue for claiming repayment when failure inevitably comes. Second, lending to an insolvent bank does not put an end to that institution's fragility. Ultimately, it must be liquidated or re-capitalized. Postponing the day of reckoning is usually costly both for the institution in question and, as a consequence of a misallocation of resources, for the economy as a whole. Third, when people find out that the central bank is willing to lend to insolvent banks—and they will find out—any bank that borrows will be suspected of being bankrupt. The resulting *stigma* will impair the useful function of the lender of last resort as a lender to *solvent, but illiquid* banks. If only those that are bankrupt borrow, the central bank's lending facility will become worse than useless.

Even with a solvent borrower, protecting public finances means that the central bank must obtain sufficient collateral. Again, this requires intimate knowledge of the quality of a bank's assets, something that supervisors routinely assess.

An example illustrates the challenge that a central bank lender faces in maintaining financial stability. On November 21, 1985, a computer software error prevented the Bank of New York from keeping track of its U.S. Treasury securities clearing operations. In line with normal practice, orders poured in and the bank made payments without having received the funds. But when it came time to deliver the bonds and collect from the buyers, the order information had been erased from the system. By the end of the day, the Bank of New York had bought and failed to deliver so many securities that it was committed to paying out nearly $23 billion that it did not have. The Federal Reserve, knowing from its up-to-date supervisory records that the bank was solvent, made an emergency $23-billion loan, taking the entire bank (complete with its furnished building) as collateral and averting a systemic financial crisis. The amount of the loan exceeded the aggregate reserves in the entire U.S. banking system at the time. Importantly, only a direct and effective supervisor was in a position to know that the Bank of New York was solvent, that it had the necessary collateral, and that its need to borrow was legitimate.[11]

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[10] For a discussion of the role of the lender of last resort, see Paul Tucker, "The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction," in BIS Papers No. 79, September 2014, pg. 10-43.

[11] See the Gerald E. Corrigan, "Testimony before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs of the House of Representatives," December 12, 1985, Serial No.

So, in order to operate responsibly and effectively as a lender of last resort, protecting the public interest, the central bank needs to have close access to confidential supervisory assessments, knowledge about an institution's business practices, and the skills to evaluate the collateral a bank is posting to secure a loan. Importantly, this information has to be available to high-ranking central bank officials on very short notice. In some cases, decisions must be made in a matter of minutes, so the quality of the data must be without question and it cannot be in the hands of people across town who may or may not choose to share it.

It is difficult to overstate the importance of liquidity provision in the prevention and management of financial crises. The Federal Reserve has a variety of methods for injecting liquidity into the banking system on short notice, including the direct purchase of securities through open market operations and the provision of intra-day credit through the payments system. But direct lending to banks, usually on the order of several hundred million dollars, is sometimes the most important means to avert panic and contain a crisis. For example, in the aftermath of the terrorist attacks of September 11, 2001, to head off what would have been a financial system collapse, the Fed lent roughly $37 billion that day (and subsequently provided an additional $100 billion through a variety of means). In the aftermath of the Lehman bankruptcy, Federal Reserve lending peaked at $441 billion. Without supervisory information, the Fed would have been flying blind, not knowing if it was lending to insolvent institutions or whether it was accepting good collateral. Not only would this have been bad policy, it would have put taxpayers at risk.

As a practical matter, liquidity provision is also the mechanism central banks use to achieve their traditional interest rate objective. During normal times, when reserves are scarce, the Federal Reserve influences the federal funds rate by adding or draining liquidity from the banking system. This means that there is no operational difference between monetary policy actions and lending operations. In fact, in terms of their impact on the Fed's balance sheet, the purchase of a security and a loan are identical.

Returning to the issue of governance, operations in the midst of a financial crisis are akin to maneuvers during a war. In the heat of battle, the military relies on a clear chain of command to ensure a consolidated view of the battle and effective coordination of resources. Separation of supervision from the central bank would be like having multiple generals with potentially differing objectives simultaneously giving orders to the same army. It is hard to see how this could possibly work. Successful crisis management requires timely and effective coordination.

Monetary policy and prudential supervision

The intimate relationship between monetary policy and prudential supervision is another important rationale for giving the central bank a major supervisory role. As a practical matter, the two are inseparable. The Federal Reserve is set up as a matrix organization, so it is nearly impossible to say where one function stops and another starts. This is particularly true of the Federal Reserve Banks, who bear the day-to-day responsibility of examining and supervising banks. Monetary policy and prudential supervision are not in siloes, but operate in tandem, sharing knowledge, staff and expertise. And, because they work together, they are both more effective.

99-65; and Huberto M. Ennis and David A. Price, "Discount Window Lending: Policy Trade-offs and the 1985 BoNY Computer Failure," *Economic Brief*, Federal Reserve Bank of Richmond, May 2015.

Prudential supervision provides important inputs into the monetary policy process. The Federal Reserve supervises those parts of the banking system that account for nearly all of its assets. This includes oversight of more than 5,000 holding companies and over 200 foreign banking operations. Through its access to these financial firms, supervisors naturally learn about the health of the borrowers as well as that of the lenders. Put differently, the Federal Reserve knows a great deal about what banks are doing, to whom they are lending, as well as the size and the terms of the loans.

