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REGULATORY RESTRUCTURING: BALANCING THE INDEPENDENCE OF THE FEDERAL RESERVE IN MONETARY POLICY WITH SYSTEMIC RISK REGULATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC MONETARY POLICY
AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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REGULATORY RESTRUCTURING: BALANCING THE INDEPENDENCE OF THE FEDERAL RESERVE IN MONETARY POLICY WITH SYSTEMIC RISK REGULATION

Thursday, July 9, 2009

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC MONETARY
POLICY AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 1:44 p.m., in room 2128, Rayburn House Office Building, Hon. Melvin L. Watt [chairman of the subcommittee] presiding.

Members present: Representatives Watt, Sherman, Green, Ellison, Adler; Paul, Castle, Gerlach, Posey, and Lance.

Ex officio present: Representative Bachus.

Also present: Representatives Perlmutter and Garrett.

Chairman WATT. Unfortunately, we have been notified that we will have a series of votes, four or five votes pretty soon, so we are going to try to get as far as we can into the process. I am going to go ahead and get started.

Let me call this hearing of the Subcommittee on Domestic Monetary Policy and Technology to order. Without objection, all members' opening statements will be made a part of the record, and I will recognize myself for an opening statement, which I will try to get in before we get called for votes, and maybe we can get the opening statements in before we get the call to the Floor.

This hearing is entitled, "Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy With Systemic Risk Regulation."

Our current regulatory system, created largely as a response to the Great Depression in the 1930's, has proven ineffective and outdated at preventing and addressing the financial crisis we are currently experiencing. Recognizing this, the President recently put forth a proposal for comprehensive financial regulatory reform. This hearing will examine one aspect of that proposal, the part that proposes to delegate to the Federal Reserve Board new powers, including the power to serve as the systemic risk regulator for all large, interconnected financial firms.

As the systemic risk regulator, the Federal Reserve would be empowered to structure and implement a more robust supervisory regime for firms with a combination of size, leverage, and inter-

connectedness that could pose a threat to financial stability. This hearing will examine whether and how the Fed could perform and balance the proposed new authority as systemic risk regulator with its current critical role as the independent authority on monetary policy.

While recent events have caused many to reevaluate and question the role and the extent of independence accorded to the Federal Reserve, the Fed's independence from political influence by the Legislative and Executive Branches of Government has long been viewed as necessary to allow the Fed to meet the long-term monetary policy goals of low inflation, price stability, maximum sustainable employment, and economic growth. Most central banks around the world, including the Federal Reserve, the Bank of England, the Bank of Japan, and the European Central Bank, have had a strong tradition of independence in executing monetary policy. Many scholars and commentators agree that an independent central bank that is free from short-term political influence and exhibits the indicia of independence, such as staggered terms for board members, exemption from the appropriations process, and no requirement to directly underwrite government debt, can better execute the long-term goals of monetary policy.

The important question that our hearing today is focused upon is whether the Fed can maintain its current role as the independent authority on monetary policy, and take on a new role, a significantly new role, as the systemic risk regulator.

Some scholars and commentators argue that the Fed is uniquely positioned to become the systemic regulator because it already supervises bank holding companies, and through its monetary policy function, helps manage microeconomic policy. Others argue that the Fed is already stretched too thin, and has strayed from its core monetary policy function, particularly by using its powers under section 13(3) of the Federal Reserve Act to purchase securities in distressed industries under existing emergency circumstances.

As Congress and the President work to enact financial regulatory reform, it is critical for us to examine carefully the extent to which proposed new rules may conflict with existing roles and whether the Fed can effectively juggle all of these roles while performing its vital function as the Nation's independent authority on monetary policy.

For our economy to function effectively, the Fed's monetary activities, such as open market operations, discount window lending, and setting bank reserve requirements must be independent and free from political influence. We need to get a clear handle on the extent to which the Administration's proposals could compromise or interfere with what the Fed already is charged to do.

I look forward to learning more about how and whether the Fed can effectively carry out additional regulatory responsibilities while maintaining its current role as the independent authority on monetary policy. I now recognize the ranking member of the full committee for 4 minutes, Mr. Bachus from Alabama.

Mr. BACHUS. I thank the chairman.

Mr. Chairman, I don't think there is anything that is in such sharp contrast as the Administration's proposal for the Fed's role and that of the Republicans in the House. We particularly object

to what we see is allowing the Fed to become a permanent bailout agency. We believe that is most troubling, and we believe if that is allowed to happen, they will sacrifice their independence. It is absolutely impossible to make them an independent agency and allow them to function as they are and yet give them the opportunity to guarantee or loan billions of dollars without substantially increasing their accountability and transparency.

But I do thank you for holding this hearing. Whether regulatory power and sweeping new powers really should be centralized and given to the Federal Reserve at a time when our country is facing unprecedented fiscal, economic, and monetary policy challenges, we believe, is very problematic.

We have some foremost experts, Governor Kohn and our second panel, so we look forward to the testimony.

During the past 2 years, we watched as the Federal Reserve has responded to dislocations in the financial markets with far-reaching interventions in virtually every corner of our economy. To confront the crisis, the Fed has used its emergency authority to bail out failing institutions—we believe, particularly with AIG and others, but particularly with AIG and with some of the auto companies, this was unwise—to provide loans and loan guarantees; to revive the credit markets, which I think has had success; and lowering the target Fed funds rate almost to zero; and more than doubling its balance sheet. Regardless of how one views these extraordinary Fed actions, I think we all agree that as we go forward, we do need a more transparent institution with a more clearly defined role.

Republicans believe that the Fed's core mission—and I stress this—is to conduct monetary policy and that mission will be seriously undermined if its supervisory responsibilities are dramatically expanded, as proposed in the Obama Administration's White Paper. Indeed, the proper role of the Fed represents, as I said, the critical difference between the Administration's proposal, which would statutorily bless what we consider an unwise cycle of bailouts, picking winners and losers, and obligating the taxpayers from our plan, which does none of those things.

The Administration would reward past regulatory and monetary policy mistakes by giving the Fed the preeminent role in regulating the financial system and determining which financial institutions are "too big to fail." This stretches the Fed's resources; I think we all agree on that. It complicates its ability to carry out monetary policy functions at a time when our country faces crippling—well, let me say this: I believe if we continue to do these things, continue to have stimulus packages and deficits, we are going to have crippling inflation. And I think the Fed will have its hands full dealing with inflationary pressures without being distracted and overextended by these new powers.

The Republican plan would therefore relieve the Fed of some of its current regulatory responsibilities and allow it to focus on monetary policy missions.

So thank you very much, Mr. Chairman. But most importantly, I am going to close by saying we need to end the bailouts in which the Fed has been instrumental, I think, in carrying out over the

last 18 months, and I mean the ad hoc bailouts of individual institutions. Thank you.

Chairman WATT. The ranking member of the subcommittee, the gentleman from Texas, Mr. Paul, is recognized for 4 minutes.

Dr. PAUL. Okay. Thank you, Mr. Chairman.

And welcome, Chairman Kohn.

I am delighted you are holding this hearing today because it deals with a subject that I have talked about for many years, and—we have had earlier discussions, and the Fed's position, of course, is that they do reveal a lot of information. And even in the testimony that we will hear today, they still argue their case for exceptions, the argument being that they don't want the independence of the Fed threatened and they don't want it to be politicized.

Well, a lot of us think of independence—we put another word in there automatically, that means "secret" and "clandestine" and "serving special interests." It is a nice word—independence. But politicize, there is no goal, I don't have a goal of making it political other than the fact that the whole system deserves political attention, and yet it gets so little attention; it has not had much attention over these many, many years.

But there is good evidence that it has been politicized already. There have been journal articles written and books written about how the Fed has been influenced by the Presidents over time, and that when a reappointment time was coming up, policies were designed to serve certain Administrations. And so I would say that to argue the case that it should never be politicized is, you know, an argument against what we have, because it has been known to be politicized.

One other point I want to strongly make is, the bill that I have offered, H.R. 1207, has been challenged at times, and I think it is justified to at least question; and that is, how much would my bill affect monetary policy? And it doesn't. It doesn't affect it in any way whatsoever.

We are not looking for the Congress to run monetary policy. We just want to know what is going on and why and the discussions. Why wait 5 years to hear the debate? There is a strong argument made that the sooner the markets know what you are thinking and what you are doing and what the plans are, the better off you are.

When I first came to Congress, we weren't even allowed to know what the targets were going to be, and the markets—immediately after the meetings, they agitated, what are they doing? They figured it out, and all of a sudden they started announcing it. It wasn't the end of the world, yet they argued, well, no, you are not allowed to know.

There is a strong argument now that the more we know about what has been going on in this last year, the more it would have helped the markets. It is the unknown. And that is why we need a much more open Fed.

And the people are demanding it. They want transparency. "Transparency" is a good word, but to say that a little bit of transparency is good, but we can't have a lot of it, there are certain things we don't want you to know—what we are doing when we are talking to foreign central banks, foreign governments, international organizations; what kind of agreements do we have with the IMF?

We have an obligation, a moral obligation, here in the Congress to know exactly what the agreements are. And we are not doing this to preempt anything. This is the reason why the support for this bill that I have is now up to 255, and it is across-the-board—liberals, conservatives, progressives, populists, libertarians, they are supporting this because—and there is no agreement among those groups of what monetary policy ought to be.

They don't want to make it a political football. They are not asking for Congress to participate in FOMC meetings, but to know what the strategy is and what the plans are. That is legitimate information, and we shouldn't be afraid of it. We shouldn't be afraid of the truth.

There have been arguments over the years made about transparency. And I can give quotes—and may later—quotes from Alan Greenspan, how important. And when you look at those quotes generically, they are very, very good. But when it comes down to the bottom line, they say, well, we want you to know what is going on on the unimportant things, but when it comes to the important things, we want secrecy.

I yield back.

Chairman WATT. I thank the gentleman for his opening statement. The gentleman from Delaware, Mr. Castle, is recognized for 1 minute.

Mr. CASTLE. Well, thank you, Mr. Chairman. I have sort of enjoyed these opening statements because I happen to agree with all sides and all positions being taken by everybody.

And let me just say, Mr. Watt, that I agree with you. I think you have asked the basic, right question that a lot of us are concerned about, and that is, can the Federal Reserve maintain its role in shaping monetary policy at the same time that it is expanding itself is to cover systemic risk in this country? I think that is a very serious question that needs to be answered, and I certainly couldn't answer it now.

I don't know if we can get that answer today, but we need to continue to work on that.

But I would add another element to that, and that is all the bailouts, whatever you want to call them, that have been going on beyond just the monetary policy issue under Section 13(3). I mean, there is a lot of money that the Fed, without any constrictions from the Congress, has been putting forth to help these various entities. And I am not necessarily being critical of that, but I am very concerned about the role of the Fed and how it has expanded.

I happen to agree with Mr. Paul. Mr. Paul and I don't always agree, but I happen to agree with him with respect to his legislation and with the idea that we do need more transparency from the Fed. I think that would help a lot of us in terms of understanding and perhaps embracing some of this. I think his legislation, which I believe is H.R. 1207, is actually very positive legislation.

I think it is interesting to see the number of cosponsors that he has. I think a lot of other people feel that perhaps the time has come for the Federal Reserve to be more transparent in terms of what it is doing.

But I think we need a clear, coherent vision of exactly why the Federal Reserve would be the right choice if we are going to have

a systemic risk regulator, which I happen to believe in conceptually. But I am not 100 percent sure that the President and others who advocate this have targeted the right source to do it, and hopefully we can start to work that out today.

Thank you, Mr. Chairman. I yield back.

Chairman WATT. I thank the gentleman for his opening statement.

The rules provide for 10 minutes per side for opening statements. The Republican side has 1 more minute, so I am going to yield it to Mr. Paul.

Dr. PAUL. Thank you, Mr. Chairman. I probably won't use the entire minute, but it gives me my opportunity to quote Alan Greenspan.

In a speech in 1996, Alan Greenspan was addressing this subject, and he said, "If we are to maintain the confidence of the American people, it is vitally important that the Fed must be as transparent as any agency of government. It cannot be acceptable in a democratic society that a group of unelected individuals are vested with important responsibilities without being open to full public scrutiny and accountability."

And I know those terms are general, and he probably might disagree with a little bit of my bill, but those are good words. And I am just carrying through on that because I think it is so important for the American people to know.

I mean, the protectors of the value of our currency are all powerful, and we need to know everything conceivable about how that policy is designed. We don't want to set the policy, but what we want to know is how it has been done and whose interests are being served.

Chairman WATT. I thank the gentleman for his opening statement. I thank all parties for their opening statements.

Mr. Perlmutter is here. He is not a member of the subcommittee. We welcome him. I haven't recognized him for an opening statement, but we are going to proceed without recognizing him for an opening statement.

We are delighted today to have on the first panel the only witness, Mr. Donald Kohn, the Vice Chairman of the Board of Governors of the Federal Reserve.

Without objection, Vice Chairman Kohn, your written statement will be made a part of the record, and you will be recognized for 5 minutes to summarize your testimony. I now recognize you for your statement.

STATEMENT OF DONALD L. KOHN, VICE CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KOHN. Thank you, Chairman Watt, Ranking Member Paul, and members of the subcommittee. I do appreciate this opportunity to discuss with you the important public policy issues associated with the Congress' grant to the Federal Reserve of a substantial degree of independence in the conduct of monetary policy and the interaction of this degree of independence with the possible enhancement of our responsibilities for financial stability.

A well-designed framework for monetary policy includes a careful balance between independence and accountability. In 1977, the

Congress amended the Federal Reserve Act by establishing maximum employment and price stability as our monetary policy objectives. At the same time, the Congress has correctly, in my view, given the Federal Reserve considerable scope to design and implement the best approaches to achieving those statutory objectives, subject to a well-calibrated system of checks and balances in the form of transparency and accountability to the public and the Congress.

Considerable experience shows that this approach tends to yield a monetary policy that best promotes economic growth and price stability. Operational independence, that is, independence to pursue legislative goals, reduces the odds on two types of policy errors that result in inflation and economic instability. First, it prevents governments from succumbing to the temptation to use the central bank to fund budget deficits; and second, it enables policymakers to look beyond the short term as they weigh the effects of their monetary policy actions on price stability and employment.

The current financial crisis has clearly demonstrated the need for the United States to have a comprehensive and multifaceted approach to containing systemic risk. The Administration recently released a proposal for strengthening the financial system that would provide new or enhanced responsibilities to a number of Federal agencies, assigning to the Federal Reserve certain new responsibilities for overseeing systemically important financial institutions and payment clearing and settlement arrangements. These incremental new responsibilities are a natural outgrowth of the Federal Reserve's existing supervisory and regulatory responsibilities.

The Federal Reserve already regulates bank holding companies, which now include large investment banks, and we have been moving to incorporate a more macroprudential approach to our supervision and regulatory programs, as evidenced by the recently completed Supervisory Capital Assessment Program.

The Federal Reserve has also long been a leader in the development of strong international risk management standards for payment clearing and settlement systems, and we have implemented these standards for the systems we supervise. In our supervision of bank holding companies, and our oversight of some payment systems, we already work closely with other Federal and State agencies. These responsibilities and close working relationships have not impinged on our monetary policy independence, and we do not believe that the enhancements to our existing supervisory and regulatory authority proposed by the Administration would undermine our ability to pursue our monetary policy objectives effectively and independently. Our independence in the conduct of monetary policy is accompanied by substantial accountability and transparency.

For instance, the Federal Reserve reports on its efforts to achieve its statutory objectives in the semiannual monetary reports and associated testimony. The Federal Open Market Committee releases a statement immediately after each regularly scheduled meeting and detailed minutes of the meeting on a timely basis. We publish summaries of the economic forecasts of FOMC participants 4 times a year, and Federal Reserve officials frequently testify before the Congress.

In addition, the Federal Reserve provides the public and the Congress with detailed annual reports on the consolidated financial activities of the system. These are audited by an independent public accounting firm. We publish a detailed balance sheet on a weekly basis.

This year, we expanded our Web site to include considerable background information on our financial condition and our policy programs. We recently initiated a monthly report to Congress on Federal Reserve liquidity programs that provides even more information on our lending, associated collateral, and other facets of the programs established to address the financial crisis.

The Congress also recently clarified the GAO's ability to audit the Term Asset-Backed Securities Loan Facility, a joint Treasury-Federal Reserve initiative, and it granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to single and specific companies under the authority provided by Section 13(3) of the Federal Reserve Act.

As this committee is aware, the Federal Reserve is already subject to frequent audits by the GAO on a broad range of our functions, including, for example, supervision and regulatory functions. The Congress, however, has purposefully and for good reason excluded monetary policy deliberations and operations from the scope of potential GAO audits.

The Federal Reserve strongly believes that removing the statutory limits on GAO audits of monetary policy matters would be contrary to the public interest. Financial markets likely would see the grant of such authority as tending to undermine monetary independence, and this would have adverse consequences for interest rates and economic stability.

An additional concern is that permitting GAO audits of the broad facilities the Federal Reserve uses to affect credit conditions could reduce the effectiveness of these facilities in helping promote financial stability, maximum employment, and price stability.

Thank you, Mr. Chairman, for inviting me to present the Board's views, and I look forward to answering your questions.

[The prepared statement of Vice Chairman Kohn can be found on page 57 of the appendix.]

Chairman WATT. I thank the gentleman for his testimony.

The bad news is that we just got called for at least five votes on the Floor of the House. The good news is that once we get through this series of votes, we will probably be able to proceed uninterrupted through the balance of this witness and the next panel, we hope, although it is a little dicey on the Floor today.

So I would at this point declare the subcommittee in recess, subject to the call of the Chair, and encourage the members to please return promptly after the last vote on the Floor in this series of votes. I hate to inconvenience all of the witnesses, but I guess you all have been through this before, so you know how it works.

The committee stands in recess.

[recess]

Chairman WATT. We will reconvene now. I will recognize myself for 5 minutes to ask Mr. Kohn questions.

I am interested in getting a better understanding of what your view is of what specific things a systemic risk regulator does, so let

me start there—or would do, I guess, to make it a theoretical question as opposed to a—

Mr. KOHN. Chairman Bernanke has made a useful distinction between microprudential regulation and macroprudential regulation. And microprudential regulation is looking at each individual institution and making sure they are robust and resilient and safe.

In a macroprudential context, you want to look at not only the individual institutions, but how they relate to each other and how they relate to the system as a whole. And sometimes it is not so much the size of the institution, but its interconnectedness—whether it is at the center of a web of relationships which, if disrupted, would have knock-on domino effects.

So I think the job of the systemic risk regulator would be to take account of those interrelationships—the markets and how they are developing, and the institutions and how they fit into the markets—and look at the overall risk to the system as well as the risk of the individual institution, how that fits in.

And I think the Federal Reserve is well positioned to play a role in that. We have not only our supervisory authority over bank holding companies, which now include all the major investment banks, but we have staff who are familiar with markets, the macro economy, and have responsibility for financial stability of the system through our lender-of-last-resort facilities.

So I think it requires a little bit of a different perspective than we are used to exercising. And I think the Fed's in good position to do that.

Chairman WATT. Not unexpectedly, you focused on the synergies that exist between the two responsibilities. Let me ask you if you could candidly focus on the prospects or possibilities of conflicts.

What are the areas in which those possibilities of conflicts might arise?

Mr. KOHN. I think there are minimal possibilities. I think some people have asked whether, if we see a systemic risk from the individual institution, that would affect our monetary policy deliberations. But in my view, I think there really is a congruence between the stability of the financial system and monetary policy. We can achieve our objectives of maximum employment and stable prices much more readily in a stable financial system. So I just don't see important instances in which there would be conflicts.

Chairman WATT. What kind of staff would you anticipate would be necessary, additional staff would be necessary, to perform the systemic risk regulatory function versus what you are already doing?

Mr. KOHN. Recalling that in our view, the systemic risk regulatory function that the Treasury has suggested for us is an incremental change to what we are doing now, it is not a big change, because we already have the systemically important institutions under our authority.

I think it would require some more staffing, both on the side of the economists and the side of the supervisors, to evaluate systemic risk in a more systematic way, but I don't think this is a major change in our responsibilities that would require a substantial increase in what we are doing.

Now, we have had to staff-up over the last year because we have several large investment banks, for example, that are now bank holding companies, and we have had to change and adapt to our new responsibilities. And we are doing that.

Chairman WATT. My time is about to expire. Actually, it just did.

But let me just squeeze in, because one comment you just made raised somewhat of an interesting question, because I had understood that a lot of the jurisdiction that you would be assuming for systemic risk regulation is not in existing entities that you already regulate.

You said that you have all of these systemic risk regulators already under your supervision. Is that, in fact, the case?

Mr. KOHN. I don't know that we have all of them, Mr. Chairman. I think that would be something that in consultation with this council—remember that the Treasury is setting up a council of regulators to look at the systemic implications of the markets and the institutions. We would consult with them as to whether they saw some institutions that weren't currently under our purview that were systemic. But at this point, I think that would be very, very few institutions.

Chairman WATT. I thank you. My time has expired.

And I will recognize the gentleman from Texas for 5 minutes.

Dr. PAUL. Thank you, Mr. Chairman.

Sometimes definitions of words are pretty important, and I alluded to that in my opening statement, about what "independent" might mean to others.

For me, independent usually is a code word for "secret," so we can't get the information. But one of your arguments for the independence of the Fed or the secrecy of the Fed is that those central banks that do have independence—and they are less monitored in public, they tend to have lower and more stable rates of interest—but how can you compare that to what we have noticed under the Federal Reserve?

You know, I remember when I first started looking at what the Federal Reserve was doing, we had 21 percent interest rates. That sort of got my attention. And today we have interest rates of less than 1 percent.

So that is hardly stable. And to me, the real mischief comes not only because they are unstable and they fluctuate radically, but also the mischief it causes because these are artificial.

I am a believer that interest rates, like prices, should be set by the marketplace. And control of prices and wages is the most serious abuse you can put onto an economy. And yet this fixing of prices seems to give us this trouble. And even the Secretary of the Treasury now, Mr. Geithner, you know, just a few months ago recognized that during the time he was in the Fed, the Fed kept the interest rates way too low for too long.

So how can you defend the Fed's maintaining independence or secrecy in order to maintain stable rates and to even try to achieve a stable economy which—obviously, nobody argues we have a stable economy?

Mr. KOHN. So I do not equate independence to secrecy. In fact, I agree with the underlying premise, I think, of your question, which is independence and secrecy in a democratic society are anti-

thetical. And I think the Federal Reserve has been quite transparent and has become much more transparent under Chairman Bernanke about what we are doing and why we are doing it. And I think we can retain our independence and your ability to trust what we are doing only by explaining to you what we are doing and why we are doing it.

We have not only the statements, which you mentioned in your opening statement, after every meeting explaining what we did and why we did it, but we also have minutes. You have hearings. There are Monetary Policy Reports. There are other hearings that you hold.

So I think there are many, many opportunities for us to explain why we are doing what we are doing. And those opportunities and that transparency is absolutely essential for retaining our independence.

Dr. PAUL. Okay. But I still think we can do better. Like I mentioned early on, there was a time when the Fed did not reveal immediately what their targets were.

Mr. KOHN. That is right.

Dr. PAUL. Why can't we consider releasing the details, instead of in 5 years, why not in 5 weeks? What is the big deal that you have to have this information?

And the other argument you use: It is in the public's interest, that one really baffles me. The public is served by you having more information that we don't have access to unless it is maybe 5 years? It seems like there are other interests; it allows the suspicion to build.

Whose interests are you really protecting? Because you say, it is the public's interests, I don't think reassures a lot of people, because all of a sudden we think, well, what are you doing? Are you protecting the bankers' interests? Are you protecting some international—another government, another central bank or what? So I don't see how you can protect the public's interest.

It seems like we in the Congress should have the responsibility for protecting the public interest by knowing more about what you are doing.

Mr. KOHN. Within 3 weeks, Congressman, we release minutes of our meetings, which give detailed explanations of why we did what we did, including the arguments back and forth, the minority opinions if people disagree.

I think you are talking about transcripts, which we release after 5 years. I would be very concerned that releasing those transcripts earlier would inhibit debate. I think it is in the public interest that we have an unfettered debate within the Open Market Committee and that we are able to speculate among ourselves—what if we did this, what if we did that, where are things going—that there be no inhibition on the back-and-forth within the Open Market Committee.

I have been at the Federal Reserve for several decades now, and in my view, publishing the transcripts themselves has had a somewhat inhibiting effect on the way the debate is carried out. There are many more prepared statements read at Open Market Committee meetings now than before the transcripts were published.

Participants would be very worried if their remarks were going to be made public very, very quickly. They would be very worried about what they would say, and they would be much more careful about what they are saying. And that is not in the public interest, provided we are willing to explain to you, as we are, why we did what we did and what the minority views are. And we do do that.

Dr. PAUL. Of course, you know, without an audit we never know.

It just seems that it would be of benefit to us to know what the detailed discussion is. Why is there any value? I just don't quite agree with that, because it is really the discussion that we have. Like I made my point in the opening statement, this is after the fact. This is after you have had your meeting; it is after you have done something.

And also, the more information the market gets, the better the market operates. And if they know what you are thinking about and what you are planning—you know, 5 years for the minutes is really way too long.

Chairman WATT. The gentleman's time has expired, but the witness may answer.

Mr. KOHN. Well, I think we do explain what we are doing and why we are thinking what we are thinking within 3 weeks. And you have ample opportunity to question Chairman Bernanke when he comes up for hearings about why he is doing what he is doing.

We would be glad to work with you on how your ideas about how we could be more transparent and more helpful.

I agree with you that for the most part transparency, where it doesn't inhibit debate and exchange of ideas, is better for the public. And we have taken huge steps in that direction over the past 3 years.

Chairman WATT. The other gentleman from Texas, Mr. Green, is recognized for 5 minutes.

Mr. GREEN. When you say, "the gentleman from Texas" and don't say which one, many microphones are opened up. Thank you, Mr. Chairman.

I thank the witness for his testimony. And I apologize for not being here to hear you in your entirety in terms of your testimony.

There are those who would like to have an independent Fed. Obviously, that has worked well. The autonomy of the Fed has inured to our benefit. And there are those who contend that if the Fed acquires these new powers and remains as independent as it has been, then the Fed becomes this awesome giant that would be beyond the control of Congress, of the Executive and Legislative Branches.

How do you respond to those folks who conclude that this is risky, to give the Fed this much power?

Mr. KOHN. I think there are two avenues for response, Congressman. One is the additional authority we are getting is incremental to what we already have, so it is not a huge increase in our authority.

And the second is, for the authority we already have, we are held accountable. We work closely with other agencies, with the FFIEC, with the other regulatory agencies, on the President's Working Group, with the Treasury.

The Government Accountability Office does audit our activities in the supervision and regulation area; they perform many audits like that. So we have been able to do that and be held accountable, work with other Agencies without sacrificing the independence that we need to exercise for monetary policy.

So I think we are already doing it, and this wouldn't be that big a change.

Mr. GREEN. How would the H.R. 1207 audit differ from the GAO audit?

Mr. KOHN. I am not sure. The H.R. 1207 would do what? That is Mr. Paul's?

Mr. GREEN. That is the audit bill that Mr. Paul—

Mr. KOHN. As I understand it, and I don't understand it perfectly, but I think it would make everything we do subject to GAO audit.

Right now, since 1978, the GAO has been able to audit most of our activities except where they touch monetary policy and our interactions with foreign central banks and foreign authorities. And I think Mr. Paul's bill would remove that exemption, so the GAO would be auditing our monetary policy as well as all the other things we would do.

Our concern is that would be perceived as impinging to some extent on our independence to meet the objectives that you have given us for price stability and full employment.

Mr. GREEN. And as a final question, how can Congress—if you have an opinion—be of assistance in making this transition if the transition is to take place? Is there something more that we need to do to help you transition to the regulatory reform side?

Mr. KOHN. No. I think the hearings that you hold and mutual understanding of what is involved in this, with us and the Treasury and others who want to make this transition, you have every right, and you ought to be asking us, as the chairman did, what additional resources we would need in order to do this, how we would carry this out.

So I think a dialogue between the Congress and the Federal Reserve is not only appropriate, but would be very useful to define what this is about.

Mr. GREEN. Thank you.

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

Chairman WATT. The gentleman yields back the balance of his time.

Mr. Adler, the gentleman from New Jersey, is recognized for 5 minutes.

Mr. ADLER. Thank you, Mr. Chairman.

