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EXAMINING THE LINK BETWEEN FED BANK SUPERVISION AND MONETARY POLICY

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

MARCH 17, 2010

Printed for the use of the Committee on Financial Services

Serial No. 111–112

U.S. GOVERNMENT PRINTING OFFICE

56–776 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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EXAMINING THE LINK BETWEEN FED BANK SUPERVISION AND MONETARY POLICY

Wednesday, March 17, 2010

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Watt, Sherman, Meeks, Moore of Kansas, Hinojosa, McCarthy of New York, Baca, Miller of North Carolina, Scott, Green, Cleaver, Donnelly, Foster, Speier, Minnick, Kosmas, Himes; Bachus, Royce, Paul, Biggert, Hensarling, Garrett, Neugebauer, Price, Marchant, Jenkins, Lee, Paulsen, and Lance.

The CHAIRMAN. Will the photographers please stand down? The only thing we could see was Mr. Volcker. Now, we can see everybody.

This hearing will come to order. It is an important hearing that is relevant to the legislative task before us.

As members know, the Senate had been considering very much the question of what the supervisory reach of the Federal Reserve should be. We obviously dealt with it in the bill that passed the House.

We will, I believe, now be going to conference some time in April or early May, and one of the questions will be the appropriate role for the Federal Reserve.

This is a subject which the chairman of the Subcommittee on Domestic Monetary Policy, the gentleman from North Carolina, has given a great deal of attention to.

Obviously, it is clear to people that many of us felt that the Senate's initial instincts here were insufficiently recognizing the importance of a role for the Federal Reserve.

There has been some movement. The differences are less than they were. I now believe, as with the legislation in general, we are entering a range where the desire and the need for a bill will be greater than any individual differences.

An important part of this will be how should the supervisory role of the Federal Reserve be structured, and that is why we are very pleased to have the Chairman and the past Chairman of the Federal Reserve with us to talk about this.

While I have the microphone, let me just say I want to make a couple of announcements that are relevant. This morning, I received letters, first from our colleague from Ohio, Ms. Kilroy, and then from Ranking Member Bachus asking for hearings into the information that was contained in the examiner's report on Lehman Brothers, and that is obviously something we should do.

It is something I believe we address in our legislation, this whole question of off balance sheet activity; that is important.

We will have a hearing on that in April. Our hearing schedule has gotten pretty crowded. In April, as I told Ms. Kilroy and Mr. Bachus, we will be having a hearing. It will be a full committee hearing because the people involved include some people at the Department head levels and those have to be at the full committee. We will be having that hearing.

We will proceed today with this hearing on the question of how to do the regulation.

I am going to yield back the balance of my time so that it can be made available to the chairman of the subcommittee.

I am going to now recognize the ranking member, but the driving force here, and the member who has put the most effort and considerable thought into this, is the gentleman from North Carolina.

I am now going to turn the gavel over to the gentleman from North Carolina, and he has my remaining 3 minutes, plus his own time to allocate as he chooses, and the gentleman from Alabama is now recognized for 5 minutes.

Mr. BACHUS. Thank you, Mr. Chairman. As Congress looks at ways to reform the country's financial infrastructure, we need to ask whether bank supervision is central to central banking.

It is worth examining whether the Federal Reserve should conduct monetary policy at the same time it regulates and supervises banks or whether it should concentrate exclusively on its microeconomic responsibilities. It is no exaggeration to say the health of our financial system depends on getting this answer right.

Frankly, the Fed's performance as a holding company supervisor has been inadequate. Despite its oversight, many of the large complex banking organizations were excessively leveraged and engaged in off balance sheet transactions that helped precipitate the financial crisis.

Just this past week, Lehman Brothers' court-appointed bankruptcy examiner report was made public. The report details how Lehman Brothers used accounting gimmicks to hide its debt and mask its insolvency.

According to the New York Times, all this happened while a team of officials from the Securities and Exchange Commission and the Federal Reserve Bank of New York were resident examiners in the headquarters of Lehman Brothers.

As many as a dozen government officials were provided desks, phones, computers, and access to all of Lehman's books and records. Despite this intense on-site presence, the New York Fed and the SEC stood idle while the bank engaged in the balance sheet manipulations detailed in the report.

This raises serious questions regarding the capability of the Fed to conduct bank supervision, yet even if supervision of its regulated

institutions improved, it is not clear that oversight really informs monetary policy.

If supervision does not make monetary policy decisions better, then the two do not need to be coupled.

Vince Reinhart, a former Director of the Fed's Division of Monetary Affairs and now a resident scholar at the American Enterprise Institution, said that collecting diverse responsibilities in one institution is like asking a plumber to check the wiring in your basement.

It seems that when the Fed is responsible for monetary policy and bank supervision, its performance in both suffers. Microeconomic issues cloud the supervisory judgments, therefore impairing safety and soundness.

There are inherent conflicts of interest where the Fed might be tempted to conduct monetary policy in such a way that hides its mistakes by protecting the struggling banks it supervises.

An additional problem arises when the supervision of large banks is separated from small institutions. Under Senator Dodd's proposal, the Fed would supervise 40 or 50 large banks, and the other 7,500 or so banks would be under the regulatory purview of other Federal and State banking agencies.

If this were to happen, the Fed's focus on the mega banks will inevitably disadvantage the regional and community banks, and I think on this, Chairman Bernanke, you and I are in agreement, that there ought to be one regulator looking at all the institutions.

H.R. 3311, the House Republican regulatory reform plan, would correct these problems. It would refocus the Fed on its monetary policy mandate by relieving it of its regulatory and supervisory responsibilities and reassign them to other agencies. By contrast, the regulatory reform legislation passed by the House in December represented a large expansion of the Fed's regulatory role since its creation almost 100 years ago.

Senator Dodd has strengthened the Fed even more. His regulatory reform bill empowers the Fed to regulate systemically significant financial institutions and to enforce strict standards for institutions as they grow larger and more complex, adopts the Volcker Rule to restrict proprietary trading and investment by banks, and creates a new consumer financial protection bureau to be housed and funded by the Fed.

In my view, the Democrats are asking the Fed to do too much.

Thank you again, Mr. Chairman, for holding this hearing. I look forward to the testimony.

Mr. WATT. [presiding] I thank the gentleman for his opening statement.

Let me see if I can try to use some of the chairman's time and my time to kind of frame this hearing in a way that we will kind of get a balanced view of what folks are saying.

The Federal Reserve currently has extensive authority to regulate and supervise bank holding companies and State banks that are members of the Federal Reserve System, and foreign branches of member banks, among others.

Last year, the House passed our financial services reform legislation that substantially preserved the Fed's power to supervise these financial institutions. The Senate bill recently introduced by Sen-

ator Dodd, however, would strip the Fed's authority to supervise all but approximately the 40 largest financial institutions.

This hearing was called to examine the potential policy implications of stripping regulatory and supervisory powers over most banks from the Fed, especially the potential impact this could have on the Fed's ability to conduct monetary policy effectively.

Proponents of preserving robust Fed supervision authority cite three main points to support their position that the Fed should retain broad supervisory powers.

First, they say that the Fed has built up over the years deep expertise in microeconomic forecasting of financial markets and payment systems which allows the effective consolidated supervision of financial institutions of all sizes and allows effective macro prudential supervision over the financial system. Proponents of retaining Fed supervision say this expertise would be costly and difficult if not impossible to replicate in other agencies.

Second, the proponents say that the Fed's oversight of the banking system improves this ability to carry out central banking responsibilities, including the responsibility for responding to financial crises and making informed decisions about banks seeking to use the Fed's discount window and lender of last resort services.

In particular, proponents say that knowledge gained from direct bank supervision enhances the safety and soundness of the financial system because the Fed can independently evaluate the financial condition of individual institutions seeking to borrow from the discount window, including the quality and value of these institutions' collateral and their overall loan portfolio.

Third, proponents say that the Fed's supervisory activities provide the Fed information about the current state of the economy and the financial system that influences the FOMC in its execution of monetary policy, including interest rate setting.

On the flip side, there obviously are many critics of the Fed's role in bank supervision. Some of these critics blast the Fed for keeping interest rates too low for too long in the early 2000's, which some say fueled an asset price bubble in the housing market and the resulting subprime mortgage crisis.

Consumer advocates and others accuse the Fed of turning a blind eye to predatory lending throughout the 1990's and 2000's, reminding us that Congress passed the HOEPA legislation in 1994 to counteract predatory lending, but the Fed did not issue final rules until well after the subprime crisis was out of control.

Other critics accuse the Fed of ignoring the consumer protection role during supervisory examinations of banks and financial institutions across a wide range of financial products, including overdraft fees and credit cards and other things.

Perhaps the appropriate policy response lies somewhere between the proponents and critics of the Fed bank supervision.

I have tried to keep an open mind about the role of the Fed going forward, and hope to use today's hearing to get more information as we move forward to discussions with the Senate, if the Senate ever passes a bill.

We are fortunate to have both the current Chairman and a former Chairman who are appearing today to inform us on these difficult issues, and with that, I will reserve the balance of our time

and recognize Dr. Paul, my counterpart, the ranking member of the subcommittee.

Dr. PAUL. I thank the chairman for yielding.

Yesterday was an important day because it was the day the FOMC met and the markets were hanging in there, finding out what will be said at 2:15, and practically, they were looking for two words, whether or not two words would exist: "extended period." That is, whether this process will continue for an extended period.

This, to me, demonstrates really the power and the control that a few people have over the entire economy. Virtually, the markets stand still and immediately after the announcement, billions of dollars can be shifted, some lost and some profits made.

It is a system that I think does not have anything to do with free market capitalism. It has to do with a managed economy and central economic planning. It is a form of price fixing. Interest rates fixed by the Federal Reserve is price fixing, and it should have no part of a free market economy. It is the creation of credit and causing people to make mistakes, and also it facilitates the deficits here.

Congress really does not want to challenge the Fed because they spend a lot. Without the Fed, interest rates would be very much higher.

To me, it is a threat to those of us who believe in personal liberty and limited government. Hardly does the process help the average person. Unemployment rates stay up at 20 percent. The little guy cannot get a loan. Yet, Wall Street is doing quite well.

Ultimately, with all its power, the Fed still is limited. It is limited by the marketplace, which can inflate like crazy. It can have financial bubbles. It can have housing bubbles. Eventually, the market says it is too big and it has to be corrected, but the mistakes have been made.

They come in and the market demands deflation. Of course, Congress and the Fed do everything conceivable to maintain these bubbles.

It is out of control. Once the change of attitude comes, when that inflated money supply decides to go into the market and prices are going up, once again the Fed will have difficulty handling that.

The inflationary expectations and the velocity of money are subjectively determined, and no matter how objective you are about money supply, conditions, and computers, you cannot predict that.

We do not know what tomorrow will bring or next year. All we know is that the engine is there, the machine is there, the high powered money is there, and of course, we will have to face up to that some day.

The monetary system is what breeds the risky behavior. That is what we are dealing with today. Today, we are going to be talking about how we regulate this risky behavior, but you cannot touch that unless we deal with the subject of how the risky behavior comes from easy money, easy credit, artificially low interest rates, and the established principle from 1913 on that the Federal Reserve is there to be the lender of last resort.

As long as the lender of last resort is there, all the regulations in the world will not touch it and solve that problem.

I yield back.

Mr. WATT. I thank the gentleman for his opening statement. I think we have about 1 minute and 30 seconds left, which is yielded to Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman. "Too-big-to-fail" is "too-big-to-exist." As we examine the power of the Fed, it begs the question, what about the provisions that prevent an audit of the Fed? The Fed is exempted from audits, not only in the area of monetary policy but also foreign agreements.

All of the efforts by the Fed to defend their exclusion from audit have focused on well, that could affect monetary policy, which begs the question, why is the Fed demanding an exemption or continuation of an exemption of its foreign agreements from the audit process?

If supervision informs monetary policy, then we have to ask why the other bank supervisors are unwilling to share information with the Fed and why economic statistics are not being shared, not only with the Fed but with the American people.

Finally, as the Supreme Court decides that corporations who hold government posts by spending unlimited amounts of money on campaigns, at least there in order to get a particular person selected for governmental authority, they have to convince humans to vote for them.

The one exception to that is the Fed regional boards where corporations get to select who sits on these boards and who exercises governmental power without them being responsible to the voters at all.

In a democracy, every agency of governmental power should be responsible for the electorate.

I yield back.

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

We are fortunate to have the Chairman of the Board of Governors of the Federal Reserve, the Honorable Ben Bernanke, and the Chairman of the President's Economic Recovery Advisory Board, and former Chairman of the Federal Reserve, the Honorable Paul Volcker.

We will recognize the Chairman first, and then, Mr. Volcker.

STATEMENT OF THE HONORABLE BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE

Mr. BERNANKE. Thank you, Chairman Watt, Ranking Member Bachus, and other members of the committee.

I am pleased to have the opportunity to discuss the Federal Reserve's role in bank supervision and the actions that we are taking to strengthen our supervisory oversight.

Like many central banks around the world, the Federal Reserve cooperates with other agencies in regulating and supervising the banking system.

Our specific responsibilities include the oversight of about 5,000 bank holding companies, including the umbrella supervision of large complex financial firms, the supervision of about 850 banks nationwide that are both State chartered and members of the Federal Reserve System, so-called "State member banks," and the oversight—

Mr. WATT. Will the gentleman pause for just a second? Ma'am, you are going to have to take that sign out of here. I am sorry. You are breaking the rules. You are either going to have to leave or we will have to have you removed or you will have to take the sign out.

Any time today would be nice, ma'am. Thank you.

Chairman Bernanke, you can resume.

Mr. BERNANKE. The Federal Reserve's involvement in regulation and supervision confers two broad sets of benefits to the country. First, because of its wide range of expertise, the Federal Reserve is uniquely suited to supervise large complex financial organizations and to address both safety and soundness risks and risks to the stability of the financial system as a whole.

Second, the Federal Reserve's participation in the oversight of banks of all sizes significantly improves its ability to carry out its central banking functions, including making monetary policy, lending through the discount window, and fostering financial stability.

The financial crisis has made it clear that all financial institutions that are so large and interconnected that their failure could threaten the stability of the financial system and the economy must be subject to strong consolidated supervision.

Promoting the soundness and safety of individual banking organizations requires the traditional skills of bank supervisors, such as expertise in examination of risk management practices. The Federal Reserve has developed such expertise in its long experience supervising banks of all sizes, including community banks and regional banks.

The supervision of large complex financial institutions and the analysis of potential risks to the financial system as a whole requires not only traditional examination skills, but also a number of other forms of expertise, including: macroeconomic analysis and forecasting; insight into sectoral, regional, and global economic developments; knowledge of a range of domestic and international financial markets, including money markets, capital markets, and foreign exchange and derivatives markets; and a close working knowledge of the financial infrastructure, including payment systems and systems for clearing and settlement of financial instruments.

In the course of carrying out its central banking duties, the Federal Reserve has developed extensive knowledge and experience in each of these areas critical for effective consolidated supervision.

For example, Federal Reserve staff members have expertise in macroeconomic forecasting for the making of monetary policy, which is important for helping to identify economic risks to institutions and to markets.