This nonpublic information can be vital for monetary policy.[12] A deep and complete understanding of the state of the financial markets and institutions, including the terms and conditions under which borrowers can obtain financing, is critical for the determination of the appropriate monetary policy stance. That is, the level of the interest rate set by the Federal Open Market Committee depends on supervisory information.

The events of mid-2008 provide a clear instance when the use of banking system information was critically important. Inflation was running a quarter of a percentage point above the Fed's 2-percent objective. A mechanical rule based solely on inflation and unemployment would have dictated that monetary policymakers raise interest rates to a level exceeding 5 percent. Fortunately, with their understanding of financial fragilities—gleaned in part from access to supervisory information about the deteriorating state of the banking sector—the Federal Open Market Committee judged interest rates at 2 percent consistent with inflation and growth prospects.[13] Needless to say, the next few months provided disastrous, dictating further policy *easing*, not *tightening*.

Information and skills also flow from monetary policymakers to prudential supervisors. An assessment of the safety and soundness of banking institutions requires an understanding of economic prospects—something that is integral to the formulation of monetary policy. In practice, this means that the economic and financial outlook is an input into supervisory evaluations. Nowhere is this more apparent than in the case of stress testing. Stress tests today are the most powerful prudential tool we have for safeguarding the resilience of the financial system. They take seriously the fact that when a large common shock hits, there may be no one who will purchase a bank's assets or provide equity capital. Ensuring that each systemic intermediary can withstand significant stress raises the likelihood that the system can survive. And, importantly, by adjusting the scenarios to reflect changing conditions, prudential authorities ensure that the system remains resilient. Formulating stress scenarios requires both knowledge about how the entire economy operates and a sense of the financial risks that are not adequately compensated. This is true both for domestic developments, like real estate booms, as well as those that could come from other parts of the world, like the cyclical downturns of major trading partners.

In sum, monetary policy and prudential supervision are complementary. Each requires information from the other. As Paul Volcker put it, the two are inextricably intertwined.

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[12] See, for example, Joe Peek, Eric S. Rosengren and Geoffrey M.B. Tootell, "Is Bank Supervision Central to Central Banking?" *Quarterly Journal of Economics*, vol. 114, no.2, May 1999, pg. 629-653.

[13] See the comments of William Dudley on pages 4 to 8 of the transcript of the June 24-25 FOMC meeting.

Financial stability and prudential supervision

Finally, there is the relationship between prudential supervision and the maintenance of systemic stability. The second of these is prudential supervision for the financial system as whole. It is clear that the central bank is the locus of that responsibility. The Federal Reserve does not have an explicit financial stability mandate. But it has a powerful, implicit one: without a modicum of financial stability, it would fail to achieve the statutory objectives of maximum employment, stable prices and moderate long-term interest rates.

With that in mind, building on the skills of its staff, its day-to-day access to and knowledge of financial markets, and its supervisory information, the Federal Reserve has created the capacity to monitor the financial system in order to ensure that both monetary and prudential policy are set in a way that enhances resilience.

Concluding remarks

I began by asking two questions: should prudential supervisors be operationally independent and should the central bank be a leading supervisor? My answer to both questions is yes. When supervisors are independent of political interference, complete with budgetary autonomy, the financial system is more stable and taxpayer costs are lower. Furthermore, a supervisory function is essential for effective and efficient execution of core central bank functions. As lender of last resort, the monetary policy authority, and the guardian of the health and stability of the overall financial system, it is essential that the Federal Reserve be a leading supervisor, including for systemically important institutions. The American public would be ill served if any of this were to change.

Statement of James C. Sivon
On behalf of
The Financial Services Roundtable
Before the
Subcommittee on Monetary Policy and Trade
And the
Subcommittee on Financial Institutions and Consumer Credit
Of the
Committee on Financial Services

September 12, 2017

Chairman Barr and Ranking Member Moore, Chairman Luetkemeyer and Ranking Member Clay, my name is James Sivon, and I am appearing on behalf of the Financial Services Roundtable (FSR).[1] FSR is a national trade association for the nation's largest financial services companies. FSR members provide banking, insurance, payments, and investment products and services to consumers and businesses.

FSR appreciates the opportunity to address the Federal Reserve Board's (Board) role as a prudential regulator. FSR members recognize the need for regulations and supervisory policies that ensure stable financial markets and protect consumers. A decade ago, gaps in financial regulation and supervision contributed to a financial crisis and a national recession. Subsequent actions taken by Congress, financial regulators, and the financial services industry itself have restored the stability of the U.S. financial system. Today, large bank holding companies have more than doubled their capital from around $500 billion in 2009 to $1.2 trillion in the first quarter of 2017, and have more than doubled their risk-based capital ratios from 5.5 percent to 12.4 percent over that period.

[1] I am appearing in my capacity as an outside counsel to FSR. I am a partner in the law firm of Barnett Sivon & Natter, P.C., and a counsel with Squire Patton Boggs LLP.