Mr. Vice Chairman, you a moment ago articulated Congress' mandate to the Federal Reserve with respect to maximum employment and to price stability.

To what extent, if any, do you think additional responsibility as a systemic risk regulator would in any way distract the Federal Reserve from its 1977 congressional mission?

Mr. KOHN. Congressman, I don't think it would distract us at all. I see the two missions, the macroeconomic goals of price stability and maximum employment and systemic stability as being completely congruent. I think the more stable the financial system is,

the easier it will be for us to pursue successfully the goals of maximum employment and stable prices.

Certainly we have seen a demonstration of that in the last 2 years. The instability in the financial system has resulted in very high unemployment and has made it very difficult for the Federal Reserve to reach our objectives of maximum employment and stable prices.

So I don't see a conflict between those types of objectives.

Mr. ADLER. You heard the gentleman a moment ago ask questions about the potential lack of accountability of the Federal Reserve as a sort of private entity, not completely under government control. Others have been concerned there is too much political interference with the Federal Reserve in the carrying out of its mission.

I wonder if you could comment about what additional political interference you think the Federal Reserve might encounter if it undertakes this responsibility as a systemic risk regulator.

Mr. KOHN. I think we can separate our accountability as a systemic risk regulator from our independence in carrying out your goals for monetary policy. So I don't see additional political interference with the objectives that you gave us.

We will be accountable as the systemic risk regulator. We will be accountable through the Government Accountability Office. We will be accountable to the Congress. We will be working closely with those other regulators in the financial system.

And we have been successfully doing that for years, and this would sort of increase our interactions, but I don't think there should be a risk that giving us this additional authority would impede our monetary policy independence.

Mr. ADLER. Mr. Vice Chairman, I thank you.

Mr. Chairman, I yield back the balance of my time.

Chairman WATT. The gentleman yields back the balance of his time.

We welcome Mr. Gerlach from Pennsylvania, and recognize him for questions, if he has any.

Mr. GERLACH. None right now. Thank you.

Chairman WATT. And we welcome the gentleman from California, Mr. Sherman, and recognize him for questions, if he has any.

Mr. SHERMAN. I do.

Chairman WATT. The gentleman is recognized for 5 minutes.

Mr. SHERMAN. Mr. Vice Chairman, I think you are aware of 13(3) of the Federal Reserve Act.

Mr. KOHN. I am.

Mr. SHERMAN. It is breathtaking in its scope, but even more breathtaking in the amounts.

I have talked to your Chairman. Almost facetiously, I asked him whether a $12 trillion limit on the total exposure under 13(3) would be acceptable to him, and believe it or not, he said yes.

Chairman Bernanke has interpreted before this committee 13(3) as allowing the Fed only to take risks that are the equivalent of triple A, that is to say, only to extend the credit of the Federal Reserve under that section where there was the lowest risk that a credit rating agency would evaluate.

Do you agree with that constrained view of 13(3) or not?

Mr. KOHN. Under section 13(3), the Reserve bank making the loan needs to be secured to its satisfaction. We have insisted on security on every loan that we have made. We have been releasing more and more information about those loans.

I think, for the most part, those loans are safe. The credit risks—

Mr. SHERMAN. I am asking you not for your prior practice but for your legal interpretation.

Let's say that the Secretary of the Treasury called you in the middle of the night and said, "By God, we need another $700 billion to shore up institutions on Wall Street. We need to do it right now or the entire world comes to an end; and those idiots in Congress, they won't vote for another TARP. So the only way we are going to save civilization as we know it is for the Fed to take some substantial risks and become a general creditor of banks that would otherwise become insolvent and other financial institutions."

Do you believe that you or your successors have the legal right to say, "Yes, Mr. Secretary, we couldn't agree with you more; we will have a vote on it and we will extend the credit?"

Mr. KOHN. I think we need a new resolution authority through the Congress.

Mr. SHERMAN. I am not asking you what new law should be passed. I am not asking you what your practice has been in the past.

I am asking you what are the legal authorities you have under present law right now?

Mr. KOHN. We need to be secured.

I think one of the issues is—

Mr. SHERMAN. So you can't take a double A risk; you can only take a triple A risk?

Mr. KOHN. We need to have enough security that we feel that the loan has good prospects of being repaid, that we are not taking fiscal risk.

Mr. SHERMAN. Let's say you were buying paper that if you worked for a credit rating agency, you would rate at single A. Is that the kind of risk that you are legally allowed to take under 13(3)?

Mr. KOHN. Only if it is discounted to an extent so that the collateral value would be less than the par value.

And that is what we do. We take paper at the discount window that isn't triple A, but we don't give it full par value; we discount it. And I think we protect the public purse in that way.

Mr. SHERMAN. It sounds like you have the power to do another TARP almost, but not quite.

Shifting to another direction, in a democracy it is supposed to be one person, one vote. Every institution of the government is supposed to reflect the results of elections held in polling booths. Yet you have these—at least your regional Boards of Governors are selected on the basis of—I will call it "one bank, one vote," to oversimplify.

Does it make any sense to invest with the image of governmental power, and everybody—I mean, you can say there is a difference between the Fed and the branches of the Fed, although throughout business, "branch" means, in effect, another office, not even a sepa-

rately incorporated subsidiary, so most of the world is going to view your branches as part of your tree.

Do you think it is appropriate to have privately elected Governors serve in what appears to everyone to be a governmental capacity?

Mr. KOHN. The boards of directors of the Reserve banks have served a valuable function in the Federal Reserve.

Mr. SHERMAN. Well, sir, in Germany before World War I, they had what many people thought was a very good government, but your voting power, your control over government agencies depended upon how rich you were. And you can argue it was a very good government that made very good decisions right up until Sarajevo.

I am not asking you whether it is good government—whether you have made good decisions. What I am asking is, is it consistent with what we celebrated on the 4th of July to have such governmental power in the hands of those elected on the basis of one bank, one vote?

Mr. KOHN. I think Congress, from 1913 on, has considered it consistent with its authorities and how it wished to carry them out.

Mr. SHERMAN. That is before we gave you the enormous additional power we are considering.

Chairman WATT. The gentleman's time has expired.

Mr. SHERMAN. I yield back.

Chairman WATT. And while I would be a lot more generous, we have a little time bind that we are operating in.

The gentleman from Delaware, Mr. Castle, is recognized.

Mr. CASTLE. Thank you, Mr. Chairman.

Mr. Kohn, I am concerned about conflicts here. As you deal with the 13(3) bailouts, or whatever you want to call them, and as you deal with monetary policy, and then you, the Fed, would get into the systemic risk regulator issue, do you at least see the potential for—and if you do, could you articulate what it would be—for conflicts of interest in terms of the different responsibilities the Federal Reserve would have if you had all those powers?

Mr. KOHN. Congressman, no, I really don't see the potential for major conflicts here. I think we carry out our monetary policy mission much more easily in a systemically sound financial system.

We have seen the demonstration of that over the last 2 years, what happens when the system isn't sound. It makes it very, very difficult for us. On the other hand, I don't see us using our monetary policy authority in any way that wouldn't be consistent with the objectives you gave us for macroeconomic stability and price stability.

So I really think the two are congruent, not conflicting.

Mr. CASTLE. I mean, I interpret from your opening statement, and what you have been saying is that the Board of Governors of the Fed welcome this responsibility—at least you seem to.

Is there any conflict at all among the Board or discussion about, should we be doing this or is it better left to an independent agency or some other agency?

Mr. KOHN. I think members of the Board have had different views about a broad grant of authority, but—I haven't polled all the members of the Board.

Mr. CASTLE. I am not asking you to speak for them, just what you observed.

Mr. KOHN. I see this as an incremental change from where we are right now, and, therefore, I am not aware of any dissent on the Board about the particular proposal that the Treasury has made.

Before the Treasury made the proposal, there was a lot of discussion of some systemic risk regulator with unspecified authorities and unspecified responsibilities. I think there was concern on the Board, which I shared, that it was impossible to carry the responsibilities out because we didn't have the authorities and because the expectations were way too high in terms of what was possible in a market economy that naturally has ups and downs.

But I see the proposal on the table as more modest, which is taking what we currently do, but giving a little more macroprudential shape to it, thinking about the implications and being sure that the core institutions, the ones that have caused the problems that have given rise to what you call the "bailouts," are safe and are not subject to the kinds of risks and the kinds of knock-on effects to the rest of the market that have caused us to intervene this time.

Mr. CASTLE. How would you interact with other regulatory bodies that have jurisdiction over some of these entities, be it an SEC or whatever it may be? How do you think that would fundamentally work?

Mr. KOHN. We would work closely with them. We already do work with the other banking regulators on FFIEC. We would be part of this council that the Treasury has looking at systemic risk and identifying systemic activities, systemic problems.

We have close working relationships with the SEC, and I see that continuing. We basically rely on them for supervision of the individual institutions. But I think this would give us some authority to make sure not only that the individual institution is safe, but that the system is safe, too.

Mr. CASTLE. What would be your responsibility with large insurers, hedge funds, and even private equity-type funds as you view it if you were to be under this legislation given that responsibility?

Mr. KOHN. It would depend upon whether those entities were considered systemically important. And to the extent that they weren't systemically important, we would have no particular authority over them.

To the extent that they were, after consulting with the council, which would have the responsibility for identifying these issues, I think if we saw there was a gap in regulation that threatened the stability of the financial system, it would be up to us to try and fill that gap.

Mr. CASTLE. I don't know this, but I would assume, because insurance is generally regulated at the State level, that you get into that whole issue of State-Federal. I don't know if you discussed that or not.

Mr. KOHN. Right. But I think your proposal is to create a Federal entity, isn't it?

Mr. CASTLE. Well, it is being discussed.

Mr. KOHN. I think the problem perhaps isn't so much the insurance companies; at least thinking back to our very bad experience with AIG, it wasn't the insurance companies, it was the stuff that

was going on next to the insurance companies. And I would hope if we saw something like that happening, we would find a way of containing that risk.

Chairman WATT. The gentleman from Minnesota.

Mr. ELLISON. Thank you, Mr. Chairman. And I thank the chairman for calling for this work. Do you believe it is appropriate for the Fed, particularly in light of the systemic risk?

Mr. KOHN. I don't think the fact that our power might be expanded is by itself a reason to relinquish the consumer authority. My personal view is that the Federal Reserve is well placed to do a good job in the public interest on consumer regulation. These are congruent, with good consumer regulation, give us a way of balancing issues having to do with consumer regulation. I think in the last years we have stepped up to the plate on high-cost mortgages, on consumer credit. We have revised truth in lending regulations coming out at the end of this month. I would hope that the Congress might think about whether there are ways of strengthening the Federal Reserve's commitment to consumer regulation as an alternative to creating a new regulator.

Mr. ELLISON. Would you allow, Mr. Vice Chairman, that the Fed was slow to the game in addressing some of these consumer issues you just pointed out, particularly in mortgages, credit cards? I mean, some of the issues that the more recent legislation addressed have been longstanding.

Mr. KOHN. I agree that we did not see the abuses as widespread as they were, and we were slow to react to them. And I think if you kept consumer regulation in the Federal Reserve, if you were to decide to do that, you need to strengthen our commitment to that regulation. I agree.

Mr. ELLISON. Do other central banks around the world have consumer protection as part of their mandate?

Mr. KOHN. I don't know.

Mr. ELLISON. Is the Fed currently working on consumer concerns right now with regard to overdraft fees and things like that?

Mr. KOHN. I am not sure, Congressman.

Mr. ELLISON. Has the Fed addressed issues like among bank staff that—sort of like sales practices that would push products, push selling accounts, having quotas for selling a certain number of accounts on a given day or a given week without regard to the consumer's best interest? So, for example, if a bank were to say to a personal banker staffer, you must produce 10 new savings accounts today, and then that staffer were to go try to get 2 and 3 accounts from the same person in a day, is that something that the Fed has focused its attention on now?

Mr. KOHN. I think our focus in that regard has been transparency, making sure that people knew what they were getting, the terms on what they were getting, and what the alternatives are. I know that we have focused on that in the mortgage area.

Mr. ELLISON. Has the Fed focused on that issue? Particularly now, I mean, overdraft fees are a significant part of bank profit.

Mr. KOHN. We have focused to some extent in the past. I don't know whether we still are focused on that.

Mr. ELLISON. And if I may be allowed a final question, I agree, I think that some of the work that Fed has done recently has been

very laudable, and I want to let you know that I feel that way. Some of the findings you made regarding credits cards and other things are just great. But I will say that given the Fed's mandate of focusing on monetary policy, I wonder—and I wonder if you wouldn't mind commenting—if there are not some occasions in which consumer protection takes a back seat to some of the other issues that the Fed is required to focus on.

Mr. KOHN. I think that has happened in the past. I don't think it has happened over the past 3 or 4 years.

Mr. ELLISON. I will agree with that.

Mr. KOHN. And I think there could be changes in our law making consumer protection explicitly a part of our mandate that would help to prevent that from happening in the future. But it has happened in the past, I agree.

Mr. ELLISON. Thank you, Mr. Vice Chairman.

Chairman WATT. The gentleman yields back the balance of his time.

The gentleman from New Jersey. We welcome Mr. Lance. If the gentleman has questions, we will recognize him for 5 minutes.

Mr. LANCE. Thank you, Mr. Chairman. Good afternoon.

Regarding the powers of the Fed at the moment and then this huge debate regarding a systemic regulator, many of us on our side are concerned, Mr. Vice Chairman, with whether or not this should exist, and if it does exist, whether it should exist in the Federal Reserve Board, given your core mission as established, I gather, under Woodrow Wilson in 1913, perhaps. And perhaps you have answered this before I entered the room, and I apologize if you have, but if you could elaborate on your views personally, sir, regarding whether you believe a systemic regulator should be housed in the Fed.

Mr. KOHN. I think the Federal Reserve is well positioned to carry that mission out in the public interest. I think we bring a variety of perspectives that are important to that. We have everyday contact with the markets, so we know what is going on there. We have supervision, so we have a view of what is happening within individual institutions. Our responsibilities for the macroeconomy give us a perspective on the intersection of financial markets in the macroeconomy. So I do think the Federal Reserve is well positioned to exercise some oversight in the systemic risk area.

Mr. LANCE. Do you believe that there might be an inherent conflict given your responsibilities in managing the macroeconomy?

Mr. KOHN. No, I don't. Several of your colleagues have asked that question. I just don't see the conflict. I see this as one of them supporting the other. I think macroeconomic stability will support financial stability, and financial stability will support macroeconomic stability.

The Federal Reserve is inevitably involved in financial stability, because we are the lender of last resort and because we have the responsibilities that you gave us for macroeconomic stability. So it doesn't matter in some sense who the financial stability regulator will be. In the end the Federal Reserve will have to be involved. And I think there are synergies for giving the Federal Reserve a little extra power to do that given our current authorities.

Mr. LANCE. Thank you.

And in a completely unrelated area, I am personally concerned with the purchase by the Fed recently in an increasing amount of long-term T-bills, and I am not sure the American public is fully aware of this situation. It is obviously arcane and something that may not be on the front pages of newspapers.

Could you update us on your recent purchases and where they are in relationship to where they might have been a year ago, sir?

Mr. KOHN. In March, the Federal Open Market Committee decided to purchase up to $300 billion of Treasury—intermediate and long-term Treasury securities. We did that because we thought it would be helpful not for the Treasury per se, but because we thought it would push down interest rates for businesses and households at a time when the economy was falling very rapidly, very weak, and we needed to free up the credit markets so businesses and households would face lower charges and lower cost of capital, and then do some more spending.

I am not exactly sure where we are in that process. I think we are about halfway through. We said, I think, it would be done by the end of September. At our last meeting we didn't make any change in that plan.

Mr. LANCE. So if I just might follow up, Mr. Vice Chairman. It is your expectation that you will not continue this beyond the September date, at least to the extent that you are currently involved in that area?

Mr. KOHN. We have made no decision on that. That would be a decision the Open Market Committee would have to make.

Mr. LANCE. Thank you. Obviously we on this committee would like to be apprised of that, and that is certainly an area of grave concern to me.

Thank you very much, Mr. Vice Chairman.

I yield back the balance of my time, Mr. Chairman.

Chairman WATT. The gentleman yields back the balance of his time.

We welcome the member of our full committee, Mr. Garrett, who is not a member of the subcommittee, but I would ask unanimous consent that he be given 3 minutes to ask questions. I would actually ask for longer, but we already displaced a meeting that was scheduled to start in this room at 4:00. There is another meeting that is scheduled to start in this room at 5:00, and we have another panel, but I would happily grant the gentleman 3 minutes, unless one of your members has an objection.

Mr. GARRETT. I appreciate that. And, who knows, they might. But is there anything more important than this meeting and the Chairman that you are leading right now? But thank you, Mr. Chairman.

Just a couple of questions. You know, you are familiar with the proposal the Administration has laid out, and I assume that you at least have the opportunity to know that the Minority party, the Republicans, have thrown out a proposal as well to deal with the situation. I don't know whether you have gotten into the weeds of it at all.

Mr. KOHN. I haven't gotten into the weeds of the Republican alternatives.

Mr. GARRETT. Well, we will be certain to send you an annotated version.

One of the provisions in it, in our plan, says, with regard to Section 13—and stop me if someone else threw this question out to you—that 13(3) should be reined in to some extent, the powers under 13(3), and one of the aspects of it to limit the ability for the Fed to actually pick, as it has in the past instance, particular institutions and proverbially bail them out as opposed to—prohibit that, but instead still allow them to use Section 13(3) in a larger, institutional-wide basis, if that is clear.

Mr. KOHN. Yes.

Mr. GARRETT. Comment?

Mr. KOHN. So I think that is consistent, if I understand it correctly, Congressman, with our own position, which is with respect to the resolution of systemically important institutions, we don't want to be involved in making those loans; that there needs to be some way of doing that. We need to have orderly resolution of these institutions, but that is not the job of the Federal Reserve. We would be consulting, we would be part of the process, but it ought to be a Treasury Department-led process.

Mr. GARRETT. But there would be a distinction, though, to simply say that we should set up this wind-down authority as the Administration proposes.

Mr. KOHN. Right.

Mr. GARRETT. And not putting a limitation on the Fed, Federal Reserve; or, as we are suggesting if it goes through, that you actually have a wind-down authority as you suggest over in the Treasury, so you wind things down, but clearly in statute saying, going forward, Federal Reserve shall not have the authority to do so. Would you concur with that?

Mr. KOHN. I would have to see the exact wording. Certainly, I agree with the idea.

Mr. GARRETT. And I know the whole discussions with regard to moral hazard and what has occurred in the past has already been laid out here.

One of the things—another issue that is totally unrelated that is in the news is with regard to the Fed Chairman and the allegations or the—with regard to pressure that has been put on certain institutions, what have you, in the past. And they only name specific institutions in those allegations, right? We are sending a letter to the White House just to try to get some more information on that, and so I will just throw the question to you right now.

Are you familiar with any other institutions that the Fed or any officials at the Fed have exerted any pressure on in any way, shape, or form, or whether the Treasury has exerted any influence as those allegations are suggesting?

Chairman WATT. The gentleman's time has expired. And since that is really a subject that is not within the parameter of this hearing, I wish the gentleman would ask the question in writing, if he wouldn't mind, since we are under some time pressure.

Mr. GARRETT. Can you give me just a yes or no?

Mr. KOHN. I would have to see the question in writing. We supervise lots of institutions, and in the process of supervising those institutions, we make lots of requests to them to change their prac-

tices. So I am not sure exactly what you are getting at. So perhaps the chairman's suggestion of a written question would be best.

Chairman WATT. The gentleman's time has expired.

The gentleman from Alabama, the ranking member of the full committee, is recognized for 5 minutes.

Mr. BACHUS. Thank you.

Governor, do we have an exit strategy from these ad hoc bailouts of failing institutions?

Mr. KOHN. We have an exit strategy from the provision of reserves that we have made, the very high level of reserves that we now have in the system. We believe we have the tools to absorb those reserves, to raise interest rates when the time comes to do so.

With respect to the individual institutions, I think each institution, like AIG, for example, is putting in place a business strategy to sell pieces of itself, repay the Federal loans and repay the U.S. taxpayer. So there are strategies being put in place for the individual institutions.

Mr. BACHUS. To me, the Obama Administration proposal actually puts in place a permanent bailout agency, and that is the Federal Reserve. It empowers you to bail out through loans or guarantees failing institutions, does it not?

Mr. KOHN. That is not my understanding, Congressman.

Mr. BACHUS. Okay.

Mr. KOHN. We are in agreement with the Administration that a separate resolution authority for failing systemic institutions needs to be established under the oversight of the Treasury, not the Federal Reserve.

Mr. BACHUS. Would that include—would that be an enhanced bankruptcy proceeding?

Mr. KOHN. It would be a substitute for bankruptcy procedure, just as we have today for banks and depository institutions under the FDIC.

Mr. BACHUS. So the Federal Reserve as the systemic regulator would have no right to guarantee or loan money to an individual institution.

Mr. KOHN. That wasn't the process of failing. That would be the resolution of that institution, like Bear Stearns, AIG, would be the province of the Treasury Department.

Mr. BACHUS. But the Fed over the past year has guaranteed some of the obligations and made loans; has it not? You participated—

Mr. KOHN. We have been in a second and third guarantee position for some obligations of Citigroup. Is that what you are referring to?

Mr. BACHUS. And AIG also.

Mr. KOHN. And AIG.

Mr. BACHUS. And what is the total obligation to AIG?

Mr. KOHN. I think we have about $45 billion of loans outstanding to AIG, plus some special-purpose vehicles that have assets that they have taken over from AIG probably total about $40 billion or $45 billion.

Mr. BACHUS. Do you anticipate or would you be opposed to a provision in any law that we pass to prohibit the Fed or the Treasury

from loaning billions of dollars of taxpayer money to these institutions or to guaranteeing their obligations?

Mr. KOHN. I think somebody in the government, not the Federal Reserve, needs to have the authority to resolve systemically important institutions in an orderly way so they don't threaten the jobs of Americans.

Mr. BACHUS. I would agree with you that there needs to be an orderly resolution.

Mr. KOHN. That is right.

Mr. BACHUS. I would not agree with you that that would include taxpayer funding or—you know, either guarantees or loans, in the case of, as you say, Citi and AIG, was in the tens of billions of dollars, actually hundreds of billions of dollars.

Do you believe that too big to fail—do you believe in that doctrine? Do you believe in the fairness of that doctrine?

Mr. KOHN. I think too big to fail is a very difficult, troublesome issue. I agree with the thrust of your question that we need to deal with. I think there is a terrible moral hazard involved in that. And my thinking is that the Administration proposal, something like the Administration proposal is very helpful in that regard. It has two things. One is that the largest institutions that might be too big to fail face much tougher scrutiny, higher capital, greater liquidity, more robust risk management systems so that they won't fail; and, secondly, that there be a resolution authority that would enable the government to resolve these in an orderly way, that might impose costs on the creditors, but in an orderly way outside of bankruptcy.

Chairman WATT. The gentleman's time has expired.

The Chair notes that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place his responses in the record.

We thank Vice Chairman Kohn for his patience and for his responses, and we will excuse this witness and call up the second panel.

While the second panel is coming forward, I ask unanimous consent to enter into the record the following statements: The statement of Thomas F. Cooley, professor of economics, Stern School of Business, New York University, dated July 9, 2009; and the statement of the Financial Services Roundtable, dated July 9, 2009. Without objection, it is so ordered.

The Chair will now briefly introduce the second panel, without giving them all of their glory in the introductions. We will put the full introductions into the record in the interest of time. But this panel includes Dr. Frederic Mishkin, Alfred Lerner Professor of Banking and Financial Institutions at the Graduate School of Business, Columbia University; Dr. Lawrence Meyer, vice chairman, Microeconomic Advisers; Dr. James K. Galbraith, Lloyd M. Bentsen, Jr., Chair in Government/Business Relations and professor of government, LBJ School of Public Affairs, University of Texas; Dr. Richard Berner, chief economist at Morgan Stanley; Dr. John B. Taylor, Mary and Robert Raymond Professor of Economics at Stanford University; and Dr. Allan Meltzer, The Allan H. Meltzer Uni-

versity Professor of Political Economy, Tepper School of Business, Carnegie-Mellon University.

We welcome each one of you, and we will recognize each of you. Your full statements will, of course, be made a part of the record, and each of you will be recognized for 5 minutes to summarize your statement.

And I will start with Dr. Mishkin.

STATEMENT OF DR. FREDERIC S. MISHKIN, ALFRED LERNER PROFESSOR OF BANKING AND FINANCIAL INSTITUTIONS, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY

Mr. MISHKIN. It is a great pleasure to be here to discuss what is a very important issue, which is what role the Federal Reserve should have as a systemic risk regulator.

I want to boil this down to three questions, even though we were asked four, but I think three that are quite relevant to these issues. And the first question is the essential one, which is, should the Fed be the systemic risk regulator? And I am going to answer yes to that question, and there are four reasons that I take that view.

The first is that the Federal Reserve is involved in daily interaction with the market, and in terms of being a systemic risk regulator, that kind of information or that contact is extremely useful.

The second is that there is a synergy between thinking about macroeconomic stability and financial stability, and that is, I think, extremely important in terms of performing the appropriate analysis to do systemic risk regulation in the best way possible.

The third is that there is a synergy between the actions that are required in terms of promoting macroeconomic stability and financial stability. And so we have seen this, of course, in very major ways during this recent crisis. This involves the role of the Federal Reserve as a so-called lender of last resort, providing liquidity to the financial system to, in fact, make sure that macroeconomic stability is preserved.

And, finally, the Federal Reserve is one of the most independent of government agencies. In order to be an effective systemic risk regulator, the kind of independence the Fed has had in the past and has used in the past would be also very helpful in this regard.

So when I look at this issue of the Fed being a systemic risk regulator, I think that, from my viewpoint, it really is the appropriate logical choice when we think about the nature of this role.

The second issue is should the Fed relinquish some of its other roles if it became the systemic risk regulator? And I think the answer here is yes. In particular, the Treasury plan has suggested that the Federal Reserve no longer be a consumer protection regulator, and I concur with this view.

There are three reasons why I think that the Fed should no longer be involved in this activity if, in fact, it is handed these additional responsibilities. The first is that being a consumer protection regulator is not at the core mission of what the Federal Reserve does, where I actually do see macroeconomic stability and financial stability is part of that core mission.

The second is that it uses a very different skill set. And so in the context of thinking about the synergies, I do not see them to be nearly as relevant.

And the third, I think, is really the most important, which is that consumer protection regulation is very political. Everybody cares about it. In the past I testified on credit cards. Everybody has issues in terms of their dealing with the credit card companies. In that context, the possibility of there being more pressure, political pressure, put on the Federal Reserve system is, in fact, greater. And so again I think that this is another reason why having something that is not in your core mission which is, in fact, something that tends to get more political could be harmful to the independence of the Fed, something that I am going to turn to later.

The third question is, are there dangers from the Federal Reserve taking on this role of systemic risk regulator? And I think the answer is yes. There are three dangers that do particularly concern me. I will argue, however, that even though these dangers exist, that the Federal Reserve still should be the risk regulator, systemic risk regulator, and there are steps that the Congress can take to, in fact, ensure that the Federal Reserve can do its job adequately both in terms of monetary policy and in terms of promoting financial stability.

So the first danger is that the Federal Reserve might lose its focus on price stability. Clearly there are concerns in the marketplace about this issue about the credibility of the Fed as an inflation fighter and steps that it needs to take in terms of making sure that inflation is not too high. And in this context I have argued elsewhere, both when I was a Governor at the Federal Reserve and also afterwards in op eds, that one way of dealing with this would be to have the Federal Reserve to have an explicit numerical objective in terms of inflation, something that it does not have at the current time.

The second issue is, could systemic risk regulation interfere with the independence of the Fed? And I think there is some danger here. The danger, of course, is that systemic risk regulation, particularly in the context of having to deal with an institution which has to be reined in, could actually mean that there is some pressure put on the Federal Reserve in that context. And so I think that there is some danger here.

But, again, I think that the issue here is that the Congress has to be aware that the independence of the Federal Reserve is very much in the national interest. Indeed, this is a very major concern that I have right now, given concerns about the Federal Reserve's independence and people who have been saying the Federal Reserve needs to be reined in, I think it actually is something that can damage the Federal Reserve's ability to maintain price stability and also macroeconomic stability. But, furthermore, I think that there is also an issue that—in that context that we could actually have even problems currently with concerns about Fed's credibility, which is actually something that can raise interest rates, something that I think has indeed happened.