In addition, they acquire in-depth market knowledge through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury.

Similarly, the Federal Reserve's extensive knowledge of payment and settlement systems has been developed through its operation of some of the world's largest such systems, its supervision of key providers of payment and settlement services, and its long-standing

leadership in the International Committee on Payment and Settlement Systems.

No other agency can or is likely to be able to replicate the breadth and depth of relevant expertise that the Federal Reserve brings to the supervision of large complex banking organizations and the identification and analysis of systemic risks.

Even as the Federal Reserve's central banking functions enhance supervisory expertise, its involvement in supervising banks of all sizes across the country significantly improves the Federal Reserve's ability to effectively carry out its central bank responsibilities.

Perhaps most important, as this crisis has once again demonstrated, the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has as both a bank supervisor and a central bank, not only in this crisis, but also in episodes such as the 1987 stock market crash and the terrorist attacks of September 11, 2001.

The Federal Reserve's supervisory role was essential for it to contain threats to financial stability.

The Federal Reserve making of monetary policy and its management of the discount window also benefit from its supervisory experience.

Notably, the Federal Reserve's role as the supervisor of State member banks of all sizes, including community banks, offers insights about conditions and prospects across the full range of financial institutions, not just the very largest, and provides useful information about the economy and financial conditions throughout the Nation. Such information greatly assists in the making of monetary policy.

The legislation passed by the House last December would preserve the supervisory authority that the Federal Reserve needs to carry out its central banking functions effectively.

The Federal Reserve strongly supports ongoing efforts in the Congress to reform financial regulation and to close existing gaps in the regulatory framework. While we await passage of comprehensive reform legislation, we have been conducting an intensive self-examination of our regulatory and supervisory performance and have been actively implementing improvements.

On the regulatory side, we have played a key role in international efforts to ensure that systemically critical financial institutions hold more and higher quality capital, have enough liquidity to survive highly stressed conditions, and meet demanding standards for company wide risk management.

We also have been taking the lead in addressing flawed compensation practices by issuing proposed guidance to help ensure that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking.

Less formally, but equally important, since 2005, the Federal Reserve has been leading cooperative efforts by market participants and regulators to strengthen the infrastructure of a number of key markets, including the markets for security repurchase agreements and the markets for credit derivatives and other over-the-counter derivative instruments.

To improve both our consolidated supervision and our ability to identify potential risks to the financial system, we have made substantial changes to our supervisory framework so that we can better understand the linkages among firms and markets that have the potential to undermine the stability of the financial system.

We have adopted a more explicitly multi-disciplinary approach, making use of the Federal Reserve's broad expertise in economics, financial markets, payment systems, and bank supervision, to which I alluded earlier.

We are also augmenting our traditional supervisory approach that focuses on firm by firm examinations with greater use of horizontal reviews and to look across a group of firms to identify common sources of risks and best practices for managing those risks.

To supplement information from examiners in the field, we are developing an off-site enhanced quantitative surveillance program for large bank holding companies that will use data analysis and formal modeling to help it identify vulnerabilities at both the firm level and for the financial sector as a whole.

This analysis will be supported by the collection of more timely detailed and consistent data from regulated firms.

Many of these changes draw on the successful experience of the Supervisory Capital Assessment Program (SCAP), also known as the "banking stress test," which the Federal Reserve led last year.

As in the SCAP, representatives of primary and functional supervisors will be fully integrated in the process, participating in the planning and execution of horizontal exams and consolidated supervisory activities.

Improvements in the supervisory framework will lead to better outcomes only if day-to-day supervision is well executed, with risks identified early and promptly remediated.

Our internal reviews have identified a number of directions for improvement. In the future, to facilitate swifter and more effective supervisory responses, the oversight and control of our supervisory function will be more centralized, with shared accountability by senior Board and Reserve Bank supervisory staff and active oversight by the Board of Governors.

Supervisory concerns will be communicated to firms promptly and at a high level, with more frequent involvement of senior bank managers and boards of directors and senior Federal Reserve officials.

Greater involvement of senior Federal Reserve officials and strong systematic follow-through will facilitate more vigorous remediation by firms.

Where necessary, we will increase the use of formal and informal enforcement actions to ensure prompt and effective remediation of serious issues.

In summary, the Federal Reserve's wide range of expertise makes it uniquely suited to supervise large complex financial institutions and to help identify risks to the financial system as a whole.

Moreover, the insights provided by our role in supervising a range of banks, including community banks, significantly increases our effectiveness in making monetary policy and fostering financial stability.

While we await enactment of comprehensive financial reform legislation, we have undertaken an intensive self-examination of our regulatory and supervisory performance.

We are strengthening regulations and overhauling our supervisory framework to improve consolidated supervision as well as our ability to identify potential threats to the stability of the financial system. We are taking steps to strengthen the oversight and effectiveness of our supervisory activities.

Thank you, and I would be pleased to respond to questions.

[The prepared statement of Chairman Bernanke can be found on page 66 of the appendix.]

Mr. WATT. We will now hear from the Honorable Paul Volcker, Chairman of the President's Economic Recovery Advisory Board, and former Chairman of the Federal Reserve.

STATEMENT OF THE HONORABLE PAUL A. VOLCKER, CHAIRMAN OF THE PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD, AND FORMER CHAIRMAN OF THE FEDERAL RESERVE

Mr. VOLCKER. I appreciate your invitation to address important questions concerning the link between monetary policy and Federal Reserve responsibilities for the supervision and regulation of financial institutions.

Before addressing the specific questions you have posed, I would like to make clear my long-held view, a view developed and sustained by years of experience in the Treasury, the Federal Reserve, and in private finance.

Monetary policy and concerns about the structure and condition of banks in the financial system more generally are inextricably intertwined, and if you need further proof of that proposition, just consider the events of the last couple of years.

Other agencies, certainly including the Treasury, have legitimate interests in regulatory policy, but I do insist that neither monetary policy nor the financial system will be well served if our central bank is deprived from interest in and influence over the structure and performance of the financial system.

Today, conceptual and practical concerns about the extent, the frequency, and the repercussions of economic and financial speculative excesses have come to occupy our attention.

The so-called "bubbles" are indeed potentially disruptive of economic activity. Then important and interrelated questions arise for both monetary and supervisory policies. Judgment is required about if and when an official response, some form of intervention is warranted. If so, is there a role for monetary policy, for regulatory actions, or for both?

How can those judgments and responses be coordinated and implemented in real time in the midst of crisis in a matter of days?

The practical fact is the Federal Reserve must be involved in those judgments and that decision-making, beyond this broad responsibility for monetary policy and its influence on interest rates. It is the agency that has the relevant technical experience growing out of working in the financial markets virtually every day.

As a potential lender of last resort, the Fed must be familiar with the condition of those to whom it lends.

It oversees and participates in the basic payment system, domestically and internationally.

In sum, there is no other official institution that has the breadth of institutional knowledge, the expertise, and the experience to identify market and institutional vulnerabilities.

It also has the capability to act on very short notice. The Federal Reserve, after all, is the only agency that has financial resources at hand in amounts capable of emergency response.

More broadly, I believe the experience demonstrates conclusively that the responsibilities of the Federal Reserve with respect to maintaining economic and financial stability require close attention to manage beyond the specific confines of monetary policy, if we interpret monetary policy narrowly, as influencing monetary aggregates and short-term interest rates.

For instance, one recurring challenge in the conduct of monetary policy is to take account of the attitudes and approaches of banking supervisors as they act to stimulate or to restrain bank lending, and as they act to adjust capital standards of financial institutions.

The need to keep abreast of rapidly developing activity in other financial markets, certainly including the markets for mortgages and derivatives, has been driven home by the recent crisis.

None of this to my mind suggests the need for regulatory and supervisory authority to lie exclusively in the Federal Reserve. In fact, there may be advantages in some division of responsibilities.

A single regulator may be excessively rigid and insensitive to market developments, but equally clearly, we do not want competition and laxity among regulators aligning with particular constituencies or exposed to narrow political pressures.

We are all familiar in the light of all that has happened with weaknesses in supervisory oversight, with failures to respond to financial excesses in a timely way and with gaps in authority. Those failings spread in one way or another among all the relevant agencies, not excepting the Federal Reserve.

Both law and practice need reform. However these issues are resolved, I do believe the Federal Reserve, our central bank, with the broadest economic responsibility, with a perceived mandate for maintaining financial stability, with the strongest insulation against special political or industry pressures, must maintain a significant presence with real authority in regulatory and supervisory matters.

Against that background, I respond to the particular points you raised in your invitation.

I do believe it is apparent that regulatory arbitrage and the fragmentary nature of our regulatory system did contribute to the nature and extent of the financial crisis. That crisis exploded with a vengeance outside the banking system, involving investment banks, the world's largest insurance company, and government-sponsored agencies.

Regulatory and supervisory agencies were neither reasonably equipped nor conscious of the extent of their responsibilities. Money market funds growing over several decades were essentially a pure manifestation of regulatory arbitrage.

Attracting little supervisory attention, they broke down under pressure, a point of significant systemic weakness, and the remark-

able rise of the subprime mortgage market developed through a variety of channels, some without official oversight.

There are large questions about the role and supervision of the two hybrid public/private organizations that came to dominate the largest of all our capital markets, that for residential mortgages.

Undeniably, in hindsight, there were weaknesses and gaps in the supervision of well-established financial institutions, including banking institutions, major parts of which the Federal Reserve carries direct responsibility.

Some of those weaknesses have been and should have been closed by more aggressive regulatory approaches, but some gaps and ineffective supervision of institutions owning individual banks and small thrifts were loopholed, expressly permitted by legislation.

As implied by my earlier comments, the Federal Reserve, by the nature of its core responsibilities, is thrust into direct operational contact with financial institutions and markets.

Beyond those contacts, the 12 Federal Reserve banks exercising supervisory responsibilities provide a window into both banking developments and economic tendencies in all regions of the country.

In more ordinary circumstances, intelligence gleaned on the ground about banking attitudes and trends will supplement and color forecasts and judgments emerging from other indicators of economic activity.

When the issue is timely identification of highly speculative and destabilizing bubbles, a matter that is both important and difficult, then there are implications for both monetary and supervisory policy.

Finally, the committee has asked about the potential impact of stripping the Federal Reserve of direct supervisory and regulatory power over the banks and other financial institutions, and whether something can be learned about the practices of other nations.

Those are not matters that permit categorical answers good for all time. International experience varies. Most countries maintain a position, often a strong position, and a typically strong position for central banks' financial supervision. In some countries, there has been a formal separation.

At the extreme, all form of supervisory regulatory authority over financial institutions was consolidated in the U.K. into one authority, with rather loose consultative links to the central bank. The approach was considered attractive as a more efficient arrangement, avoiding both agency rivalries and gaps or inconsistencies in approach.

The sudden pressure of the developing crisis revealed a problem in coordinating between the agency responsible for the supervision, the central bank, which needed to take action, and the Treasury.

The Bank of England had to consider intervention with financial support without close and confident appraisals of the vulnerability of affected institutions. As a result, I believe the U.K. itself is reviewing the need to modify their present arrangements.

For reasons that I discussed earlier, I do believe it would be a really grievous mistake to insulate the Federal Reserve from direct supervision of systemically important financial institutions.

Something important but less obvious would also be lost if the present limited responsibilities for smaller member banks were to be ended. The Fed's regional roots would be weaker and an useful source of information lost.

I conclude with one further thought. In debating regulatory arrangements and responsibilities appropriate for our national markets, we should not lose sight of the implications for the role of the United States in what is in fact a global financial system.

We necessarily must work with other nations and their financial authorities. The United States should and does still have substantial influence in those matters, including agreement on essential elements of regulatory and supervisory policies.

It is the Federal Reserve as much as and sometimes more than the Treasury that carries a special weight in reaching the necessary understandings. That is a matter of tradition, experience, and of the perceived confidence in the authority of our central bank.

There is a sense of respect and confidence around the world, matters that cannot be prescribed by law or easily replaced.

Clearly, changes need to be made in the status quo. That is certainly true within the Federal Reserve. I believe regulatory responsibilities should be more clearly focused and supported. The crisis has revealed the need for change within other agencies as well.

Consideration of broader reorganization of the regulatory and supervisory arrangements is timely. At the same time, I urge in your deliberations that you do recognize what would be lost, not just in the safety and soundness of our national financial system, but in influencing and shaping the global system, if the Federal Reserve were to be stripped of its regulatory and supervisory responsibilities, and no longer be recognized here and abroad as "primus inter pares" among the agencies concerned with the safety and soundness of our financial institutions.

Let us instead strengthen what needs to be strengthened and demand high levels of competence and performance that for too long we have taken for granted.

Thank you, ladies and gentlemen.

[The prepared statement of Chairman Volcker can be found on page 100 of the appendix.]

Mr. WATT. I thank both the Chair and former Chair for your statements. We will now recognize the members for 5 minutes of questions. I will remind the members that there is a second panel of witnesses, so we want to try to stick to the 5 minutes.

I will recognize myself first for 5 minutes.

Chairman Bernanke, the current system we have has a division of supervisory responsibilities between the Fed, the FDIC, the OCC, and I guess a fourth agency that would be consolidated under the House bill. How has that worked and how have you been able to compensate for the things that you say are so critical in that framework?

Mr. BERNANKE. Mr. Chairman, I think there were some flaws at each level. There were flaws at the level of the legislative structure. There were flaws at the level of execution. I think we need to look at all of those.

I think there are two main lessons from the crisis. One is that every systemically critical large institution needs to have a consolidated supervisor that can look at the whole company and understand the risks that are faced by that company.

Many of the worst problems in the investment banks and AIG and in other companies and markets were areas where there was no strong supervisor, where there was just a gap. We need to fix that as we go forward.

We also, I think, need to strengthen the concept of consolidated supervision. We currently have a system where each supervisor is assumed to defer to the functional regulator of each subsidiary, and in some cases, that is not appropriate. When a consolidated supervisor sees a problem in a subsidiary, it needs the authority to go in and look at that.

The other broad concern, the other thing we learned from the crisis at the very highest level, is the need to look at the system from a systemic perspective, not just look at each individual firm, but to look at broad risks to the whole system.

I think that some of the ideas which have been advanced in the House bill and Senator Dodd's proposal, such as creating a systemic risk council, and broadening the responsibilities of some of the regulators, would help address that problem, and together with tougher regulations like higher capital standards, I think that would improve our oversight considerably.

Mr. WATT. The Dodd bill that was recently introduced sets a $50 billion threshold for supervision of the Fed. Is there any rationale for either that $50 billion threshold or any other threshold? How does this cut in terms of actual need to be able to be involved in these things to determine or set monetary policy?

Mr. BERNANKE. Mr. Chairman, we are quite concerned by proposals to make the Fed a regulator only of the biggest banks. It makes us essentially the "too-big-to-fail" regulator. We do not want that responsibility.

We want to have a connection to Main Street as well as to Wall Street. We need to have insights into what is happening in the entire banking system to understand how regulation affects banks, to understand the status of the assets and credit problems of banks at all levels, all sizes, and smaller and medium-sized banks are very valuable to us and they provide irreplaceable information, both in terms of making monetary policy and in terms of us understanding the economy, but also in terms of financial stability.