The largest bank holding companies also have increased liquid assets from about $1.5 trillion to about $2.3 trillion between 2011 and the first quarter of 2017.[2]

Yet, experience has shown that some of the regulations and supervisory policies put in place in response to the financial crisis are holding back a more robust economic recovery. Loans to mortgage borrowers and small businesses illustrate this problem. The Urban Institute has estimated that over 5 million consumers were unable to obtain a mortgage loan between 2009 and 2014 because of a combination of new regulatory requirements and increased litigation risks faced by lenders and investors.[3] Other studies have found that since the financial crisis small businesses have suffered low rates of formation and tepid growth due, in part, to regulations that make it difficult for small businesses, especially those with limited credit histories, to obtain credit.[4]

A recent analysis of post-crisis lending by large bank holding companies supports these findings. That analysis, which was conducted by the economic research division of the Board, found that, while bank lending has been robust for the past three years, lending growth by more heavily regulated large banks (those with more than $50 billion in assets) lags lending growth by smaller banks.[5]

FSR believes that the goal of prudential regulation and supervision should be to promote both financial stability and economic growth. FSR appreciates the steps the Board already has taken to tailor some prudential standards and supervisory policies. Last year, for example, the Board revised the rules governing capital planning and stress testing for

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[2] Jerome H. Powell, Member Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs U.S. Senate, June 22, 2017.

[3] Bin Bai, Laurie Goodman and Jun Zhu, *Tight Credit Standards Prevented 5.2 Million Mortgages Between 2009 and 2014*, Urban Institute (Jan. 28, 2016).

[4] Federal Reserve Banks, 2016 Small Business Credit Survey, (Apr. 2017), https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf. *See also* Amanda Hindlian, Sandra Lawson, Katherine Maxwell, Koby Sadan, and Sonya Banerjee, *The Two Speed Economy*, Goldman Sachs Global Markets Institute (Apr. 2015).

[5] Cindy M. Vojtech, Post-Crisis Lending by Large Bank Holding Companies, FEDS Notes (July 6, 2017), https://www.federalreserve.gov/econres/notes/feds-notes/post-crisis-lending-by-large-bank-holding-companies-20170706.htm.

bank holding companies defined as "large, non-complex" institutions.[6] More recently, the Board has proposed changes in its supervisory policies related to boards of directors, and, in conjunction with the other federal banking agencies, the Board has proposed some refinements to the Basel III capital rules. However, more can be done to tailor existing regulations.

The first part of my testimony highlights several proposed reforms to existing prudential standards and supervisory policies that would enable FSR members to meet the financial needs of consumers and businesses while preserving financial stability. The proposed reforms are taken from a larger set of proposed reforms FSR recently submitted to the Treasury Department.[7] The second part of my testimony makes three general recommendations for financial regulatory reform.

I. FSR's Recommendations Related to Specific Regulations and Supervisory Policies Administered by the Board

The Dodd-Frank Act gave the Board authority to implement prudential standards for large bank holding companies and nonbank financial companies designated by the Financial Stability Oversight Council (FSOC) for supervision by the Board. My testimony addresses the standards related to: capital planning and stress testing; capital and liquidity requirements; resolution planning and recovery requirements; the prudential standards applicable to insurance companies supervised by the Board; model validation and vendor management guidance. It also addresses the Volcker Rule.

The Capital Planning and Stress Testing Rules Should be Adjusted

[6] Under the Federal Reserve's Final Rule this includes institutions with average total consolidated assets between $50 billion and $250 billion and that have average total nonbank assets of less than $75 billion.
[7] That submission, which includes over 100 recommendations, was made in response to Executive Order 13772, which directed the Department to conduct an assessment of the extent to which the regulation of the U.S. financial system is consistent with a set of Core Principles set out in the Order. A copy of that submission may be found at the following Internet address: http://www.fsroundtable.org/wp-content/uploads/2017/06/FSR-Letter-to-Treasury-on-Core-Principles-May-3.pdf.

The comprehensive capital analysis review (CCAR) and stress testing rules are among the most impactful rules adopted since the crisis. Those rules have helped FSR members build stronger capital positions and address risk management weaknesses that contributed to the crisis. As time has passed, however, it is increasingly apparent that the rules can be adjusted without impairing their fundamental purpose.

The General Accountability Office (GAO) has recommended several adjustments to the capital planning and stress testing rules that are designed to increase the transparency of these rules.[8] As GAO noted in that report, transparency is a key feature of accountability and incomplete disclosure may limit understanding of the stress test results and hinder public and market confidence in the program. FSR supports many of the GAO's proposed reforms.