The third issue is something that is not really discussed as much as I would like to see discussed, which is the Federal Reserve's resources have been stretched to the limit by this crisis. And this is

particularly true of the Board of Governors. I saw this as a member of the Board of Governors where the staff was working extremely long hours and was exhausted. And I left in September of 2008, before the crisis really got bad. So there are issues in terms of the Fed having enough resources and the support of the Congress for the Fed to acquire the resources that it needs. And I think, again, that is something that is quite important.

So the bottom line here for me is that one of the important lessons from this crisis is that we absolutely desperately need a systemic risk regulator. And then I look at the issue about who can do that the best, and my view is that the Federal Reserve is, in fact, best positioned to do so.

On the other hand, there are some dangers here, but this is why I think the Congress needs to, in fact, support the Federal Reserve in its independence in terms of the resources that it needs to do this job. And as a result, I think that we would be better served having the Fed pursue this role.

Thank you very much.

[The prepared statement of Dr. Mishkin can be found on page 83 of the appendix.]

Chairman WATT. I thank you, Dr. Mishkin, for your testimony. And, Dr. Meyer, you are recognized for 5 minutes.

STATEMENT OF DR. LAURENCE H. MEYER, VICE CHAIRMAN, MACROECONOMIC ADVISERS

Mr. MEYER. Thank you very much. And thank you for giving me this opportunity to testify before you this afternoon.

The independence of central banks with respect to monetary policy is absolutely essential. Policies that are focused on financial stability, on the other hand, require a more cooperative approach, including, in the United States, the central bank, functional regulators of banks and nonbank subsidiaries, and a clear role for the Treasury. But there needs to be a bright line between the more cooperative approach to financial stability policy and the independence of the Fed with respect to monetary policy.

Supervising systemically important financial institutions is, of course, a central part of financial stability policy. I don't believe there is a conflict between the current or newly proposed role for the Fed as systemic risk regulator and the traditional role as independent authority on monetary policy. But then, again, I do not see the Treasury proposal as conferring on the Fed vast new authority as systemic risk regulator.

The Fed is already bank holding company or consolidated supervisor for all financial institutions that have a bank. Of the systemically important financial institutions today, most are already bank holding companies. Other institutions that might be designated systemically important could be a couple of insurance companies, a few other large financial firms that are not supervised today, and, in principle but not likely in practice initially, very large and highly leveraged hedge funds.

It also should be recognized that there are functional supervisors of the bank and the investment banking and insurance subsidiaries of bank holding companies, and they do much of the heavy lifting

in overseeing the risks in their respective parts of the bank holding company.

There has always been a debate about whether the Fed's role in bank and bank holding company supervision complements or conflicts with its role in monetary policy. One of the cases for a complementary role is that the Fed's responsibility as hands-on supervisor of some banks and all bank holding companies provides firsthand information about the state of the banking sector, which can be a valuable input into the assessment of the economic outlook, especially in periods of extreme stress like today.

The counterargument is that the Fed's concern for the health of the banking system, derived from its role as bank and bank holding company supervisor, can encourage the Fed at times to sacrifice its macro-objectives in order to help the banking system when it is ailing. When I was on the Board, I never witnessed any conflict in practice between these two roles. I don't see why the debate should change as a result of the marginal increase in supervisory reach under the Treasury proposal.

A basic premise for my view is that a central bank should always have a hands-on role in bank supervision. First, central banks always have at least an informal responsibility for monitoring systemic risk, and the banking system is a major source of such risk. Second, the central bank is always a source of liquidity to and lending to banks, and must therefore have firsthand knowledge of their creditworthiness, and this is especially true at times of stress. Finally, the central bank will always be called upon to cooperate with Treasury at times of interventions in particular institutions where the Fed will sometimes provide the liquidity, and Treasury should take all the credit risk.

Given the Fed's role already as consolidated supervisor of most systemically important financial institutions, the choice may be whether to remove the Fed from its role in banking supervision altogether, or expand its role modestly to cover all systemically important financial institutions. This seems like an obvious choice for me. I also don't see the need to isolate these two functions from each other within the Federal Reserve, at least more than they are today.

Now, if the Fed were getting substantial new powers as systemic regulator and had to devote considerable new resources to this new responsibility, then it seems reasonable that it should give up some of its current responsibilities. If something is to be given up, the most obvious choice is consumer protection and community affairs. These are not seen around the world as core responsibilities of central banks. In addition, the case for giving up consumer protection and community affairs is strengthened by the Treasury proposal to unify these responsibilities in a single agency.

The bottom line is that the Fed is the best choice for consolidated supervision of systemically important financial institutions in addition to its role as independent authority on monetary policy, and these joint roles are much more complementary than they are conflicting. Indeed, there is a very natural fit between these two roles.

Thank you.

[The prepared statement of Dr. Meyer can be found on page 77 of the appendix.]

Chairman WATT. Thank you, Dr. Meyer.

Dr. Galbraith, you are recognized for 5 minutes.

STATEMENT OF DR. JAMES K. GALBRAITH, LLOYD M. BENTSEN, JR., CHAIR IN GOVERNMENT/BUSINESS RELATIONS AND PROFESSOR OF GOVERNMENT, LBJ SCHOOL OF PUBLIC AFFAIRS, UNIVERSITY OF TEXAS

Mr. GALBRAITH. Thank you very much, Mr. Chairman. And as a member or an alumnus of this committee staff, it is again a pleasure and privilege to be here.

I want to begin with a comment on this question of independence which has been touched on repeatedly. Vice Chairman Kohn said, and I think with very carefully chosen words, that the Congress granted a substantial degree of independence to the Federal Reserve. That independence is, of course, independence from the Executive Branch. It is not and cannot be independence from the Congress itself. The Federal Reserve may be delegated certain functions by the Congress, but the Congress can always choose to hold it accountable, and this committee, of course, has the responsibility of oversight precisely for that reason. So I think we should be very clear that, when speaking of the independence of the Federal Reserve, it is a legal independence of a kind that other regulatory institutions have had over the course of our history. It is not an independence which is specific to monetary policy per se.

The question before us is whether the Federal Reserve is the best agency to take on the responsibility for regulating systemic risk, and I have some reservations about that, and I would classify them in three broad categories. The first one we might call constitutional, and I would pick up the point that was already made this afternoon by Congressman Sherman, concerning the fact that the Federal Reserve is constituted in part of regional Federal Reserve, of Federal Reserve district banks, who have boards of directors who are formed from the member banks themselves. And it is, of course, true that the district banks are represented on the Federal Open Market Committee with a voting power whose constitutionality, incidentally, was challenged in court by the chairman of this committee back in the 1970's when I was serving here on the staff. The issue was never resolved on the legal merits.

It is also the case, as I understand it, that the examiners under a systemic risk supervision regime would actually reside in the district banks rather than at the Federal Reserve Board, and it seems to me this does raise a question at least of perception; that is to say, whether it is appropriate to have systemic risk regulators who are part of institutions that report in part and are accountable in part to boards of directors consisting in part of the member banks of those institutions for two reasons. One, there may be a systematic conflict between the interests of the member banks and the interests of system stability. And, secondly, there may be conflicts between the interests of member banks and the interests of other Tier I financial holding companies who are not member banks. So it seems to me that is at least a question which is worth considering as you think about the architecture of this particular system.

The second concern that I would have is institutional. It is whether, in an agency whose primary functions are macroeconomic,

one would ever have a commitment to the systemic risk regulation, to the supervisory responsibilities that are commensurate with the importance of that particular function. It seems to me worth pointing out that there is in the Treasury proposal basically a two-stage process, one of which is analytical, and the other one has more of an enforcement character.

The analytical question is to determine what is a systemically dangerous institution to be classified as a Tier I financial holding company. That, it seems to me, would be an appropriate function to vest in the Federal Reserve Board, where an office that is incremental in the sense that Vice Chairman Kohn stipulated could decide amongst the relatively small number of large institutions who is and who is not in that category. The enforcement, the supervision, and the regulation of the behavior of the institutions, it seems to me, naturally would be more appropriately placed in an agency for whom that is the primary priority, an agency such as the FDIC.

The third concern that I have is a question of really the leadership of the Federal Reserve. Historically this is—the chairmanship of the Board of Governors of the Federal Reserve is an extremely high-profile appointment. It is an individual who tends to be close to and to need the confidence of the financial markets, and there is a real question as to whether there is any record in the history of the Federal Reserve of effective response to systemic risk in advance of crisis.

This was not the case of Benjamin Strong of the 1920's, who was the leading figure at the time, although not the Chairman of the Board. It was not the case of Alan Greenspan in the run-up to the latest crisis. We had a doctrine which, in effect, denied that systemic risk could, in fact, bring down the system. That doctrine was articulated at the peak of the Federal Reserve, and it seems to me that we had a test of that proposition, and it came up wanting. So it does seem to me that there are reasons to be worried about investing the authority for systemic risk in the Federal Reserve.

Thank you very much.

[The prepared statement of Dr. Galbraith can be found on page 50 of the appendix.]

Chairman WATT. I thank you for your testimony.

And, Dr. Berner, you are recognized for 5 minutes.

STATEMENT OF DR. RICHARD BERNER, CHIEF ECONOMIST, MORGAN STANLEY

Mr. BERNER. Thank you, Mr. Chairman, Ranking Member Paul, and other members of the committee. Thanks for inviting me to this hearing to address this important question, the role of the Federal Reserve in systemic risk regulation.

I think the broader question here is how should we address the significant weaknesses in our financial system and our financial regulatory structure that the current financial crisis has exposed?

Among market participants, and I talk to many of them, I think there are two policy changes that are needed that are well recognized: first, strengthen our regulatory infrastructure; and second, adopt appropriate regulation oversight to mitigate systemwide risks across financial market instruments, markets, and institu-

tions. In addition, I believe that macroeconomic policy should lean against asset and credit booms, which create financial instability.

In my view, the Federal Reserve is best equipped to take the lead on systemic risk regulation and oversight. Like others, I think this function is an essential and natural extension of the Fed's traditional monetary policy role and of its responsibilities as lender of last resort.

Three factors support that claim: First, the Fed is the ultimate guardian of our financial markets, and so it should be the agency that ensures the safety and soundness of the most important financial institutions operating in those markets.

Second, the process of intermediation through traditional lenders in the capital markets has become increasingly complex. Supervision of the institutions involved will enhance the Fed's ability to make the right monetary policy decisions.

And, finally, the Fed's expertise in financial markets and institutions makes it the natural choice for this role. The Fed's leadership in the Supervisory Capital Assessment Program demonstrated that expertise.

In short, good monetary policy and financial stability, in my view, are complementary. Asset booms and busts destabilized the economy and financial system at great cost. A financial stability mandate for the Fed requires that focus on asset and credit booms as well as systemic regulation and oversight. And the policy tools required for each overlap substantially.

That may explain why the other countries that separate such responsibilities from the traditional role of the central bank have fared no better than we did in this crisis. The U.K. is a good example. While the Bank of England and the Financial Services Authority clearly have collaborated in the recent crisis, their separation of powers did not help manage the current crisis more successfully than U.S. regulators.

However, naming the Fed to this role won't solve all of our problems that I just enumerated. To see why, in the rest of my time, I outline some related remedies. I will conclude by answering the four questions you posed.

In my view, our regulatory system has three major shortcomings: First, we supervise institutions rather than financial activities, which allows some firms to take on risky activities with inadequate oversight. A focus on systemic risk is one remedy for that problem. Designating the Fed to take the lead will limit risky activities and important market information slipping through the cracks, and it will promote supervisory accountability.

Second, our regulatory safety net is excessively prone to moral hazard, encouraging inappropriate risk-taking. Concentration, as you have all alluded to in this hearing, in our financial services industry has created institutions that are too big to fail.

Remedies needed should include: more extensive oversight and supervision of large, complex financial institutions; an explicit regulatory charge on such institutions to help us offset the moral hazard created by an implicit guarantee; and a strong resolution framework that is understood by all before crisis hits. An ad hoc approach creates uncertainty and reduces the credibility of policy.

The third problem is procyclicality. Our regulatory infrastructure encourages excessive leverage, which magnifies financial market volatility. Three remedies needed here are: First, we need a stronger system of capital regulation that should improve financial stability and help monetary policy lean against the wind of asset booms. We must resolve the tension between accountants who want to limit reserves and regulators who want to build them—in favor of the regulators. Second, securities must be more transparent and homogeneous and less reliant on credit ratings. And third, to reduce settlement and payment system risk, we need greater use of central counterparties for over-the-counter derivatives.

I want to conclude by answering your four questions. Are there conflicts with the Fed's traditional role here? Yes, there can be. In a crisis, decisions about particular firms likely would involve the Fed in inherently political considerations and the use of taxpayer funds that could compromise its independence.

We should insulate the Fed's independence with two firewalls. First, the resolution of troubled financial institutions should fall to the FDIC; and, second, and globally, we must change institutions now too big to fail into being too strong to fail. Remedies will include many of the options I just discussed. Both firewalls should strengthen the Fed's role as lender of last resort by reducing moral hazard, especially by reducing the chance that we will keep nonviable institutions alive, a concern you have expressed.

What are the policy pros and cons here? In my view, the pros outweigh the cons. Interconnectedness means that supervision must look horizontally across instruments, markets, institutions, and regions rather than in vertical silos. In my view, the Fed has the most expertise and reach to provide that. The Fed is also best positioned to prescribe and enforce remedies to procyclicality and to build financial shock absorbers.

Now, I hasten to state the obvious: The Fed is imperfect. As the guardian of our financial system, the Fed in the past has come up short in a number of ways. I would only say that while we consider making the Fed the lead systemic regulator, the Fed and we must examine how it can improve its functioning to take on these new duties.

What about the arguments against? Well, ensuring financial stability may be too big a job for just one regulator. Even if the Fed takes the lead, coordination with other regulators will be essential for success. Coordination with regulators and central banks abroad may be even more critical than being in sync with regulators at home. Our markets and institutions are global, but our regulation is largely local. So I like the President's recommendations for the Financial Services Oversight Council and international cooperation and coordination especially.

Last, what about reassigning some Federal responsibilities to other agencies? Regulators should do what they do best. And, for example, as others have said, consumer protection and promotion of financial literacy could go to another agency, but I think that the Fed may still play a useful role in supporting these areas.

Mr. Chairman, let me add that these views are mine and not necessarily those of my employer, Morgan Stanley, or its staff. I

want to thank you for your attention. I am happy to answer any questions.

[The prepared statement of Dr. Berner can be found on page 46 of the appendix.]

Chairman WATT. Thank you for your testimony.

Dr. Taylor, you are recognized for 5 minutes.

STATEMENT OF DR. JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Paul, and members of this subcommittee, for inviting me to testify on this important subject.

In my view, the Administration's plan would grant to the Fed significant new powers, more powers than it has ever had before. These powers would include determining whether a financial firm is a threat to financial stability. These designated firms by the Fed would then be put in a special group called Tier I FHCs, financial holding companies. The Fed would then have the power to supervise and regulate this newly defined group. And the firms in this group would be subject to this new resolution regime chosen by the Fed.

Taken as a whole, these powers mean that the Fed would be a systemic risk regulator. Though that term is not defined in the documents, I take it as a definition these new powers. In my view, these new powers will negatively affect the Fed's role as an independent monetary authority. I have four main concerns.

First, it seems to me that the additional powers and responsibilities would dilute the key mission of the Federal Reserve, which is to maintain overall economic and price stability by controlling the growth of the money supply and thereby influencing the overall level of interest rates in the economy. My experience in government, including the U.S. Treasury and elsewhere, is that institutions work best when they focus on a limited set of understandable goals and are held accountable to the public for achieving these goals. As the number of goals and the lack of clarity increases, the effectiveness and the performance generally decline.

My second concern is that responsibility for these new Tier I financial holding companies would reduce credibility of the Federal Reserve by involving it directly in potentially controversial decisions. In fact, it seems to me the experience of the last few months illustrates this problem. The Fed's credibility is an extraordinarily valuable asset, and it would be terrible to lose that asset.

My third concern is that the plan would create a conflict of interest. Indeed, this has been discussed widely already at this hearing with the Vice Chairman and others. In my view, firms in the Tier I financial holding company category would be perceived as too big to fail and perhaps even too big to resolve to go through that complicated process that is being proposed. In my view, there will therefore be a temptation to adjust the instruments of monetary policy, the money supply or the interest rates to help protect these institutions. It is a natural evolution. Lower interest rates, whether or not appropriate, will be harmful to the economy, and a larger

Fed's balance sheet when not appropriate would be harmful to the economy.

My fourth concern is that by giving so much new power to the Federal Reserve, that the plan would actually threaten the Fed's independence regarding monetary policy. Why would this be the case? In my view, sooner or later the increased power will result in checks and limits on it, perhaps through micromanaged political interference or perhaps through legislative change. It would be impossible, as some have suggested, in practice to prevent such interference from spreading from the new regulatory powers and supervisory powers to the traditional monetary function of the Fed. After all, they are in the same institution, and they are run by the same CEO.

I think this loss of Federal Reserve independence is a serious issue, especially at this time of rapidly growing Federal debt and greatly expanded Federal Reserve balance sheet. Actually, I could not do any better than to quote a former Secretary of the Treasury, also former Secretary of State, Secretary of Labor, and Director of the Budget, Secretary George Shultz, who, after studying carefully the events of the last few months, came up with the following statement. And I quote Secretary Shultz:

"Observing this process, the question comes forcefully at you, has the accord gone down the drain?"

The Secretary, of course, is referring to the 1951 accord where the Fed regained its independence from the Treasury, which it had lost during World War II, and was committed to pegging Treasury interest rates. And then he goes on to say:

And remember how difficult it was for the Fed to disentangle itself from the Treasury in the post-World War II period.

So these are very serious concerns, my four concerns, and I would be happy to answer any questions you have about them.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor can be found on page 86 of the appendix.]

Chairman. WATT. Thank you, Dr. Taylor.

Dr. Meltzer, you are recognized for 5 minutes.

STATEMENT OF DR. ALLAN H. MELTZER, THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

Mr. MELTZER. Thank you, Chairman Watt. And greetings to my old friend, Congressman Ron Paul, and to the members. Thank you for the opportunity to present my appraisal of the Administration's proposal for regulatory changes. I will confine most of my comments to the role of the Federal Reserve as a systemic regulator, and will offer an alternative proposal much closer to the Republican proposal.

I share the belief that change is needed and long delayed, but appropriate change must protect the public, not the bankers.

During much of the past 15 years, I have written three volumes entitled, "A History of the Federal Reserve." Working with two assistants, we have read virtually all of the of the minutes of the Board of Governors, the Federal Open Market Committee, and the

Directors of the New York Federal Reserve Bank. We have also read many of the staff papers and the internal memos supporting decisions. I speak from that perspective.

Two findings are very relevant for the role of the Federal Reserve. First, I do not know of any single clear example in which the Federal Reserve acted in advance to head off a crisis or a series of banking and financial failures. We all know of several where it failed to act in advance.

Members of Congress should ask themselves this question: Can you expect the Federal Reserve or anyone else as systemic regulators to close Fannie Mae and Freddie Mac after Congress has decided that it declined to act? What kind of a conflict is that going to pose? And how is it going to be resolved?

Second, in its 96-year history, the Federal Reserve has never announced a lender of last resort policy. It has discussed internally the content of such a policy several times, but it rarely announced what it would do. And the announcements that it made, as in 1987, were limited to the circumstances of that time.

Announcing and following a policy would alert financial institutions to the Fed's expected actions and might reduce pressures on Congress to aid failing entities. Following the rule in a crisis, the lender-of-last-resort rule in a crisis would change bankers' incentives and reduce moral hazard.

A crisis policy rule is long overdue. The Administration proposal recognizes the need, but doesn't propose the rule. Experiences in the past from the history suggest three main lessons:

First, we cannot avoid banking failures, but we can keep them from spreading and creating crises;

Second, neither the Federal Reserve nor any other Agency has succeeded in predicting crises or anticipating systemic failure. It is hard to do, in part because systemic risk is not well defined. Reasonable people will differ, and since much is often at stake, some will fight hard to deny that there is a systemic risk.

One of the main reasons that Congress in 1991 passed FDICIA, the Federal Deposit Insurance Corporation Improvement Act, was to prevent the Federal Reserve from delaying closure of failing banks, increasing losses, and weakening the FDIC fund. The Federal Reserve and the FDIC have not used FDICIA against large banks in this crisis. That should change.

The third lesson is that a successful policy will alter bankers' incentives and avoid moral hazard. Bankers must know that risk-taking brings both rewards and costs, including failure, loss of managerial position and equity, followed by sale of continuing operations.

Several reforms are needed to reduce or eliminate the cost of financial failure to the taxpayers. Members of Congress should ask themselves and each other, is the banker or the regulator more likely to know about the risks on the bank's balance sheet? Of course, it is the banker, and especially so if the banker is taking large risks that he wants to hide. To me, that means the reform should start by increasing the banker's responsibility for losses.

The Administration proposal does the opposite, by making the Federal Reserve responsible for systemic risk. Systemic risk is a term of art; I doubt that it can be defined in a way that satisfies

the many parties involved in regulation. Members of Congress will properly urge that any large failure in their district is systemic. Administrations and regulators will have other objectives. Without a clear definition, the proposal will bring frequent controversy, and without a clear definition, the proposal is incomplete.

Resolving the conflicting interests is unlikely to protect the general public. More likely, regulators will claim that they protect the public by protecting the banks.

I think that is wrong. I believe there are better alternatives than the Administration's proposal. First step, end "too big to fail." Require all financial institutions to increase capital more than in proportion to the increase in the size of their assets. "Too big to fail" is perverse; it allows banks to profit in good times and shifts the losses to the taxpayers when crises or failures occur.

Second step, require the Federal Reserve to announce a rule for "lender of last resort." Congress should adopt a rule that they are willing to sustain. The rule should give banks an incentive to hold collateral to be used in a crisis period. Bagehot's Rule from the 19th Century Bank of England is a great place to start.

Third step, recognize that regulation is an ineffective way to change behavior. My first rule of regulation states that lawyers regulate, but markets circumvent burdensome regulation. The Basel Accord is a current example. It told banks to hold more reserves if they held more risky assets. So they put the assets off their balance sheets. Later, after the fact, they had to take them back, but that was after the fact.

Fourth step, recognize that regulators do not allow for the incentives induced by their regulations. In the dynamic financial markets, it is difficult, perhaps impossible, to anticipate how clever market participants will circumvent the rules without violating them.

The fifth step, either extend FDICIA to include holding companies or subject financial holding companies to bankruptcy law. Make the holding company subject to early intervention either under FDICIA or under bankruptcy law. That not only reduces or eliminates taxpayer losses, but it also encourages prudential behavior.

Other important changes should be made. Congress should close Fannie Mae and Freddie Mac and put any subsidy for low-income housing on the budget. The same should be done to other credit market subsidies. The budget is the proper place for subsidies.

Three principles should be borne in mind:

First, banks borrow short and lend long. Unanticipated large changes can and will cause failures. Our problem is to minimize the costs of failures to society.

Second, remember that capitalism without failure is like religion without sin. It removes incentives for prudent behavior.

Third, those that rely on regulation to reduce risks should recall that this is the age of Madoff. The Fed, too, lacks a record of success in managing large risks to the financial system, the economy, and the public. Incentives for fraud, evasion, and circumvention of regulation often have been more powerful than incentives to enforce regulation that protects the public.

Thank you, sir.

[The prepared statement of Dr. Meltzer can be found on page 71 of the appendix.]

Chairman WATT. I thank the gentleman for his extensive statement. I am going to recognize the members for questions, and I will just reserve my questions until last if we have time, because we have to be out of here by 5 o'clock. There is another meeting.

I recognize the gentleman from Texas, Mr. Paul, for 5 minutes.

Dr. PAUL. I thank you, Mr. Chairman, and I welcome the panel. It is especially nice to see Dr. Meltzer here.

I would like to start with a question of Dr. Meltzer because I wanted to follow up on his testimony about the Latin America crisis, where you mention that the Federal Reserve went to the IMF and instructed the IMF to pay interest to those banks that were exposed. And, of course, that was without congressional permission, and I think it makes a point, one of the points I have been trying to make, and that is transparency of the Federal Reserve.

Now it sounded to me like the majority here is for independence, which is a code word for secrecy and in opposition to transparency. And it is always used for the public interest. Of course, I think the public interest is served by exposure and knowing what is going on and whose interests are being served, and that is why I would like to see a lot more transparency.

But the question I have for Dr. Meltzer is, since he is aware of this, he has published this, is this a good reason for us to know a lot more about the agreements that the Federal Reserve makes? Because they can make agreements with international banking institutions, and we have no right—we may have a right under the Constitution that we should, but we don't—and we have given up that right, we have given up that privilege.

Would this be a good example of why we need to know more of what exactly the Federal Reserve is doing?

Mr. MELTZER. Yes.

Let me begin by saying independence, to me and, I believe, to many of the members of the panel, does not mean lack of transparency. It means protection. The reason we have independent central banks is so that they don't expand under pressure from Congress, from the Administration, from the banking community, and from others. We want them to be independent, to make their judgments without—because they are obligated by law to maintain high employment and low inflation.

Now, that law doesn't work very well, at least in my opinion, but that is why we want independence.

So transparency, how can you be against transparency? But I believe the Congress would be more effective in its oversight of the Federal Reserve if it concentrated much more on outcomes and much less on process. Let them make their decisions the way they want to make them and monitor the process. They are not living up to the mandate to maintain full employment or high employment and low inflation, and that is what we should be concerned about.

Dr. PAUL. I thank you. And I am going to hurry along because our 5 minutes runs out rather quickly.

But I wanted to ask Dr. Galbraith a question, because he has worked here and he knows the system, so I have been rather

shocked at what you presented here. You actually talked about the Constitution. Didn't you find out that we are not supposed to do that around here? We don't have that much concern about it.

So I was delighted, from my viewpoint, that you brought this up and reminded us about Henry Ruess's concern about the constitutionality of the FOMC. And, of course, I agree with that.

But I wanted to see if there was a little bit more that you might agree with, because there are some who believe that we shouldn't be doing anything unless it is explicitly authorized. And, of course, the central bank is not authorized. It has been ordained by the courts and the Congress, but it was never explicitly authorized.

But the point, the more practical point that I might be able to get you to comment on is the concept of the budget. I mean, the Fed is a government unto itself. You know, they hire and make their wages and it doesn't go through the ordinary process. The Constitution says it should all go through the constitutional process.

And also maybe you could comment on these foreign agreements. These are like treaties. The Federal Reserve goes and makes these agreements, and they pass out money.

Does this strike you as maybe that too might be challenged if you happen to come at this from a constitutional viewpoint?

Mr. GALBRAITH. Well, I think under the Constitution, the Congress has every right for whatever information it seeks from the Federal Reserve. And if the Congress were to decide to change the way the Federal Reserve is funded, it would also have the right to do that. It seems to me it would be an appropriate decision for Congress to make.

Dr. PAUL. So they would then have a right—so my proposal that we find out more, you would say that would be right and proper to find out what type of agreements they have made with other governments, other central banks, international banking organizations?

Mr. GALBRAITH. My own view on this is that as a Member of Congress, you are entitled to that information. That would be the position I would have understood to be the case when I was working here 30 years ago.

Dr. PAUL. Thank you.

Chairman WATT. The time of the gentleman has expired.

The gentleman from Delaware, Mr. Castle, is recognized for 5 minutes.

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

Let me just say, I thought this was a very good panel. I think you had some good ideas. Whether one agrees or not with the concept of where we are going to go, I would hope that staff and all of us will take note of what you stated here today. I think it makes a difference.

I might start with you, Dr. Meyer. You basically indicated that in going to systemic risk regulation, it wouldn't be a great change as far as the Fed is concerned. I don't mean to put words in your mouth, but that was my impression of what you stated.

And if that is the case—and others have indicated that the Fed did not anticipate particularly well the problems which have arisen in the banking industry in the last year or two, but if that is the

case, is it arguable that the Fed had some of this power and did not succeed in carrying out the responsibility of dealing with systemic risk to the limits they had before, and therefore we should question whether they should expand or not?

Mr. MEYER. First, let me reiterate what I said before, and I agree with Vice Chairman Kohn here, that what the Treasury proposal does is very incremental and not very dramatic, not a vast expansion of powers—basically asking the Fed to do what it has been doing as bank holding company supervisor and extending that reach to a modest degree over systemically important financial institutions that don't have a bank.