Let's not forget that small institutions have been part of financial crises in the past, including in the 1930's, in the thrift crisis, and other examples.

We think it is very important for the Federal Reserve not to be just the big institution regulator. We need to have exposure to the entire economy and to the broad financial system.

Mr. WATT. Chairman Volcker, you indicated that some division of supervisory and regulatory responsibility is appropriate. I am trying to get a better view of what you think that division should be if neither the Senate bill nor the House bill is necessarily ideal.

Mr. VOLCKER. If you are going to have more than one regulatory agency, and I have some sympathy for that, you have to have some division of responsibility.

Just where you place that, I do not know. I do not know the implications of the $50 billion. I do not know how many banks are below $50 billion offhand, and if the Federal Reserve maintained a small number of member bank supervision, what the FDIC would have and what the OCC would have. I think that is a practical and maybe pretty arbitrary matter in the last judgment.

I do think we do not want to signal out some institutions as "too-big-to-fail." I think we want a system in which particularly non-banking institutions can fail. That brings up many other issues in financial reform that do not rest significantly on precise quantitative amounts.

Mr. WATT. My time has expired. I will recognize the gentleman, Mr. Bachus.

Mr. BACHUS. Thank you. Chairman Bernanke, was the New York Fed aware that Lehman Brothers was using an accounting gimmick, repo 105?

Mr. BERNANKE. Congressman, first of all, the Federal Reserve was not the supervisor of Lehman Brothers, and indeed, one of the issues I was talking about was that under the existing system, an investment bank like Lehman Brothers would not have a consolidated supervisor. We did not have that information.

We had only a couple of people in the company whose primary objective was to make sure we got paid back the money we were lending to Lehman through our primary lender credit facility. We were not the supervisor, and in any case, we would not have had the authority to address accounting and disclosure issues in that context.

Mr. BACHUS. The Federal Reserve had run three stress tests on Lehman and in the course of those stress tests, would you not have found out they were using this accounting gimmick?

Mr. BERNANKE. No, sir. These were liquidity stress tests. The objective was to discover whether they had enough liquidity to deal with a stressed situation, and they failed all three tests. That was information we shared with the SEC and with Lehman Brothers.

Mr. BACHUS. The argument that you and former Chairman Volcker have used is as the lender of last resort, you must have direct access to bank data to assess the creditworthiness and collateral of a would-be borrower, but the New York Fed made the discount window available for cheap money with this going on.

I will ask Chairman Volcker, does that not trouble you? Then, I will ask Chairman Bernanke.

Mr. BERNANKE. We assess the value of the collateral. We put in an extra haircut because we were concerned about the solvency of the company, and we were repaid fully. That part of it worked fine.

Again, we were not charged with supervising the company. Clearly, it was a very troubled company. If we had some kind of provision to take a non-bank into receivership, we would have applied that in the case of Lehman.

Mr. BACHUS. All right. Thank you. Chairman Volcker?

Mr. VOLCKER. I think this is an example of why we need some pretty thorough reform, so that an institution of that size would have some official oversight.

I would also hope that if we have the kind of reform that is being talked about, the issue of the Federal Reserve lending to those in-

stitutions, non-bank institutions, would not be relevant because if push came to shove and they were failing, it would come under the so-called "resolution authority" that would have the power and resources to provide a suitable liquidation or merger of that institution.

The Federal Reserve would not have to get directly involved as a lending organization.

Mr. BACHUS. They should not be lending money to failing institutions?

Mr. VOLCKER. Not ordinarily.

Mr. BACHUS. Through the discount lending window.

Mr. VOLCKER. Quite true. We want a system so they would not be put in that dilemma, to save the rest of the market, so to speak. We want to have a system that can provide—

Mr. BACHUS. Do you support our efforts to not allow under Section 13(3), the bailouts that you have seen in the last year? Senator Dodd says 13(3) cannot be used, and the House Republicans also had a provision saying 13(3) cannot be used for an ad hoc bailout of a non-bank financial institution. Do you agree?

Mr. VOLCKER. If you had the resolution authority, you would not need 13(3).

Mr. BACHUS. Let me ask you, you said in your testimony in debating regulatory arrangements and responsibilities appropriate for our national markets, we should not lose sight of the implications for the role of the United States in what is in fact a global economy. We necessarily must work with other nations and their financial authorities.

How about the Volcker Rule? What if the proposed limitations on proprietary trading—what if other countries do not adopt that? Would that put us at a disadvantage, and could we instead use sort of capital requirements and maybe restrictions on leveraging or restrictions on coming to the discount window for cheap money?

Mr. VOLCKER. I think that question is a little premature. The first thing we ought to do is get other countries to go along, and then we would not face that kind of a problem. I am hopeful that will be the result.

Mr. BACHUS. If they do not?

Mr. VOLCKER. If they do not, I think we should still apply it in the United States, but in American institutions, I think it would present relatively minor problems.

Mr. BACHUS. All right.

Mr. VOLCKER. These activities we are talking about, just so I am clear, are a small part of the activity of very few American banks.

Mr. BACHUS. Thank you.

Mr. WATT. The gentleman's time has expired. The gentleman from Pennsylvania, Mr. Kanjorski, is recognized for 5 minutes.

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

Chairman Bernanke, if I may ask, I heard you refer to some loopholes and legislative holes in things you can or cannot do.

It brought to mind, has the Federal Reserve done a critique of the legislation put together by this committee and passed in the House, and a critique of the Dodd bill, so that we can have a criticism as to whether or not any loopholes exist that should be covered or if not covered, what the impact will be?

Mr. BERNANKE. No, sir. We do not have a specific critique of these individual bills. We have been pretty clear about what we think is the right approach. I would be happy to discuss any specific item.

Mr. KANJORSKI. Could I make the request of you, and I appreciate the discussion and having an open discussion like that, but could I ask you if you could have your experts really make those thorough reviews so that if there are any loopholes that have to be closed or considered or at least identified—there are many members of the committee, including myself, who would not recognize a loophole if we walked into it.

I am sure the expertise of the Federal Reserve sees them and sees the tilt light go off that they are there. I would like to be informed about it.

If you could have your experts at the Federal Reserve review our piece of legislation that passed the House and the Dodd bill and any other bill that ultimately comes out of the Senate, to give us that critique so that we may use that critique when we go to the conference committee to address those loopholes?

Mr. BERNANKE. Congressman, what we have been doing is trying to provide technical assistance on each issue. We do not want to overstep our bounds and say, this is good and that is bad. We like to help wherever we can.

Mr. KANJORSKI. That is part of the legislation I am responsible for. Do not worry about overstepping bounds.

Mr. BERNANKE. Okay.

Mr. KANJORSKI. Mr. Volcker, unfortunately, we did not have the Volcker Rule before us when we went through the House side of regulatory reform, but now obviously, it is included in the Dodd bill.

I guess I have two questions: one, did the Dodd bill include the entire Volcker Rule or are there important portions of it that have been left out that you think we should look at or address if we go to conference; and two, if you could for the record indicate why you think it is so important that we have mandatory provisions such as the Volcker Rule?

Mr. VOLCKER. The first part of your question, I do think the Dodd bill makes a big step forward. There may be a few areas where I think maybe additional clarification would be desirable.

I am out of office so I have no reluctance to overstate my ability to make comments.

Mr. KANJORSKI. I am inviting you to.

Mr. VOLCKER. I do think it has to be mandatory because I have been a regulator, I have been a supervisor, and I have observed regulators and supervisors. It is very hard to take tough restrictive measures before the crisis, and after the crisis, of course, it is too late.

I really think in an area like this where the rationale to me at least is quite clear, the law should say as specifically and as mandatorily as possible, and I think the Dodd bill, as I understand it, goes considerably in that direction.

Mr. KANJORSKI. Very good. In view of the fact that there are so many members, Mr. Chairman, I will yield back what balance of time I have.

Mr. WATT. I thank the gentleman. The gentleman from Texas, Dr. Paul, the ranking member of the subcommittee.

Dr. PAUL. Thank you, Mr. Chairman. I have a question for Chairman Bernanke.

During the early part of the decade, a lot of the free market economists keet saying, well, interest rates have been too low for too long, and there was a financial bubble and a housing bubble, and there had to be a correction.

Of course, we did in 2008. Since 2008, many of the mainstream economists have more or less agreed with that assessment because frequently we will hear them say interest rates were held too low for too long, and I think even Secretary Geithner has made that statement.

Where do you come down on that perception? Do you think interest rates were held too low for too long?

Mr. BERNANKE. Congressman, I have given a speech on this. I think the bottom line is, nobody really knows for sure, but that the evidence is really quite mixed.

I would say even if they were too low for too long, the magnitude of the error was not big enough to account for the huge crisis we had. I think what caused the crisis were the failures of regulation. I would fault the Fed here, too, because some of those failures were ours in the sense that we did not do enough, and I have admitted this and acknowledged this many times, we did not do enough on mortgage regulation.

I think it was the weakness of the regulatory system, not monetary policy, that was most important here.

Dr. PAUL. Of course, I do not agree with that, but if you assume for a minute that it was too low for too long, and you had perfect regulations, what is the harm done by interest rates being too low for too long? Do you see any damage by interest rates being artificially low for a long period of time? Let's sort that away from regulations for a second.

Mr. BERNANKE. Certainly, one possibility which my colleagues to the left know a lot about is that if you keep rates too low for too long, you get inflation. Every central banker wants to be sure that the price level remains stable. That is an important consideration.

Dr. PAUL. Do you think the investor, the businessman, makes mistakes if interest rates are lower than say the market? Are not low interest rates an indication there are savings and if there are no savings but the interest rates are low because of newly created credit by the Fed, does that not send a false signal to some investors and to some business people?

Mr. BERNANKE. If interest rates are below their normal levels, it is because the economy is operating at a very low level. Currently, we are not in anything an economist would call optimum equilibrium or anything like that.

We certainly are in a situation where a lot of people are out of work and consumption is well below its normal levels and low interest rates serve the function of increasing demand and putting people back to work.

Dr. PAUL. You do not think that if interest rates are 2 and 3 percent instead of 6 percent, without artificially low interest rates, there would not be a temptation for people to build too many

houses or people to try to capitalize on the fact they are anticipating price inflation and in the bubble?

Mr. BERNANKE. Congressman, interest rates are very low right now, and I do not think building too many houses is really a problem.

Dr. PAUL. That makes a very important point. In the boom part of the cycle, the low interest rates cause people to do things that might not be proper and best for the economy, and then when the bust comes, we resort to the same policy of keeping interest rates extremely low for too long.

What are the chances—do you think there is any chance in a year or two or three from now we will look back and say well, not only were they too low for too long in the early part of the decade, they were too low for too long in the latter part of the decade?

When the prices start to go up, it is sort of a little bit too late, and then you have the job of reigning that all in.

Mr. BERNANKE. It is a difficult—central banking is an art and we need to balance our dual mandate. Our dual mandate is to maximize employment and price stability. We need to try to find an appropriate policy that gets us as close as we can to both sides of that mandate.

Dr. PAUL. The free market people say the dependency on regulation is just imaginary because the fault is all these mistakes being made because they have false information.

Price fixing, nobody is advocating wage and price controls because of all the false information. You cannot run the economy with price fixing. That is why socialism fails.

If you fix the price with interest rates, it is one-half of the economy because you are messing around with the monetary system, and then all of a sudden instead of dealing with that, we say we just need more and smarter regulations and we are going to solve all these problems.

That does not concern you at all?

Mr. BERNANKE. You need some system to set the money supply. I guess you are a gold standard supporter.

Dr. PAUL. I am for the Constitution.

Mr. BERNANKE. Every major country currently in the world uses a central bank which must make some decision about the money supply, whether it is to keep it stable or to move it around. Nevertheless, it is a choice that is made.

Dr. PAUL. Then there is no good information for the investor, unfortunately.

Mr. WATT. The gentleman's time has expired. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you, Mr. Chairman.

I do not think the folks in the financial world understand the permanent damage done to our social and political institutions, done to the social contract by the Wall Street bailouts and the prospect of future bailouts which exist as long as we allow to exist institutions that we brand as "too-big-to-fail."

Chairman Volcker, with three Federal prudential supervisors plus various States, how can we in the future get consistent, comprehensive, and effective regulation and supervision of all banks and similar institutions?

Should there not be a single body for setting out one set of rules that all the supervisors would comply consistently?

Mr. VOLCKER. Conceptually, there could be one supervisor. I think that is the way to go. Many countries have it that way. We have a particularly big and complex country and financial markets with their own traditions. That has led to a multiplicity of regulatory agencies, and I think it is fair to say, a certain amount of confusion. We have to do better in coordinating what they do. We have been left with extremely weak supervision outside the banking system as a matter of historic development.

Let me say on the other side as I said in my statement, and this is basically a political decision, there are some advantages in having more than one regulator. In many instances, I think, countries find a single regulator gets pretty rigid in its bureaucracy and there are legitimate complaints by the financial institutions that there is too little room for innovation and flexibility and freedom.

On the other hand, I do not want regulatory agencies competing with each other in liberalism.

Mr. SHERMAN. I can agree with you on that.

Mr. VOLCKER. I think what this comes down to—

Mr. SHERMAN. I need to interrupt you, because I have two other questions to squeeze in.

Chairman Bernanke, you have outlined the advantages of mixing monetary policy and bank supervision. I want to address one of the perceived disadvantages. I will ask you not to just offset it by saying, well, here are all the advantages, but rather address the disadvantages.

Bureaucracies hate bad headlines. They will often do desperate things behind the scenes to avoid that big headline from breaking. Prudential regulators are going to get bad headlines if a big institution fails, particularly under some circumstances, and they can prevent that failure if they can just put it off for 6 months. Their reputations and careers can be saved.

Monetary policy, just cutting the interest rate by a quarter of a point, can save a troubled institution. How can we be sure that monetary policy is not influenced by the natural human desire of bank supervisors to save one or two institutions for at least long enough for them to move over to another department? How do we make sure monetary policy does not meet the career needs of bank supervisors?

Mr. BERNANKE. I do not think that is a very realistic scenario. If a bank was really that sick, I do not think a quarter point interest rate change would help it very much and the consequences—

Mr. SHERMAN. Every dying patient is on the borderline at some point. Yes, there can be circumstances where it is touch and go.

Mr. BERNANKE. Again, I do not think that is an efficient way or effective way even to achieve that objective. The central bank chairman would nevertheless still be presumably around and concerned about his or her reputation when the economy has excessive inflation or whatever problem might arise from that interest rate policy.

I do not think there is much evidence for that particular issue.

Mr. SHERMAN. I am going to squeeze in one more question. You may have to respond for the record.

Why should our statutes exempt the Fed from audits of—I will quote the statute—"Transactions for or with a foreign central bank, government of a foreign country, or a non-profit international financial organization," and are you willing to provide for the record a description of all such transactions from the 1990's, where they are old and gold, so we can get an idea of what the bank was doing internationally?

Mr. BERNANKE. We have told you—

Mr. WATT. You have been invited to submit your answer for the record.

Mr. BERNANKE. Okay. Thank you.

Mr. WATT. I think you have already done it on several occasions, but do it again.