FSR also supports more disclosure regarding the modeling principles used in the Board's stress testing formulas and the full disclosure of the Board's supervisory models after a reasonable delay.[9] FSR members find significant disparities between their own internal evaluations of risk and the loss projections predicted by the models used by the Board. This creates a level of uncertainty around the process that can impact lending decisions. It leads companies to make assumptions about the Board's models and then adjust their loan portfolio to conform to those assumptions in order to meet their capital

[8] GAO, *Additional Actions Could Help Ensure the Achievement of Stress Test Goals*, (Nov. 15, 2016). (The recommendations made in this report include the following: (1) The Board, FDIC, and OCC should harmonize their agencies' approach to granting extensions and exemptions from stress test requirements; (2) The Board should publicly disclose additional information that would allow for a better understanding of the methodology for completing qualitative assessments, such as the role of ratings and rankings and the extent to which they affect final determination decisions; (3) The Board should assess—and adjust as necessary—the overall level of severity of its severely adverse scenario by establishing a process to facilitate proactive consideration of levels of severity that may fall outside U.S. postwar historical experience, and expanding consideration of the trade-offs associated with different degrees of severity; (4) The Board should assess whether a single severe supervisory scenario is sufficient to inform CCAR decisions and promote the resilience of the banking system; (5) The Board should develop a process to test its proposed severely adverse scenario for pro-cyclicality annually before finalizing and publicly releasing the supervisory scenarios; and (6) The Board should improve management of model risk and ensure decisions based on supervisory stress test results are informed by an understanding of model risk.)

[9] Alternatively, the Federal Reserve could establish a process by which banks could meet individually with the Board's staff in Washington, D.C. to discuss concerns regarding the outputs of Federal Reserve models. At a minimum these discussions would allow banks to learn if discrepancies are being driven by specific model assumptions or because of specific model factors that are being used by the Federal Reserve.

requirements. More transparency surrounding the Board's models would reduce this uncertainty and help to ensure that the Board's CCAR practices do not discourage appropriate lending activities.

As I have noted, the Board recently revised the capital planning and stress testing rules for large, non-complex bank holding companies. Under the revised rules, the Board will assess a company's risk management practices as part of the Board's normal supervisory process, rather than in conjunction with the capital planning and stress testing process. In other words, the Board will not object to a company's capital plan based upon a company's compliance with "qualitative" standards. In proposing this change, the Board stated that it was designed to ensure that companies did not "over-invest in stress testing and capital planning processes that are unnecessary to adequately capture the risk of these firms."[10] FSR recommends that the Board expand this treatment to all bank holding companies, regardless of size, based upon the ongoing supervision that occurs onsite and offsite at these institutions.[11]

Additionally, capital planning and stress testing standards is an area where greater coordination between regulators is needed. While the Board has changed its policies regarding qualitative assessments, the Office of the Comptroller of the Currency (OCC) has retained enhanced documentation and disclosure standards that conflict with the Board's attempt to reduce the regulatory burden requirements entailed in the annual capital planning process. FSR recommends that the OCC modify its policies to be consistent with those adopted by the Board.

Finally, FSR recommends that the Board revise its rules governing capital distributions outside of the capital planning cycle. Under current rules, a company may make capital distributions outside of the capital planning cycle only if those distributions

[10] 81 Fed. Reg. 67241 (Sept. 30, 2016).
[11] Notably, the Board has recently proposed a new rating system for large institutions that will include a specific rating for capital planning obviating the need for a separate measure as part of the CCAR process. 82 Fed. Reg. 39049 (Aug. 17, 2017).

meet a de minimis standard or the company obtains special permission from the Board. If a company has successfully passed a stress test, FSR believes the company should have the ability to manage its own capital position and distribute excess capital in situations where its performance surpasses the projections embedded in its earlier capital plan.

Tailor the Capital Rules and Liquidity Rules

Recent stress test results show that bank holding companies subject to CCAR can withstand an economic downturn comparable to the financial crisis in 2007-2008.[12] These results indicate that we have reached a point where the capital and liquidity rules could be adjusted to promote economic growth, without jeopardizing financial stability. Toward that end, FSR recommends:

- Adjust the Supplemental Leverage Ratio – Banking regulators should revise the calculation of the supplementary leverage ratio to exclude risk-free assets from the calculation of a company's total assets for purposes of the ratio. This would include reserves held at the Federal Reserve, cash, and Treasury securities. This change would free funds to enable banks to offer products, such as derivatives clearing and securities financing agreements that both support financial stability and foster economic growth. The Bank of England recently exempted cash deposits held at the central bank from its calculation of the leverage ratio.[13] Similarly, FSR recommends that the Board eliminate the "enhanced" SLR requirement for the nation's largest banking organizations.[14] The current U.S. requirements double international standards and create a competitive disparity for U.S. banking organizations.

- Revise the Capital Surcharge – FSR recommends that the capital surcharge for the nation's largest banks be aligned with international standards. In implementing the

[12]https://www.federalreserve.gov/publications/files/2017-dfast-methodology-results-20170622.pdf.
[13] Bank of England, *Financial Policy Committee Statement from its Policy Committee Meeting* (July 25, 2016), http://www.bankofengland.co.uk/publications/Documents/news/2016/062.pdf.
[14] The enhanced SLR requires these companies to meet a 5% SLR at the holding company level and a 6% SLR at the bank level. The standard included in Basel III is 3%.

capital surcharge for U.S. banking organizations, the Board adopted an additional requirement (called "method 2") for the nation's largest bank holding companies that imposes a surcharge beyond the international standard. The internationally accepted G-SIB surcharge framework produces a risk score derived from a firm's attributes in five categories: size, interconnectedness, complexity, cross jurisdictional activity, and substitutability. Method 2 replaces the substitutability category with a measure of a firm's reliance on short-term wholesale funding. While FSR appreciates the risks associated with overdependence on short-term wholesale funding, these risks are already accounted for in the 30-day liquidity coverage ratio, new rules requiring the issuance of minimum levels of unsecured debt, and the Dodd-Frank Act enhanced prudential standards 30-day liquidity stress test. This change would help large U.S. bank holding companies remain competitive with foreign firms in domestic and foreign markets.