I think it is clear that the Federal Reserve didn't distinguish itself in carrying out its responsibilities as supervisor and regulator of banks and bank holding companies. This is an extraordinary period; it is the first financial crisis since the Great Depression, and I don't believe any other financial supervisor or regulator carried out its responsibilities to protect the safety and soundness of the banks and institutions under their control in this circumstance either.

So I think what we need to do is not only ask the Fed to carry out its responsibilities, but to encourage it to do what I think it would otherwise do, to change capital standards that make them more onerous for systemically important institutions, carry out more macroprudential supervision than it has done before, although, let me say, the Treasury proposal separates that out and gives that responsibility mainly to Treasury—well, mainly to the risk council that is staffed by Treasury and chaired by the Secretary.

Mr. CASTLE. Thank you. I am not sure I understand all that quite yet, but I will try to absorb it. But I appreciate your answer.

Dr. Berner, you indicated that coordination with other regulators will be essential on this. Can you be more explicit about that?

What other regulators? I assume the FDIC and others. And exactly what that coordination would be? Would this be something that the Federal Reserve would do on its own, or should there be some sort of a council in which they would meet on a regular basis? How would that coordination occur, in your mind at least?

Mr. BERNER. Well, I mentioned that there are probably two aspects to that coordination. One is within our own boundaries in the United States and for U.S. financial institutions. But I also think that we need to coordinate globally, since our markets and institutions are global as well.

As far as the United States is concerned, you know, we have a multiplicity of regulators. And even in the sweeping proposal from the Treasury or in other regulatory proposals, I haven't heard any move to, you know, to consolidate them all into one. And as I indicated, it is not clear to me that doing so would produce a better outcome.

So the coordination would have to take place among the various regulators that we have, however we reshape them, so that information doesn't slip through the cracks, so that we don't miss the activities of institutions who are regulated by one group or one regulator, but who are engaged in activities that are properly the responsibility of—if you will, collectively all the regulators.

That extends, I think, across borders because markets are global. And so we need to coordinate, or the Federal Reserve and other regulators will need to coordinate across borders with their counterparts overseas, taking into account what institutions are doing either to, as Dr. Meltzer indicated, avoid regulation by doing things in one place rather than in another, so that they are aware of what is going on and so that they can appropriately safeguard markets and institutions.

Mr. CASTLE. I think what you have just discussed is vitally important. And I hope everybody gives a lot of thought to exactly how that would be done, because I think ultimately that is something that is going to have to happen no matter which way we go.

Dr. Galbraith, you indicated, I thought—

Chairman WATT. The gentleman's time has expired.

Mr. CASTLE. I am sorry. I yield back. I may write to you about that question.

Chairman WATT. The gentleman from New Jersey, Mr. Lance, is recognized for 5 minutes.

Mr. LANCE. Thank you, Mr. Chairman. Let me agree with my colleagues that I believe this is an extremely distinguished panel, and it is my privilege to participate this afternoon.

Dr. Galbraith, to follow up on some of the questioning of Ranking Member Paul, you indicated one way out of the difficulty might be the elimination of the boards of directors of the regional Federal Reserve Banks, or alternatively, to remove the voting power of the regional bank presidents on the FOMC.

Realistically, is that likely to occur?

Mr. GALBRAITH. As a witness, it is not my responsibility to be the most realistic person.

Mr. LANCE. We do rely on your expertise, however.

Mr. GALBRAITH. I do think that one has to look at this question of the perception of a privileged position to whom the presidents of the regional districts are responsible.

Mr. LANCE. Absolutely.

Mr. GALBRAITH. An alternative, of course, is not to put the examining power in the regional Federal Reserve Banks, to leave it in the hands of a tough cop who is entirely autonomous.

Mr. LANCE. Yes. I think on our side of the aisle we have great difficulty with reposing these powers in the Federal Reserve Board at all.

To Dr. Taylor and Dr. Meltzer, regarding the establishing of Tier I financial holding companies, I think many of us have a concern that if that were to occur, there would be some sort of assumption that they would have the backing of the Federal Government. We already may be in that place in some areas, and certainly we were in that place regarding Fannie Mae and Freddie Mac.

Your comments, both of you as distinguished persons regarding this area of your expertise, could you elaborate on that a little bit for me?

Mr. TAYLOR. Yes. I think the reason why I would characterize this proposal as giving significant, not incremental powers to the Federal Reserve, largely lies in this ability to distinguish certain institutions as a threat to the financial system as defined by the Treasury. And so once an institution—we don't know, quite frank-

ly, how many there will be; it is not clear. I think that would be a good question to ask Treasury or the Fed, but it could be quite large.

Mr. LANCE. In your opinion, could you give us an estimate as to how many you think it might be?

Mr. TAYLOR. I have no idea. That is one of the problems.

Mr. LANCE. Yes, sir.

Mr. TAYLOR. Operationally, there is no definition of "systemic risk" here, and so it could be quite large.

It might not be, by the way, this Federal Reserve, these people, who make the decision; it could be their successors.

Mr. LANCE. Yes, sir.

Mr. TAYLOR. And so I think the danger is, just as you say, once these institutions are in this group, then they do become too big to fail, certainly—in fact, probably too big to resolve because it will look like a black mark. And so they could become Fannie Maes and Freddie Macs of the future.

Mr. LANCE. Yes. Thank you.

Dr. Meltzer?

Mr. MELTZER. Yes, I like your emphasis on realism. That is—

Mr. LANCE. I am new here, so I am sure I will get over it.

Mr. MELTZER. Try hard not to. The realism, to me, says what would the systemic risk regulator do with the Tier I holding companies? In my opinion, it would be Fannie Mae and Freddie Mac, writ large.

Mr. LANCE. That is my concern.

Mr. MELTZER. These are going to be banks or institutions that are going to have branches all over the country. Every Member will feel an obligation to say, we can't let that happen in our district and in our districts. And so too big to fail will really become an even greater problem now.

How can you limit the risks that bankers, some bankers, are going to take? Make them bear the risk.

Mr. LANCE. Thank you. Thank you very much.

I yield back the balance of my time, Mr. Chairman. Thank you.

Chairman WATT. The gentleman yields back.

The gentleman from Alabama, Mr. Bachus, is recognized for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Meyer, you described the proposed changes as incremental to the Federal Reserve?

Mr. MEYER. Right.

Mr. BACHUS. Reading the Treasury proposal on what they say about it, they say this report proposes a number of major changes to the formal powers and duties of the Federal Reserve, including the addition of several new financial stability responsibilities. These proposals would put into effect the biggest changes to the Federal Reserve's authority in years—or decades.

Mr. MEYER. I think you have to read the rest of the report and see whether you agree with that.

I read the rest of the report, and I don't see that there is this vast new power. The Administration possibly wants to look at this as a more sweeping set of proposals than perhaps it is.

Mr. BACHUS. Okay.

Mr. MEYER. But as Vice Chairman Kohn said, that is just not the case.

Mr. BACHUS. Okay. So actually, you don't agree with their description of—

Mr. MEYER. Absolutely not.

Mr. BACHUS. —their own plan? Okay.

Let me ask the panelists, can you function as a systemic risk regulator of significant institutions without a robust examination and supervision authority? Can you do that?

Mr. MEYER. Impossible.

Mr. BACHUS. Impossible?

Mr. GALBRAITH. I agree.

Mr. MISHKIN. I completely agree here that clearly part of this issue of being a systemic risk regulator is that you have to go in and know what is going on in the institutions that you are regulating. And so I think it is essential that this be part of the role.

And I think clearly that there is already an element of this, a very strong element in what the Federal Reserve does now with the bank holding companies.

Mr. BACHUS. Do you think the Federal Reserve had a robust supervision and examination of those institutions that failed, including AIG?

Mr. MISHKIN. Well, certainly the Federal Reserve did not have this responsibility for AIG.

Mr. BACHUS. Well, they were a holding company, were they not?

Mr. MEYER. Not a bank holding company.

Mr. MISHKIN. Not a bank holding company.

Mr. BACHUS. How about Citi?

Mr. MELTZER. But they have people monitoring Citigroup and all from the New York Fed every day. Did they find anything at Citigroup? Nothing that they were willing to do anything about.

Mr. BACHUS. And I guess Wachovia was a bank holding company.

Does the Fed—do they have, you think, the robust examination or supervision, or is that something that the OCC or the FDIC does on a day-to-day basis?

Mr. MEYER. The OCC and the FDIC have never been responsible for consolidated supervision. They have no history of doing that. The FDIC does not have a supervisory staff that has any expertise in the complex banking situation of the institutions we are talking about. The OCC is already involved and was the bank supervisor of many of the institutions that have gotten into trouble. And in most of the large institutions, OCC is the bank supervisor and the Fed is the holding company supervisor, and they both have to work together.

Mr. BACHUS. Yes. And they didn't do that in the last—

Mr. MEYER. Well, I think—let's say, neither distinguished themselves.

Mr. BACHUS. Okay. I agree.

Do we need to determine the causes of the present financial crisis before we start legislating a fix? And have we done that?

Mr. GALBRAITH. It would be very helpful, in my view, to conduct a full and independent investigation into the cause of the financial

crisis, similar to the Pecora Committee investigations of the early 1930's.

Mr. BACHUS. How about Dr. Mishkin? Do you agree?

Mr. MISHKIN. Well, I think that clearly we do have to think more about these issues and that, in particular, the rush to do regulatory reform is something that I have been concerned about.

I do actually think, however, that the need for a resolution authority is absolutely critical. And so—

Mr. BACHUS. And I don't disagree.

Mr. MISHKIN. And I think that one of my concerns has been that if we go down the route of worrying about the big picture and then don't do anything, that we are actually in a situation which not only means institutions can get in trouble, and we can't do anything about them, but also we are in a very weak position to get them to fix things because we have no ammunition.

Mr. BACHUS. Let me say this. The Republican proposal is for an enhanced resolution, a bankruptcy-like proceeding for nonbank financial companies.

I don't know. Have you all looked at the Republican proposal?

Mr. TAYLOR. Not in detail.

Chairman WATT. The gentleman's time has expired. And I would encourage him to send each of these witnesses the Republican proposal.

Mr. BACHUS. How about a second round of questions?

Chairman WATT. Unfortunately, there is another meeting scheduled, as I had previously announced, in this room at 5 o'clock. If we had been more expeditious on the Floor, perhaps we could have had more time to do what we do in committee.

And I am not trying to be mean about it. I just—

Mr. BACHUS. I don't think you are being mean.

Chairman WATT. I can't give more time than the room allows me to give. The gentleman's time has expired.

Dr. Galbraith, let me just ask one question. You distinguished between the two responsibilities on the bottom of page 2 and top of page 3 of your testimony. One was to identify as Tier I financial holding companies considered to be so large and interconnected; and then the second was the institution of a regime of examination and regulation.

If the first part of that—the first one of those, I take it you concluded, was not constitutionally suspect to be done by the Fed?

Mr. GALBRAITH. It could be done in the Federal Reserve Board, and it would be an incremental responsibility of the kind that Vice Chairman Kohn described, yes.

Chairman WATT. And then I take it that you are recommending that the second part of that be undertaken by the FDIC.

Mr. GALBRAITH. By an agency for whom it is the highest priority and for whom it is a major mission, yes.

Chairman WATT. Even for institutions that are not federally insured. What about—

Mr. GALBRAITH. Yes.

Chairman WATT. Okay. The Chair notes that 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 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I thank the witnesses for their unending patience throughout the afternoon, and regret that we have to rush out of the room. Otherwise, we would be happy to go another round. But I am sure the members will follow up with vigorous written questions, and I encourage you to answer them as expeditiously as you can so that we can continue the process moving along. I thank you for coming.

And the hearing is adjourned.

[Whereupon, at 5:06 p.m., the hearing was adjourned.]

A P P E N D I X

July 9, 2009

Regulatory Restructuring: Balancing the Independence of the Federal Reserve Regarding Monetary Policy with Systemic Risk Regulation
Testimony of Richard Berner, Morgan Stanley, Inc.
Financial Services Committee Subcommittee of Domestic Monetary Policy and Technology
July 9, 2009

Chairman Watt, Ranking Member Paul, members of the Subcommittee, and members of the Financial Services Committee, my name is Richard Berner. I am Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to address the appropriate role for the Federal Reserve in systemic risk regulation.

The current financial crisis has exposed significant weaknesses in our financial system and in the regulatory structure responsible for its oversight. To assure that we have a strong and stable financial system, there is broad agreement on two needed policy changes. First, we need to strengthen our financial regulatory infrastructure. Second, regulators and supervisors must adopt appropriate regulation and oversight of the system-wide risks across financial instruments, markets and institutions. Such a "macroprudential," systemic focus would monitor and mitigate the common exposures and behavior that threaten financial stability. In addition, I believe that macroeconomic policies, especially monetary policy, should lean against asset and credit booms.

In my view, the Federal Reserve is best equipped to take the lead on systemic risk regulation and oversight. While some may see conflict between this role and the more traditional responsibilities of a central bank, I think such supervision is an essential and natural extension of the Fed's role in the conduct of monetary policy and of its responsibilities as lender of last resort.

Three factors support that claim. First, the Fed is the ultimate guardian of the safety, soundness and integrity of our financial markets, and thus should be the agency primarily responsible for ensuring the safety and soundness of the most important financial institutions within those markets. Second, the conduct of monetary policy in today's complex financial markets requires understanding of the process of intermediation, both through traditional lenders and through the capital markets. Giving the Fed clear supervisory oversight of the institutions involved in that process enhances its ability to make the right monetary policy choices. Finally, the Fed's expertise and understanding of financial markets and institutions makes it the natural choice for this role. The Fed's leadership in the Supervisory Capital Assessment Program (SCAP) demonstrated that expertise.

While it is more controversial, all central banks are rethinking the role of asset prices in conducting monetary policy. Asset booms and busts have destabilized the economy and financial system at great cost, but the Fed's narrow set of traditional monetary policy tools may not be adequate to dampen such booms. What's needed is an expanded set of tools. As I will discuss in a moment, these are the very same tools that are appropriate for systemic risk regulation. Thus, there is substantial overlap between the goals of monetary policy and those of macroprudential regulation and oversight, as well as in the tools needed to achieve them.

It's appealing to argue that separate policy goals require separate agencies and separate policy instruments, at least in the abstract. But as a practical matter, the experience of other countries that separate such responsibilities from the traditional role of the central bank has been no better than our own. For example, the Bank of England has been more narrowly focused on monetary policy, while the Financial Services Authority has had responsibility for all financial regulation and oversight. While the Bank and the FSA clearly have collaborated in the recent crisis, arguably their separation of powers did not enable them to manage the systemic risks arising in the current crisis more successfully than US regulators.

In what follows, I outline some of the shortcomings of the US regulatory system, and remedies needed. I'll conclude by answering the four questions you posed.

Our regulatory system has three major shortcomings.

1. *Regulatory structure based on institutional boundaries.* Our antiquated regulatory infrastructure supervises institutions rather than financial activities, which allowed some firms to take on risky activities with inadequate or no oversight. The interconnectedness of global markets and institutions creates vulnerabilities across the banking system, capital markets, and the payments and settlement systems that our current regulatory system is not equipped to recognize or manage.

There is broad agreement that a focus on systemic risk is one remedy. Designating the Fed as the lead systemic regulator will limit the extent to which risky activities and important market information slips through the cracks, and it will promote supervisory accountability to the Congress and the taxpayer.

2. *Regulatory safety net excessively prone to moral hazard, encouraging inappropriate risk-taking.* There is no escaping some moral hazard in any regulatory safety net. In our case, however, concentration in the financial services industry has created complex, systemically important institutions that are "too big to fail," with no appropriate way to shut them down when they run into trouble.

Remedies needed to reduce this weakness include:

More extensive oversight and supervision of large, complex financial institutions.

An explicit regulatory charge on institutions that are deemed too big to fail. If imposed through capital requirements, it is called a *systemic capital charge*. This would help to offset the moral hazard created by an implicit guarantee, which encourages excessive risk taking and discriminates against smaller institutions.

Legislation that provides a resolution process for bank holding companies and non-bank financial institutions. As long as we have institutions that are too big to fail, we need a strong resolution framework that is understood by all before a crisis hits. As the current crisis has demonstrated, an *ad hoc* approach creates uncertainty and reduces the credibility of policy.

3. *Procyclicality.* Our regulatory infrastructure promotes procyclical swings in institutional and investor behavior that magnify financial market volatility rather than dampening it. Our system of capital requirements, collateral and haircuts is tied to credit ratings, and compensation is tied to short-term performance, all reinforcing procyclical behavior. Regulatory capital measures lag well behind market-based measures of capital and risk. Lenders are constrained partly by accounting rules from building up reserves in good times as a cushion against losses, encouraging excessive leverage in good times and excessive deleveraging in periods of stress. Regulators have not insisted that banks cut dividends to conserve capital or to rebuild it amid a crisis. The procyclical nature of collateral requirements and haircuts curtails the risk-dispersion powers of financial innovation when liquidity dries up in the face of financial shocks, and makes the financial system less stable, not more so. And regulators have been too willing to allow the use of new instruments untested for stress that can increase procyclicality.

Three remedies are needed here:

First, we need a stronger system of capital regulation that builds reserves and limits leverage in good times. Such a regime should improve financial stability and help monetary policy lean against the wind of asset booms. For example, regulators widely agree that banks should hold more capital. But the composition of that capital is also important to mitigate systemic risk. One proposal ties capital to incentives for management by mandating capital increases in the form of debt convertible to equity. Such contingent capital might provide an equity cushion in periods of stress, and it might reduce the temptation for managers to boost returns through excessive leverage.

Second, securities must be more transparent and homogeneous, and thus less complex. Opacity, heterogeneity and complexity in time of stress have resulted in reduced liquidity, higher volatility and demands for collateral, and forced deleveraging. These factors also promoted excessive reliance on credit ratings, which in turn increased acceptance of opaque, complex securities. Perhaps new securities should be stress tested using prescribed methods before they are adopted.

Third, to reduce settlement and payments-system risk, we need greater use of central counterparties (CCPs) or exchanges for over-the-counter derivatives. Regulators have made great strides here, especially for credit default swaps, but more is needed.

Four Questions

Given those regulatory shortcomings and remedies for them, your four questions appropriately focus on the benefits and risks in giving the Fed new powers. I want to conclude by answering them.

1. *Conflict with traditional role.* I agree that this new role may conflict with the Fed's traditional role as the independent central bank. In a crisis, decisions about particular firms may determine whether a stressed institution will survive. Such decisions would involve the Fed in inherently political considerations and the use of taxpayer funds that could compromise its independence.

2. *The Fed's independence.* I believe that it is necessary to insulate the Fed's independence from that part of the systemic risk regulatory role. Two firewalls are needed:

First, while the Fed should be supervisor, the resolution of troubled financial institutions — including the new authority that is needed to wind down bank holding companies and nonbanks — should fall to another agency. In my view, the appropriate agency would be the FDIC, which is properly part of the US Treasury.

Second, our regulatory architecture, not just in the US but globally, must be changed such that institutions now too big to fail will become instead too strong to fail. Remedies will include new approaches to capital regulation, credit risk and liquidity management; restructuring management incentives; stronger oversight across all business lines and geographies; and regulations that increase the cost of participation in certain activities in direct proportion to their potential to increase systemic risk.

Both firewalls should actually strengthen the Fed's role as lender of last resort by reducing moral hazard — especially by reducing the chance that such lending is required to keep afloat nonviable institutions simply because they threaten the stability of the financial system.

3. *Public policy pros and cons.* The public policy considerations for making the Fed the systemic risk regulator outweigh the negatives when you examine our regulatory challenges and who is best equipped to provide the remedies.

As noted above, the crisis made it clear that a micro-regulatory focus on one set of institutions or markets misses important systemic spillovers and vulnerabilities from one part of the financial system to others. In the current crisis, our fragmented regulatory system made coordination among regulators difficult, allowed important information to fall between the cracks, and diluted accountability for supervisory failures. The interconnectedness of markets and institutions means that supervision must look horizontally across instruments, markets, institutions, and regions, rather than in vertical silos. In my view, only the Fed has the expertise and reach, in concert with other central banks, to provide that systemic monitoring, oversight and risk mitigation.

In my view, the Fed's oversight of the process of intermediation and capital markets puts it in the ideal position to prescribe and enforce remedies to the procyclicality in our financial and regulatory system. The Fed is also best equipped to build financial shock absorbers that will reduce the impact of shocks on the system as a whole.

I hasten to state the obvious: The Fed is not perfect. As the guardian of our financial system, the Fed in the past has come up short in ways that others have documented better than I can. I would only say that while we consider making the Fed the lead systemic risk regulator, it's worth examining whether and how the Fed can improve its functioning to better meet these new duties.

Turning to the public policy arguments against giving the Fed such responsibilities, I find one most compelling. The responsibility to regulate systemic risk is not a narrow, technical exercise. Whoever has it

will find the task complex, daunting, global in scope and fraught with political conflicts. It will require enormous experience and judgment and support from both the Congress and other regulators. Those considerations suggest that systemic risk regulation may be too big a job for just one regulator. Indeed, assuming that regulatory reform leaves our regulatory institutions largely intact, even if the Fed takes the lead, coordination with other regulators will be essential for success. In that regard, the President's plans for a Financial Services Oversight Council are laudable.

When it comes to overseeing and monitoring systemic risk, coordination with other regulators and central banks abroad may be even more critical than being in sync with regulators at home. Our financial markets are clearly global in scope, and many of our financial institutions, especially those at the core of the financial system, have long had global business models. Yet our regulatory structure, our regulations and our capacity to resolve troubled institutions are largely local. In that context, the President's recommendations for international cooperation and coordination are especially commendable.

4. *Reassigning some Fed responsibilities to other agencies.* Whether the Fed should relinquish any roles in order to accept these new responsibilities in my view depends on the principle of assigning appropriate roles to regulators to do what they do best, as well as on the resources that are available. For example, giving another agency the oversight of regulations aimed at protecting consumers and promoting financial literacy might well be appropriate to allow the Fed to focus on systemic risk issues, although the Fed might still play a useful supporting role in these areas.

Mr. Chairman, thank you for your attention. I will be happy to answer your questions.

Statement of Professor James K. Galbraith[1] to the Subcommittee on Domestic Monetary Policy and Technology, Committee on Financial Services, U.S. House of Representatives, 2128 Rayburn House Office Building, July 9, 2009, 1:30 PM.

Chairman Watt, Ranking Member Paul, Chairman Frank and Ranking Member Bachus, as an alumnus of this committee's staff it is again a pleasure and a privilege to appear before you.

This hearing is directed at specific questions concerning the functions of the Federal Reserve under the administration's proposals for reform of financial regulation. Let me address those points directly from the beginning:

"To what extent, if any, would the newly proposed role of systemic risk regulator be in conflict... with the Fed's traditional role as the independent authority on monetary policy?"

A Constitutional Question

First, the Federal Reserve is not established as an "independent authority on monetary policy" *per se*. It is an agency created by Congress – a creature of Congress – intended to be independent of the executive branch in all of its functions, just as other regulatory agencies of the progressive era were so intended, including the ICC, the FTC, and many others. There is no intrinsic difference between the independence (from the executive branch) accorded to the Federal Reserve Board on monetary policy and that accorded to it on regulation, except as noted in the next paragraph.

The one significant difference is that the Federal Reserve Board is not the ultimate decision-maker on monetary policy. That body is the Federal Open Market Committee, which is constituted of the seven members of the Board of Governors, and the 12 Presidents of the regional Federal Reserve Banks, of whom five vote at any given time. Though the regional Federal Reserve banks are public agencies, their Presidents report to boards of directors constituted in part from their member banks, which therefore enjoy special access to the formation and conduct of monetary policy.

The constitutionality of this arrangement was challenged by the Chairman of this committee in the 1970s, Henry Reuss. The issue posed in Reuss v. Bolles was whether the voting status of the Federal Reserve Bank Presidents on the FOMC violates the appointments clause of the Constitution. Unfortunately neither Reuss, nor later Senator Riegle could establish standing to sue, and ultimately (when Senator Baucus did establish standing) the Supreme Court denied cert in the matter, so the issue was never tested in court. Nevertheless, there is little doubt that

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[1] Lloyd M. Bentsen, jr. Chair in Government/Business Relations and Professor of Government, The University of Texas at Austin; Senior Scholar, Levy Economics Institute and Chair of the Board, Economists for Peace and Security.

Reuss was right on the merits. The FOMC is a constitutional anomaly, whose voting members are not all duly constituted "officers of the United States" as the Constitution requires.

Does the role of a systemic risk regulator conflict with the conduct of monetary policy, vested in the FOMC and partly therefore under the influence of the regulated banks? Clearly, in principle, the interests of the member banks could differ from the public interest in system stability. Member bank interests could also come into conflict with those of other financial holding companies, whose representatives do not sit on those boards of directors, but which would come under the purview of this system. This raises the question of a perceived conflict, at the level of institutional design.

It is difficult to say how serious that conflict might be in practice. But perception is an important problem. The fact that systemic risk examiners would be actually be located inside the regional banks (and not at the Board) adds to the difficulty. The credibility of their function will rest on the perceived effectiveness of internal firewalls separating them from the Directors. Given the institutional set-up, many outside observers will never be convinced.

One way forward would be to eliminate the boards of directors of regional Federal Reserve banks – as should have been done anyway long ago. They could be converted, without loss, into broadly-based advisory boards. Another approach would be to remove the voting power of the regional bank presidents on the FOMC, while locating the systemic risk examiners at the Board rather than within the regional banks. Either measure would eliminate the constitutional anomaly, while also resolving the perception of conflict.

Institutional Conflicts

The difficulty with this solution is that, leaving aside the FOMC, the Federal Reserve Board itself has two large conflicts when it comes to serving effectively as a systemic regulator. The first is institutional. The Board's primary mission is macroeconomic. Rigorous enforcement of safety and soundness regulation is never going to be the first priority of the agency in the run-up to a financial crisis. The issue is whether this problem can be overcome, whether systemic risk regulation can be made a sufficient priority by internal organizational reform.

It would be all too easy for the Federal Reserve Board to open an internal Office of Systemic Risk Assessment, to staff it with mathematical risk modelers, and to let the matter rest there. Then, when the next crisis hits, the Fed would say that it was something "no one could have foreseen" – just because their internal model-builders failed to foresee it. This is probably not the outcome Congress seeks. Nor is it the outcome the administration has in mind.

The Treasury proposal would approach systemic risk regulation in two basic steps. The first is to identify "Tier One Financial Holding Companies," considered to be so large and interconnected as to endanger the system in the event of failure. The second would be the institution of a regime of examination and regulation, as well as capital and liquidity

requirements, for the practices of those companies, to ensure that they are safely operated and adequately capitalized.

Note that the two steps are separable. One is analytical: it involves identifying the institutions that are "systemically risky." It might well be appropriate for this task to be under the purview of an office at the Federal Reserve Board, comprised of lawyers, historians, economists, criminologists, statisticians and mathematicians, who would take evidence and referrals from throughout the government – but especially from the regional Federal Reserve Banks – and make determinations as to who is, and who is not, subject to the T1-FHC regime. Since the idea is to identify large institutions, the numbers would not be large and could be handled, in principle, by a small office, applying general criteria established in law.

To avert the development of dangerous practices within large institutions, systemic risk regulation needs to be deeply integrated into ongoing examination and supervision. Essentially, the job is to recognize emerging patterns of dangerous behavior. This function is best taken on by an agency with experience, expertise, and focus on these functions, an agency with no record of regulatory capture or institutional identification with the interests of the regulated sector.

That agency is the FDIC. The FDIC could establish a bureau for T1-FHCs and stock it with the most experienced examiners, accountants, criminologists and statisticians, whose purpose would be to identify dangerous practices in systemically dangerous institutions and to stop them. Their function would not differ greatly from what the FDIC already does, except insofar as the supervised entities are not covered by the deposit insurance. But the point of designating T1-FHCs is to admit that there is taxpayer exposure in the failure of such institutions, so that from a functional point of view this is a distinction without a difference.

In short, if systemic risk is to be subject to consolidated prudential regulation, why not place that responsibility in the hands of an agency for whom it is the first priority? Heading off systemic risks requires a culture of examination, of accounting, and of actual enforcement, including criminal referrals where fraud is suspected. The FDIC and related entities are better suited to the job of examination and regulation, because they specialize in it.