Mr. VOLCKER. Can I make just a brief comment on the previous question? I think you put your finger on what is sometimes called the "not on my watch syndrome" and it does not have to be by monetary policy. It could be a direct rescue of an institution.

That is why it is so important to get this resolution authority enacted into law in a rigorous way, so that the policymaker is not faced with what seems to me to be an awful dilemma of letting the institution fail in a messy kind of way or rescuing it and contributing—

Mr. SHERMAN. I sure hope that resolution authority is not just a TARP bailout.

Mr. WATT. The gentleman's time has expired.

Mr. SHERMAN. I thank the chairman.

Mr. WATT. The gentleman from Texas, Mr. Neugebauer, is recognized for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Chairmen, I want to go to this process of the Fed being a prudential regulator. I go to this point. We have had a lot of people coming in here.

For the last 18 months, we have been trying to find out who the bogeyman was in all of the calamity that has happened in the financial markets. Everybody who comes in says well, it was not my fault.

I think the bottom line here is under the proposed structure by the House version or the Senate version, basically in many cases, the Fed had regulatory authority over many of these entities that people are saying was part of the problem.

I guess the question I have is, if it did not work before, how does it work now? The second part of that is these very large financial institutions, if you had gone into them, let's say 18 months ago, and said, we are a little concerned about what is going on here, and they said well, we have record earnings, we are making lots of money, we have good liquidity, we have good balance sheets, our ratios are in place. What do you mean you want us to stop originating more mortgages? What do you mean you want us to slow down our securitization activity? What do you mean you want us to get out of the credit default swap business?

How did you miss it and how would you have done it differently? If you are not going to do it differently, then we are moving in the wrong direction here.

I will start off with Chairman Bernanke.

Mr. BERNANKE. That is the $64 billion question you just asked.

Mr. NEUGEBAUER. No, it is the trillion dollar question.

Mr. BERNANKE. There were mistakes and problems throughout the system. Regulators, the Federal Reserve, the private sector, and even Congress made mistakes in this crisis. The only thing we can do is go forward and fix the mistakes.

We are working at every level. We, of course, are recommending changes to the overall statutory structure to address gaps and other problems in the system, but we are also taking actions ourselves.

We are strengthening our capital requirements, for example. Liquidity turned out to be a big issue in this crisis. We have been working internationally to strengthen that substantially.

I think execution is very important. Within our own supervisory system, we have been doing a lot of soul searching and a lot of changes and those changes are both at the level of the framework for supervision, which we believe needs to be more systemic, more so-called "macro-prudential," but also in terms of execution.

We have found situations just like you described, where we were not fast enough, we were not forceful enough. We need to change our culture, our structure, and our instructions to examiners and so on to make sure we do a better job next time.

Everyone has to do a better job. We are working to do a better job. We think there are structural reasons that the central bank needs to be involved in this process.

Mr. NEUGEBAUER. Chairman Volcker?

Mr. VOLCKER. Let me make a general point. We have a lot of discussion about supervision and gaps and supervisory policies. Supervision is a tough job.

You are dealing with a very complex situation with some known and some unknown factors in a political world where your tools are limited and you have to be able to explain what you are doing, which is very hard to take restrictive rules when things are going well.

Do not put more burdens on the supervisors than are necessary. If there are some structural factors in the market that you want to promote or eliminate, do it by legislation and do not leave everything up to the supervisor, or give the supervisor a very clear framework within which to work. The more you do that, I think the better off we will be in terms of supervision.

Mr. NEUGEBAUER. I do not disagree with that, Chairman Volcker. I am a "less regulation" person but I think the point is we actually had regulation in place. We had regulators in place. I think there is an unreasonable expectation here that somehow we are going to fix this.

We have bank regulators today and we have over 100-some banks fail, and the question is, I think some people think well, by expanding or reshuffling the deck that we are going to have a better outcome. I think we would have had a much better outcome if we had people who were doing the job they were already supposed to be doing.

Mr. VOLCKER. I cannot deny that. There were gaps in regulations, gaps in authority. One was large gaps in the investment banking area, in my opinion, where a lot of the crisis arose.

You had gaps in the subprime mortgage. You had some regulatory authority over some parts of it, but none over other parts of it.

You had a big gap given what we know now, and I keep coming back to it because I think it is important, in the resolution authority. There was no resolution authority that gave the supervisors a reasonably effective and efficient way of closing down a non-bank institution with minimal damage.

That is something you have to legislate.

Mr. WATT. The gentleman's time has expired. The gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman. Thank you, Chairman Bernanke, and former Chairman Volcker, for your testimony.

Let me ask Chairman Bernanke first, we have this language in the House bill empowering regulators to deal with systemic risk. My question to you is, do you think the language that we have in the House bill is strong enough to expedite a removal of systemic risk or do we need—there was a question, do we need something mandatory like the Volcker Rule?

Mr. Volcker, I would like to get your response on that, too.

Mr. BERNANKE. I would like to maybe answer you in writing on that because it is a very complicated bill. I think the general direction is good, but there are some areas where we think if we had our preference, we would make some changes. It is a complicated bill.

Mr. NEUGEBAUER. I would gladly wait for you to give us a response in writing, because I want to see if you think you have the authority from what we put in there or do not.

Mr. Volcker?

Mr. VOLCKER. I will give you a particular example of what I am concerned about and responsive to the previous comment.

On the so-called "Volcker Rule," a prohibition of proprietary trading and hedge funds and equity funds, the House bill has a provision and it is kind of voluntary, just turns it over to the regulators and the supervisors. In my opinion, it is very unlikely that the regulators and supervisors would invoke a strict prohibition until a crisis came and then it is too late. That is why you want it in legislation.

Mr. MEEKS. The question, I guess, or part of it, and I will wait for Chairman Bernanke's response in writing, is would the Volcker Rule at least set a floor from which to work?

I know you said it will be in writing, so I look forward to hearing that.

Let me ask you, Chairman Bernanke, if you added up the cumulative working hours at the Fed, could you tell me about what percentage of work is spent on bank oversight, on consumer protection, on monetary policy, and on monetary systemic risk? Is there any way you could tell us how much time is spent there?

Mr. BERNANKE. We have separate divisions that work on each of those areas to some extent. We are also doing a lot of cross disciplinary/multi-disciplinary work. Once again, if I could send you data on the number of people in each area, that would be more exact than just taking a guess off the top of my head, if that would be okay.

Mr. MEEKS. That would be great. Mr. Volcker, from your experience when you were Chair of the Fed, could you tell me at that time if you know how the Fed spent the majority of its time? Was it on bank oversight, bank regulation, or whatever, from your experience?

Mr. VOLCKER. I must say, through history, I think the Federal Reserve activities in this area have varied quite a lot, depending upon the leadership in the place.

Specifically, during my term in office when we had some big problems, we were fortunate at one point in having an extremely effective head of the supervision area and the regulation area.

That made a big difference in the effectiveness of the way we went about our work, which I think emphasizes the importance of having effective people on the job and effective leadership in the organization.

I have been an advocate of something that is in the Dodd bill, of having a new position in the Federal Reserve or new in the sense of one of the Governors designated as Vice Chairman for Supervision.

I think you need that continuing focus and clear sense of responsibility so that the attention that the Federal Reserve pays is less subject to ups and downs over time.

Let's build it into the organization in a way that it has not been built, and as conclusively as it should have been, in the past.

Mr. MEEKS. I basically agree. Sometimes, and I know in our congressional offices, for example, sometimes you have to prioritize. An office might prioritize something as being more important than others, and those priorities, sometimes in my office, that means something else might be subordinate. Generally, that is the way things work.

I am concerned about that but I will wait to see what the Chairman sends back. I do have some concerns there. That is just generally what people do in offices.

Mr. VOLCKER. I think that is why you need this vice chairman, to give continuity. It is his priority by law to pay attention to this and report to the Congress as appropriate and be designated and confirmed on the basis that he had a particular responsibility for overseeing the Federal Reserve's efforts in that area.

Mr. MEEKS. Thank you.

Mr. WATT. The gentleman's time has expired. The gentleman from California, Mr. Royce, is recognized for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman Bernanke, watching the trends in the market for Treasuries, it appears as though the two major creditors, which would be Japan and China, have begun to scale back their purchases of U.S. Government securities.

Filling the void in demand have been other foreign governments or other foreigners, as they say, and I would assume that would be foreign banks and hedge funds, and then also U.S.-based financial institutions.

Clearly, there is market play here, the carry trade is in effect here by these banks, which essentially amounts to borrowing at next to nothing from central banks and lending it back to the U.S.

Government at 1 or 2 percent, depending on how far out they go on the yield curve.

Have we backed ourselves into a corner here? Essentially, if you raise interest rates, the carry trade evaporates, as does the demand in the Treasury market, and our ability to finance the $1.5 trillion deficit this year.

Who is going to lend to us if we do that? If foreign governments are scaling back and financial institutions can no longer make money in this market, where will the demand for Treasuries come from?

Mr. BERNANKE. This is a very large and deep market. Indeed, when you see stress in other areas around the world, perhaps in other countries' fiscal positions, for example, the dollar tends to strengthen because money flows into U.S. Treasuries.

I have not seen any reduction in demand for U.S. Treasuries. The foreign demand remains quite strong. I do not anticipate any problem.

I guess there is always the question of price. There, the question is, will all our creditors, including domestic creditors, remain confident in the long-run fiscal stability of the United States, and there, I think it is very, very important for the Congress to be devising a plan to create a trajectory whereby we have a more stable debt position going forward. That is very important.

Mr. ROYCE. I concur on the points you have made on that publicly. Getting back to the question of the extent that we are dependent upon the carry trade to finance our debt, do you think there is an element of truth to that point?

Mr. BERNANKE. Sometimes, there is a misunderstanding that the carry trade is an arbitrage for pure profit opportunity. It is not. When you borrow to buy a long-term security, you are taking on considerable risk associated with the longer-term life of the security.

I think what will happen is if short-term interest rates go up because the economy strengthens, then long-term rates might go up as well. That would affect our cost of financing our deficit, another reason to get the deficit under good control.

The interest rate will do what is necessary to attract the demand for our securities. Again, I do not see any reason to think there will not be demand for those securities.

Mr. ROYCE. Let me ask a question of Mr. Volcker, too. With the introduction of Mr. Dodd's legislation in the Senate, we now have regulatory reform bills in each chamber that institutionalize rather than eliminate this "too-big-to-fail" concept.

The ultimate cost of "too-big-to-fail" will be borne by our capital markets and the broader economy.

The approach put forward in these bills essentially bifurcates our financial system and those institutions that will be labeled systemically significant will likely see lower borrowing costs and greater access to capital compared to their smaller competitors.

That would give these firms a significant competitive advantage. This is what happened with Fannie Mae and Freddie Mac. They wiped out the competition and they formed a duopoly over the prime secondary mortgage market because they were perceived to be government-backed.

Mr. Volcker, are we recreating the moral hazard problem found at Fannie and Freddie by labeling these institutions "too-big-to-fail?" How would you expect creditors and counterparties of these institutions to react to this label or even make the label official?

Mr. Volcker?

Mr. VOLCKER. When you talk about Fannie and Freddie in particular, and the moral hazard in the mortgage market, the moral hazard with respect to those institutions, I think it is very real and it will be a real challenge to change that in the future. You are not going to do it right now.

The mortgage market is wholly dependent or mostly dependent on government participation, including support for Fannie Mae and Freddie Mac. You are stuck with it.

I do not think we want to get ourselves in that position in the future. I hope that is on your agenda next year, and we reorganize the mortgage market.

So far as other financial institutions are concerned, I hope your opening comment that both bills institutionalize "too-big-to-fail" is not correct. I understand your concern about labeling an institution implicitly as "too-big-to-fail." I do not want to do that, which is part of the reason hiding behind or in the forefront of the kind of proposal I like, I do not want that presumption to exist particularly for non-banks. I want it to exist for banks as little as possible but banks do have access to the Federal Reserve. I do not think we are going to change that. They do have deposit insurance. They also are heavily regulated, and that is the balance. They do not have that much competitive advantage.

The other ones, I do not want to have any competitive advantage. If they are extremely vulnerable, they will get some regulation, but they should not have any expectation they are going to be bailed out.

Mr. WATT. The gentleman's time has expired.

Mr. ROYCE. Thank you, Mr. Volcker.

Mr. VOLCKER. That is the point behind my concerns.

Mr. ROYCE. I understand.

Mr. WATT. The gentleman's time has expired. The gentlelady from New York, Ms. Maloney.

Mrs. MALONEY. Thank you. Welcome, particularly to Paul Volcker, who is a proud resident of the great State of New York, and we are very proud of your many years of contributions to our country and your public service.

There is a great deal of concern about the proposal in the Dodd bill in the Senate regulatory reform proposal that limits the Fed's banking supervision to banks that are larger than $50 billion. First of all, do you see a need to make the distinction between large and small banks?

I would specifically like to comment on the Federal Reserve's interest rate setting body, the Federal Open Market Committee, which met yesterday. It is comprised of Federal Reserve Governors, the President of the New York Fed, and on a rotating basis, the presidents of five of the 11 regional Reserve Banks.

Would reducing the number of institutions supervised by the Federal Reserve have an impact on the FOMC's activities? First, Mr. Bernanke, and then Mr. Volcker.

Mr. BERNANKE. Yes, we are very concerned about being the regulator of only the big banks. We think that is a bad idea. We need to see the broad financial system. We need to have the information about the broader economy. We need to know what is going on across the country, not just in the great State of New York, for example.

There is a close connection between the need for the Federal Reserve to look at banks of all sizes and our regional structure. It is exactly why we have a regional structure. We have policymakers drawn from 12 districts around the country who speak to local people, including local bankers, and get information about what is happening in their part of the country.

Both the regional structure of the Federal Reserve and the supervision of small and medium-sized banks, 5,000 holding companies, 850 State member banks across the country, both of those things together provide us with information, qualitative information, which cannot be obtained really any other way.

Mrs. MALONEY. You would say it is important to monetary policy to have supervision over all the banks?

Mr. BERNANKE. Both to monetary policy, but also to financial stability because we need to see what is happening in the entire banking system, and indeed, small banks can be part of a financial crisis.

Mrs. MALONEY. Mr. Volcker, do you have a position on this?

Mr. VOLCKER. I think I have similar views to Chairman Bernanke, which should not surprise you.

Let me make one comment again on this "too-big-to-fail." There was a $50 billion limit. I would not interpret that as $50 billion is a limit between who will be saved and who will not be saved. From that criteria, $50 billion is much too low in my opinion.

It is a difficult and rather arbitrary decision as to which size banks would be regulated by the Federal Reserve apart from losing the contact through the Federal Reserve of the smaller banks.

Mrs. MALONEY. It is interesting. I have received a number of calls today on this proposal, many from small banks who are concerned that they would not be part of the Federal Reserve supervisory system, that they want to be a part of it.

Mr. Bernanke, could you comment on the Federal Reserve's supervisory powers over your member institutions on various financial activities in which they operate? What is your role with derivatives, lending and custodial services?

Why is it important that you have a supervisory or role over these particular activities and what is your role in those activities?