- Expand the Scope of High-Quality Liquid Assets (HQLA) under the Liquidity Rule – FSR recommends that the Board (and other federal banking agencies) adjust the treatment of mortgage securities, municipal securities, FHLB obligations, and securities issued by governments sponsored entities (GSEs) such as Fannie Mae and Freddie Mac in the liquidity coverage ratio (LCR). The LCR requires a banking organization to hold enough high quality assets to cover a net outflow of cash over a 30 day period. The final rule defines three categories of high quality assets, level 1, level 2A and level 2B. Level 2A and 2B assets are subject to haircuts of 15 and 50 percent respectively. Currently, however, most municipal securities and private mortgage backed securities are not treated as high quality liquid assets, and FHLB and GSE obligations are treated as level 2A assets, subject to a 15 percent haircut. This is despite the fact that there are highly-liquid markets for each of these obligations, and including them in the category of high quality liquid assets would reduce reliance on Treasury securities.

- Revise the Outflow Assumptions in the Liquidity Rule – FSR recommends that the Board (and other federal banking agencies) revise the run-off assumptions in the LCR. The calculation of net cash outflows under the LCR rule is overly conservative and should be aligned with the international LCR requirements or be adjusted to better match the conditions experienced by failing banks in the most recent financial crisis. Appropriate changes include: (1) eliminating the maturity mismatch add-on component of the U.S. LCR calculation and instead use cumulative net cash outflow amounts over the 30-day assumed stress period to address maturity mismatches; and (2) allowing net cash outflows to be calculated on the final business day of every month instead of daily. Additionally, the agencies should modify cash outflow rates and assumptions. For example, the final U.S. LCR rules provide for 0% liquidity value for non-operating deposits and excess operational deposits of financial institutions. This assumption does not take into account the wide range of regulated financial companies and observed historical behaviors during times of stress.

Coordinate Resolution and Recovery Planning Requirements

Resolution planning has helped FSR members rationalize operations and contracts and put in place plans to respond to financial distress. Yet, this requirement, combined with separate recovery planning requirements, is an area where greater coordination among the agencies is needed.

The Dodd-Frank Act requires all bank holding companies with more than $50 billion in assets to submit periodic resolution plans to the Board and the Federal Deposit Insurance Corporation (FDIC). Using its general authority to issue regulations under the Federal Deposit Insurance Act, the FDIC has issued a companion rule that requires insured banks with more than $50 billion in assets to submit annual resolution plans. [15] The Board and the OCC separately have also required institutions under their supervision to develop

[15] *Resolution Plans Required for Insured Depository Institutions with $50 Billion or More in Total Assets*, Fed. Reg. 3075 (Jan. 23, 2012) (codified at 12 C.F.R. pt. 360).

recovery plans that map actions the company may take to remain a going concern when experiencing financial or operational distress.[16] FSR recommends that the Board, FDIC and OCC align these requirements so materials developed for one purpose could be incorporated by reference into other filings.

FSR also recommends that the reporting cycle for resolution plans required under the Dodd-Frank Act and the FDIC's rule for insured depository institutions be moved to a two-year cycle rather than annually. This step could be taken at the sole discretion of the Board in tandem with the FDIC. It is increasingly evident that these annual requirements are neither efficient nor effective for both regulators and covered firms. For firms, resolution plans do not change substantially from year to year, absent a material change in a firm's structure. Regulators, in turn, have been hard pressed to provide feedback on plans under the current annual cycle.

Tailor Prudential Standards for Insurance Companies

As a result of the Dodd-Frank Act, the Board gained regulatory and supervisory authority over insurance companies that operate as savings and loan holding companies (SHLCs) as well as insurance companies designated by FSOC for supervision by the Board. While the Board has indicated a willingness to consider the unique characteristics of the business of insurance through tailored rulemaking, FSR believes the Board could be more attentive to the differences between the business of insurance and banking.

For example, in 2011, shortly after it assumed authority for SHLCs, the Board indicated that it would supervise SLHCs in a manner consistent with its approach to supervising bank holding companies while taking into account any unique characteristics of SLHCs.[17] Since then, however, the Board has issued numerous supervisory letters

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[16] The Board's rules apply to the nation's largest eight bank holding companies, and the OCC's rules apply to all national banks with more than $50 billion in assets.
[17] Federal Reserve, *SR 11-11: Supervision of Savings and Loan Holding Companies* (July 21, 2011), https://www.federalreserve.gov/supervisionreg/srletters/sr1111.pdf.

applicable to SLHCs that do not specifically address how they should be applied to SLHCs with substantial insurance operations.[18] Such guidance should be better tailored to insurance SLHCs.