A Problem of Leadership

The second problem with vesting systemic risk regulation at the Federal Reserve concerns the leadership of the Federal Reserve. The Chair of the Federal Reserve Board is a very high-profile appointment, largely chosen over the years from among people who are close to the banking industry and to the financial sector. Where exceptions are made – as in the case of Chairman Bernanke, an academic – it is considered axiomatic, for the effectiveness of monetary policy, that the outsider win the "confidence of the markets." All of this means that, in a word, Brooksley Born will never be appointed to chair the Federal Reserve Board. And

those who do come to lead at the Federal Reserve, from Benjamin Strong in the 1920s[2] to Alan Greenspan in the 1990s and 2000s, are very likely sooner or later to be swept away in the euphoria of a financial boom, and to come up with every argument as to why they *should not* effectively regulate systemic risk.

Already in 1955, in his classic *The Great Crash, 1929* my father identified this problem:

> "No one can doubt that the American people remain susceptible to the speculative mood – to the conviction that enterprise can be attended by unlimited rewards in which they, individually, were meant to share. A rising market can still bring the reality of riches. This in turn can draw more and more people to participate. The government preventatives and controls are ready. In the hands of a determined government their efficacy cannot be doubted. There are, however, a hundred reasons why a government will determine not to use them."

In the run-up to the financial collapse of August 2007, it was plain to disinterested observers that there was an unsustainable bubble in housing prices. It was plain to the FBI, as early as late 2004, that behind the then-emerging bubble lay an "epidemic of mortgage fraud." It should have been plain to regulators, in an industry where terms like "liars' loans," "neutron loans" and "toxic waste" were part of the business language, that there was a pervasive problem of reckless irresponsibility and fraud in the financial sector, and particularly in the origination and securitization of home mortgages. Federal Reserve economists wrote about systemic risk, but --- blinded by the doctrine of efficient markets --- they failed to identify the epidemic of mortgage fraud. Among insiders only Edward Gramlich clearly saw the emerging problem.

Yet one searches vainly for evidence that his or any of the outside warnings were taken seriously at the top. Chairman Greenspan actively encouraged consumers to sign up for the innovative adjustable-rate mortgage products that would, eventually, destroy the system. Right up to July, 2007 in public statements and testimony before Congress, Chairman Bernanke continued to say that problems in the housing sector were manageable, and that the "predominant risk" was inflation. No doubt this emphasis reflected the macroeconomic priorities of the Federal Reserve at the time. Perhaps there was, also, a calculated desire to maintain public confidence. But that is precisely the problem. An effective systemic-risk regulator would not have those conflicting considerations.

My answer to the first question is therefore, "yes." There are ways in which the macro-economic role of the Federal Reserve could come into perceived or actual conflict with its capacity to regulate systemic risk effectively.

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[2] Strong was not chair of the Board, but Governor of the FRB of New York, and chair of the Committee of Governors on Centralized Execution of Purchases and Sales of Government Securities by Federal Reserve Banks. In this capacity he dominated policy in those years.

Would it be necessary to insulate the Fed's traditional independence in executing monetary policy from its new role as systemic risk regulator, and if so, how could that be accomplished?

I find this question difficult to understand. The Federal Reserve should not of course *ever* conduct monetary policy in ways that undermine systemic stability and sustainability. Unfortunately on occasion it has done so. The Fed's failure to use the regulatory tools it has – including margin requirements in the 1990s information technology boom and the bully pulpit as well as its examination authority in the housing bubble of the past few years, are precisely failures to take account of systemic risk in the work of monetary policy.

If the Federal Reserve is to have control of systemic risk regulation, then the goal of institutional design should be to give that regulation priority, and to ensure that it is integrated into, and not separated from, the execution of monetary policy. For the reasons given earlier in this testimony, this is intrinsically very difficult goal to achieve. It would be better, therefore, to vest the regulation of systemic risk in an agency that is focused on that objective.

What are public policy considerations for and against making the Fed the systemic risk regulator, given its role as central banker and independent authority on monetary policy?

There is an argument in favor of consolidating systemic risk regulation into the Federal Reserve's existing role as lender of last resort. The lender of last resort function is there to keep the financial system from collapsing in panic when systemic regulation fails. It may make sense for the same agency to be charged with both establishing the fire code and dispatching the fire trucks. But – to make my earlier point once again – it is clear that such an agency should not be, in any way, under the influence of the arsonists. The Federal Reserve's institutional structure and political history raise doubts about its independence in this respect.

A principal public policy consideration is the actual track record of the agency in predicting and averting systemic risk. By any standard, the record of the Federal Reserve in this area, from Greenspan's "New Paradigm" in advance of the 2000 technology crash to Bernanke's "predominant risk of inflation" in advance of the Great Crisis, is poor. (As I documented in a review of Bob Woodward's book on Greenspan in 2001[3], the Fed's leadership was also poor in slumps, always fearing inflation when none actually threatened, dragging its heels in providing support for the economy when that would have been most useful, and anticipating recoveries long before they occurred.) It does not seem reasonable to add an additional task to the burdens of an agency that has difficulty, even in relatively ordinary times, in handling the macroeconomic role of central banker and "independent authority on monetary policy."

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[3] "Watching Greenspan Grow: Justin Martin, Greenspan: The Man Behind Money, and Bob Woodward, Maestro: Alan Greenspan and the American Boom," The American Prospect, Vol. 12, No. 2, January 29, 2001, pp. 36-38.

The final question is whether the Fed "should relinquish any roles and why"?

The administration proposes to remove the role of consumer protection from the Federal Reserve, and to give that function to a new Consumer Financial Product Commission. In line with the view that important regulatory functions should go to entities that specialize in those functions, I'm inclined to support this proposal. Everything depends, of course, on powers, staffing, leadership and implementation.

More broadly, the administration's proposal sets out to restore the shadow banking system and all the various securities markets that have arisen in the past fifteen years or so, including credit default swaps. The underlying presumption is that these markets serve public purpose, that they can be restored, and that they should, in fact, be restored.

The presumption is not correct. The sub-prime and alt-a mortgages that caused the crisis could never have been securitized had there not been a systematic failure of the credit rating agencies to examine the documentation behind the loans, and a reliance instead on statistical models in giving out ratings. Now the ratings agencies have lost credibility entirely. It is by no means clear that these markets can now be restored, because trust in the underlying documentation cannot be conjured out of thin air. It would be necessary to establish, credibly, that the residential mortgage backed securities held by the banking system are not hopelessly contaminated by misrepresentation, missing documentation, imperfect assignments of title, and fraud. Yet the evidence that we have, so far, leads prudent observers in the opposite direction.[4]

Similarly, the market in over-the-counter credit default swaps is less than a decade old, having been legalized only in 2000. These instruments are intrinsically dangerous; Warren Buffett's characterization as "weapons of financial mass destruction" is apt. Why tolerate their existence? Humanity got along quite well for thousands of years without them.

Would the country be worse off with a smaller, simpler financial system, largely operating out of institutions called banks and thrifts, themselves reorganized, downsized, broken up, more competitive and less profitable than the financial sector has been in recent years? I can see no reason to permit the continued existence, let alone to foster the market dominance, of financial institutions so large as to be unmanageable by their own top leadership, let alone efficiently regulated by public authority. Edward Liddy, CEO of AIG, has written that he realized quite early on that the firm was "too complex, too unwieldy and too opaque" to manage as a going concern. In general, "too big to fail" is a synonym for "too big to manage" and "too big to regulate." Such institutions exist, in part, to help with international tax evasion, to evade

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[4] For months, Congressman Doggett has been pressing the Treasury department to conduct an evaluation of the quality of the documentation behind the mortgage-backed securities held by the banking system. Despite a promise in March to do so, Secretary Geithner has not responded to Congressman Doggett's request.

regulations, to project political power, to facilitate the kind of "financial innovation" that is the essence of systemic risk.. They are intrinsically unsafe. An appropriate goal of public policy would be to shrink them, permitting other institutions of more reasonable size, more conservative practice and greater alignment with public purpose to grow into their market space.

Unlike scientific knowledge, in this case the genie *can* be put back into the bottle. If a contract is declared unenforceable, it generally will not be made. If institutions like hedge and private equity funds are to be considered as posing systemic risks similar to banks, they can be declared to be banks, and regulated as such. Money market mutual funds, which are now subject to insurance, can be reconstituted and regulated as narrow banks, as I believe Chairman Volcker has advocated. The problem of regulation will be simplified, if we recognize that the crisis presents an opportunity to simplify, restructure and downsize the entire structure financial system. Then some of the complex tasks envisioned for the regulatory agencies in the Obama plan would become much easier. Having given the task of regulating systematically-dangerous institutions to the FDIC, one medium-term goal of regulatory policy would be, in as many cases as possible, to alter those institutions, so that after five years or so they can be declared no-longer-dangerous, and removed from the T1-FHC list.

Moreover, there is precedent for reorganization of this kind. An exotic but very clear example is the reorganization of airlines in China. In that country, as travelers from the old days may recall, there used to be a single, national airline, which was an inefficient, obsolete and dangerous state monopoly. The response of the government was not to privatize the monopoly, but to break up the company, and to allow other parts of the government, at the provincial and municipality level, to form their own competing airlines. The result was a riot of competition, a huge increase in efficiency, and improvement in service quality as travelers in modern China observe every day. There is nothing uniquely Chinese about this: as it happens the idea originated in the early 1980s with an American physicist, John Archibald Wheeler, and was relayed to the Chinese government by a Chinese physicist then working in the United States.

Competition generally improves efficiency, lowers profitability due to market power, and can reduce the rent-seeking, lobby-driven politics associated with the relationship between industry and government. If large banks and other large financial holding companies pose systemic risks, then why not require them to shrink, to divest, and otherwise reduce the concentration of power that presently exists in the financial sector? I do not argue that this would be, by itself, sufficient to control all systemic risks. But it would help, over time, bring the scale of financial activity into line with the capacity of supervisory authorities to regulate it, and the result would be a somewhat safer system.

Thank you for your time and attention.

For release on delivery
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July 9, 2009

Statement of

Donald L. Kohn

Vice Chairman

Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy and Technology

Committee on Financial Services

U.S. House of Representatives

July 9, 2009

Chairman Watt, Ranking Member Paul, and other members of the Subcommittee, I appreciate the opportunity to discuss with you the important public policy reasons why the Congress has long given the Federal Reserve a substantial degree of independence to conduct monetary policy while ensuring that we remain accountable to the Congress and to the American people. In addition, I will explain why an extension of the Federal Reserve's supervisory and regulatory responsibilities as part of a broader initiative to address systemic risks would be compatible with the pursuit of our statutory monetary policy objectives. I also will discuss the significant steps the Federal Reserve has taken recently to improve our transparency and maintain accountability.

Independence and Accountability

A well-designed framework for monetary policy includes a careful balance between independence and accountability. A balance of this type conforms to our general inclination as a nation to have clearly drawn lines of authority, limited powers, and appropriate checks and balances within our government; such a balance also is conducive to sound monetary policy.

The Federal Reserve derives much of the authority under which it operates from the Federal Reserve Act. The act specifies and limits the Federal Reserve's powers. In 1977, the Congress amended the act by establishing maximum employment and price stability as our monetary policy objectives; the Federal Reserve has no authority to establish different objectives. At the same time, the Congress has--correctly, in my view--given the Federal Reserve considerable scope to design and implement the best approaches to achieving those statutory objectives. Moreover, as I will discuss in detail later, the independence that is granted to the Federal Reserve is subject to a well-calibrated system of checks and balances in the form of transparency and accountability to the public and the Congress.

The latitude for the Federal Reserve to pursue its statutory objectives is expressed in several important ways. For example, the Congress determined that Federal Reserve policymakers cannot be removed from their positions merely because others in the government disagree with their views on policy issues. In addition, to guard against indirect pressures, the Federal Reserve determines its budget and staff, subject to congressional oversight. Thus, the system has three essential components: broad objectives set by the Congress, independence to pursue those legislated objectives as efficiently and effectively as possible, and accountability to the Congress through a range of vehicles.

Benefits of Independence to Conduct Policy in Pursuit of Legislated Objectives

The insulation from short-term political pressures--within a framework of legislated objectives and accountability and transparency--that the Congress has established for the Federal Reserve has come to be widely emulated around the world. Considerable experience shows that this type of approach tends to yield a monetary policy that best promotes economic growth and price stability. Operational independence--that is, independence to pursue legislated goals--reduces the odds on two types of policy errors that result in inflation and economic instability. First, it prevents governments from succumbing to the temptation to use the central bank to fund budget deficits. Second, it enables policymakers to look beyond the short term as they weigh the effects of their monetary policy actions on price stability and employment.

History provides numerous examples of non-independent central banks being forced to finance large government budget deficits. Such episodes invariably lead to high inflation. Given the current outlook for large federal budget deficits in the United States, this consideration is especially important. Any substantial erosion of the Federal Reserve's monetary independence likely would lead to higher long-term interest rates as investors begin to fear future inflation.

Moreover, the bond rating agencies view operational independence of a country's central bank as an important factor in determining sovereign credit ratings, suggesting that a threat to the Federal Reserve's independence could lower the Treasury's debt rating and thus raise its cost of borrowing.[1] Higher long-term interest rates would further increase the burden of the national debt on current and future generations.[2]

The second way in which political interference with monetary policy can damage the economy is by promoting an undue focus on the short term. Because excessively easy monetary policy tends to boost economic activity temporarily before the destabilizing effects of higher inflation are felt, policymakers with a relatively short-term outlook may be tempted to ease monetary policy too much. The eventual result is higher inflation without any permanent benefit in terms of employment, an outcome that is inconsistent with the dual mandate for maximum employment and price stability. Thus the increase in inflation must be followed by policies to bring inflation back down--policies that have the side effect of temporarily reducing output and employment. The fixed, lengthy, and overlapping terms of Federal Reserve Board members, in combination with the other elements of operational independence, help ensure that the Federal Reserve appropriately considers both the short-term and long-term effects of its policy decisions.

Statistical studies have confirmed that countries with more independent central banks experience lower and more stable rates of inflation with no sacrifice of jobs or income.[3]

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[1] Standard & Poor's (2004), "Sovereign Credit Ratings: A Primer," March 15, www2.standardandpoors.com/spf/pdf/products/SovRatingsPrimer_sov.pdf.

[2] The beneficial effects of central bank independence on a government's borrowing costs have been observed even when budget deficits are not unusually large. For example, on May 6, 1997, the U.K. government announced that the Bank of England would be given considerable operational independence. The yield on 10-year U.K. government bonds fell 30 basis points that day, even though the government made no change to the Bank of England's policy objectives and there was no other prominent economic or policy news. Market participants widely attributed the decline in long-term interest rates to the surprise announcement of independence and the consequent increased confidence in future price stability.

[3] See, for example, the survey in Alex Cukierman (2008), "Central Bank Independence and Monetary Policymaking Institutions--Past, Present, and Future," *European Journal of Political Economy*, vol. 24 (December), pp. 722-36.

Moreover, low and stable rates of inflation help to deliver strong economic growth and high rates of employment. The benefits of central bank independence appear to be a major explanation for the trend I mentioned earlier of countries moving to establish or to enhance the independence of their central banks. It is surely no coincidence that countries around the world have experienced sustained declines in the level and variability of inflation as they have moved to grant their central banks greater operational independence.

Monetary Policy Independence and the Mitigation of Systemic Risk

Is monetary policy independence threatened by giving a central bank other responsibilities, such as supervisory and regulatory authority for some parts of the financial system? Are there potential conflicts between a high degree of independence for monetary policy and accountability in supervisory and regulatory policy? I believe that U.S. and foreign experience shows that monetary policy independence and supervisory and regulatory authority are mutually compatible and even have beneficial synergies.

The current financial crisis has clearly demonstrated the need for the United States to have a comprehensive and multifaceted approach to containing systemic risk. The Administration recently released a proposal for strengthening the financial system that would provide new or enhanced responsibilities to a number of federal agencies, including the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission with respect to over-the-counter derivatives, the SEC with respect to hedge funds and their advisers, and several agencies, including the Treasury, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the SEC with respect to the resolution of systemically important failing nonbank financial institutions. In addition, the proposal would

provide the Federal Reserve certain new responsibilities for overseeing systemically important financial institutions and payment, clearing, and settlement arrangements.

These incremental new responsibilities are a natural outgrowth of the Federal Reserve's existing supervisory and regulatory responsibilities. Through our role as consolidated supervisor of all bank holding companies (BHCs), the Federal Reserve has long been responsible for supervising many of the most important U.S. financial organizations, and in the current crisis several more large complex financial firms--including Goldman Sachs, Morgan Stanley, and American Express--have become bank holding companies. And the expanded regulatory authority of the Federal Reserve with respect to payment and settlement systems builds upon our existing responsibilities for supervising certain critical payment, clearing, and settlement systems, such as the Depository Trust Company and CLS Bank, as well as our historical efforts to reduce risk in such systems through, for example, our Payment System Risk Policy.[4]

The authorities that the Administration's proposal would provide the Federal Reserve with respect to systemically important non-BHC financial firms and payment, clearing and settlement systems also are similar in many respects to the authorities that the Federal Reserve currently has with respect to bank holding companies and payment, clearing, and settlement systems under our supervision. The Administration's proposal does call for a more macro-prudential approach to the supervision and regulation of systemically important financial firms and payment, clearing, and settlement systems, including the establishment of higher capital, liquidity, and risk-management requirements for systemically important firms. The Federal Reserve already has been moving to incorporate a more macro-prudential approach to our supervisory and regulatory programs, as evidenced by the recently completed Supervisory

[4] The Federal Reserve's Payment System Risk Policy can be found at http://www.federalreserve.gov/paymentsystems/psr/default.htm.

Capital Assessment Program. The Federal Reserve has also long been a leader in the development of strong international risk-management standards for payment, clearing, and settlement systems and has implemented these standards for the systems it supervises.

In our supervision of bank holding companies and our oversight of some payment systems, we already work closely with other federal and state agencies and participate in groups of regulators and supervisors such as the Federal Financial Institutions Examination Council and the President's Working Group on Financial Markets. These responsibilities and close working relationships have not impinged on our monetary policy independence, and we do not believe that the enhancements proposed by the Administration to the Federal Reserve's supervisory and regulatory authority would undermine the Federal Reserve's ability to pursue our monetary policy objectives effectively and independently.

Indeed, these enhancements would complement the Federal Reserve's monetary policy responsibilities. The Federal Reserve and other central banks have always been involved in issues of systemic risk, most notably because central banks act as lenders of last resort. Central banks, which operate in markets daily and have macroeconomic responsibilities, bring a broad and unique perspective to analysis of developments in the financial system. And, as we have seen over the past two years, threats to the stability of the financial system can have major implications for employment and price stability. Thus, 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.

Accountability and Transparency

In a democracy, any significant degree of independence by a government agency must be accompanied by substantial accountability and transparency. The Congress and the Federal Reserve have established a number of policies and procedures to ensure that the Federal Reserve continues to use its operational independence in a manner that promotes the nation's well-being. The Federal Reserve reports on its experience toward achieving its statutory objectives in the semiannual *Monetary Policy Report*s and associated congressional testimony. The Federal Open Market Committee (FOMC) releases a statement immediately after each regularly scheduled meeting and detailed minutes of each meeting on a timely basis. We also publish summaries of the economic forecasts of FOMC participants four times a year. In addition, Federal Reserve officials frequently testify before the Congress and deliver speeches to the public on a wide range of topics, including economic and financial conditions and monetary and regulatory policy.

Our financial controls are examined by an external auditor, and Reserve Bank operations and controls are reviewed by each Reserve Bank's independent internal audit function and by Board staff who oversee Reserve Bank activities. We provide the public and the Congress with detailed annual reports on the consolidated financial activities of the Federal Reserve System that are audited by an independent public accounting firm. We also publish a detailed balance sheet on a weekly basis.

The Federal Reserve recognizes that the new programs we have instituted to combat the financial crisis must be accompanied by additional transparency. Americans have a right to know how the Federal Reserve is using taxpayer resources and they need to be assured that we are acting in a responsible manner that minimizes risk and maintains the integrity of our operations. We have increased the transparency of our actions while safeguarding our ability to

achieve our public policy goals of fostering financial and economic stability. This year we expanded our website to include considerable background information on our financial condition and our policy programs. Recently, we initiated a monthly report to the Congress and the public on Federal Reserve liquidity programs that provides even more information on our lending, the associated collateral, and other facets of programs established to address the financial crisis. These steps should help the public understand the considerable efforts we have taken to minimize the risk of loss as we provide liquidity to the financial system in our role as lender of last resort. Altogether, we now provide a higher degree of transparency than at any other time in the history of the Federal Reserve System. Because of the large volume of information we publish, the Federal Reserve is among the most transparent central banks in the world.

Federal Reserve policymakers are highly accountable and answerable to the government of the United States and to the American people. The seven members of the Board of Governors of the Federal Reserve System are appointed by the President and confirmed by the Senate after a thorough process of public examination. The key positions of Chairman and Vice Chairman are subject to presidential and congressional review every four years, a separate and shorter schedule than the 14-year terms of Board members. The members of the Board of Governors account for seven seats on the FOMC. By statute, the other five members of the FOMC are drawn from the presidents of the 12 Federal Reserve Banks. District presidents are appointed through a process involving a broad search of qualified individuals by local boards of directors; the choice must then be approved by the Board of Governors. In creating the Federal Reserve System, the Congress combined a Washington-based Board with strong regional representation to carefully balance the variety of interests of a diverse nation. The Federal Reserve Banks

strengthen our policy deliberations by bringing real-time information about the economy from their district contacts and by their diverse perspectives.

Oversight by the Government Accountability Office

On the topic of Federal Reserve accountability and transparency, the possibility of expanding the audit authority of the Government Accountability Office (GAO) over the Federal Reserve has recently been discussed. As you know, the Federal Reserve is subject to frequent audits by the GAO on a broad range of our functions.

For example, the supervisory and regulatory functions of the Federal Reserve are subject to audit by the GAO to the same extent as the supervisory and regulatory functions of the other federal banking agencies. Thus, the GAO has full authority to--and does in fact--audit the manner in which the Federal Reserve supervises and regulates bank holding companies on a consolidated basis. Moreover, if the Congress were to provide the Federal Reserve with responsibility for serving as the consolidated supervisor of systemically important financial firms that are not bank holding companies, the GAO would, under existing law, have full authority to audit the Federal Reserve's supervision and regulation of such firms as well. We would expect the GAO to actively use that authority, as it does today. Indeed, as of June 29, 2009, the GAO had 19 engagements under way involving the Federal Reserve, including 14 that were initiated at the request of the Congress. In addition, since the beginning of 2008, the GAO has completed 26 engagements involving the Federal Reserve, including engagements related to the Basel II capital framework, risk-management oversight, the Bank Secrecy Act, and the Board's Regulation B, which implements the Equal Credit Opportunity Act.

The Congress also recently clarified the GAO's ability to audit the Term Asset-Backed Securities Loan Facility (TALF), a joint Treasury-Federal Reserve initiative, in conjunction with

the GAO's reviews of the performance of Treasury's Troubled Asset Relief Program (TARP). The Federal Reserve has been working closely with the GAO to provide that agency with access to information and personnel to permit it to fully understand the terms, conditions, and operations of the TALF so that the TARP can be properly audited. At the same time, the Congress granted the GAO new authority to conduct audits of the credit facilities extended by the Federal Reserve to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act, including the loan facilities provided to, or created for, American International Group and Bear Stearns. These facilities are markedly different from the widely available credit facilities--such as the discount window access for depository institutions, the Primary Dealer Credit Facility, and the Commercial Paper Funding Facility--that the Federal Reserve either has historically used or has recently established to address broad credit and liquidity issues in the financial system. For this reason, the Federal Reserve did not object to granting the GAO audit authority over these institution-specific, emergency credit facilities.

The Congress, however, has purposefully--and for good reason--excluded from the scope of potential GAO audits monetary policy deliberations and operations, including open market and discount window operations, and transactions with or for foreign central banks, foreign governments, and public international financing organizations. By excluding these areas, the Congress has carefully balanced the need for public accountability with the strong public policy benefits that flow from maintaining the independence of the central bank's monetary policy functions and avoiding disruption to the nation's foreign and international relationships.

The same public policy reasons that supported the creation of these exclusions in 1978 remain valid today. The Federal Reserve strongly believes that removing the statutory limits on GAO audits of monetary policy matters would be contrary to the public interest by tending to

undermine the independence and efficacy of monetary policy in several ways. First, the GAO serves as the investigative arm of the Congress and, by law, must conduct an investigation and prepare a report whenever requested by the House or Senate or a committee with jurisdiction of either body. Through its investigations and audits, the GAO typically makes its own judgments about policy actions and the manner in which they are implemented, as well as recommendations to the audited agency and to the Congress for changes or future actions. Accordingly, financial markets likely would see the grant of audit authority with respect to monetary policy to the GAO as undermining monetary independence--with the adverse consequences discussed previously--particularly because GAO audits, or the threat of a GAO audit, could be used to try to influence monetary policy decisions.

Permitting GAO audits of monetary policy also could cast a chill on monetary policy deliberations through another channel. Although Federal Reserve officials regularly explain the rationale for their policy decisions in public venues, the process of vetting ideas and proposals, many of which are never incorporated into policy decisions, could suffer from the threat of public disclosure. If policymakers believed that GAO audits would result in published analyses of their policy discussions, they might be less willing to engage in the unfettered and wide-ranging internal debates that are essential to identifying the best possible policy options. Moreover, the publication of the results of GAO audits related to monetary policy actions and deliberations could complicate and interfere with the communication of the FOMC's intentions regarding monetary policy to financial markets and the public more broadly. Households, firms, and financial market participants might be uncertain about the implications of the GAO's findings for future decisions of the FOMC, thereby increasing market volatility and weakening the ability of monetary policy actions to achieve their desired effects.

These concerns extend to the policy decisions to implement the discount window and broadly available credit facilities. These facilities are extensions of our responsibility for promoting financial stability, maximum employment and price stability. Indeed, unlike the institution-specific loans that the Federal Reserve has made that now are subject to GAO audit, these broader market facilities are designed to unfreeze financial markets and lower interest rate spreads in concert with our other monetary policy actions. It is important that, like other monetary policy decisions, the Federal Reserve remain independent in making policy decisions regarding these facilities.

An additional concern is that permitting GAO audits of the broad liquidity facilities the Federal Reserve uses to affect credit conditions could reduce the effectiveness of these facilities in helping promote financial stability, maximum employment, and price stability. For example, even if strong confidentiality restrictions were established, individual banks might be more reluctant to borrow from the discount window if they knew that their identity and other sensitive information about their borrowings could be disclosed to the GAO. Rumors that a bank may have used the discount window can cause a damaging loss of confidence even to a fundamentally sound institution. Experience, including experience in the current financial crisis, shows that banks' unwillingness to use the discount window can result in high and volatile short-term interest rates and limit the effectiveness of the discount window as a tool to enhance financial stability.

Overall, the Federal Reserve believes that removing the remaining statutory limits on GAO audits of monetary policy and discount window functions would tend to undermine public and investor confidence in monetary policy by raising concerns that monetary policy judgments in pursuit of our legislated objectives would become subject to political considerations. As a

result, such an action would increase inflation fears and market interest rates and, ultimately, damage economic stability and job creation.

Thank you for inviting me to present the Board's views on this very important subject. I look forward to answering any questions you may have.

Regulatory Reform and the Federal Reserve

By Allan H. Meltzer

The Allan H. Meltzer University Professor of Political Economy and Visiting Scholar at the American Enterprise Institute

Testimony, July 9, Subcommittee on Monetary Policy, House Committee on Financial Services

Thank you for the opportunity to present my appraisal of the administration's proposal for regulatory changes. I will confine most of my comments to the role of the Federal Reserve as a systemic regulator and will offer an alternative proposal. I share the belief that change is needed and long delayed, but appropriate change must protect the public, not bankers.

During much of the past 15 years, I have written three volumes entitled A History of the Federal Reserve. Working with two assistants we have read virtually all of the minutes of the Board of Governors, the Federal Open Market Committee, and the Directors of the Federal Reserve Bank of New York. We have also read many of the staff papers and internal memos supporting decisions. I speak from that perspective.