Mr. BERNANKE. We operate the way all the bank regulators do, which is we want to make sure the banks are safe and sound, so to the extent they are taking derivative positions or hedging their risk, we want to make sure they are doing so in a way that is safe, that takes into account counterparty risk, takes into account the full range of risks they face.

Clearly, safety and soundness is a big part of our mission. We want to make sure those banks are safe.

At the same time, the stability of the entire system depends on the operation of derivatives markets, for example. We saw in the

crisis how problems with credit default swaps and other types of derivatives caused broader issues in the economy.

As a regulator of the banking system, we will be able to see what is happening and be able to make better decisions about how to address any potential risks to the broad system that those kinds of products might pose.

Mrs. MALONEY. Mr. Volcker, any comments?

Mr. VOLCKER. No, I do not think I have anything to add to that.

Mr. WATT. The gentlelady's time has expired.

Mrs. MALONEY. Thank you.

Mr. WATT. The gentleman from Texas, Mr. Hensarling, is recognized for 5 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. Chairman Bernanke, welcome. Chairman Volcker, welcome.

Chairman Bernanke, I have been an outspoken proponent for having a Federal Reserve that restricts itself to conduct monetary policy tied to specific inflation targets.

In your testimony, you posit that it is a critical element of conducting monetary policy to have the prudential regulator role. I certainly have an open mind to that argument. Is not our own historical evidence and international examples—is not the empirical evidence kind of murky, if you look at the U.K., if you look at Japan, and if you look at Germany, clearly they did de-couple the two. They had similar economic challenges that we had. We did not de-couple.

Can you please elaborate on the evidence that is out there that might be convincing to members of this committee?

Mr. BERNANKE. Congressman, those three examples are quite interesting because, as you point out, in each case there was a decoupling, to some extent, of the regulatory function and the central banking function.

I believe in all three—certainly in Germany and the UK—the current trend is very strongly towards giving supervisory authority back to the central bank. And, indeed, in Europe the ECB, the European Central Bank, is being made, essentially, also the financial stability regulator for the entire continent.

I think the perception was in each of those countries that moving the central bank out of regulation deprived it of information it needed to be effective in the financial crisis, including executing its lender of last resort function.

Mr. HENSARLING. But, Mr. Chairman, we—

Mr. BERNANKE. So, again, in each case the tendency is to go back towards—

Mr. HENSARLING. But clearly, we have not decoupled here. And yet, we did not avoid the panic. We did not avoid the recession.

Mr. BERNANKE. That's absolutely right. And—

Mr. HENSARLING. So what should I derive from that?

Mr. BERNANKE. Well, the question is, can we identify problems? I have already tried to identify some. I think there are some in the structure of our regulatory system, and there are some in the execution. Certainly there were problems. And I'm not saying this is the one and only issue. But I think the lessons of history are generally on the side of having integration of monetary and supervisory functions.

Mr. HENSARLING. On the next panel we are going to hear from Dr. Meltzer, who is sitting over your left shoulder there. I notice he was kind enough to quote me in his testimony, so I'm going to return the favor. I have looked through his testimony.

He says, "Setting up an agency to prevent systemic risk without a precise operational definition is just another way to pick the public's purse. Systemic risk will forever remain in the eye of the viewer. Instead of shifting losses onto those that caused them, systemic risk regulation will continue to transfer costs to the taxpayer," which clearly, again, takes us back to the whole question of "too-big-to-fail."

So, I guess I have a two-part question here, and that is, is the concept of a systemically significant firm really in the eye of the beholder?

And if so, in order for you to execute your charge of maximum employment and price stability, is it not counterproductive to have any type of designation of a fund that creates the impression, again, that there are firms that are "too-big-to-fail?"

Is there not another method—a resolution authority, as you have argued for—that would avoid creation of an explicit fund? And would there not be—could not the proper application of capital and liquidity standards be used in order to avoid the designation of "too big-to-fail," but essentially solve the problem?

Mr. BERNANKE. I think what you just said was very, very cogent. I agree with most of it. I think the fund could very well be exposed, which would mean that the industry, not the taxpayer, would bear any cost.

I think it's very important to have tough ex-ante regulation on capital and liquidity and other aspects, to make sure that if an institution threatens the institution if it fails, we need to be especially careful with it, and make sure that it's as safe as possible.

But in particular, going back to a question that was raised earlier, we really have to address "too-big-to-fail," and that means that the resolution regime that we devise has to be one that makes sure that all the providers of capital, including subordinated debt and convertible capital and so on, will be wiped out, that they will not be protected, and that the authorities have the ability to go further up the obligations to the extent that it's consistent with stability.

So, we need to create market discipline. We can only do that if people actually believe they're going to take losses. We didn't have the flexibility in 2008, when we were dealing with these crises—we didn't have the flexibility, in many cases, to impose losses without creating the bankruptcy that we were trying to avoid.

So, with a well-designed resolution regime, we can impose losses, and that will bring market discipline back to the system.

Mr. WATT. The gentleman's time has expired. The gentlelady from New York—I'm sorry, the gentlelady from California, Ms. Waters, is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to thank both Mr. Volcker and Chairman Bernanke for being here today. And while we are not going to get into the Volcker Rule today, I understand that we are going to hold a hearing to talk about it more. I understand the President is very interested in

what he calls the Volcker Rule. And I want to learn a lot more about it, too.

But we are very pleased that you are here. We have respected your work for so many years. And I am looking forward to having you back with us again, so we can talk about the Volcker Rule.

Having said that, I want to go to Chairman Bernanke. It was not until 2008, well after the predatory mortgage loan products had done their damage, that the Fed finalized its rule-making for the Home Ownership and Equity Protection Act, which Congress passed in 1994, mandating that the Federal Reserve prohibit unfair, deceptive, or abusive acts or practices in mortgage lending.

I know the work that you have done, and you mentioned the intensive self-examination that the Federal Reserve has taken of its regulatory and supervisory performance, and I really do appreciate that. I am not going to get deeply into the consumer financial protection agency that has been talked about so much, and what's happening with the Dodd bill.

But here is what I really wanted to try and focus on. I have this notion that there are some products that are so bad, that are so predatory, that they should never have been on the market, should not be on the market. It seems to me that flies in the face of what those of you in the industry think about, the ways that you think about it.

You feel that in a free market society, businesses are able to come up with all kinds of ideas about how they want to provide products or services or what have you, and it's up to you to regulate them, not to prohibit them and say, "You can't do that."

I don't understand why a regulator can't take a look at a product and say, "This is so bad, this is so predatory, that it shouldn't be on the market, and we're not going to allow it to be on the market," or, "We're going to discourage it from being on the market." And that's one of the reasons I am so interested in the Consumer Financial Protection Agency, because I think they can start to see these things in different ways than they have been seen in the past.

Do you feel that, as a regulator, you should have the ability to say, "No, you can't put that product on the market. It is just too bad. It is too predatory."

Mr. BERNANKE. Absolutely, and we have done it.

Ms. WATERS. Really?

Mr. BERNANKE. Credit cards, for example. We have banned a number of practices, like double-cycle billing, for example. If there are practices which serve no good business purpose, and which the consumer cannot understand, there is no reason to allow them.

Ms. WATERS. Yes.

Mr. BERNANKE. And we have banned them.

Ms. WATERS. But if I may, Mr. Chairman, those were banned, I think, after they had been so abusive and out in the market for such a long period of time. We don't get to see these mortgage products, for example.

They are calling my office every day—and I am looking at an elderly couple who took out an interest-only loan and, after 5 years, that loan adjusts. They had something called a 30-year adjustable

rate, which is kind of a contradiction in the way that they showed that loan to work.

And what happens is that loan that they took out was at about 4.5 percent a few years ago. And that loan could go up to 9 percent in this 30-year adjustable after it resets. The couple was over 65, and in the next 5 to 10 years, it could go up to 9 percent. We don't know what the interest rates are going to be. And they said that they didn't have that when they first took out the loan, but that an amendment was slipped in somewhere into this package of papers, and they signed off on it.

What can we do about that kind of thing?

Mr. BERNANKE. Well, the Federal Reserve, or whoever is in charge of consumer protection, needs to make sure that the products are safe for people to use. And we have done—you are right to criticize the Federal Reserve for being late in doing the mortgage regulation. You are correct about that. We did do some things, but we didn't do enough.

But once we did it—and under my chairmanship, we have worked hard in these areas—we banned a lot of bad practices. You can't offer a mortgage that has those practices any more, like a prepayment penalty for a short ARM, for example.

I don't know about this particular case you're talking about, we would have to look at it, but we are looking at features of mortgages and other financial instruments. And some of them we just ban, because we don't think they serve any purpose, and they're not—the public can't understand what they're about.

Ms. WATERS. Thank you, Mr. Chairman.

Mr. WATT. The gentlelady's time has expired. The gentleman from New Jersey, Mr. Garrett, is recognized for 5 minutes.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you, both of you Chairmen.

A quick question off point in all this. I have a bill in that deals with the GSEs, that suggested the GSEs should be on budget by the OMB, the same way the CBO does it. So, a quick question to you is, do the GSE's obligations—are they sovereign debt?

Mr. BERNANKE. The government has been pretty vague about that, and your chairman says—

Mr. GARRETT. I thought I knew where the chairman stood, but now I don't know where the chairman stands, after his first comment and after his second comment. Where do you stand?

Mr. BERNANKE. Well, it's my interpretation that the government is standing behind the—

Mr. GARRETT. We're paying it, but do you think it is sovereign debt?

Mr. BERNANKE. Whether it's legally sovereign debt or not, I am not equipped to tell you. I don't know.

Mr. GARRETT. Okay. Mr. Volcker, Chairman?

Mr. VOLCKER. I agree with—

Mr. GARRETT. You agree that it's—you're not equipped to tell. Okay.

Mr. VOLCKER. The government is standing behind it, and it's a bad arrangement, where you have this—

Mr. GARRETT. Right.

Mr. VOLCKER. —quasi-private organization and the government—

Mr. GARRETT. Right.

Mr. VOLCKER. —stands behind it.

Mr. GARRETT. Well then, let's move back to the other questions. The report in the paper, with regard to the Lehman situation. I heard the question earlier and your answer to that. It seems as though the answer you gave—and I was outside, listening to that—was you were not the primary regulator in that case.

But let me just ask it this way. The Fed was there on scene. The paper reports your folks being over at Lehman's, embedded, as they say, over there. Was the Fed aware of the 105 repo situation, and the accounting irregularities going on?

Mr. BERNANKE. No.

Mr. GARRETT. So you were not?

Mr. BERNANKE. No.

Mr. GARRETT. And the reason that you were not aware of them was?

Mr. BERNANKE. They were hidden. We are currently the principal regulator of Goldman Sachs, and we have about a dozen people on-site, and another dozen people who are looking at the company. We had, in this case, I think two people assigned to Lehman. And their main obligation was to make sure we got paid back our loans.

So, it was not our responsibility, or our capacity, in the middle of the crisis, to look at that.

Mr. GARRETT. So when the paper reports—all I know is what I read in the paper on this one—what the paper reports is that there were a dozen people over there. Only a couple of them, two, were yours?

Mr. BERNANKE. I don't think—yes.

Mr. GARRETT. The rest of them were the SEC's?

Mr. BERNANKE. That's my information, yes.

Mr. GARRETT. And should there have been more, and as much as—before, Lehman would not have had access to the discount window up until this period of time. Correct?

Mr. BERNANKE. Well, again, our objective was to make sure our loan was safe, and they were safe. We got paid back.

Mr. GARRETT. Well, you did get paid back, but is that because the collateral was adequate? And how would you know that, if not an adequate investigation was going as far as their accounting was being done?

Mr. BERNANKE. Well, it was largely the collateral. Also, the loan we made was to the brokerage, and not to the holding company. So that was a bit of a distinction, as well. But we took collateral, and we took extra large haircuts, to make sure that it was safe.

Mr. GARRETT. You intrigue me when you say that you only have a couple of folks over at Goldman—and I guess that's as we speak.

Mr. BERNANKE. There about a dozen folks who come—

Mr. GARRETT. A dozen folks over there?

Mr. BERNANKE. I got that number this morning.

Mr. GARRETT. Okay, all right.

Mr. BERNANKE. About a dozen folks who go to work at Goldman every day.

Mr. GARRETT. Okay, and I'm not going to hold you to the number on that.

In light of these reports, is that something that we should be concerned about, activity of these other houses, as well? Is that something that we should be concerned about? Is that something the Fed should be concerned about?

Mr. BERNANKE. Well—

Mr. GARRETT. And are you looking into it?

Mr. BERNANKE. Lehman, of course, obviously is no longer in existence. But Goldman and Morgan Stanley and Merrill, etc., are now under the Fed's consolidated supervision. And so now it's our responsibility, and we are paying attention to these issues.

Mr. GARRETT. And so you are—are you specifically looking at their accounting procedures, to see whether this same sort of activity is going on now, or was it going on at that time, as well?

Mr. BERNANKE. I don't know. I would have to check and see whether we have been looking at that. This report just came out this week.

Mr. GARRETT. Right. Would that be one of the gaps, then, that we should be concerned about, going forward?

Mr. BERNANKE. If we are the consolidated supervisor, then it's our responsibility, and we need to do a good job to do that. But, of course, there are lots of things to look at.

I have to say, in the case of Lehman, it was pretty clear that they were in weak condition, independent of this particular piece of accounting.

Mr. GARRETT. Well, that's interesting that you say that, because the New York Fed did not one, not two, but three actual stress tests, right?

Mr. BERNANKE. Liquidity stress tests.

Mr. GARRETT. Liquidity stress tests. And each time, they came back as they failed those stress tests, correct?

Mr. BERNANKE. Right.

Mr. GARRETT. Right. Were any recommendations then made to Lehman before additional funds were lent to them?

Mr. BERNANKE. We pushed them, and Secretary Paulson pushed them, and I'm sure the SEC pushed them to improve their financial position and to raise capital, if at all possible. But they were unable to raise sufficient capital.

Mr. GARRETT. Well, my understanding is, according to the examiner's report, the New York Fed required no action from Lehman in response to the stress test. Is that an incorrect understanding?

Mr. BERNANKE. The key word there is "required." We have no authority to require them to do anything.

Mr. GARRETT. And did you indicate this to their regulator, that their regulator should require that, then, of them?

Mr. WATT. The gentleman's time has expired.

Mr. BERNANKE. I don't have the exact information that you're asking.

Mr. GARRETT. If you could, get back to me on that last point.

Mr. WATT. The gentleman's time has expired.

Mr. GARRETT. Thank you.

Mr. WATT. The gentleman from Kansas, Mr. Moore, is recognized for 5 minutes.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Chairman Bernanke and former Chairman Volcker, thank you both for your testimony this afternoon. And thank you for your public service. You both have had to take some very unpopular actions during economic downturns. But I believe without your efforts, which I approve and applaud, and without an independent Fed, I don't think we would be where we are today in our recovery from the financial crisis.

Last year, this committee and the House approved a strong bill creating an independent consumer financial protection agency. And Senator Dodd's recent proposal has a truly independent consumer financial protection bureau located in the Fed.

Chairman Volcker, would you support separating safety and soundness regulations from consumer protection, so that each can focus on one mission and do their job better? Is that something you can support, sir?