Additionally, last year, the Board invited comment on two different capital standards for the insurance companies it regulates: a "building block" approach (BBA) for insurance companies that are SHLCs and a "consolidated" approach (CA) for the insurance companies that have been designated by FSOC for supervision by the Board. FSR believes the BBA should be applied to all insurers supervised by the Board, not just SHLCs. The BBA-based framework offers a uniform and effective approach that effectively accounts for the various activities and risks of the different legal entities within a covered insurance group. It leverages existing standards that have already been vetted, tailored, and calibrated to the business of insurance by state insurance authorities. It also minimizes any disparate impacts that could arise from pursuing different approaches to capital for different types of insurance companies.

Review Model Validation and Vendor Management Standards

During the past several years, the Board (and other federal banking agencies) has increased supervisory attention on model validation[19] and vendor management.[20] FSR appreciates that these practices deserve supervisory oversight, since both impact an

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[18] SR 14-9 extended nearly 120 prior SR letters to SLHCs without any differentiation for insurance companies that are SLHCs. Federal Reserve, SR 14-9: Incorporation of Federal Reserve Policies into the Saving and Loan Holding Company Supervision Program (Nov. 7, 2014), https://www.federalreserve.gov/supervisionreg/srletters/sr1409.pdf

[19] *See* Federal Reserve, *SR 11-7: Supervisory Guidance on Model Risk Management* (Apr. 4, 2011), https://www.federalreserve.gov/bankinforeg/srletters/sr1107.htm

[20] *See* OCC, *Risk Management Guidance, OCC Bulletin 2013-29* (Oct. 30, 2103), http://www.occ.treas.gov/news-issuances/bulletins/2013/bulletin-2013- 29.html; Federal Reserve, *Board Supervisory Letter 13-19 and Guidance on Managing Outsourcing Risk* (Dec. 5, 2013), https://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf; FDIC, *Guidance For Managing Third-Party Risk*, Financial Institutions Letter 44-2008 (2008),https://www.fdic.gov/news/news/financial/2008/fil08044a.html; NCUA, *Evaluating Third Party Relationships*, NCUA Supervisory Letter 07-01 (Oct. 2007) https://www.ncua.gov/resources/documents/lcu2007-13enc.pdf and FFIEC, *Handbook on Outsourcing Technology Services*, http://ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services.aspx.

organization's operations, and potentially its reputation. However, in both cases, we believe that it is time to reassess existing standards and requirements.

Model validation should be limited to models that have a material impact on an organization. Current guidance, however, often requires firms to justify and validate non-critical analysis tools or develop and monitor models for activities that are highly subjective, such as BSA/AML compliance.[21] Notably, this guidance is in tension with other supervisory letters directing banks to establish risk management processes that are tailored to their individual needs.[22] To remedy this conflict, FSR recommends that the Board and OCC revise their current supervisory guidance related to model risk.

Similarly, vendor management requirements are inadvertently causing firms to only rely on larger vendors, resulting in an increasing concentration of vendor risk. FSR recommends that the Board (and other federal banking agencies) review current guidance to provide some flexibility for financial institutions to engage with vendors that undergo due diligence and are deemed not risky to the institution's customers.[23]

Revisit the Volcker Rule

FSR recommends that the federal financial regulators revisit the Volcker Rule. During the comment period on the Volcker Rule, many commenters asserted that the Rule would impair liquidity in the nation's capital markets. That concern since has been documented in an analysis of liquidity in the corporate debt markets conducted by

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[21] SR 11-7. Federal Reserve Supervisory Assessment of Capital Planning and Positions for Large and Noncomplex Firms (Dec. 18, 2015), https://www.federalreserve.gov/supervisionreg/srletters/sr1519_PW.pdf.

[22] See, Federal Reserve, SR 15-19

[23] OCC Bulletin 2013-29 (http://www.occ.treas.gov/news-issuances/bulletins/2013/bulletin-2013-29.html); FRB Supervisory Letter 13-19 and Guidance on Managing Outsourcing Risk (https://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf); FDIC Financial Institutions Letter 44-2008 (https://www.fdic.gov/news/news/financial/2008/fil08044a.html); NCUA Supervisory Letter 07-01 (https://www.ncua.gov/resources/documents/lcu2007-13enc.pdf); and FFIEC Handbook on Outsourcing Technology Services (http://ithandbook.ffiec.gov/it-booklets/outsourcing-technology-services.aspx).

economists at the Board.[24] Additionally, several Governors on the Federal Reserve Board have acknowledged that the Rule is overly complex and should be reviewed.[25]

As part of a review of the Volcker Rule, FSR recommends that:

- The Rule be tailored by exempting institutions that score below a certain threshold on the "complexity" and "interconnectedness" indicators within the systemic indicator framework;

- The scope of the covered fund prohibitions in the Rule be amended or reinterpreted to limit the definition of covered fund only to Section 3(c)(1) or Section 3(c)(7) funds that engage in prohibited proprietary trading. This would achieve the goal of prohibiting indirect, impermissible proprietary trading through investment in a covered fund and limiting banking entities from bailing out sponsored covered funds, while preserving safety and soundness and without sweeping in core asset management, ordinary corporate structures, securitizations and related activities that were not meant to be restricted by the Volcker Rule;