Two findings are very relevant to the role of the Federal Reserve. First, I do not know of any clear examples in which the Federal Reserve acted in advance to head off a crisis or a series of banking or financial failures. We know that the Federal Reserve did nothing about thrift industry failures in the 1980s. Thrift failures cost taxpayers $ 150 billion. AIG, Fannie and Freddie will be much more costly. Of course, the Fed did not have responsibility for the thrift industry, but many thrift failures posed a threat to the financial system that the Fed should have tried to mitigate. The disastrous outcome was not a mystery that appeared without warning. Peter Wallison, Alan Greenspan, Bill Poole, Senator Shelby and others warned about the excessive risks taken by Fannie and Freddy, but Congress failed to legislate. Why should anyone expect a systemic risk regulator to get requisite Congressional action under similar circumstances? Can you expect the Federal Reserve as systemic risk regulator to close Fannie and Freddie after Congress declines to act?

Conflicts of this kind, and others, suggest that that the administration's proposal is incomplete. Defining "systemic risk" is an essential, but missing part of the proposal. Trying to define the authority of the regulatory authority when Congress has expressed an interest points up a major conflict.

During the Latin American debt crisis, the Federal Reserve acted to hide the failures and losses at money center banks by arranging with the IMF to pay the interest on Latin debt to those banks. This served to increase the debt that the governments owed, but it kept the banks from reporting portfolio losses and prolonged the debt crisis. The crisis ended after one of the New York banks decided to write off the debt and take the loss. Others followed. Later, the Treasury offered the Brady plans. The Federal Reserve did nothing.

In the dot-com crisis of the late 1990s, we know the Federal Reserve was aware of the growing problem, but it did not act until after the crisis occurred. Later, Chairman Greenspan recognized that it was difficult to detect systemic failures in advance. He explained that the Federal Reserve believed it should act after the crisis, not before. Intervention to control soaring asset prices would impose large social costs of unemployment, so the Federal Reserve, as systemic risk regulator would be unwise to act.

The dot com problem brings out that there are crises for which the Federal Reserve cannot be effective. Asset market exuberance and supply shocks, like oil price increases, are non-monetary so cannot be prevented by even the most astute, far-seeing central bank.

We all know that the Federal Reserve did nothing to prevent the current credit crisis. Before the crisis it kept interest rates low during part of the period and did not police the use that financial markets made of the reserves it supplied. The Board has admitted that it did not do enough to prevent the crisis. It has not recognized that its actions promoted moral hazard and encouraged incentives to take risk. Many bankers talked openly about a "Greenspan put," their belief that the Federal Reserve would prevent or absorb major losses.

It was the Reconstruction Finance Corporation, not the Fed, that restructured banks in the 1930s. The Fed did not act promptly to prevent market failure during the 1970 Penn Central failure, the Lockheed and Chrysler problems or on other occasions. In 2008, the Fed assisted in salvaging Bear Stearns. This continued the too-big-to-fail (TBTF) policy and increased moral

hazard. Then without warning, the Fed departed from the course it had followed for at least 30 years and allowed Lehman to fail in the midst of widespread financial uncertainty. This was a major error. It deepened and lengthened the current deep recession.

In 1990-91, the Fed kept the spread between short- and long-term interest rates large enough to assist many banks to rebuild their capital and surplus. This is a rare possible exception, a case in which Federal Reserve action to delay an increase in the short-term rate may have prevented banking failures.

Second, in its 96-year history, the Federal Reserve has never announced a lender-of-last-resort policy. It has discussed internally the content of such policy several times, but it rarely announced what it would do. And the announcements it made, as in 1987, were limited to the circumstances of the time. Announcing and following a policy would alert financial institutions to the Fed's expected actions and might reduce pressures on Congress to aid failing entities. Following the rule in a crisis would change bankers' incentives and reduce moral hazard. A crisis policy rule is long overdue. The administration proposal recognizes this need.

A lender-of-last-resort rule is the right way to implement policy in a crisis. We know from monetary history that in the 19th century the Bank of England followed Bagehot's rule for a half-century or more. The rule committed the Bank to lend on "good" collateral at a penalty rate during periods of market disturbance. Prudent bankers borrowed from the Bank of England and held collateral to be used in a panic. Banks that lacked collateral failed.

Financial panics occurred. The result of following Bagehot's rule in crises was that the crises did not spread and did not last long. There were bank failures, but no systemic failures. Prudent bankers borrowed and paid depositors cash or gold. Bank deposits were not insured until much later, so bank runs could cause systemic failures. Most bankers were prudent and held more capital and reserves in relation to their size than banks currently do, and they held more collateral to use in a crisis also.

These experiences suggest three main lessons. First, we cannot avoid banking failures but we can keep them from spreading and creating crises. Second, neither the Federal Reserve nor any other agency has succeeded in predicting crises or anticipating systemic failure. It is

hard to do, in part because systemic risk is not well defined. Reasonable people will differ, and since much is often at stake, some will fight hard to deny that there is a systemic risk.

One of the main reasons that Congress in 1991 passed FDICIA (Federal Deposit Insurance Corporation Improvement Act) was to prevent the Federal Reserve from delaying closure of failing banks, increasing losses and weakening the FDIC fund. The Federal Reserve and the FDIC have not used FDICIA against large banks in this crisis. That should change.

The third lesson is that a successful policy will alter bankers' incentives and avoid moral hazard. Bankers must know that risk-taking brings both rewards and costs, including failure, loss of managerial position and equity followed by sale of continuing operations.

An Alternative Proposal

Several reforms are needed to reduce or eliminate the cost of financial failure to the taxpayers. Members of Congress should ask themselves and each other: Is the banker or the regulator more likely to know about the risks on a bank's balance sheet? Of course it is the banker, and especially so if the banker is taking large risks that he wants to hide. To me that means that reform should start by increasing a banker's responsibility for losses. The administration's proposal does the opposite by making the Federal Reserve responsible for systemic risk.

Systemic risk is a term of art. I doubt that it can be defined in a way that satisfies the many parties involved in regulation. Members of Congress will urge that any large failure in their district is systemic. Administrations and regulators will have other objectives. Without a clear definition, the proposal will bring frequent controversy. And without a clear definition, the proposal is incomplete.

Resolving the conflicting interests is unlikely to protect the general public. More likely, regulators will claim that they protect the public by protecting the banks.

The administration's proposal sacrifices much of the remaining independence of the Federal Reserve. Congress, the administration, and failing banks or firms will want to influence decisions about what is to be bailed out. I believe that is a mistake. If we use our capital to avoid failures instead of promoting growth we not only reduce growth in living standards we

also sacrifice a socially valuable arrangement—central bank independence. We encourage excessive risk-taking and moral hazard.

I believe there are better alternatives than the administration's proposal.

First step: End TBTF. Require all financial institutions to increase capital more than in proportion to their increase in size of assets. TBTF is perverse. It allows banks to profit in good times and shifts the losses to the taxpayers when crises or failures occur.

My proposal reduces the profits from giant size, increases incentives for prudent banker behavior by putting losses back to managements and stockholders where they belong. Benefits of size come from economies of size and scale. These benefits to society are more than offset by the losses society takes in periods of crisis. Congress should find it hard to defend a system that distributes profits and losses as TBTF does. I believe that the public will not choose to maintain that system forever. Permitting losses does not eliminate services; failure means that management loses its position and stockholders take the losses. Profitable operations continue and are sold at the earliest opportunity.

Second step: Require the Federal Reserve to announce a rule for lender-of-last- resort. Congress should adopt the rule that they are willing to sustain. The rule should give banks an incentive to hold collateral to be used in a crisis period. Bagehot's rule is a great place to start.

Third step: Recognize that regulation is an ineffective way to change behavior. My first rule of regulation states that lawyers regulate but markets circumvent burdensome regulation. The Basel Accord is an example. Banks everywhere had to increase capital when they increased balance sheet risk. The banks responded by creating entities that were not on their balance sheet. Later, banks had to absorb the losses, but that was after the crisis. There are many other examples of circumvention from Federal Reserve history. The reason we have money market funds was that Fed regulation Q restricted the interest that the public could earn. Money market funds bought unregulated, large certificates of deposit. For a small fee they shared the higher interest rate with the public. Much later Congress agreed to end interest rate regulation. The money funds remained.

Fourth step: Recognize that regulators do not allow for the incentives induced by their regulations. In the dynamic, financial markets it is difficult, perhaps impossible, to anticipate how clever market participants will circumvent the rules without violating them. The lesson is to focus on incentives, not prohibitions. Shifting losses back to the bankers is the most powerful incentive because it changes the risk-return tradeoff that bankers and stockholders see.

Fifth step: Either extend FDICIA to include holding companies or subject financial holding companies to bankruptcy law. Make the holding company subject to early intervention either under FDICIA or under bankruptcy law. That not only reduces or eliminates taxpayer losses, but it also encourages prudential behavior.

Other important changes should be made. Congress should close Fannie Mae and Freddie Mac and put any subsidy for low-income housing on the budget. The same should be done to other credit market subsidies. The budget is the proper place for subsidies.

Congress, the regulators, and the administration should encourage financial firms to change their compensation systems to tie compensation to sustained average earnings. Compensation decisions are too complex for regulation and too easy to circumvent. Decisions should be management's responsibility. Part of the change should reward due diligence by traders. We know that rating agencies contributed to failures. The rating problem would be lessened if users practiced diligence of their own.

Three principles should be borne in mind. First, banks borrow short and lend long. Unanticipated large changes can and will cause failures. Our problem is to minimize the cost of failures to society. Second, remember that capitalism without failure is like religion without sin. It removes incentives for prudent behavior. Third, those that rely on regulation to reduce risk should recall that this is the age of Madoff. The Fed, too, lacks a record of success in managing large risks to the financial system, the economy and the public. Incentives for fraud, evasion, and circumvention of regulation often have been far more powerful than incentives to enforce regulation that protects the public.

Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation

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Testimony to the House Financial Services Committee,
Subcommittee on Domestic Monetary Policy and Technology

July 9, 2009

[1] The views expressed here are my own and do not necessarily reflect the views of Macroeconomic Advisers, LLC.

Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation

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The independence of central banks with respect to monetary policy is absolutely essential. Policies that are focused on financial stability, including intervention at specific financial institutions, on the other hand, require a more cooperative effort, including, in the U.S., the central bank, functional regulators of banks and non-bank subsidiaries, and a clear role for the Treasury. However, there needs to be a bright line between the more cooperative approach to financial stability policy and the independence of the Fed with respect to monetary policy. This distinction is affirmed in a joint statement of the Department of the Treasury and the Board of Governors of the Federal Reserve System on March 23, 2009: "While the Federal Reserve has traditionally collaborated with other agencies in efforts to preserve financial stability, it alone is responsible for monetary policy...The Federal Reserve's independence with respect to monetary policy is critical to ensuring that monetary policy decisions are made only with regard to the long-term economic welfare of the nation." I believe, implicit in this statement and explicit in the Treasury's regulatory reform proposal is the conviction, which I share, that the Fed's joint but collaborative responsibility for financial stability does not conflict with its singular responsibility as independent authority with respect to monetary policy.

The independence of the Fed as monetary policy authority

I do not interpret this hearing as being about or questioning the independence of the Fed with respect to its role as monetary policy authority, but rather focused on how to balance that unquestioned independence with its proposed role as systemic regulator, and indeed whether it would serve the interests of both financial stability and monetary policy to separate these two roles. Nevertheless, I will take a minute to discuss the Fed's independence with respect to monetary policy, because many market participants and some very respectable economists have raised serious concerns about whether the Fed can remain independent in the circumstances that will unfold over the next several years. As a result, these observers are projecting very high rates of inflation over the intermediate term.

This apprehension is based principally on the massive borrowing requirements associated with the deficit today and prospects for very large deficits over the coming years. The question that is asked is whether Congress will intrude on the Fed's independence if this massive borrowing leads to sky-rocketing interest rates, with significant costs to long-run growth prospects as well as to near-term growth and unemployment. Will Congress insist that the Fed help out by maintaining interest rates too low for too long, leading to significantly higher inflation, and thereby inflating away some of the debt and debt service burden? A surprising number of savvy investors and well respected economists share the view that this is either possible or even probable. The best antidote to these

fears is to both take disciplined action to lower the deficit and to reaffirm in no uncertain terms your unequivocal commitment to the independence of the Fed.

To what extent if any would the newly proposed role as systemic risk regulator be in conflict with the Fed's traditional role as the independent authority on monetary policy? I don't believe there is a conflict. But, then again, I do not see the Treasury proposal as conferring on the Fed vast new authority as systemic risk regulator to the point where it would become a "super-regulator."

The Fed is already bank holding company (or consolidated) supervisor for all financial institutions that have a bank. Of the systemically important financial institutions today, almost all are already bank holding companies. To be sure, if this were just several months ago, there would have been five systemically important stand-alone investment banks that likely maintained that status to avoid coming under the consolidated supervision of the Fed. These investment banks have failed, been acquired by or merged into bank holding companies, or changed their charter to become a bank holding company. As such, they are already supervised by the Fed. Other institutions that might be designated as systemically important could be a couple of insurance companies, a few systemically important financial firms that are not supervised today and, in principle but initially not likely in practice, large and highly levered hedge funds.

Following up on this theme it should also be recognized that there are functional supervisors of banks and of the investment banking and insurance subsidiaries of bank holding companies. They do much of the heavy lifting of overseeing the risks in their respective parts of the bank holding company. And the Fed, while a functional supervisor of many banks, is not the functional supervisor of many of the largest, systemically important banks. As consolidated supervisor, its responsibility is to ensure that risks emanating from the non-banking subsidiaries do not impose risks to the bank itself, to oversee transactions between the bank, other subsidiaries, and the bank holding company to insure these don't impose risks to the bank, and to ensure that the bank holding company itself has sufficient capital to support the bank if necessary.

The Fed would likely be a more active bank holding supervisor under the Treasury's proposal, no longer limited to the so-called "Fed-lite" approach prescribed by Gramm-Leach-Bliley. It should continue to rely predominantly on the reports of the functional supervisors, but it is now free to join examinations and impose higher capital requirements, after consultation with the functional supervisors.

The Fed also gets explicit regulatory and supervisory authority over the institutions that form the backbone of the payments system. Previously it had to use moral suasion to influence them – but it is pretty good at moral suasion.

Finally, there are two potential roles of a systemic risk regulator. The first is the consolidated supervision of all systemically important financial institutions. This is the role the Fed gets under the Treasury proposal. The second is as monitor of emerging systemic risks, not looking at individual financial institutions, but across markets, sectors,

practices, instruments, asset prices, etc. That is a role that has been assigned to the new Financial Services Oversight Council, of which the Fed is a member, but is chaired by and staffed by the Treasury.

There has been some debate about whether the Fed's role in bank and bank holding company supervision today complements or conflicts with its role in monetary policy. The role as a hands-on supervisor of some banks and of all bank holding companies, for example, provides first-hand information about the state of the banking sector, which can be a valuable input into the assessment of the economic outlook, especially in periods of extreme stress in the banking sector. The counter-argument is that the Fed's concern for the health of the banking system, derived from its role as a bank and bank holding company supervisor, can encourage the Fed, at times, to sacrifice its macro objectives in order to help the banking system when it is ailing. When I was on the Board, I never witnessed any conflict in practice between these two roles. I don't see why this debate should change as a result of the increase in supervisory reach under the Treasury proposal..

A basic premise for my view is that a central bank should always have a hands-on role in bank supervision. First, central banks always have at least an informal responsibility for monitoring systemic risk, and the banking system is a major source of such risk. Second, the central bank is always a source of liquidity to banks and must therefore have first-hand knowledge of their credit worthiness, and this is especially true in times of stress. In the current episode, the Fed has had to be especially creative in developing liquidity facilities to meet this need. Finally, the central bank will always be called upon to cooperate with Treasury at times of intervention in particular institutions, where the Fed provides liquidity and Treasury should take any credit risk. A good example of this cooperation is the Term Asset-Backed Securities Loan Facility, where the Fed provides liquidity to various securitization markets and the Treasury provides first loss protection. Given the Fed's role already as consolidated supervisor of most systemically important financial institutions, the choice may really be whether to remove the Fed from its current role as bank holding company supervisor or to expand it to cover all systemically important financial institutions. This seems like an obvious choice to me.

Would it be necessary to insulate the Fed's traditional role in executing monetary policy from its new role as systemic risk regulator, and, if so, how could that be accomplished? These two roles are housed in different divisions as well as shared with Reserve Banks, with the supervision division overseen by a committee of Board members and monetary policy made by the FOMC. I don't see any need to separate them any more than they already are.

If one wanted to totally separate these two functions within the Federal Reserve System, some have suggested two different Boards, one for supervisory policy and one for monetary policy. Alternatively, regulatory reform could be much more far-reaching, either by assigning the role of consolidated supervision to one of the other federal banking regulators, or by creating a unified financial services regulator with supervisory authority for banks, investment bank and insurance subsidiaries of bank holding

companies, and stand-alone investment banks and insurance companies to this agency. This has the advantage of promoting consistent prudential supervision of all financial institutions.

However, moving in either direction would be a radical change in the structure of regulation, with uncertain consequences. In any case, the recent experience with extreme stress in the banking system has cast considerable doubt on the wisdom of transferring all banking supervision to another banking supervisor or to a unified financial services agency, and specifically taking the central bank out of the role as a hands-on supervisor of bank holding companies. In periods of stress, it is the central bank that will inevitably be called upon to be the liquidity provider of last resort and, with the Treasury, to intervene when particular institutions are near collapse. In this case, it must have first-hand knowledge of the credit worthiness of institutions it might be called upon to lend to.

What are the public policy considerations for and against making the Fed the systemic risk regulator, given its role as central banker and independent authority on monetary policy?

Let me set out the case for the Fed maintaining both consolidated supervision of systemically important financial institutions and monetary policy. First, the Fed has considerable experience in the role as consolidated supervisor of bank holding companies. Second the two roles are more complementary than conflicting. Third, the central bank will be inevitably called upon to intervene in periods of extreme stress, and the timing and effectiveness of its response can be compromised if it lacks hands-on knowledge about banking organizations. The Fed has already developed a very successful collaborative approach with Treasury and other functional regulators in support of its special role in periods of extreme stress.

The case against could include the following: To the extent that the role of systemic regulator confers upon the Fed vast new authority, there could be some reluctance to augment the power of this already powerful institution. Removing the Fed from its role as systemic supervisor and bank supervisor could allow some consolidation of federal banking supervisors, a worthy goal that the Treasury plan does not accomplish. Separating these two roles would guarantee that any potential conflict between them was eliminated.

Should the Fed relinquish any roles and why?

If the Fed was getting substantial new powers as systemic regulator – and had to devote considerable new resources to this responsibility – then it seems reasonable that it should give up some of its current responsibilities.

One reason for removing some current authority is a political consideration: Congress might be cautious about giving, on net, substantial additional powers to an already very powerful institution. In this case, given my views of the limited degree to which the Fed's current role as bank holding company supervisor is expanded in the Treasury proposal, it is not obvious that the case for giving something else is powerful from this perspective. If something is to be given up, the most obvious choice is consumer

protection and community affairs. These are not seen around the world as core responsibilities of central banks. The case for giving up consumer protection and consumer affairs is strengthened by Treasury's proposal to unify these responsibilities in a single agency.

The bottom line is that the Fed is the best choice for consolidated supervision of systemically important financial institutions in its current role, as well as in any expanded role under the Treasury proposal, and this authority is much more complimentary than conflicting with its role as an independent authority on monetary policy. Indeed, there is a natural fit between these two roles.

TESTIMONY TO

UNITED STATES HOUSE OF REPRESENTATIVES

SUBCOMMITEE ON DOMESTIC MONETARY POLICY

AND TECHNOLOGY

July 9, 2009

by

Frederic S. Mishkin

It is a pleasure to testify today to the House Subcommittee on Domestic Monetary Policy and Technology on the important issue of what role the Federal Reserve should have as a systemic regulator of the financial system. The subcommittee posed four questions, but I would like to respond to them by providing answers to three questions which deal with the same issues as the questions the Subcommittee posed. Let me comment on each of these in turn.[1]

Should the Federal Reserve Be the Systemic Regulator?

There are four reasons why I believe that the Federal Reserve should be made the systemic regulator of financial markets in the United States.

First, the Federal Reserve has daily trading relationships with market participants as part of its core function of implementing monetary policy and is well placed to monitor market events and to flag looming problems in the financial system. No other public institution in the United States has comparable insight and access to the broad flows in the financial system.

Second, the Federal Reserve's mandate to preserve macroeconomic stability is well matched to the role of ensuring the stability of the financial system. Macroeconomic downturns are often tightly connected to the financial system, and similar analyses, drawing on the disciplines of macroeconomics and financial economics, can provide guidance for both types of oversight. As a result, macroeconomic policy and systemic regulation are tailor made for each other.

Third, the Federal Reserve is among the most independent of government agencies. Successful systemic regulation requires a focus on the long run. Because they face relatively short re-election cycles, politicians tend to focus on the short run. Insulating the systemic regulator from day-to-day interference by politicians will help ensure a systemic regulator's success. The respect and independence that the Federal Reserve enjoys therefore makes it the natural candidates to be the systemic regulator.

[1] This testimony draws heavily on a working paper published by the Squam Lake Working Group on Financial Regulation, "A Systemic Regulator for Financial Markets," which can be found at http://www.cfr.org/publication/19256/systemic_regulator_for_financial_markets.html.

Fourth, the Federal Reserve is the lender of last resort. It has a balance sheet that it can use as a tool to meet systemic financial crises. As the lender of last resort, it will be called on to provide emergency funding in times of crisis. Too often during the current crisis, the Federal Reserve has been drawn in at the last minute to provide funding to institutions about whom they had no firsthand knowledge because they were not supervised by the Federal Reserve.. Bear Stearns, for example, was supervised directly by the SEC and not by the Federal Reserve. No amount of information sharing can substitute for the firsthand information gathered in direct on-site examinations. If the Federal Reserve will be asked to lend money to save an institution, it needs to have firsthand supervisory information.

Should the Federal Reserve Relinquish Any Roles?

I believe that the Federal Reserve should give up its role as a consumer protection regulator. My reasoning for this conclusion is as follows.

The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator. Protecting consumers involve setting and then enforcing the appropriate rules under a transparent legal framework. The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and managing systemic risk may end up devoting too much of its attention to rule enforcement.

A second, and more important, problem with the combination of systemic and consumer regulation is that consumer regulation is highly charged politically. Because consumer regulation affects so many constituents, politicians sometimes put tremendous pressure on regulators to take actions to protect consumers without worrying about unintended consequences. Political pressure on a systemic regulator because politicians are unhappy with its role as a consumer regulator may interfere with the regulator's independence and ability to perform systemic regulation.

The arguments above imply that the role of systemic regulator should be separate from a consumer protection regulator and so if the Federal Reserve is asked to be a systemic regulator it should relinquish its role as a consumer protection regulator.

Are There Dangers From Having the Federal Reserve Become the Systemic Regulator?

There are three dangers from handing this new responsibility to the Fed.

The Congress has appropriately given the Federal Reserve a dual mandate, achieving price stability and maximum sustainable employment. One danger is that the clear focus on achieving output and price stability might become blurred once the Federal Reserve has to focus on financial stability objectives.

Second, there is a danger of increased political pressure on the Fed that could subject it to attacks on its independence when it takes action to reign in risk-taking by systemically important institutions. Not only could this compromise the ability of the Federal Reserve to do its job as a systemic regulator, but attacks on the Federal Reserve's independence because of its actions as a

systemic regulator could spill over to compromise its independence in the conduct of monetary policy. Both theoretical work in economics and past experience has shown that central bank independence is crucial to achieving good monetary policy outcomes.

Third, right now the Fed does not have sufficient resources to take on this new role. Without sufficient resources, the systemic regulator will not be able to identify systemic risks and craft the needed regulations. As I learned when I was a governor of the Fed during the current crisis, its staff has been stretched to the limit. Asking it to become a systemic regulator will stretch already thin resources, perhaps even compromising its ability to conduct monetary policy.

The Bottom Line

Despite these dangers, given the importance of the financial stability goal and the fact that some institution must play the role of the systemic regulator, I strongly believe that the Fed should take on this new task in spite of the difficulties this will pose. Some safeguards can mitigate the difficulties. For example, some central banks have used explicit, numerical long-run inflation objectives to keep the price stability goal firmly in view. As I have argued in speeches when I was a member of the Board of Governors of the Federal Reserve System, the Fed should head in this direction. It is also imperative that Congress reaffirm its support for Federal Reserve independence, which is a serious concern right now. It also needs to be supportive of the Federal Reserve's need for additional resources to perform both its monetary policy and systemic regulator roles.

An important lesson from the current crisis is that we desperately need a systemic regulator, and I am convinced that the Federal Reserve is the only logical choice.

Monetary Policy and Systemic Risk Regulation

Testimony before the
Subcommittee on Domestic Monetary Policy and Technology
Committee on Financial Services
U.S. House of Representatives

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July 9, 2009

Thank you Chairman Watt, Ranking Member Paul, and other members of the House Subcommittee on Monetary Policy and Technology for inviting me to testify on "Regulatory Restructuring: Balancing the Independence of the Federal Reserve Regarding Monetary Policy with Systemic Risk Regulation."

The Administration's plan for financial regulatory reform would grant the Federal Reserve significant new powers—more powers than ever before in American history. The Federal Reserve would have the power to determine "whether an individual financial firm poses a threat to financial stability" considering such issues as size or interconnectedness. All such Fed-designated firms would then be placed in a special group called "Tier I FHCs." The Federal Reserve would then have the power to supervise and regulate all firms in this new group. Such Tier I FHCs would also become subject to a proposed "resolution regime" which would expand the existing resolution regime for insured deposit institutions under the Federal Deposit Insurance Act. The Federal Reserve would also have the power to collect "periodic and other reports" from all U.S. financial firms that meet certain minimum (as yet unspecified) size standards. The power of the Federal Reserve under Section 13(3) of the Federal Reserve Act—the unusual and exigent circumstances clause which has been used frequently to intervene during the past year—would not be circumscribed in any specific way, though it would "be subject to prior written approval of the Secretary of the Treasury".[1]

What Are the Main Concerns?

Taken as a whole these new powers proposed by the Administration are what constitute the Fed becoming a systemic risk regulator, though the term "systemic risk' is not defined operationally. The important question being examined by this Subcommittee is whether these

[1] Quoted passages in this paragraph are from "Financial Regulatory Reform: A New Foundation." U.S. Treasury 2009

new powers—these systemic risk powers—will affect the Fed's "traditional role as the independent authority on monetary policy."[2] In my view, these new powers will have a significant negative impact on this role to the potential detriment of the conduct of good monetary policy. I have four main concerns.

First, the additional powers and responsibilities would *dilute the key mission* of the Federal Reserve to maintain overall economic and price stability by controlling the growth of the money supply and thereby influencing the overall level of interest rates. My experience in government and elsewhere is that institutions work best when they focus on a limited set of understandable goals and are held accountable to the public for achieving these goals.[3] As the number of goals and the lack of clarity increases, the effectiveness and performance generally declines. By giving the Federal Reserve the responsibility for determining which firms should be classified as Tier I FHCs and then giving them broad responsibility for their stability and impact on the economy, the proposed plan would greatly expand the goals of the Federal Reserve and thereby have these negative consequences.

Second, responsibility for Tier I FHCs would *reduce credibility* of the Federal Reserve by involving it directly in potentially controversial decisions. We see this tendency already in the recent criticism of the Fed's alleged involvement in the Bank of America merger with Merrill Lynch as well as in the backlash against the large bailouts of financial institutions and questions about the collateral. Academic research and practical experience show that the Fed's credibility is an extraordinarily valuable asset which would be terrible to lose.

Third, the plan would *create a conflict of interest.* With firms in the Tier I FHC category being perceived as too big to fail, or perhaps even too big to resolve, there will be a temptation to adjust the instruments of monetary policy to protect these institutions, perhaps by not increasing short-term interest rates even though such an increase would be warranted under the price stability or overall economic stability goals. Or the Fed could mistakenly recommend an otherwise inappropriate start of the resolution regime for one or more Tier I FHCs because that would make it easier to raise interest rates in order to achieve its price stability goals.

Fourth, by giving so much power to the Federal Reserve, the plan would *threaten the Fed's independence regarding monetary policy*. There is a good rationale for an independent monetary authority. It helps prevent the monetary authority from giving too great a focus to the short run at the expense of the long run, and international comparisons have shown that independent monetary authorities deliver better economic performance. Why would giving more power to the Fed in the area of regulation and supervision of Tier I FHCs of its choosing result in less independence in the monetary sphere? Because sooner or later the increased power will result in checks and limits on it, perhaps through micro-managed political interference or even through legislative changes. It would be impossible in practice to prevent such interference from spreading from the new regulatory and supervisory function to the traditional monetary function,

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[2] This question and related issues are discussed in *The Road Ahead for the Fed,* John C. Ciorciari and John B. Taylor (Eds.) Hoover Press, Stanford University, 2009. See in particular the essay by Andrew Crockett, "Should the Federal Reserve Be a Systemic Risk Stability Regulator" in that volume.