Mr. VOLCKER. I think you can separate consumer protection from safety and soundness. I think there is some overlap, because some of the consumer protection has implications for safety and soundness. But, by and large, I think they are distinct enough so that you can separate them, yes.

Mr. MOORE OF KANSAS. Thank you. And with respect to the Fed's bank supervision powers contained in the Senate's recent proposal, I am concerned that it will turn the Fed's focus away from smaller financial institutions, and focus it only on the largest banks and institutions on Wall Street. Do you share this concern, Chairman Bernanke?

Mr. BERNANKE. Very much so. We value very greatly our connections to small and medium-sized banks. We learn a lot from them. We learn a lot about the economy. It keeps us in contact with the country, as a whole, and not just Wall Street. And we hope very much to retain those connections.

Mr. MOORE OF KANSAS. Okay, thank you. And if the Senate's proposal became law, what would that mean for community banks, smaller financial institutions, and our local economy back in Kansas? Any thoughts there, sir?

Mr. BERNANKE. The law would give the oversight to the FDIC for State member banks, or State banks. But what it would do, from our perspective, besides being quite disruptive for both the banks and the regulators, what it would do from our perspective is close off an important source of information and connection to the broader economy.

Mr. MOORE OF KANSAS. Thank you. Any thoughts, sir? Mr. Volcker?

Mr. VOLCKER. This is one area where the discussion came up earlier as to whether you have one regulator, or there is some value in having a variety of regulators.

There are a lot of small banks. And we now have divided direct supervisor authority over them. I think this is one area where it is possible to argue that having more than one supervisor is not a bad thing. It doesn't pose the same kind of systemic risk that the big institutions do, but there is value to the Federal Reserve, and maybe some value in having more than one agency concern there. Because the FDIC has a legitimate interest in knowing what's

going on among a lot of institutions that it may have to—does provide insurance for.

Mr. MOORE OF KANSAS. Thank you. Another issue I'm interested in is in looking at how we become dependent on debt across the board: corporations; consumers; governments; and especially financial firms.

In a letter to Senators, Tom Hoenig, the president of the Kansas City Fed, wrote last month, "This financial crisis has shown the levels to which risk-taking and leveraging can go when our largest institutions are protected from failure by public authorities. A stable and robust financial industry will be more, not less, competitive in the global economy. Equitable treatment of financial institutions will end the enormous taxpayer-funded competitive advantage that the largest banks enjoy over the regional and community banks all over the country."

As we think of how overleveraged the largest financial firms became leading up to the crisis that we have experienced, if the Fed is disconnected from smaller financial institutions who were not overleveraged, and leaving the Fed with nothing to compare to, would that hinder the Fed's supervision of the largest institutions? Any thoughts there, Chairman Bernanke?

Mr. BERNANKE. I think it's helpful to know what's going on in the whole banking system, because you can learn about the asset quality. You can learn about the impact of regulation. And small banks can be involved in financial crises, as well. So I think there is a lot to be learned from not restricting yourself narrowly to one class of institutions.

And I agree with his basic point, that we have to get rid of "too-big-to-fail," and that theme has come up today quite a few times. We have to have a system where the creditors of—and shareholders of a large organization can take losses when the firm can't meet its obligations.

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. Again, thanks to both of you for your service to our country.

Mr. WATT. The gentleman's time has expired. The gentleman from Minnesota, Mr. Paulsen, is recognized for 5 minutes.

Mr. PAULSEN. Thank you, Mr. Chairman. And I want to thank both of you for taking the time to testify here again today.

Chairman Bernanke, a document that you sent to the Senate Banking Committee contains the statement, "We recognize, of course, that bank supervision, including ours, needs to be more effective than in the past. And we have reviewed our performance, and are making improvements at multiple levels."

I just came from a meeting with a bunch of local bankers from Minnesota, and they talked about how they have money to provide for credit, and they want to lend it out into the market. And their overwhelming concern was in regards to the uncertainty or the inconsistency that is being created by the regulators: the OCC, and the FDIC. These regulators are being inconsistent in the sense that when they come in and visit with the banks, from visit to visit, their demands essentially are changing, and they're preventing good loans from being continued or from even being made in the first place.

I know we had a hearing in this committee, along with the Small Business Committee just a few weeks back. And I think every single member—nearly every single member—of this committee raised this issue. And the FDIC and the OCC responded essentially by saying they have told their people in the field to kind of take a step back in regard to what is actually happening. But I think there is still a disconnect that's going on.

And so, I am just wondering, knowing that I met with 30-some bankers, and it seems like nothing has really changed in recent times regarding the examinations that are going on with the banks, what can the Federal Reserve do better to handle this issue and create some consistency for the bankers so more credit is available to be put out into the market?

Mr. BERNANKE. This has been one of our top priorities. It's very, very important. What you need to do here is get an appropriate balance, on the one hand, between making sure the banks are safe and sound, making good loans. On the other hand, making sure that credit-worthy borrowers can get credit, and that the economy can grow.

So we need to find the appropriate balance there, and we have done that in a number of ways. We have taken the lead on issuing guidance to our examiners and to the banks on small business lending, on commercial real estate lending, where the emphasis is on finding that appropriate balance. And it's giving lots of examples to the banks and the examiners, where you can look at the example and it gives you some insight into what criteria to apply when you're looking at a loan.

And, in particular, one point that we have made repeatedly is that just because the asset value underlying a loan, the collateral of the loan has gone down, doesn't mean that it's a bad loan. Because as long as the borrower can make the payments, that still can be a good loan, and we shouldn't penalize the banks for making those loans.

So, we have issued those guidances, and we have done an enormous amount of training with our examiners to make sure they understand it. We have been gathering information and feedback from the field, including asking for more data and more information, but at each of the reserve banks around the country, having meetings that bring in small businesses, banks, and community leaders, to try and get into the details of what's going on.

We have also tried to support the small business lending market with our TALF program, which has helped bring money from the securities markets into the small business lending arena. So it is a very important priority for us.

We were asked before about the interaction between being responsible for the macro-economy and being a supervisor. Well, here is one case where knowing what's going on in the banking system is extremely important for understanding what's going on in the economy broadly. And we take that very seriously.

So, I realize it's still an issue. It's going to be a concern, because certainly standards have tightened up. Certainly some people who were credit-eligible before are no longer eligible, because their financial conditions are worse. But we really think it's very impor-

tant that credit-worthy borrowers be able to get credit, and we are working really hard on that.

Mr. PAULSEN. Okay. Mr. Volcker, can you add some comments on that, based on your history?

Mr. VOLCKER. I would be glad to add a comment, because I think this is an old problem.

I remember when I was a young fellow writing about the Federal Reserve. And the long-standing chairman of the Federal Reserve in the 1930's was one Marriner Eccles, who repeatedly complained in the 1930's, in the midst of the recession, that the other banking—the sole responsibility for banking supervision and other agencies—they were being too tough because they had had a lot of losses on their watch, and they were overreacting, in terms of strict regulations at a time when it was inappropriate, because the economy was mired in recession.

There have been other times when, if you're just looking at banking regulation, that's your only responsibility, maybe you're going to be too easy when things are going very well, and the economy is on the verge of—you know, the party is getting a little too ebullient.

I think, really, that the Federal Reserve is in a better position to get a balanced regulatory position, regulatory approach, simply because they are responsible for monetary policy and responsible for business activity, too. That is one of the strengths in keeping the Federal Reserve in the regulatory business, in my view.

Mr. WATT. The gentleman's time has expired. The gentleman from Georgia, Mr. Scott, is recognized.

Mr. SCOTT. Thank you very much, Mr. Chairman. And welcome to both Chairman Bernanke and Chairman Volcker.

Let me ask you, Chairman Bernanke, as we grapple with this whole issue of stripping the Fed of its supervisory authority and concentrating on the larger banks only—and I must admit, you make a good argument, but I'm torn for this one reason. Let me give you an example where there has been a massive failure on the part of the Fed, in my opinion, to be able to handle both the big banks and the smaller banks.

I represent the State of Georgia. And in the State of Georgia, over the last 36 months, there have been 27 bank failures of these smaller banks. And that accounted for 26 percent of all of the bank failures in this country, 1 State.

The issue becomes, where was the Fed in this? Is this not a sign of a realization as to why maybe we're asking too much of the Fed, as we move into this new economic climate? And I'm wondering, where was the Fed? How did this happen under your watch, where 1 State accounted for 26 percent of all the bank failures, and over a short period of just 36 months, 27 banks failed in 1 State?

Mr. BERNANKE. Well, I would make two points. The first is, of course, that there are multiple regulators. And the question you have to ask is where—did the Fed do as good a job as everybody else? And I think the answer is, on a national basis, that we have done a good job with small and medium-sized banks.

But we have been actually leaders in this area. Because one of the key issues—and particularly in Georgia, particularly for small and medium-sized banks, has been commercial real estate. The

Federal Reserve, back in 2000, took lead in developing some guidance on commercial real estate about not having too much, about managing the risk better, about not having too much geographic concentration—which has been an issue, I know, in the southeast. We got resistance on that, and it took longer to do, and the banks resisted. It took longer to get done than it should have taken.

But that was something that we pushed, and we thought was very important. And banks that were particularly careful about managing their commercial real estate have done better because that has been one of the main risk areas. So, I would say that we took those issues into consideration, and did a good job, at least in trying to address them.

Mr. SCOTT. How can you say you did a good job, when the Fed's policy became—made a decision not to examine the books, but to allow the banks to examine themselves? That—not to examine their portfolios, when we saw that some of these banks had a 78 percent portfolio just in this real estate?

So, if there is a problem area here that I have been able to detect, it was in the Fed's failure to—or willingness, or laxity, whichever, to allow these banks to self-examine, to assess themselves. And do you think that, going forward, should continue? Or do you not agree that might have been an area where the Fed fell down?

Mr. BERNANKE. No, I don't agree with that. We examined the banks, and we made sure that they met appropriate capital and liquidity standards.

Now, it turns out that they should have been tougher. And we have done a lot of work, internationally, to strengthen those standards.

Mr. SCOTT. I have here where—and it might not be with you—but the Fed announced that the Fed would no longer directly examine banks' portfolios, but would instead rely on bank self-examination and self-assessments.

Mr. BERNANKE. That's not our policy.

Mr. SCOTT. So that policy has changed, and this is inaccurate?

Mr. BERNANKE. It probably relates to the notion of Basel II, and the structure of banks using proprietary models as a way of evaluating the risks of some of their positions. Basel II was never implemented, and clearly, it's very important that whenever models are used, that they be closely vetted and closely evaluated. This is what we do.

And again, we are going to be very careful to make sure that banks are meeting the appropriate standards.

Mr. SCOTT. And so, you were aware—or were you not aware—that the portfolios of these banks were averaging between 75 and 80 percent total concentration in real estate?

Mr. WATT. The gentleman's time has expired. And I am kind of being tough on him, because we have just been called for votes. I would like to try to get the other three members who are here, who have been here for a while, in. So, if you can respond to that in writing, that might be helpful to us.

The gentleman's time has expired. And I will now recognize the gentleman from Texas, Mr. Marchant, for 5 minutes, and I encourage the members to exercise as much restraint as they can, in an effort to get all three members in who are still here, allow us to

release this panel, and be set to go with the next panel immediately after this series of votes is over. Mr. Marchant?

Mr. MARCHANT. Thank you, Mr. Chairman. Chairman Bernanke, I would like to ask you about the inter-connectedness of Fannie Mae, which is owned—the largest shareholder is the United States Government in conservatorship. And, arguably, every loan that is originated today in Fannie Mae is explicitly guaranteed by the Treasury.

When the mortgage-backed security—when Fannie Mae packages the mortgage-backed securities, the Fed is a principal holder of mortgage-backed securities. You have $1 trillion with authority, I think, to go to $1.25 trillion.

Fannie Mae, every month, is accruing a loss on the loan that the Treasury is making it. And the Treasury is assessing Fannie Mae at a rate of 11 percent every month. This loan—and they're loaning Fannie Mae the money to make the interest payment.

At what point—who exits first? Does Fannie Mae slow its lending down, so that the flow of the mortgage-backed securities slows? Does the Treasury lower the interest rate to Fannie Mae, so that the losses are less? Or does the Fed exit the mortgage-backed security—its holdings in mortgage-backed securities? Which will move first? Which part will move first?

Mr. BERNANKE. First, just very quickly, as Chairman Volcker indicated, the Federal Reserve was very concerned about Fannie and Freddie for many, many years. This was an issue that we pointed out and noted the moral hazard with the implicit government guarantee.

My assumption is that sometime soon, the Congress will reform Fannie and Freddie, perhaps break them up, perhaps make them officially governmental. At that point, then there will have to be decisions made about whether the government is going to stand behind their securities and, if so, in what way.

My assumption is that the mortgage-backed securities, which are already outstanding, will be grandfathered, and will retain the U.S. Government backing that they currently have.

So, at some point there will be a change in the structure, and there will be no more of the current type of MBS created. But the existing MBS, I assume, will be protected until such time as they either expire or are purchased back.

Mr. MARCHANT. A couple of weeks ago, I read that the Treasury had sold $200 billion worth of notes, paper, and had deposited that with the Fed. And the explanation for that was to provide a liquidity for the Fed, if the Fed decided to begin to liquidate its position in mortgage-backed securities. Is that correct?

Mr. BERNANKE. The Treasury has restored what it had last year, which was a $200 billion account at the Fed. We pay interest on that account—

Mr. MARCHANT. Right.

Mr. BERNANKE. —so that the taxpayer is not losing any money. And it has the advantage that it reduces the amount of reserves in the banking system for the given amount of mortgage-backed securities that we hold. And that gives us more flexibility as we manage policy, going forward.

Mr. MARCHANT. And my last question, how does the Fed acquire the mortgage-backed securities? Does it acquire them directly from the agencies' auctions? Or do they acquire them as collateral from banks that are borrowing against them?

Mr. BERNANKE. We buy them in the open market.

Mr. MARCHANT. Okay. Thank you, Mr. Chairman.

Mr. WATT. The gentleman's time has expired. The gentleman from Kansas City, Mr. Cleaver, is recognized.

Mr. CLEAVER. I will do this quickly. Thank you very much for being here. My district office is 3 blocks from the Kansas City Fed. I have gotten to know Tom Hoenig very well. In fact, we flew in together on Monday. So I am concerned about some of the regional issues.

And first, Chairman Volcker, here in this post-economic crisis, how should the Fed and the regional banks relate? Right now, it appears we have two seats of power: the one you lead, Mr. Bernanke; and the one in New York. And so, I am concerned about what happens to the regional banks. Are we going to emasculate them any further?

How should we, in this moment of reorganization, create the relationship between the Federal Board and the regional banks?

Mr. VOLCKER. Well, I take off on a basic point that Chairman Bernanke has been emphasizing about the importance of the regional banks, in terms not just of information, but in terms of contact with regional financial institutions and regional publics right around the United States. It has been a great strength of the Federal Reserve.

That is anchored, to some extent, in their supervisor responsibilities. Supervisory responsibilities are shared between the Board in Washington and the banks. But it's fundamentally, in the end, the responsibility of the Board of Governors in Washington. But it is delegated, in substantial part, to the banks. And I think that works out to the mutual interest.