- The prohibition on proprietary trading be adjusted not to reach client-oriented activities. The Rule does not clearly define proprietary trading, and such ambiguity forced dealers toward more conservative trading strategies, leading to less liquid markets. For example, the current prohibition captures certain asset-liability management activities and Treasury functions. To address this, we recommend that

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[24] Jack Bao, Maureen O'Hara, and Alex Zhou, *The Volcker Rule and Market-Making in Times of Stress*, Financial and Economics Discussion Series (2016).
[25] See, Departing Thoughts, Remarks by Daniel K. Tarullo, Member Board of Governors of the Federal Reserve System at The Woodrow Wilson School Princeton University Princeton, New Jersey April 4, 2017, ("....several years of experience have convinced me that there is merit in the contention of many firms that, as it has been drafted and implemented, the Volcker rule is too complicated.") See also, Remarks by Jerome H. Powell, Member Board of Governors of the Federal Reserve System, Salzburg Global Seminar Salzburg, Austria June 26, 2017 ("In our view, there is room for eliminating or relaxing aspects of the implementing regulation in ways that do not undermine the Volcker rule's main policy goals.")

the prohibition be revised to focus on trading activities that are wholly unrelated to financial intermediation, risk management, or asset/liability management;

- The agencies should reverse the presumption in the Volcker Rule's regulation of short-term trading. The regulation currently presumes that a position held for 60 days or less *is* proprietary trading. Instead, any security or derivative held longer than 60 days should be presumed *not* to be proprietary trading (i.e., not in a Volcker trading account under the Rule). Further, any security or derivative not held in a broker-dealer or swap dealer desk, or not subject to market risk capital rules (or their equivalent under applicable regulations), should be presumed to be excluded from a Volcker trading account; and

- Banking institutions with assets of $50 billion or more not be required automatically to meet standards for "enhanced compliance programs." While these safeguards may be appropriate for some firms, the use of an arbitrary asset-based threshold does not distinguish between companies with extensive trading portfolios and covered activities and those with simple investment activities used solely for traditional asset liability management. The regulators should amend the Rule to replace the $50 billion asset threshold with a threshold that accounts for a company's activities and risk profile.

II. FSR's General Recommendations

In addition to the foregoing recommendations, FSR has three general recommendations for aligning financial regulations and supervisory policies with economic growth. These recommendations apply broadly to all federal financial regulatory agencies. They are: (1) to base prudential standards on an assessment of risk rather than the size of an institution; (2) to improve policy coordination among all federal financial regulatory agencies; and (3) to conduct an assessment of the impact of the Current Expected Credit Loss (CECL) accounting standard on lending and economic growth.

Prudential Standards should be Based upon an Assessment of an Institution's Risk, Not Size

Currently, many of the prudential regulations imposed on financial firms are based upon the size of an institution, not the risk it may pose to financial stability. For example, heightened prudential standards apply to all bank holding companies with more than $50 billion in assets and all nonbank financial companies designated by the FSOC for supervision by the Federal Reserve Board (Board); stress tests apply to any bank holding company with more than $10 billion in assets; and the federal banking agencies have established other supervisory standards based upon a $250 billion threshold that was incorporated in the Basel capital framework over a decade ago.

Such fixed dollar thresholds result in "cliff" effects for institutions near the thresholds. These effects cause institutions to take actions simply designed to avoid the thresholds, including not undertaking new business opportunities that could contribute to economic growth. Similarly, institutions that cross a threshold suddenly find themselves in a new supervisory category that carries substantial compliance costs, even though their risk profile has not changed.

To overcome these problems, FSR recommends that prudential standards be based upon an assessment of the risk posed by the operations and activities of a company, not just a company's asset size.[26] Asset size could be used as a factor in such an assessment, but should not be the determinative factor.[27] Regulators could also develop an approach under which a company that crosses an asset threshold is subject to a risk analysis to determine whether the company should be subject to a particular prudential standard. This approach also would allow regulators to impose prudential standards on institutions that may be below an asset threshold but pose some risk based upon their mix of activities.

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[26] Making these changes requires a combination of actions by Congress and federal regulators. Several of the current asset thresholds were established in the Dodd-Frank Act. Others, such as the $250 billion threshold, have been set by the federal banking agencies under their general regulatory authority and can be changed under the same process.

[27] We note that information on a variety of systemic risk indicators, which could be used for such a calculation, is already provided to the Federal Reserve via the FR-Y 15 form.

FSR is not alone in calling for prudential standards to be based upon risk rather than size. It is now widely accepted that risk-based criteria provide a better measure of risk than an exclusive reliance on asset size.[28] Think tanks [29] and even members of the Board[30] have called for either raising asset thresholds or replacing them with a risk assessment. FSR further supports the bipartisan framework set out in H.R. 3312, the "Systemic Risk Designation Improvement Act of 2017." We thank Chairman Luetkemeyer and other committee members for their work on this issue and pledge our support to your continued efforts in this area.