[3] John B. Taylor, *Global Financial Warriors*, W.W. Norton, New York, 2007.

because they are in the same institution with the same CEO. The loss of independence can occur via the executive branch or the legislative branch of government.

Loss of Federal Reserve independence is a serious issue, especially at this time of rapidly increasing Federal debt and a greatly expanded Federal Reserve balance sheet. Indeed, after reviewing recent events, George Shultz writes: "Observing this process, the question comes forcefully at you: Has the Accord gone down the drain? And remember how difficult it was for the Fed to disentangle itself from the Treasury in the post-World War II period."[4] Secretary Shultz is of course referring to the 1951 Accord where the Federal Reserve regained its independence following the World War II peg of Treasury borrowing rates. Requiring the Secretary of the Treasury approve using Section (13)3 raises additional independence concerns. Better to carve out specific Section 13(3) actions in specific ways in legislation and perhaps assign those to the Treasury.

What Are the Alternatives?

Given these disadvantages, what are the alternatives for systemic risk regulation? In general, I would define systemic risk in the financial sector as a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.[5] The triggering event for such a macro impact can come from the public sector—as when the central bank suddenly contracts liquidity, or from the financial markets—as when a large private firm fails, or externally—as when a natural disaster or terrorist attack shuts down the payments system.

Examples of systemic events prior to the current crisis were the default by the Russian government in 1998 which affected markets around the world leading the Federal Reserve to cut interest rates, and the 9/11 terrorist attacks which spread through the payments system in the United States by severely damaging financial firms intimately engaged in the system. It is important to emphasize that contagion or chain reactions are not automatic; they can be altered by changes in the rules of the game established by public policy. When Argentina defaulted on its debt in 2001, three years after the Russian default, there was no global contagion, even though the world economy was in worse shape, primarily because the rules of International Monetary Fund (IMF) support were better explained and anticipated.

What were the systemic events in the current crisis? Fortunately, there was no terrorist attack or natural disaster, so was it government forces or market forces? In my view, government actions—from monetary policy being too easy to government sponsored agencies encouraging too much risk—were the primary causes. The failure to regulate adequately entities that were supposed to be, and thought to be, regulated encouraged the excesses. Risky conduits

[4] George P. Shultz "Think Long" in John D. Ciorciari and John B Taylor (Eds.) *The Road Ahead for the Fed*, Hoover Press, Stanford University, 2009.

[5] See John B. Taylor "Systemic Risk and the Role of Government," Dinner Keynote Speech, Conference on Financial Innovation and Crises, Federal Reserve Bank of Atlanta, Jekyll Island, Georgia, May 12, 2009 from which the material in this section is drawn.

connected to regulated banks were allowed by regulators. The SEC was to regulate broker-dealers, but its skill base was in investor protection rather than prudential regulation. Similarly, the Office of Thrift Supervision (OTS) was not up to the job of regulating the complex financial products division of AIG. These regulatory gaps and overlapping responsibilities added to the problem and they need to be addressed in regulatory reform.

So efforts to reform the regulatory system are in order. What are reasonable objectives and tasks for systemic risk regulation? Based on recent experience, closing present and future regulatory gaps and de-conflicting overlapping and ambiguous responsibilities would help reduce systemic risk, especially as new instruments and institutions evolve. In addition, systemic risk might be reduced if disaggregated information were aggregated and passed back to the private sector as Myron Scholes suggests.[6]

But none of these tasks and objectives requires a new systemic risk regulator whether at the Fed or elsewhere. Indeed, such a regulator might serve as an excuse for existing regulatory agencies to pass off responsibilities for past and future regulatory failures.

I have suggested that these tasks be done within the existing President's Working Group on Financial Markets suitably expanded with the additional regulatory agencies and with funding to support sufficient staff at the Treasury to take on the tasks. This recommendation is very close to replacing the President's Working Group with the Financial Services Oversight Council as proposed by the Administration. In my view this would be a sufficient reform in the systemic risk area, and it would not require giving the additional powers to the Federal Reserve.

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[6] Myron Scholes, "Market-Based Mechanisms to Reduce Systemic Risk" in *The Road Ahead for the Fed,* John D. Ciorciari and John B. Taylor (Eds.) , Hoover Press, Stanford, California, 2009

STATEMENT OF
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FOR THE HEARING ON
THE ROLE OF THE FEDERAL RESERVE

BEFORE THE
HOUSE FINANCIAL SERVICES COMMITTEE,
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
U.S. HOUSE OF REPRESENTATIVES
JULY 9, 2009

Chairman Watt and Ranking Member Paul and members of the Subcommittee. I am sorry I cannot be with you in person today but I am grateful for the opportunity to present my views on this important topic.

The set of institutions that today provide the architecture for our financial system – the Federal Reserve System, The SEC, the FDIC– all emerged over time in response to events, most often to crises. Those that survive today exist because they turned out to be useful. They contributed to the stability and growth of our financial markets for many decades during which our system was the envy of the world and did much to foster the growth of the U.S. economy. They are survivors. There are many other institutions that did not meet that test, either because they were ill conceived from the beginning or because financial innovation rendered them obsolete.

There is a great desire to reform the institutions that regulate our financial system and there is some urgency to do so because of the huge costs to society caused by their manifest failure in the current financial crisis. Our current system is a patchwork that has evolved from a series of past disruptions to our financial system. The proposals that have been put forth by the Administration and that are now under discussion in Congress contain many valuable and important ingredients and address many of the central problems. One central feature of these proposals, however, is to assign the task of regulating systemic risk to the Federal Reserve. This is not visionary policy making. More importantly it is not the best approach to addressing the problem of systemic regulation.

I suggest that it is not the best path for four reasons: 1. Systemic risk is a form of "market failure" resulting from the size and/or interconnectedness of financial institutions that would be best addressed by means of a new regulatory construct. 2. It changes and broadens the mandate of the Federal Reserve in ways that make it more connected to the Treasury and that threaten its long-standing and fiercely defended independence. 3. It risks diverting the focus of the Federal Reserve from its primary task of conducting monetary policy and insuring the integrity of the

payments system. 4. There is an alternative solution to assigning systemic risk control to the Fed that makes more sense and makes better use of the regulatory resources that exist in our financial architecture.

Historical Precedent

The most successful financial institutions to arise out of the financial crisis of the 1930's succeeded because they addressed specific market failures. The most successful policy response to the banking crisis of the 1930s was the creation of the Federal Deposit Insurance Corp., which can be traced to an amendment to the Banking Act of 1933. President Franklin D. Roosevelt opposed the creation of the FDIC, as did many leading bankers in the major US money centers of the time.

Nevertheless, this one institution was responsible for calming the fears of depositors and ending bank runs. Its creation was followed by many decades of relative stability in the financial system. The FDIC has been a successful institution because it solved a well-defined problem--uncertainty about the liquidity and solvency of American banks. More importantly, it did so in a way that acknowledged the contradictions and risks inherent in fractional reserve banking by making those responsible for incurring the risks pay for insuring against them.

Similarly, the Securities and Exchange Commission, created under the Securities Exchange Act of 1934, was successful because it addressed a market failure – the lack of standardized reliable information about firms whose securities were offered for sale to the public. It doubtless contributed to decades of sustained growth in our capital markets.

Regulatory institutions tend to be successful when they address specific market failures in a way that does not stifle the markets and discourage innovation but rather makes them more robust. The Fed itself was founded in response to the panic of 1907 when the need for a lender of last resort for solvent but illiquid institutions and responsive monetary policy become an obvious compelling public policy issue.

This is the reason not to rush into delegating further regulatory responsibilities to the Fed, the FDIC, the SEC and others. Maybe we need to think first about whether these are the institutions we need. And perhaps think again about what regulating systemic risk actually means.

Systemic Risk

Systemic risk is like pollution. It originates because of one activity but affects many. There is no market discipline that works to control it. Financial firms that accumulate risk are similar. They add risk to the system and endanger the entire market. The failure of a firm that is an important counterparty to others has the potential to severely disrupt many other financial institutions, their customers and other markets. Market discipline fails to work to constrain them if creditors and

counterparties believe they will not be allowed to fail. The free insurance implied by that notion creates incentives for firms to become excessively large and complex. True, financial collapse will severely punish shareholders, but not various classes of debt-holders likely to get bailed-out, thereby giving such firms an unmatched cost of capital advantage and distorting the financial intermediation process. When combined with corporate governance failures, this can create incentives that in turn lead to severe systemic risk.

The first step is to define and quantify the systemic risk involved. We need measurement first. Note that banks and bank holding companies are not the only candidates for study. Insurance companies and hedge funds can also create systemic risk, as history has shown. The second task is to put a price on the risk that these firms create. This is not a trivial problem, but there are a number of thoughtful proposals circulating about how to do this.

The last step is to make the "polluters" – the institutions that create systemic risk - pay in order to reduce the system's exposure to such risk. In effect an un-priced risk in the financial system should in the future be appropriately priced, and this by itself will create incentives for markets and institutions to respond appropriately without expensive, granular intervention by government in the functioning of financial institutions.

This is what we should mean by systemic risk regulation. The systemic risk that firms create should be priced into a fee for access to the Federal Reserve's lending facilities. It should be priced into the fee the FDIC charges for deposit insurance or any other kind of insurance the firms benefit from. It should be reflected in the capital and liquidity firms are required to hold. And it should be public information. Only then will market discipline begin to discourage the creation of systemic risk. We have the opportunity to improve both the Fed's lender of last resort provisions and our deposit insurance system if we do the regulatory reform right.

A process to allow the orderly failure or restructuring of systemically important but insolvent firms should accompany systemic risk regulation. The Administration's proposals anticipate the need for these elements but have responsibility scattered among a variety of existing institutions.

Capabilities of the Federal Reserve

There is and always will be a critical role for the Fed in insuring the integrity of the financial system. That the Fed itself should be the systemic risk regulator is much less obvious.

Many of the approaches the Federal Reserve and the Treasury have taken to date have clearly added to future systemic risk . The very fact that some of the institutions that have been bailed-out are systemic (or have been encouraged to merge into financial Goliaths by acquiring other firms) creates a bias towards greater consolidation and financial firms that are arguably too large, too interconnected, too complex, and with too much counterparty exposure.

More directly to the point, while the Federal Reserve has the ability to monitor financial markets and the condition of the firms it regulates, it has no particular expertise in the critical elements of systemic regulation outlined above – pricing and insuring systemic risk and orderly resolution and liquidation of financial institutions.

Monetary Policy and Federal Reserve Independence

History shows that we need the Fed to be independent for the conduct of monetary policy and to serve as a lender of last resort. And it is a reasonable and experienced candidate for assuring the stability and security of the payments system.

An independent central bank can focus on monetary policies for the long term - that is, policies targeting low and stable inflation and a monetary climate that promotes long term economic growth. Political cycles, alas, are considerably shorter. Without independence the political cycle will subject the central bank to pressures that in turn would impart an inflationary bias to monetary policy. On this view politicians in a democratic society are shortsighted because they are driven by the need to win their next election. There is plenty of evidence for this in countries around the world that spans decades in time – and indeed the US has traditionally advocated central bank independence in other countries as part of economic policy reforms designed to promote sustainable growth. In short, a politically insulated central bank is more likely to be concerned with long-run objectives.

The dramatic expansion of the balance sheet of the Fed in the last two years, together with its close involvement in the bailout of financial institutions like AIG and Merrill Lynch, have put this respected institution firmly in the spotlight. It is a problem precisely because, when Fed programs target particular asset classes, or industries or firms (which they do), the Fed has put itself in the business of allocating credit. Its actions can also distort prices for these assets. This they should not do as a matter of principle. Buying Treasury securities is completely neutral with respect to the allocation of credit. Buying securities backed by, say auto loans, is not.

The presence of these assets on the balance sheet in such quantities creates yet another problem for the Fed, one that exposes it to intervention. First, these huge un-borrowed reserves make some observers nervous about future inflation, even though there is no evidence of it right now. Somehow, this overhang will have to be dealt with going forward. But if the Fed has to reduce the assets on its balance sheet to forestall an inflation threat, that could be very disruptive to credit markets. Complicated positions could be hard to unwind. If these assets were already liquid, the Fed wouldn't have had to buy them in the first place. This means it may be difficult to get the cash out of the economy before it is too late.

A Different Solution

The institution with the most experience at facilitating the orderly failure/restructuring of financial institutions today remains the FDIC. It also has –

at least in principle – experience with insuring financial firms. But, the FDIC in its present form is not the right institution to regulate systemic risk. It is too vulnerable to capture by the banks and to political pressure.

Banks have lobbied hard to limit FDIC's ability to behave like a true insurance fund. They have won limits on the size of insurance fund – set currently at between 1.15 and 1.5% of insured deposits. It wasn't until passage of the Federal Deposit Insurance Reform Act in 2005 that insurance rates could be tied to risk assessments of the institutions. During the crisis the FDIC may also have added to systemic risk through the Temporary Liquidity Guarantee Program. It guaranteed newly issued senior unsecured debt of banks for a fee of 75 basis points, the same rate for all banks regardless of their risk profile. This remarkable intervention was justified by invoking the FDIC's statutory authority to prevent systemic risk.

Perhaps what we need is an institution like the FDIC, one that incorporates and expands its role but is more independent. Its purview could extend to other systemic institutions (hedge funds, insurance companies). The systemic risk that firms create should be priced into the fee for deposit insurance and into a fee for access to the Federal Reserve's lending facilities.

Whatever direction regulatory reform takes it is really important to think about institutional designs that are less subject to capture by politics or by the financial institutions themselves.

Biographical Summary

Thomas F. Cooley

Thomas F. Cooley is the Richard R. West Dean and the Paganelli-Bull Professor of Economics at the New York University Stern School of Business, as well as a Professor of Economics in the NYU Faculty of Arts and Science. The former President of the Society for Economic Dynamics and a Fellow of the Econometric Society, Professor Cooley is a widely published scholar in the areas of macroeconomic theory, monetary theory and policy and the financial behavior of firms, and is recognized as a national leader in both macroeconomic theory and business education. Dean Cooley is a member of the Council of Foreign Relations and numerous advisory boards. He also writes a weekly column for FORBES.com. He is an organizer of and contributor to the volume *Restoring Financial Stability: How to Repair a Failed System*, published by Wiley, March 2009.

Before joining NYU Stern, Dean Cooley was a Professor of Economics at the University of Rochester, University of Pennsylvania, and UC Santa Barbara. Prior to his academic career, Dean Cooley was a systems engineer for IBM Corporation. Dean Cooley received his BS from Rensselaer Polytechnic Institute, and his MA and PhD from the University of Pennsylvania. He also holds a doctorem honoris causa from the Stockholm School of Economics.

STATEMENT OF
THE FINANCIAL SERVICES ROUNDTABLE
On
REGULATORY RESTRUCTURING: BALANCING THE INDEPENDENCE OF THE FEDERAL RESERVE IN MONETARY POLICY WITH SYSTEMIC RISK REGULATION
Before the
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY AND TECHNOLOGY
FINANCIAL SERVICES COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
JULY 9, 2009

Chairman Watt, Ranking Member Paul, and Members of the Subcommittee on Domestic Monetary Policy and Technology, the Financial Services Roundtable appreciates this opportunity to submit this statement for the record. The Roundtable is a national trade association composed of the nation's largest diversified banking, securities, and insurance companies. Our members provide the full range of financial products and services to every kind of consumer and business.

The Roundtable supports the urgent need for bold and comprehensive regulatory reform of financial services. We need to be mindful of lessons learned from the worst financial crisis in our lifetime, but we also need to be forward-looking and rebuild our financial regulation and regulatory architecture to ensure in the longer term that U.S. financial markets and firms are the most competitive and innovative in the world consistent with high standards for risk management and good governance. Financial services firms must be well positioned to meet the needs of their customers, support sustained economic recovery and growth, and provide a foundation to create new jobs. Any reforms enacted by Congress and signed by the President must be mindful of this simple economic imperative.

The Obama Administration has put forward a thoughtful proposal for regulatory reform, its New Foundation. The Treasury Department's white paper released on June 17, 2007, is a positive contribution to the current public policy debate. Specifically, we support the creation of a new Financial Services Coordinating Council (Council) and designating the Federal Reserve as what we prefer to call a market stability oversight authority (authority); in both cases, we recommend several changes to strengthen the Administration's proposal.

The Roundtable has testified numerous times in 2008 and 2009 on both the market and regulatory failures exposed by the financial crisis; this statement, therefore, will dispense with reciting that testimony again today. Instead, this statement will focus on three points that are directly relevant to your inquiry: 1) the Roundtable's detailed position on the need for better oversight and surveillance of systemic risk by the U.S. Government as one important part of regulatory reform; 2) the need for clear objectives and principles for our financial system to support our economy as a starting point for regulatory reform; and 3) the need for a new regulatory architecture for our financial system that fully supports stable economic growth and serves consumers. Since we only have analyzed the Treasury's white paper, we reserve the right to provide additional testimony when the detailed draft legislation on systemic risk is sent to Congress.

1. THE NEED TO LIMIT AND MITIGATE SYSTEMIC RISK

As a practical matter, we believe that "systemic risk" should be defined as an activity or practice that crosses financial markets or financial services firms, and which, if left unaddressed, would have a significant, material adverse effect on financial services firms, financial markets, or the U.S. economy. Risk is inherent in all competitive financial markets – banking, insurance, and securities. It is part of the intermediation process between providers and users of all financial services. It needs to be managed first at the institution level as well as at the systemic level to the extent possible, recognizing that no Government will be able to fully protect open and competitive markets from all financial stress and even occasional panic in the future.

After a brief review of why the Roundtable believes a market stability oversight authority is necessary, we analyze two important parts of the Administration's New Foundation: the creation of a permanent Financial Services Coordinating Council and the designation of the Federal Reserve as the market stability oversight authority.

Why do we need a systemic risk regulator?

The activities and practices of U.S. financial markets are interconnected, nationally and internationally. Banks, broker-dealers, insurance companies, finance companies, hedge funds, and other regulated and unregulated financial services firms are continuously and mutually engaged in a variety of lending, investment, trading, and other financial transactions. Yet, under our existing financial regulatory structure, no single agency has the authority to look across all sectors of the financial services industry and all markets to evaluate risks posed by these interconnections.

While often it is assumed that some combination of the U.S. Treasury Department (Treasury) and the Federal Reserve Board (Federal Reserve) are responsible for broad financial market stability, neither the Treasury nor the Federal Reserve has the explicit mandate and the full arsenal of supervisory authorities to promote market stability and prevent systemic risk across different company charters and products. Different regulators are responsible for the different silos they oversee; no single agency looks at the entire financial system serving consumers and our economy.

Prior to 2008, the only authority the Secretary of the Treasury (Secretary) had to look at the financial markets as a whole was the authority delegated to the Secretary by the President (through an Executive Order) in 1988 to chair and convene the President's Working Group on Financial Markets (PWG). The PWG could only ask regulators to cooperate on key issues and issue occasional reports. In 1991, the Congress gave the Secretary a pivotal role in the implementation of the systemic risk exception to the FDIC's least-cost resolution process. Under that process, the Secretary, in consultation with the President, must agree that paying uninsured depositors or creditors "would have serious adverse effects on economic conditions or financial stability" and as such, the FDIC would have the power to intervene in the market to address systemic risk. Yet, the FDIC Improvement Act did not give the Secretary any additional responsibilities, either to determine what constitutes systemic risk, to more closely monitor systemically relevant institutions, or to make any detailed reports about its analysis when this exemption is invoked.

The Federal Reserve plays multiple roles in financial markets, but also does not have an explicit market stability mandate or clearly defined role to identify and prevent systemic risk to U.S. financial markets. As the nation's central bank, it has broad monetary policy tools to promote price stability and full employment in the U.S. economy. It oversees part of the U.S. payments system, but not all. It regulates and supervised state-member banks at the national level, but not national banks, which are regulated by the OCC or state nonmember banks, which are regulated by the FDIC. It regulates and supervises all bank and financial holding companies, but not thrift holding companies, which are regulated and supervised by the OTS, or investment bank holding companies, which are supervised by the SEC. It lends to financial institutions through normal discount window operations. Starting in 2008 during the current crisis, the Federal Reserve greatly expanded its emergency lending to financial institutions and others using its authority to lending in Section 13(3) during "unusual and exigent circumstances." But even in these roles, the Federal Reserve's market stability activities are confined mainly to *reactive* actions and financing vehicles under its unique lending powers.

The missing link is a single federal authority with the mandate, responsibility, and expertise to oversee the nation's entire financial system, not just its individual parts, and to promote market stability while preventing systemic risk for firms that operate in this global marketplace. This would resolve the regulatory redundancy that currently creates the gaps in oversight.

Why the Federal Reserve as a market stability oversight authority?

From the Roundtable's perspective, the U.S. financial system does not need another layer of regulation and a new bureaucracy on top of the current structure. What we do need, however, is better surveillance of interconnected activities and practices among all providers of financial services across the financial system, not another super-regulator of individual institutions. As such, we support and prefer the nuanced designation of a new Market Stability Oversight Authority that is the Federal Reserve, without making the Federal Reserve a super-regulator and without drawing a "bright line" around a set of providers publically designated as "systemically important". This nuance is explained in greater detail below.

Designating the Federal Reserve is a natural complement to the Board's existing role as the nation's central bank and lender of last resort. However, we recognize that this new role would require the Board to expand its staff to include experts in all types of financial activities, practices, and markets. Also, if the Board is given this new authority, it would need to establish a clear and transparent governance structure internally to minimize any potential conflicts with its existing responsibilities. Rigorous Congressional oversight of this new role will be critical.

Furthermore, we would recommend that the Board establish an Advisory Council on Market Stability to review activities and practices that may pose a systemic risk, balanced against the need for continuing market innovation and competitiveness. The Advisory Council should include representatives of domestic and international financial services firms doing business in the United States as well as representatives of consumers of financial services.

What is the role of a market stability oversight authority?

The purpose of a market stability oversight authority should be to promote the long-term stability and integrity of the nation's financial markets and financial services firms by identifying and addressing significant risks to the financial system as a whole.

This new authority should be authorized to oversee all types of all financial markets and all financial services firms, whether regulated or unregulated. However, a market stability authority should **not** focus on financial services firms based upon size. The designation of "systemically significant financial services firms" would have unintended competitive consequences and increase moral hazard as these firms would be deemed too big to fail.

The authority should **not** be just another layer of regulation added to the existing system; it should **not** be a "super-regulator". Absent an immediate, systemic threat, it should be required to work with and through other financial regulators, including a national insurance regulator. Also, a national insurance regulator is needed to give the federal government a better understanding and role in the supervision of this key part of our nation's financial services sector.

Congress, by statute, should require this new authority to balance the identification of activities or practices that pose a systemic risk against the need for continuing market innovation and competitiveness. This new responsibility should not stifle innovation, or preclude isolated failures. Failures in a market-based economic system are a fact of life and should be resolved in an orderly manner across all financial services. Innovation is a key to economic growth and new job creation.

Congress also should direct this new authority to focus attention on factors that present the greatest potential for systemic risk, such as excessive concentrations of assets or liabilities, rapid growth in assets or liabilities, high leverage, a mismatch between long-term assets and short-term liabilities, currency mismatch, and regulatory gaps. This authority should **not** focus attention on products or practices that pose little or no systemic risk.

How would this new authority function?

The authority should identify, prevent, and mitigate systemic risk by –

- Collecting and analyzing data from other financial regulators and individual financial services firms to understand potential or existing systemic risks in the financial system. Data on individual firms should be treated as confidential supervisory information;
- Establishing a surveillance system for activities and practices to detect early crisis warning signs and vulnerabilities, conduct scenario planning, and develop contingency planning with other prudential financial regulators across all financial markets;
- Examining individual financial services firms when a systemic risk is apparent. If a firm is engaged in activities and practices that are a threat to market stability and regulated by another national or state financial regulator, such examinations should be limited and coordinated with such regulator. Examination results should be treated as confidential supervisory information;
- Issuing, as necessary, reports and public notices on activities or practices that may pose a systemic risk;

- Working closely with other international authorities to ensure a global perspective on financial markets and potential systemic risk; and
- Taking corrective actions to prevent or address systemic risk.

To help prevent this authority from becoming a "super-regulator", we would recommend that, absent an emergency situation, the market stability regulator should take actions through other primary regulators. In other words, in non-emergency times, the market stability authority should be authorized to make recommendations to other regulators, the new Coordinating Council, and/or Congress to address activities and practices that could pose a potential systemic risk, but do not pose an immediate systemic threat to markets or the economy.

Whenever this new authority identifies a practice or activity that could pose a systemic risk and such practice or activity is within the jurisdiction of another national or state financial regulator, then it should issue a finding and recommend appropriate preventive actions to the other regulator. It also should submit any such findings and recommendations to the Administration's new Council and/or to the Congress. If another regulator disagrees with the authority's finding and recommendation, then the regulator can submit its own findings and recommendations to the new Council or this Congress.

If the new authority identifies an activity or practice that could pose a systemic risk, and such activity or practice is not subject to regulation or supervision by another regulator – a clear regulatory gap – then it should make a recommendation to Congress on how best to regulate and supervise such activity or practice in the future to close the regulatory gap.

The authority should be granted the ability to take unilateral actions only in the most limited situations to address significant activities or practices and only when the authority determines that they pose an immediate, systemic risk, which could not be addressed in a timely fashion if the authority were to recommend actions by any other regulator. Such unilateral actions would include the power to issue orders or regulations affecting activities or practices of individual firms or categories of firms. Such unilateral actions should only be approved by a super-majority of the members of the Federal Reserve Board, and should be agreed to by the Secretary of the Treasury, who must consult with the President. Such unilateral actions also should be reported immediately to Congress. This authority would be in addition to the Board's existing authority under section 13(3) of the Federal Reserve Act to make extend credit to financial or non-financial institutions in "unusual and exigent" circumstances. The Board should retain that authority, with full and timely public disclosure every time this authority is used.

If market stability oversight authority had been in place before this crisis, how would it have impacted the crisis?

We should not expect a market stability oversight authority to identify all potential systemic risks and eliminate the potential for any crisis in a competitive, market-based, global economy. In fact, some level of risk is inherent in all financial systems by definition. As noted earlier, any new authority should be required explicitly by Congress to balance risk mitigation and innovation to serve all consumers better in the future and meet all the financing needs of the economy.

That said, there are a couple of activities or practices that this new authority could have flagged, and, if such activities and practices had been adjusted, the current crisis should have been identified earlier and

as a result could have been less severe. First, it is now clear that one of the practices that contributed to the current crisis was excessive leverage by large financial services firms, especially investment banks. This new authority as the Roundtable envisions could have identified this leverage as a potential warning sign sooner and urged the SEC to take corrective actions. Has the SEC not acted, the authority could have taken its case to the new Coordinating Council for a full inter-agency review and debate.

Another practice that contributed to the current crisis was growth in non-traditional mortgage instruments. A new oversight authority might have seen this and recognized the value of these innovations for certain consumers, as well as the risk to other consumers who were at risk from no documentation, no money down, adjustable rate loans. This new authority then could have recommended new uniform, national standards for such products long before the banking agencies acted on their own joint guidance.

Managing systemic risk better in the future

There are two major and inter-related components in the Administrations proposal that will help to prevent and mitigate systemic risk in the future, recognizing that no architectural design is a guarantee against all future financial crises. The first is the Administration's proposal to create a new Financial Services Oversight Council, which is modeled on the Roundtable's 2007 proposal. The second is making the Federal Reserve responsible for the promotion of market stability and the prevention of systemic risk. We support both of these improvements to the U.S, financial regulatory architecture with some further refinements to strengthen what has been proposed by the Administration. We reserve the right to recommend additional changes once the Administration sends Congress draft legislation.

Financial Services Oversight Council. The Roundtable has been a consistent advocate of better regulatory coordination and cooperation since our 2007 Blueprint on Financial Modernization. We called for the codification of an enhanced and expanded President's Working Group on Financial Markets (PWG) with all regulators having a seat at the table, including representatives of state regulated industries (banking, insurance, securities).