And what you do in terms of parceling out these regulatory responsibilities, supervisory responsibilities, will inevitably bear on the point of the organization of the Federal Reserve, if not immediately, over time. And I think it's something you ought to take into account.

Because for who knows how many years now—95 years almost—I think this kind of regional system is clearly controlled at the center here in Washington, but nonetheless has regional participation, and has served the country well. It served the independence of the Federal Reserve and the credibility of the Federal Reserve, I think, through many decades.

Mr. CLEAVER. So it should remain the way it is now?

Mr. VOLCKER. Pardon me?

Mr. CLEAVER. It should remain the way it is now?

Mr. VOLCKER. Yes.

Mr. CLEAVER. The relationship. Mr. Hoenig would probably consider this heresy, what I'm about to ask you, Mr. Bernanke. He may even jump out of the window if he just knew I asked this question. But the regional bank presidents and regional boards could be viewed as captive, somewhat as captives, of the regional banks industry, since the presidents are chosen by the member

banks' directors in the regions. And to break it down, three of the regional bank board directors are chosen by the Fed in D.C., and three are chosen by regional bank members.

What would you think of having the three who are chosen by the region, chosen by the Federal Board?

Mr. BERNANKE. To begin with, I just want to make clear that the perception of a conflict is more perception than reality. The members of the boards are completely insulated from supervisory decisions, and the presidents are all approved by the Board of Governors in Washington. So the conflict isn't quite as great as is sometimes made out to be.

That being said, I think we would be open to discussing changes of that type that you just described, to try to make sure that everybody understands that the role of those boards, regionally, is to represent their area, their broad public, and to give us the feedback and information that is provided by banks, but is also provided by other folks: community development people; business leaders; and so on. And we want a broad representation on those boards.

Mr. CLEAVER. Really quickly?

Mr. WATT. You have 5 seconds.

Mr. CLEAVER. Then, I surrender.

Mr. WATT. Which you have just lost. The gentleman's time has expired, and I have to go to Mr. Foster from Illinois, as the last questioner.

Mr. FOSTER. Thank you both for waiting around to the end here.

In the Wall Street Journal's list of the recommendations for what should be done to reform the financial system, the number one recommendation was to improve capital standards, including the incorporation of contingent capital, into the capital structure of large financial firms.

I was the author of the amendment that passed out of this committee, authorizing contingent capital requirements. And I understand it's being dealt favorably in the Senate proposal, as well.

So, what I was interested in was what—do you view the role of the Fed in administering standards for contingent capital, and possibly administering the stress test that's often talked about as the trigger mechanism for the debt conversion? Do you think that's an appropriate Federal—one that's likely to happen?

Mr. BERNANKE. We have a couple of roles. One is the international agreements discussions that take place in developing international capital standards, and we have put the contingent capital idea on the table, internationally.

Then, assuming we maintain our consolidated supervision and oversight of holding companies, we would be working with the functional regulators to develop stress tests at that level. So we would be, obviously, very much involved in both the setting of the standards, and analyzing whether or not the contingent capital should be converted or not.

We think that's a very intriguing idea. There are some issues to be resolved, and some details to be worked out, but we are looking at it pretty actively at the Federal Reserve.

Mr. FOSTER. Thank you. And, let's see, countercyclical mortgage underwriting standards are being implemented at various levels in different countries around the world. And, simply put, what this

means, when a housing bubble begins to develop, you turn up the downpayment that's required.

And I guess my first question to Chairman Bernanke is that had these type of policies been in place in the previous decade, how effect would they have been at damping down the housing bubble, even in the presence of very loose monetary policy?

And more—and secondly, in respect to the subject of this hearing, would countercyclical underwriting requirements be easier to implement in the context of consolidated Fed supervision?

Mr. BERNANKE. It's a somewhat speculative question. I can't give you a precise answer. But there are some countries where they are using variable LTVs. And I think we have discussed this before. I think that's an interesting idea. And it's clear that because of piggyback mortgages and other kinds of instruments, loan-to-value ratios got way too high in the United States and, going forward, the financial system and the regulators were being much more conservative.

I think that's another interesting idea to look at.

Mr. FOSTER. Yes. I have a concrete proposal that I will get to you in writing. I would like your reaction, if possible, in writing afterwards.

Thank you. I yield back.

Mr. WATT. The gentleman yields back. I ask unanimous consent to insert into the record the Fed's policy statement entitled, "The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation."

Hearing no objection, is is so ordered.

Mr. WATT. I ask unanimous consent to submit for the record my full opening statement.

Mr. WATT. Hearing no objection—nobody else is here to object—it is so ordered.

We thank both of these distinguished gentlemen for their patience and their time. We will release them, and I will announce that as soon as the votes are concluded, we will convene the second panel, and we will be back promptly.

We stand in recess until after the votes.

[Recess.]

Mr. WATT. The hearing will reconvene, and I will introduce the witnesses. I'm told that Mr. Meltzer has a time constraint in that he needs to be on a plane at 6:30.

Mr. MELTZER. My plane is at 6:30.

Mr. WATT. Your plane is at 6:30. Okay. So I'm totally happy to have you testify first and allow you to leave, if it's all right, because otherwise, you are not going to make it. So let me quickly introduce the witnesses. I will not elaborate on bios so as to save time. Our panel consists of: Mr. Anil Kashyap, Edward Eagle Brown professor of economics and finance, and Richard N. Rosett faculty fellow at the Booth School of Business, University of Chicago; Mr. Allan Meltzer, the Allan H. Meltzer university professor of political economy, Tepper School of Business, Carnegie Mellon University; Mr. Rob Nichols, president and chief operating officer of the Financial Services Forum, which I have had some dealings with; and Mr. Jeffrey L. Gerhart, president, Bank of Newman

Grove, on behalf of the Independent Community Bankers of America.

And with everyone's consent, we will allow Mr. Meltzer to go first, so he can scoot out the door and catch his flight. Your full statements will be made a part of the record, so please summarize in 5 minutes, if you can.

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

Mr. MELTZER. Thank you, Mr. Chairman. Happy St. Patrick's Day. It's a pleasure to be here again. Both Houses of Congress have worked hard to develop means of reducing greatly the risk of future financial crises. I believe they have neglected to remove completely the two most important causes of the recent crisis.

First, in my opinion, the disastrous mortgage and housing problem, especially the rules as followed by Fannie Mae and Freddie Mac and all recent Administrations. If they had not existed, the crisis would not have happened.

Second, without advance warning, the Treasury and the Federal Reserve ended a 30-year policy of "too-big-to-fail" in the midst of a recession by letting Lehman fail.

The first reform, the one that is ignored most is, I believe you need to put Fannie Mae and Freddie Mac on the budget the way—with a subsidy on the budget. It's not a question of whether there should be a housing and mortgage policy; it's where it should be located. It should not be located as a subsidy through the financial markets, subsidies in a well-run democratic country are on the budget.

After the failure, after the mistake of allowing Lehman to fail, the Fed acted forcefully, directly, aggressively, and intelligently to prevent the failure from spreading. What we want to consider is what might be done to avoid a repeat of government policy failure. "Too-big-to-fail" encouraged some large bankers, to use the word of the then-chairman of Citigroup, "to get up to dance when the music was playing." That was a mistake. That mistake, I believe, would not have happened if there were not—if he didn't believe that he could take the risks and allow the taxpayers to pay the losses. The taxpayers, indeed, paid for the losses. So did he.

We need a system that protects the public. The current system leans toward protecting the banks. It's important, most important, to end "too-big-to-fail" in a way that will work in crises. Regulation often fails. We have the examples of Madoff, Stanford, the structured—the SIVs that circumvented the Basel Accord Basel regulated risks. The markets circumvented it. Ask yourselves what happened to FDICIA. This committee, in 1991, passed a rule that said we're going to try to do early intervention before companies fail, before banks fail. It didn't happen. FDICIA has been missing. Is that unusual? No. It's the common effect of regulation.

The first law of regulation, my first law of regulation is that bureaucrats, lawyers make regulations. Markets learn to circumvent the costly ones. The second law of regulation is regulation is static; markets are dynamic. If they don't figure out how to circumvent

them at first, they will after a while. That's what has happened very often in the case of regulation.

So you need to do something. You must regulate, but you have to regulate in ways that rely on incentives that affect the way the bankers behave. And my proposal is, you want to tie the capital standards to the size of the bank. Let the banks choose their size. Beyond some minimum size, say $10 billion, for every 1 percent they increase their assets, they have to increase their capital by 1.2 percent. That way, the capital ratio will go up and up and up with the size of the bank and that will limit the size of the bank and it will put the stockholders and the management at risk. That's the way to prevent failures.

One other step: If failures occur, markets require something to be done about the counterparties. In the 96 years of its history, the Fed has never announced or followed a consistent lender of last resort policy. Never. They have never announced it. They have discussed it internally many times. They have never had a consistent policy. Congress should insist on a lender of last resort policy and it has to be one that the Congress will honor in a crisis. So it should negotiate with the management of the Fed to choose a lender of last resort strategy that the Congress is willing to honor.

Let me say a few other things in my remaining 10 seconds. First, the regulators talk about systemic risk, and there's a systemic risk council. No one can define systemic risk in an operational way. You and your colleagues will properly say there is a large failure in your district. It's a responsibility to do something about it. That's a systemic risk as far as you're concerned. Who will decide on systemic risk? The Secretary of the Treasury. Who has been the person most active in bailouts? The Secretary of the Treasury. Therefore, moving to a systemic risk council with the Secretary of the Treasury as its chairman is an invitation to continue to do the things we have been doing: bailing them out.

Mr. WATT. Mr. Meltzer, you are putting yourself in systemic risk of missing your flight.

Mr. MELTZER. My time is up.

[The prepared statement of Professor Meltzer can be found on page 88 of the appendix.]

Mr. WATT. Your time is up, and at least one of our members—I don't have any questions for you, but at least one member has a question, maybe two.

So, Dr. Paul?

Dr. PAUL. Thank you, Mr. Chairman. And welcome, Dr. Meltzer. It's good to see you. I have a very brief question and I don't think it will take 5 minutes, but I want to follow up on a question I asked earlier in the day, and that is, dealing with the flaws of monetary policy and whether or not all we have to do is write regulations to take care of it.

Most of us recognize the fact that rising prices is a monetary phenomenon. Price inflation comes from monetary policy so—but not many people, anyway there are not that many economists around now who say the solution to price inflation is wage and price controls. Most people would say correct the monetary policy. But there are other problems with monetary policy, other types of consequences from a flawed monetary policy. When that happens,

is it wise to believe that we can compensate by just having more regulators and more regulations to compensate for bad monetary policy?

Mr. MELTZER. No. I mean, monetary policy—I have just completed 15 years of working on the history of monetary policy. If you listen—if you ask yourself what are the good years, what are the years in which the congressional mandate, which came later, but the congressional mandate, which said let's have low unemployment and low inflation. Well, there's 1923 to 1928, there are a few years in the 1950's and early 1960's, and then there's a period that we just went through when they were following, more or less following, the Taylor Rule, and we had for about 15 years, we had low inflation and low unemployment.

The rest of the time, we haven't had that. So it hasn't been a very successful enterprise, and it needs to be changed. Independence of the Fed began under the gold standard. When the gold standard came off, so did the limits on what the Fed could do. Congress needs to do something to replace those standards. It needs to legislate something which would say, look, we have told you to have low inflation and low unemployment. Now what we want you to do is announce and agree with us, or with the Secretary of the Treasury or with the President, what you're going to do over the next 2 to 3 years. Tell us what you are going to do, what you are going to achieve. If you achieve it, fine. If you don't achieve it, you can offer—you should offer your resignations and an explanation.

There are lots of valid reasons why you might not achieve it. There may be an oil shock, there may be a devaluation of the dollar. A lot of things can happen. The weather may be bad. So then Congress can accept the regulation, can accept the explanation, or they can accept the resignation, but we need to discipline the Fed.

Dr. PAUL. Thank you.

Mr. WATT. Mr. Hensarling is recognized for one question.

Mr. HENSARLING. Thank you, Mr. Chairman, and I understand, Dr. Meltzer, you have to run. Your testimony was very helpful, and I certainly could not agree with you more that but for Fannie and Freddie and misguided housing policies, this—I believe you said, "These actions converted a garden variety recession into worldwide crises." And I could not agree with you more.

My precise question, before you have to leave, is I'm a little uncertain as to precisely what type of lender of last resort policy you may be advocating for the Federal Reserve. You state that 13(3) should be removed because, I believe, it was used in the AIG case, which was institution-specific. So are you advocating a policy of clearly articulated standards that would open the discount window to non-depository institutions on a pre-stated basis that Congress would agree to, or could you elaborate on what you are advocating, sir.

Mr. MELTZER. Yes. First, let me just say about 13(3); 13(3) was passed in the Great Depression. It was there to help small and medium-sized borrowers who couldn't get accommodation, very much like some of them now. That was the idea of 13(3). It never was very important. The Fed made some loans under 13(3), but not very much. It was never intended to be used to bail out something

like AIG. That's a complete perversion of the spirit of that legislation.

What do I mean by a lender of last resort agreed to by the Congress? Well, if you don't agree to it, it won't—if Congress doesn't agree to it, it won't work. That is because you—the pressures on the Fed will be just too great. So you have to agree to it, what should you agree to.

There was something called Bagehot's Rule, which the Bank of England used. The Bank of England was an international lender, similar to what the United States is now. It had loans all over the world. It said, look, if you have good collateral, you can borrow. If you don't, goodbye. They had bank failures, big ones in some cases, but no crises. Why? Because the borrowers knew that they had to come with collateral and they held collateral.

We have to go back to a system in which the responsibility is on the banker. I want a system where the chairman of the bank goes in every morning and says to his number two guy, "How the devil did we get that junk on our balance sheet? Get rid of it at once." That way, we'll have safety and soundness.

Mr. HENSARLING. Dr. Meltzer, I think the chairman is trying to do you a favor. The 5:00 traffic—

Mr. WATT. I have been trying to do him a favor, and he seems to be resisting me doing him a favor.

Mr. MELTZER. Mr. Chairman, I thank you.

Mr. WATT. Before you do that, Mr. Meltzer, I do need to make you aware that some members may have additional questions for you, and other members of this panel, that 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. So we may be following up with you with written questions.

Mr. MELTZER. Of course.

Mr. WATT. You are excused unless you have something else.

Mr. MELTZER. No. I just want to thank you for your forbearance.

Mr. WATT. Okay. Well, I hope you make your flight.

Now, we will recognize Professor Kashyap.

STATEMENT OF ANIL K. KASHYAP, EDWARD EAGLE BROWN PROFESSOR OF ECONOMICS AND FINANCE, AND RICHARD N. ROSETT FACULTY FELLOW, BOOTH SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO

Mr. KASHYAP. Thank you, Chairman Watt, and members of the committee. Besides my affiliation at Chicago Booth, I want to mention I'm also a member of the Squam Lake Group, since I'm going to tout a couple of their recommendations. Today, I'm going to consider whether and how the Fed supervisory role should change by considering three specific questions.