Greater Coordination Among Federal Financial Regulatory Agencies is Needed

FSR members are subject to regulation and supervision by multiple federal regulatory agencies. While each of these agencies has its own statutory mission, those missions can overlap and conflict. This results in a misallocation of resources by regulators and regulated firms, and increases the cost of financial products and services to consumers and businesses. Greater coordination among federal financial regulators would help to make financial regulation more predictable, reduce regulatory gaps, and minimize regulatory conflict that can impair economic growth.

Some of the regulatory and supervisory policies addressed in this statement illustrate this overlap and conflict. Other areas where greater coordination is needed include examination practices, reporting requirements,[31] and cybersecurity standards.

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[28] Aite Group, *Bank Size vs. Systemic Importance* (Oct. 2015), http://www.fsroundtable.org/wp-content/uploads/2015/10/Bank-Size-vs-Systemic-Importance_Aite-Group-Study_FINAL_October-19-2015.pdf.
[29] Bipartisan Policy Center, Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture (Apr. 2014), https://bipartisanpolicy.org/library/dodd-franks-missed-opportunity-road-map-more-effective-regulatory-architecture-2/.
[30] Departing Thoughts, Remarks by Daniel K. Tarullo, Member Board of Governors of the Federal Reserve System at The Woodrow Wilson School Princeton University Princeton, New Jersey April 4, 2017, ("... I have said for several years now, we have found that the $50 billion in assets threshold established in the Dodd-Frank Act for banks to be "systemically important," and thus subject to a range of stricter regulations, was set too low. Similarly, the $10 billion asset threshold for banks to conduct their own required stress tests seems too low.")
[31] FSR has submitted a letter to the Office of Financial Research cataloging some of the overlap in existing

Enhancing coordination among federal financial regulators does not require a wholesale restructuring of those agencies. Federal financial regulators have the ability to coordinate policies and practices, but lack a clear directive to do so. This problem could be resolved through the enactment of a statutory set of guiding principles for federal financial regulators. Once embodied in law, these principles would serve as a touchstone against which all future financial regulations and supervisory practices could be evaluated. Statutory guiding principles encourage federal financial regulators to coordinate policies and practices without diminishing their independent missions. The Core Principles in Executive Order 13772 could serve as a model for statutory principles.

FSOC also is positioned to facilitate greater policy coordination among federal financial regulators. Absent the enactment of a set of guiding principles for financial regulation and supervision, FSR urges the Committee to use the required annual hearing on the FSOC's activities to promote regulatory and supervisory coordination among the members of FSOC.

The Impact of CECL on Lending Should Be Evaluated

The Financial Accounting Standards Board (FASB) has finalized an accounting standard that fundamentally alters the manner in which banks must reserve for loan losses. Rather than establishing a reserve when a loss is likely to be incurred, the Current Expected Credit Loss, or CECL standard, requires banks to estimate expected losses when a loan is made.

This change is intended to increase financial stability and improve liquidity throughout economic cycles. However, FSR members are concerned that the new standard

reporting requirements for large banking organizations. Letter to Richard Berner, Director of the Office of Financial Research from the Financial Services Roundtable (Mar. 22, 2017), http://www.fsroundtable.org/wp-content/uploads/2017/09/FSR_SUBMISSION_TO_OFR_ON_DUPLICATIVE_DATA_REQUESTS.v3.0.final_.pdf.

could reduce lending in recessionary periods (i.e., be pro-cyclical), and generally reduce lending to certain types of loans, such as mortgage loans and small business loans. An earlier analysis of the impact of the new standard performed by the Office of the Comptroller of the Currency (OCC) estimated that CECL would require national banks to increase loss reserves by as much as 30% to 50% over current levels.[32]

The implementation of CECL presents immense operational challenges. In setting a loss reserve an institution must take into consideration economic conditions not only when the loan is made, but throughout the entire term of the loan. Thus, CECL is premised on an institution's ability to accurately forecast future economic conditions over a period of decades. Making such forecasts can be challenging and could greatly impact the availability of long-term lending products such as a 30-year mortgage.

The CECL standard is scheduled to be effective for public companies, including bank holding companies, starting December 2019, and for other companies starting in December 2020. Before this standard goes into effect, FSR recommends policymakers conduct a comprehensive assessment of its potential impact on lending and economic growth. This assessment should include an evaluation of the relationship between loan loss reserves and capital requirements. In other words, if CECL goes into effect as proposed, consideration should be given to counting an institution's loss reserve as part of its common equity Tier 1 capital, since both are designed to enable an institution to continue to operate throughout economic cycles.[33]

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[32] Curry, Thomas J. "Remarks by Thomas J. Curry, Comptroller of the Currency, Before the AICPA Banking Conference, Washington, D.C." September 16, 2013.

[33] The FDIC's Risk Management Examination Manual states that one of the fundamental purposes of capital is to enable an institution to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced. (https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.) The Financial Accounting Standards Board similarly states that CECL will enable an institution to operate in all economic conditions: "The new standard requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts." (http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168232790.)

III. Conclusion

Thank you again for the opportunity to address the Federal Reserve Board's role as a prudential regulator. I would be pleased to answer any questions.