Therefore, we generally support the creation of a new Financial Services Oversight Council along the lines described in the Treasury's report, with four additional suggestions: 1) a new National Insurance Supervisor for all insurance companies opting or mandated by Congress to have a national insurance charter to serve their customers nationally or internationally should also have a seat on the new Council; a new national insurance regulator is needed to give the federal government a better understanding and role in the systemic supervision of a key part of our nation's financial services sector; 2) representatives of state banking, insurance, and securities regulators also should be included; 3) as part of a more forward looking mandate, the Council should also monitor the adherence to whatever principles Congress legislates to guide financial regulation and preferred regulatory outcomes in the future; and 4) each regulatory agency should develop comprehensive regulatory action plans to review the costs and benefits of each regulation under an agency's purview; in turn, these regulatory action plans would be presented and reviewed by the Council on an ongoing basis to ensure regulations are as effective and efficient as possible in serving their intended purpose.

Market Stability Oversight Authority. There clearly is a need for a market stability or systemic risk oversight authority to look across all financial markets and try to identify and then mitigate potential

threats of systemic risk from activities and practices before they undermine market stability. The Roundtable supports the Administration's position that the Federal Reserve should play this role of greater market surveillance, leading the effort to set new standards for capital, liquidity, and risk management, and then working with other regulators to prevent a systemic collapse or another financial panic in the future. In this capacity, the Federal Reserve should focus primarily on the activities and practices by firms that may pose a risk to the economy across markets, while leaving the regulation and supervision of individual firms to their primary regulator under the new system. We also support the addition of a private-sector Advisory Council on Market Stability as noted above.

From our perspective, there is no need to create an artificial distinction of a Tier 1 Financial Holding Company (FHC), as proposed by the Administration, if the new standards we are setting for all financial institutions – capital, liquidity, risk management, and governance – are risk-based and focused on the desired regulatory behaviors and outcomes mandated by these reforms. Therefore, the Roundtable opposes drawing any bright line around an artificially determined class of institutions because of their size or business lines – which will vary constantly over time - especially since doing so will only increase moral hazard, have a destabilizing effect on competition and the pricing of products, services, and funding, and ultimately work to the disadvantage of the long-term competiveness of U.S. financial services firms and markets.

Consequently, the Roundtable also opposes any forced or unnecessary divestitures of ongoing businesses, especially during an anemic economic recovery. We support stronger capital and liquidity requirements as well as better risk management and supervision – including better consolidated supervision at the parent company level - based on underlying risk fundamentals, but we oppose the artificial and public designation of institutions as systemically important (Tier 1 FHCs) and therefore assumed by the public, potentially, as still "too big to fail," for the reasons noted above. No financial institution should be too big to fail, and, as an aside, the Roundtable fully supports a new orderly resolution process for nonbank financial institutions during times of economic emergencies. In other normal times, bankruptcy should be the preferred option for orderly resolution of failing nonbank financial firms, and it should be harmonized across the financial services industry over time.

2. THE NEED FOR CLEAR OBJECTIVES AND GUIDING PRINCIPLES

The starting for any regulatory reform effort should be common agreement on a few clear objectives for our financial system's role on the real economy – what we want to achieve – and then a companion set of some basic principles for both regulators and regulated firms - to guide how they achieve those objectives. The Administration has outlined five objectives for financial regulatory reform, which at their highest level are hard to oppose and in fact the Roundtable supports as well. We also would encourage the Congress to write into law a set of even higher objectives for our financial markets and their connection to serving consumers and the broader U.S. economy. The Roundtable's three simple objectives, to serve as a discussion starter in this evolving debate, are:

1. Enhance the competitiveness of financial services firms to meet the financial and related needs of all consumers;
2. Promote financial market stability and security; and

3. Support sustained economic growth and new job creation in a globally integrated economy.

If we can agree on some basic objectives about "what" we want our financial system to achieve for the benefit of society, then we need to agree on a set of principles that everyone can understand – regulators, regulated firms, and consumers – about "how" we will achieve those objectives. Guiding principles don't replace the need for more detailed rules especially at the retail level – it's not an either-or discussion - but they do inform desired behavior and outcomes, and they can act as a much needed compass for every stakeholder in our financial markets. Again, the Roundtable believes that Congress should develop a clear set of guiding principles in any reform legislation. To begin this aspect of the debate, our regulatory reform principles for Congress' consideration are:

1. New Architecture. *Our financial regulatory system should be better aligned with modern market conditions and developing global standards.*
2. Consumer and Investor Protection Standards. *Financial services firms engaged in offering comparable products and services should be subject to comparable prudential, consumer, and investor protection standards. In the event of multiple oversight authorities, uniform standards should apply nationwide. Consumer protection should be part of prudential supervision.*
3. Balanced and Effective Regulation. *Financial regulation should be focused on outcomes, not inputs, and should seek a balance between the stability and integrity of financial services firms and markets, consumer protection, innovation, and global competitiveness.*
4. International Cooperation and National Treatment. *U.S. financial regulators should coordinate and harmonize regulatory and supervisory policies with international financial regulatory authorities, and should continue to treat financial services firms doing business in the United States as they treat U.S. financial services firms. The United States should continue to play a leadership role in the current G-20 process to develop new international norms for financial regulation across markets.*
5. Failure Resolution. *Financial regulation should provide for the orderly resolution of failing financial services firms to minimize systemic risk.*
6. Accounting Standards. *U.S. financial regulators should adjust current accounting standards to account for the pro-cyclical effects of the use of fair value accounting in an illiquid market. Additionally, U.S. and International financial regulators should coordinate and harmonize regulatory policies to develop accounting standards that achieve the goals of transparency, understandability and comparability.*

3. THE NEED FOR BOLD, COMPREHENSIVE REGULATORY REFORM

The latest financial crisis has shown us that the time is now for bold, comprehensive regulatory reform. The Roundtable has developed a proposed "Financial Regulatory Architecture" to address the flaws in our current system. Our proposed architecture is designed to:

- Create a better, more rational financial regulatory architecture to support the U.S. economy and meet all consumer financial needs;
- Limit and mitigate systemic risk;
- Reduce regulatory overlap and close critical gaps in regulation;
- Provide for greater coordination among all financial regulators;

- Promote uniform regulation and supervision; and
- Preserve state financial regulation.

Our proposed regulatory architecture can be found on our website at www.fsround.org.

Briefly, the six components of this proposed architecture are as follows. First, to enhance coordination and cooperation among the many and various financial regulatory agencies, we propose to expand membership of the President's Working Group on Financial Markets (PWG) and rename it as the Financial Markets Coordinating Council (FMCC). This Council should be established by law, in contrast to the existing PWG, which has operated under a Presidential Executive Order dating back to 1988. This would permit Congress to oversee its Council's activities. The Council should include representatives from all major federal financial agencies, as well as individuals who can represent state banking, insurance and securities regulation. The Council should serve as a forum for national and state financial regulators to meet and discuss regulatory and supervisory policies, share information, and develop early warning detections. The Council should not have independent regulatory or supervisory powers. However, it might be appropriate for the Council to have some ability to review the goals and objectives of the regulations and policies of federal and state financial agencies, and thereby ensure that they are consistent.

Second, to address systemic risk, we propose that the Federal Reserve Board (Board) should be authorized to act as a market stability oversight authority. If granted this new authority, the Board should be responsible for looking across the entire financial services sector to identify activities, practices, and interconnections that could pose a material systemic risk to the U.S. economy. The interaction of these two points is addressed in the last section of this statement.

Third, to reduce gaps in regulation, we propose the consolidation of several existing federal agencies into a single, National Financial Institutions Regulator (NFIR). This new agency would be a consolidated prudential and consumer protection agency for banking, securities and insurance. The NFIR would reduce regulatory gaps by establishing comparable prudential standards for all of these of nationally chartered or licensed entities. For example, national banks, federal thrifts and federally licensed brokers/dealers that are engaged in comparable activities should be subject to comparable capital and liquidity standards. Similarly, all federally chartered insurers would be subject to the same prudential and market conduct standards.

In the area of mortgage origination, the NFIR's prudential and consumer protection standards should apply to both national and state lenders. Mortgage lenders, regardless of how they are organized, should be required to retain some of the risk for the loans they originate. Likewise, mortgage borrowers, regardless of where they live or who their lender is, should be protected by the same safety and soundness and consumer standards.

Fourth, to focus greater attention on the stability and integrity of financial markets, we propose the creation of a National Capital Markets Agency (NCMA) through the merger of the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), preserving the best features of each agency. The NCMA would regulate and supervise capital markets and exchanges. As noted above, the existing regulatory and supervisory authority of the SEC and CFTC over firms and individuals that serve as intermediaries between markets and customers, such as

broker/dealers, investment companies, investment advisors, and futures commission merchants, and other intermediaries would be transferred to the NFIR. The NCMA also should be responsible for establishing standards for accounting, corporate finance, and corporate governance for all public companies.

Fifth, to protect depositors, policyholders, and investors, we propose that the Federal Deposit Insurance Corporation (FDIC) would be renamed the National Insurance and Resolution Authority (NIRA), and that this agency act not only as an insurer of bank deposits, but also as the guarantor of retail insurance policies written by nationally chartered insurance companies, and a financial backstop for investors who have claims against broker/dealers. These three insurance systems would be legally and functionally separated. The failure of Lehman Brothers illustrated the need for such a better system to address the failure of large non-banking firms.

Finally, to supervise the Federal Home Loan Banks and to oversee the emergence and future restructuring of Fannie Mae and Freddie Mac from conservatorship we propose that the Federal Housing Finance Agency remain in place, pending a thorough review of the role and structure of the housing GSEs in our economy.

Conclusion

The Roundtable believes that the reforms to our financial regulatory system we have proposed would substantially improve the protection of consumers by reducing existing gaps in regulation, enhancing coordination and cooperation among regulators, ensuring greater regulatory accountability for commonly desired regulatory outcomes, and identifying systemic risks. Broader regulatory reform is important not only to ensure that financial institutions continue to meet the needs of all consumers but to restart economic growth and much needed job creation. We support the thrust of the Administration's proposals for a new Council and designating the Federal Reserve as a new market stability oversight authority with the caveats noted above.

Financial reform and ending the recession soon are inextricably linked – we need both. We need a financial system that provides market stability and integrity, yet encourages innovation and competition to serve consumers and meet the needs of a vibrant and growing economy. We need better, more effective regulation and a modern financial regulatory system that is unrivaled anywhere in the world. We deserve no less. The Roundtable stands ready to work closely with the Congress and the Administration to achieve our common goals to help all consumers of financial services and provide a stronger financial market foundation for our economy.

Vice Chairman Donald Kohn subsequently submitted the following in response to written questions received from Chairman Melvin Watt in connection with the July 9, 2009, hearing before the Subcommittee on Domestic Monetary Policy and Technology:

(1) Should Federal Reserve Board monetary policy decisions be subject to different levels of transparency than a) the Board's supervisory and regulatory functions and b) single company credit facilities such as Bear Stearns and AIG? Describe the levels of transparency you believe should be applicable to these areas of responsibility.

Audits and reviews by the Government Accountability Office (GAO) are an appropriate means of promoting transparency for most areas of Federal Reserve activity, including our supervisory and regulatory functions and our single-company credit facilities. An array of information related to these activities is available to the public on the Board's web site, including information on applications filed by financial institutions and actions taken by the Board on those applications, legal interpretations issued, and aggregate and institution-specific data derived from public reports. The Federal Reserve Bank of New York provides substantial additional information on the single-company credit facilities on its web site, including detailed descriptions of transactions and copies of relevant agreements.

The Federal Reserve Board is also highly transparent in monetary policy. Experience has shown that granting central banks operational independence in the conduct of monetary policy leads to improved economic performance, but monetary policy independence does not imply a lack of transparency. Indeed, to some extent it necessitates even greater efforts to promote or ensure transparency. For example, the Federal Reserve publishes a semiannual *Monetary Policy Report to the Congress*, issues statements and minutes after monetary policy meetings, and makes available on our website information on all aspects of monetary policy. In addition, Federal Reserve officials regularly testify before the Congress and give speeches to the public on monetary policy.

However, in the area of monetary policy, financial markets are keenly aware of the potential for inflationary outcomes when short-term political pressures influence policy actions. GAO reviews of monetary policy actions taken by the Federal Reserve would likely be perceived by the market as an attempt by Congress to influence Federal Reserve decisionmaking. A reduction in the perceived independence of the Federal Reserve to conduct monetary policy would likely increase long-term interest rates and reduce economic and financial stability. It is for this reason that the Congress, after debating the issue in 1978, purposely excluded monetary policy from the scope of potential GAO reviews.

(2) What specific additional resources does the Fed need from Congress to adequately staff both existing responsibilities for executing monetary policy and proposed new responsibilities for implementing systemic risk regulation?

The Federal Reserve continuously evaluates its staffing levels and expertise in light of changing needs and challenges. As we discussed at the hearing, since the beginning of the financial crisis, both the Board and the Reserve Banks have added staff with appropriate skills to

ensure that critical functions are performed in a thorough and timely fashion. For example, additional staff resources have been required to supervise several large financial firms previously not subject to mandatory consolidated supervision that elected to become bank holding companies--including Goldman Sachs, Morgan Stanley, and American Express. While the number of additional financial institutions that would be subject to supervision under the Administration's proposal would depend on standards or guidelines adopted by the Congress, the criteria offered by the Administration suggest that the initial number of newly regulated firms would probably be relatively limited. The new responsibilities and authorities that are contemplated in the Administration's proposal would require some expansion of staff but we anticipate that expansion would be an incremental and a natural extension of the Federal Reserve's existing supervisory and regulatory responsibilities. Given the manner in which Federal Reserve operations are financed, no appropriation would be required to fund any necessary increases in staff.

(3) If the Federal Reserve is granted powers to regulate systemically significant entities, how would the Fed harmonize systemic risk and monetary policy responsibilities with other central banks around the world?

With the world's economies and financial systems becoming increasingly integrated, and with financial stability a prerequisite to achieving our dual mandate of maximum employment and price stability, the Federal Reserve already places a high priority on close cooperation with foreign regulators and monetary policymakers. Federal Reserve officials discuss monetary and economic policy issues with their foreign counterparts in a broad array of forums, including regular meetings sponsored by the BIS, OECD, G8, and G20. Similarly, the Basel Committee and Financial Stability Board, among other groups, provide a framework for addressing the common challenges to financial stability around the world. Outside of such venues, Federal Reserve officials maintain close contact with foreign authorities in a wide range of countries in order to share information and lay the basis for further cooperation. If the Federal Reserve were given additional responsibilities, the need for additional international consultation would need to be carefully considered in light of the exact nature of those responsibilities. In any case, as the global economy becomes ever more tightly knit, and as the role of the Federal Reserve evolves, we will continue to work closely with our counterparts abroad.

August 4, 2009

Below are my responses to the questions you asked in your July 24 letter.

Describe the negative ramifications from political interference with monetary policy.

The monetary authority is authorized to produce and destroy money, the means of payment. That is its principal function. Governments often want to use the money power to finance budget deficits. The common result is inflation; excess money creation raises prices. To protect the Federal Reserve from pressure to finance the deficit and inflate, the Federal Reserve was made independent within the government. Initially, Federal Reserve actions were restricted by the rules of the gold standard, adopted by the Congress in 1900 (before there was a Federal Reserve.) Congress should continue independence but it should restrict Federal Reserve actions by adopting a rule, or quasi-rule, restricting the Federal Reserve's discretionary action. An example of a rule is given in the next answer.

Describe the levels of transparency you believe should be applicable.

Article 1, Section 8 of the Constitution gives monetary authority to the Congress. The Federal Reserve is the agent of Congress. Congress has long tried to find satisfactory ways to monitor Federal Reserve actions.
Congress should establish general rules of conduct that limit the Federal Reserve's discretionary actions. At quarterly hearings it should receive reports showing how the rules have been applied. I believe that the chair and members of the Federal Reserve should be expected to explain deviations from the general rules and should offer their resignations if they violate the rules. The president and congress can then accept the explanation or the resignation.

An example is the policy in New Zealand where the governor of the central bank agrees on an inflation target with the Minister of Finance. If he or she misses the target, they must explain why and offer to resign. Discipline such as this improves policy operations and concentrates responsibility. It makes it possible for the banking committees of Congress to monitor the outcomes that we must live with.

Allan Meltzer

To: Chairman Watt, House Financial Services Committee
From: Laurence H. Meyer
Re: Response to your questions, following the July 9, 2009 testimony on "Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation."

Thank you for giving me the opportunity to further share my views on regulatory reform and Fed independence.

(1) Please describe the potential negative ramifications for the markets if there is political interference (either perceived or real) with the Federal Reserve's monetary policy independence.

I think this is pretty obvious. There would be chaos in the financial markets: equity prices would fall sharply, the dollar would plunge, and long-term interest rates and long-term inflation expectations would move sharply higher. Equities, long-term interest rates, and the dollar would also become much more volatile. I expect the responses would be large enough for the Congress to step back from such a bad decision, indeed, from being the first developed country in history (I believe) to take independence away from its central bank. Indeed, the history of the last two decades is one of more and more central banks becoming independent.

One more relevant point: To see the sharpness of the reaction, compare the inflation forecast of Alan Meltzer, a very well-respected economist and student of the Fed, and someone who also testified with me, with the consensus forecast, the FOMC's forecast or our forecast. Whereas the latter all expect inflation to fall and stay relatively low, Meltzer is expecting inflation to rise to the level of the 1970s as a result of the Fed losing its independence. Indeed, a number of our clients who also expect the Fed to lose its independence mention the name "Zimbabwe" in their more extreme nightmares. Why do Alan and many of our clients worry about much higher inflation? They worry that continued large budget deficits and further large increases in the debt-to-income ratio could send interest rates skyrocking. They do not beklive the Congress wold tolerate this and would, as a result, infringe on the independence of the Fed. This is not the dominant view, but it is the view of a vocal minority and should not be ignored.

(2) Should the Federal Reserve Board monetary policy be subject to different levels of transparency than a) the Board's supervisory and regulatory functions and b) single credit facilities such as Bear Sterns and AIG? Describe the level of transparency you believe should be applicable to these areas of responsibility.

There is absolutely no doubt that monetary policy is more transparent that either the Fed's supervisory and regulatory functions or its single company credit facilities. This is not even a close call.

Do you have semi-annual testimony specifically focused on the Fed's supervisory and regulatory responsibilities (like the Chairman's semi annual monetary policy testimony)? I don't think so. Does the public get immediate notification of changes in supervisory guidance, like the post-FOMC meeting statement. Well, there is usually an announcement when there is a formal change in guidance but not when the Fed gives individual banks or bank holding companies guidance. And remember, Fed guidance is like a rule that must be followed! Is there anything like the minutes or the transcripts that provide a record of discussions of the Board on supervisory and regulatory issues, much of which takes place in the Board's Committee on Supervisory and Regulatory Affairs, made up of three governors and supported by the staff (a committee I chaired for most of the time I was on the Board)? Is there anything that corresponds to the minutes or transcripts that reports the discussions (in the transcript identifying the positions and verbatim discussion by individual member of the Board and the President of the NY Fed and the Secretary of the Treasury) with respect to the Fed invoking emergency powers under 13.3 or with respect to interventions at particular institutions? To be sure this would be a serious mistake to even think of going in this direction (and perhaps I shouldn't even have mentioned it. But I am trying to make the case that there is much more transparency with respect to monetary policy than with respect to any of the other responsibilities of the Fed.

In addition, the transparency with respect to monetary policy has improved dramatically under Greenspan and Bernanke. Before this, the Fed never announced its decision with respect to the funds rate and left the markets guessing. There was no statement after the meeting. There were (I believe) no FOMC forecasts (now quarterly with an expanded list of variables), and no guidance on the FOMC's inflation objective and estimate of the NAIRU (that the Fed now provides though its long-term forecasts of inflation and unemployment.

If there is any problem with Fed transparency, with all due respect, it arises because of the lack of focus on, and therefore expertise, of the Congress with respect to monetary policy. Members of the oversight committees are often distracted by other issues, particularly ones that Congress has the authority for. The semi-annual testimony is a really great opportunity for transparency. Please don't waste it.

Is monetary policy transparent enough? Well, there are always possibilities of improving it, but it is already very good, despite the complaints of some on your committee. In particular, although there is no magic number for the number of years that transcripts should lag meetings, I see no reason to change the current five-year lag. For example, moving it up substantially would increase the focus on who said what as opposed to what the Committee discussed, what the range of views were, and what decisions were taken. The broad themes and disagreements in the FOMC are revealed three weeks after the meeting in the minutes. Also, if the transcripts were to come out too soon after meetings, this would undoubtedly constrain the discussion at meetings.

One direction I can think of is to require the Fed to hold a press conferences after each FOMC meeting. Some other central banks already do this. That is something the Fed

can discuss internally, but I would not mandate it. Another is to support any decision by the FOMC to set a formal, explicit inflation objective. This is hardly necessary, given the information the Committee already supplies about the central tendency with of long-run inflation. But some members of the Committee, including the Chairman, support it. I did when I was on the Board, and still do. But this decision again should be made by the FOMC, in consultation with the oversight committees. No legislation is needed, in my view, because this is simply providing more transparency about how the Fed interprets its price stability mandate.

Let me end with a related issue: whether the GAO should audit the FOMC's monetary policy. As you know, the GAO audits virtually every other aspect of the Fed (financial, efficiency, bank supervision and regulation, consumer protection, and, a new addition, the Fed's credit easing programs, including interventions at particular institutions). The difference with monetary policy is the Fed's independence in this realm. It will be perceived as, and could easily become, an infringement on the Fed's independence were the GAO to audit monetary policy. This would especially be the case, if members of Congress could require an audit at any time. In the past, this would always have been when it appeared that the Fed might be at the end of an easing cycle or at the beginning of a tightening cycle. When I was on the Board for 5½ years, this was the only time we ever heard from members of Congress. OK, you need to score points back home, we never minded the letters, but neither did we pay any attention to them. The independence of the Federal Reserve with respect to monetary policy allowed the FOMC to conduct monetary policy in a way that best served the public interest. Isn't that why governments around the world have delegated monetary policy decisions to independent central banks, specifically because they appreciated that the government could not responsibly carry out this task themselves? The GAO was established by the Congress and is effectively an arm of the Congress. Allowing them to audit monetary policy would be a small but important step in the direction of infringing on Fed independence (see answer to question 1).

There could however be opportunities for more transparency about supervisory and regulatory responsibilities and interventions at individual institutions, though, in the latter case, there are extensive Congressional hearings with all the parties involved.

(3) From your previous experience as a Federal Reserve Governor, what level of resources would the Fed need to effectively mange systemic risk regulation and monetary policy?

First, the Fed has the deepest, most experienced, and highest quality staff of any agency in the U.S., and perhaps in the world. Relative to the Fed, the Treasury, for example, is notoriously understaffed, especially today, given the vetting process! The Board staff is certainly more than adequate to support the Board's governors and the FOMC in their deliberations about monetary policy. Nothing here needs to be changed, perhaps with one exception. A sophisticated knowledge of finance and financial markets is increasingly important in the Federal Reserve System. There are ample resources at the NY Fed, but the Board has always had trouble hiring (and retaining) staff in finance

because they are so well paid even as assistant professors at business schools, not to mention in the private sector. The Board has tried a variety of incentive schemes to deal with this problem, but has never been prepared to close the competitive gap. The Board tried to remedy this deficiency by growing their own staff in finance, first identifying those with the theoretical and mathematical skills required in this area and then sending them to graduate programs to study finance. The result however was that most of these staff were quickly wooed away by the private sector after "returning" to the Fed.

The adequacy of the supervisory and regulatory staff at the Board and throughout the Reserve Banks is quite a different story, but closely related to the difficulty of attracting and retaining people in finance. The greatest problem at the Fed is attracting and retaining the most sophisticated examiners to oversee and think about regulation for the largest and most complex banking organizations (now the most systemically-important financial institutions). The Fed and especially the Reserve Banks (where the examiners are housed) operate under a higher pay scale than federal workers. So this would be a more acute problem if any other institution was given this responsibility. In addition, no other agency has experience with the consolidated supervision of bank holding companies at systematically important financial institutions.

There are, it should be noted, two rather distinct functions of a systemic regulator. Under the Treasury proposal, the Fed is assigned one of these responsibilities, the consolidated supervision of all systemically important financial institutions. As I noted at the testimony, the Fed, as bank holding company supervisor, is already the consolidated supervisor of nearly all systemically-important institutions. There are only a few, maybe two or three, out of say 25 systemically-important financial institutions remaining. Note also that the only casualties among systemically-important financial institutions occurred among those who at the time were not subject to Fed supervision (Bear Sterns, Lehman, and AIG). So it is a myth that the Fed would be given vast new powers under the Treasury proposal. This is a very serious myth because this misunderstanding has resulted in a lot of hostility in Congress about the Treasury proposal, given the reluctance in Congress to give the Fed any substantial additional powers.

The other function of a systemic regulator is to monitor emerging systemic risks (risks that cut across individual institutions, and show up in developments related to market functioning, innovation in financial instruments, and evolving financial practices). This is a new and very important responsibility and it has been assigned to the new Risk Council, chaired by the Secretary of the Treasury and supported by Treasury staff. I understand that the Treasury was sensitive to giving the Fed still more additional powers and also wanted to take on this responsibility itself, but this was a poor choice. The Treasury, understaffed as it is, will lean heavily on Fed staff. In addition, the Fed, as informal monitor of financial stability, will duplicate this effort in any case. It would be more efficient, and a better solution, to give this responsibility to the Fed. I appreciate that there is little chance that this would happen.

By the way, assigning the Risk Council the responsibility for consolidated supervision of the systemically-important financial institutions not now supervised by the Fed, would

be, with all due respect, sheer idiocy. Please don't even think of going in this direction. Indeed the only other way to ensure adequate supervision of these institutions would be the alternative direction I discuss immediately below.

(4) You testified that systemic risk regulation, including intervention at specific financial institutions, requires cooperation between the Federal Reserve, functional regulators of banks and non-banks, and the Treasury Department. Is the "Financial Services Oversight Council" proposed by the Administration sufficient to facilitate that cooperation? Are there other changes or other structures that might better facilitate this cooperation more effectively? Please describe.

As I am sure you know from experience, any inter-agency council's effectiveness will be undermined by squabbling, competitiveness, different perceptions of mission, as well as jealousy of the Fed because of its power and status. But this is going to be true of any inter-agency council. When I was on the Board, we participated in the FFIEC (the Federal Financial Institutions Examination Council) with the three other federal bank supervisors (OCC, FDIC and OTS). The heads of the OTC, FDIC, and OTS participated in this council, but the Fed representative was the chairman of the Fed's Committee on Supervision and Regulation (me during most of the time I was on the Board). I would only bring out the cannon (Greenspan) when I could not persuade the others of the merits of our position! (By the way, Greenspan never lost a battle!) The state supervisors would participate, but in a perfunctory way. The Board staff, and me as oversight governor, also met, toward the end, with the SEC to smooth out the respective responsibilities of the SEC as functional regulator of broker dealers in bank holding companies and the Fed's authority over bank holding companies. In any case, none of the ideas for an inter-agency council will operate especially well, particularly especially in terms of monitoring emerging systemic risks. The Council could play a useful role of gather of information and coordination across agencies. But don't expect too much here. Nevertheless, I don't have a better solution.

Now I am sure that you have read or had testimony on more sweeping proposals for regulatory reform that typically call for the supervision of all financial institutions to be transferred to and unified in a new financial services agency, like the FSA in the U.K. There is somewhat of a trend over the last decade in this direction. However, I think this would be a mistake and that the proposals are seriously flawed. First, it would be a radical change in the structure of regulation, with quite uncertain results. Second, it would be a serious mistake to take the Fed out of hands-on supervision, especially of the systemically-important financial institutions. Central banks around the world are always assigned, at least informally, the role of monitor of financial risks. Indeed, this was the reason that the Fed was founded, not monetary policy as we practice it today. Also, the Fed, as liquidity provider in general and the liquidity provider of last resort in financial crises, needs to know directly about the credit-worthiness of the institutions it could be called upon to lend to. Hands-on knowledge of the health of systemically-important institutions is also vitally important to projecting what will happen to the macro-economy and therefore has an important synergy with monetary policy. Finally, when the Bank of

England became independent, the government took away its hands-on supervisory authority over banks and transferred it to the FSA. I think it is fair to say that taking the Bank of England out of hands-on supervision delayed the Bank's response to the crisis and ended up intensifying the damage done. This, in my mind, has discredited this direction.

Thank you again for giving me this opportunity to share my views with you and the Committee about these very important issues.