First, I want to ask how the most costly mistakes in the United States regarding individual institutions might have differed if the Fed had been stripped of its supervisory powers; second, I want to review the U.K. evidence where the Central Bank was not involved in bank supervision and ask if those outcomes were particularly good; and third, time permitting, I'll look at the overall financial system and ask what might have been done to protect the whole

system better. I'm going to skip large parts of my written testimony, but I would be happy to take up questions about that.

So let's look at the biggest individual supervisory failures. As has already been mentioned here today, by far the most expensive rescue was for Fannie and Freddie. CBO's latest estimates put the costs to the taxpayer at over $200 billion and the problems of these institutions were well known, and as Chairman Bernanke indicated, the Fed was testifying as early as 2004 about the risks that they posed. So it seems hard to put the blame for these two on the Fed.

The next most expensive rescue was for AIG. The cost of this intervention was estimated at probably upwards of $30 billion. In this case, the Fed wrote the check for the rescue, and the Fed actions, particularly regarding the transparency around the transaction, have been legitimately and heavily criticized. AIG's primary regulator was the Office of Thrift Supervision, which had absolutely no experience in understanding what was happening inside AIG Financial Products.

So when the decisions that had to be made about AIG were taken, the Fed was flying blind. Chairman Bernanke has said the AIG case causes him the most trouble of anything that happened in the crisis, and I think it also provides the best example of why stripping the Central Bank of its supervisory authority would likely make problems, such as AIG, more probable in the future.

No one thinks it's possible to have a modern financial economy without a lender of last resort facility. So let me offer an analogy. As a lender of last resort, you're never sure who is going to come through the door and ask for a date. When your date shows up on Friday night and it's AIG, the question at hand is, would you like to know something about them or would you rather have to pay $85 billion to buy them dinner. If we mandate that the Fed is not involved in supervision, then we make hasty, uninformed decisions inevitable whenever the lender of last resort has to act.

The third most expensive rescue is likely to turn out to be Bear Stearns. Here again the primary regulator, in this case the SEC, was clueless about what was going on as Bear's demise approached. The Fed crossed the rubicon in this rescue, but as with AIG, it was forced to act on short notice with very imperfect information about Bear's condition and with no supervisory authority to shape the outcome.

Whatever the criticisms one wants to make about the Fed's actions regarding Bear Stearns, the problems didn't come because of incompetent Fed supervision of Bear. If anybody wants to ask about Citigroup, we could talk about that as well. That is a case where the Fed had direct responsibility.

My point in reviewing these cases is not to absolve the Fed. As we say in this town, plenty of mistakes were made. But I think this quick summary shows that if another supervisor had taken over the Fed's responsibilities, the U.S. taxpayer still would be on the hook for billions of dollars.

One obvious objection to the way I have been reasoning is that I took the rest of the environment as given in contemplating a supervisory system without the Central Bank. Perhaps if the Fed had been out of the picture, other supervisors would have stepped in

and built a better system. Here the lessons of the United Kingdom are particularly informative.

The U.K. has deep financial markets with many large financial institutions and London is a financial center. The U.K. separated the Central Bank from supervision in the 1990's and set up a separate organization—the Financial Services Agency—to focus on bank supervision. The agreement that was reached required the treasury, the Central Bank, and the FSA to agree on any rescues.

The first real test of this system came when Northern Rock got into trouble. The management of Northern Rock notified the FSA of its problems on August 13, 2007; the Bank of England found out the next day. It took over a month of haggling between the Bank of England, the treasury, and the FSA to decide what to do before the Bank of England eventually announced its support for Northern Rock. Even that support was not enough to prevent a run, and the first failure related to a run in the U.K. since 1866.

While the distribution of blame is debated, there is complete agreement that the situation was mismanaged and the lack of coordination was important. Besides Northern Rock, several other large British banks, including Lloyd's and Royal Bank of Scotland, required government assistance in the United Kingdom. The total taxpayer burden from these interventions is guesstimated as being about 20 to 50 billion pounds.

I expect that if we formed a council to oversee the U.S. financial system, we would arrive at the same arrangement as in the U.K. In particular, it would rely on consensus, and information sharing amongst the different agencies would be poor. The events in the U.K. suggest when this system was actually adopted, it didn't work. And I see no reason to expect it would work in the United States.

So, what should we do? Well, the problems with the existing regulatory structure go far beyond the question of which organizations do the supervision of individual institutions. The gaps in supervisory coverage were critical. The fact that institutions could change regulators if the regulator became too tough is appalling, and that let the risks in the system grow for no good reason.

But the crisis has also shown us that while there were many sources of fragility, nobody was watching the whole financial system. And when individual regulators did see problems, they were often powerless to do anything about them. Thus, a critical step in reforming regulation must be the creation of a systemic risk regulator that is charged with monitoring the whole financial system. The regulator must have the authority and tools to intervene to preserve the stability of the system.

I know Mr. Watt's subcommittee held some very nice hearings in July on exactly this issue, and the lack of progress on this front is disappointing. But even with a vigilant systemic risk regulator, it seems likely that most of the problems in the crisis would have appeared anyway.

The Squam Lake Group has argued that the cost of the AIG rescue could have been substantially reduced if we had a package of reforms. And this package would have included: one, just designating the Fed as systemic risk regulator; two, increasing the use of centralized clearing of derivatives; three, creating mandatory liv-

ing wills for financial institutions and bolstering resolution authority; four, changing capital rules for systemically important institutions; five, improving the disclosure of trading positions; and six, holding back pay at systemically relevant institutions. I would be glad to discuss this in the question-and-answer period.

I just want to close with one last thought, which is I don't want to sound like I think that the Fed has a role or comparative advantage in all types of financial regulation, and I want to reiterate the Squam Lake Group's recommendation to get the Fed out of the business of consumer protection regulation. This is a case where there are very few synergies between the staffing requirements of consumer protection and other essential Central Bank duties. The Fed would be far better off handing off these duties to another regulator. Thank you.

[The prepared statement of Professor Kashyap can be found on page 80 of the appendix.]

Mr. WATT. Thank you very much for your testimony.

Next, Mr. Nichols of the Financial Services Forum.

STATEMENT OF ROBERT S. NICHOLS, PRESIDENT AND CHIEF OPERATING OFFICER, THE FINANCIAL SERVICES FORUM

Mr. NICHOLS. Chairman Watt, Ranking Member Paul, thank you for the opportunity to participate in today's hearing, to share our views regarding the Federal Reserve, and specifically, the relationship of supervisory authority to the Central Bank's effective discharge of its duties as our Nation's monetary authority.

By way of background, the Financial Services Forum is a nonpartisan financial and economic policy organization comprised of the chief executives of 18 of the largest and most diversified financial institutions doing business in the United States. Our aim is to promote policies that enhance savings investment in a sound, open, competitive financial services marketplace. Reform and modernization of our Nation's framework of financial supervision is critically important. We thank you, Mr. Chairman, Ranking Member Paul, and all the members of this committee for all of your tireless work over the past 15 months.

To reclaim our position of financial and economic leadership, the United States needs a 21st Century supervisory framework that is effective and efficient, ensures institutional safety and soundness, as well as systemic stability, promotes the competitive and innovative capacity of our capital markets, and protects the interests of depositors, consumers, investors, and policyholders.

In our view, the essential elements of such a meaningful reform are enhanced consumer protections, including strong national standards, systemic supervision ending once and for all "too-big-to-fail," by establishing the authority and procedural framework from winding down any financial institution in an orderly non-chaotic way in a strong, effective, and credible Central Bank, which in our view requires supervisory authority.

On the 11th of December, your committee passed a reform bill that would preserve the Federal Reserve's role as a supervisor of financial institutions. On Monday of this week, Chairman Dodd of the Senate Banking Committee released a draft bill that would as-

sign supervision of bank and thrift holding companies with assets of greater than $50 billion to the Fed.

While we think that it is sensible that the Fed retains meaningful supervisory authority in that bill, we also believe the Fed and the U.S. financial system would benefit from the Fed also having a supervisory dialogue with small and medium-sized institutions, a point which is well articulated by Jeff Gerhart in his testimony. You will hear from him in a moment.

As this 15-month debate regarding the modernization of our supervisory architecture has unfolded, some have held the view that the Fed should be stripped of all supervisory powers, duties which some view as a burden to the Fed and distract the Central Bank from its core responsibility as the monetary authority and lender of last resort. Mr. Chairman, we do not share that view. Far from a distraction, supervision is altogether consistent with and supportive of the Fed's critical role as the monetary authority and lender of last resort for the very simple and straightforward reason that financial institutions are the transmission belt of monetary policy.

Firsthand knowledge and understanding of the activities, condition and risk profiles of the financial institutions through which it conducts open market operations, or to which it might extend discount window lending, is critical to the Fed's effectiveness as the monetary authority and lender of last resort. It must be kept in mind that the banking system is the mechanical gearing that connects the lever of monetary policy to the wheels of economic activity. If that critical gearing is broken or defective, monetary policy changes by the Fed will have little, or even none, of the intended impact on the broader economy.

In addition, in order for the Federal Reserve to look across financial institutions and the interaction between them and the markets for emerging risks, as it currently does, it is vital that the Fed have an accurate picture of circumstances within banks. By playing a supervisory role during crises, the Fed has a firsthand view of banks, is a provider of short-term liquidity support, and oversees vital clearing and settlement systems.

As former Fed Chairman Paul Volcker observed earlier this afternoon, monetary policy and concerns about the structure and condition of banks and the financial system, more generally, are inextricably intertwined. While we don't see eye-to-eye with former Chairman Volcker on everything, we sure do agree with him on that.

As Anil Kashyap noted, U.S. policymakers should also be mindful of international trends in the wake of financial crisis. In the United Kingdom—I'll point to the same example as Anil—serious consideration is being given to shifting bank supervision back to the Bank of England, which had been stripped of such powers when the FSA was created in 2001. It has been acknowledged that the lack of supervisory authority and the detailed knowledge and information derived from such authority likely undermined the Bank of England's ability to swiftly and effectively respond to the recent crisis.

Thank you for the opportunity to appear before you today.

[The prepared statement of Mr. Nichols can be found on page 96 of the appendix.]

Mr. WATT. Thank you for your testimony.

Finally, Mr. Gerhart is recognized.

STATEMENT OF JEFFREY L. GERHART, PRESIDENT, BANK OF NEWMAN GROVE, ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA (ICBA)

Mr. GERHART. Chairman Watt and members of the committee, I am Jeff Gerhart, president of the Bank of Newman Grove in Newman Grove, Nebraska. I'm also a former director of the Federal Reserve Bank of Kansas City. The Bank of Newman Grove is a State member bank supervised by the Federal Reserve with $32 million—that's "M" in million, not "B" in billion—in assets. Our bank was founded in 1891, and I'm the fourth generation of my family to serve as the bank's president.

Newman Grove is an agricultural community of 800 in the rolling hills of northeast Nebraska. Our bank works hard to ensure Newman Grove is a vibrant community through loans to our local farmers, small businesses, and consumers. I am pleased to testify on behalf of the Independent Community Bankers of America and its 5,000 community bank members nationwide at this important hearing to link the Fed's examination—or supervision of monetary policy.

Some in Congress have proposed that the Federal Reserve's supervision of State member banks be eliminated and that a supervision over holding companies be eliminated or limited to the very largest companies. Although the primary responsibility of the Federal Reserve is to conduct monetary policy, the ICBA opposes separating the Federal Reserve's monetary policy role from its role as financial supervisor. For decades, the Federal Reserve has played a critical role in the banking regulatory system as a supervisor of State member banks and holding companies.

ICBA believes the local nature of the regional Federal Reserve banks, working in harmony with State bank regulators, gives them a unique ability to serve as a primary regulator for State member banks, the vast majority of which are community banks serving consumers and small businesses. This, in turn, gives the Federal Reserve an efficient means for gauging the soundness of the banking sector, information that is critical to developing and implementing sound monetary policy.

Federal Reserve Chairman Bernanke recently testified that the Federal Reserve's supervision of community banks gives the Fed insight into what has happened at the grass roots level to lending and to the economy. This is particularly true with respect to the vital small business sector. While community banks represent about 12 percent of all bank assets, they make 40 percent of the dollar amount of all bank small business loans under a million dollars. The Federal Reserve monetary policy is to promote this important sector of the economy. The Federal Reserve's supervision of community banks must be maintained.

In addition, regulation of community banks gives the Federal Reserve a window on the vast array of local economies served by community banks, many of which are not served by any larger institutions at all. The inside gain from the supervision of State member banks and holding companies, both large and small, allows the

Federal Reserve to identify disruptions in all sectors of the financial system in order to meet its statutory goal of ensuring stability of the financial system.

The record shows the Federal Reserve has been a very effective regulator of community banks, and this role should be preserved. ICBA is very concerned that limiting the Federal Reserve's oversight to only the largest or systemically dangerous holding companies could lead to a bias and favor the largest financial institutions. This is a risky approach to financial reorganization and a path that the United States should not go down.

The Federal Reserve Bank of Kansas City, the Federal supervisor of my bank, brings to its bank supervisory role a highly regarded expertise in the agricultural economy. The Federal Reserve's expertise in agriculture enhances its ability to supervise Midwestern community banks like mine with a significant ag loan portfolio. It would be a mistake to remove the Federal Reserve's economic expertise from the country's financial supervisory structure.

Having multiple Federal agencies supervising depository institutions provides valuable regulatory checks and balances and promotes best practices among those agencies. The contributions and views of the Federal Reserve have been an important part of this regulatory diversity, which would significantly be diminished if the Federal Reserve were stripped of all or most of its supervisory authority.

I want to thank you for inviting me here today, and I would be glad to answer any questions.

[The prepared statement of Mr. Gerhart can be found on page 73 of the appendix.]

Mr. WATT. Thank you for your testimony.

Mr. Foster has been so patient and diligent. He has been here the whole time. I think I'm going to reward him by recognizing him first for 5 minutes to ask questions.

Mr. FOSTER. Well, thank you. Let's see. My first question, briefly, if you could all three comment on where you are on the discussion that was touched on with Chairman Bernanke about whether it was monetary policy or regulatory failure that was responsible for the crisis we have just gone through. So just go down in order, if you could.

Mr. KASHYAP. Many more regulatory problems, I mean, the banks ate their own cooking. You have to remember the most financially sophisticated banks ended up sitting on these AAA subprime securities that ended up coming back to haunt them. And I think if we had somebody looking out across the system seeing those concentrations of risks and being able to adjust things like loan to value ratios in the housing market and also haircuts and margins on those securities, you would not have the deleveraging that I think was so dangerous.

Mr. FOSTER. Thank you.

Mr. NICHOLS. Congressman Foster, I think it was a perfect storm of activities, activities, conditions, behaviors, failures, in a lot of places. So like Chairman Bernanke pointed to two or three different factors, I even think it's broader than that. Certainly, the industry played a role in terms of internal controls and risk manage-

ment; lack of mortgage origination standards; the role of credit rating agencies; even our trade imbalance, a lot of money coming in for yield, interest rate policy. There was a perfect storm of failures. People were overleveraged. Some Americans bit off more than they could chew. It was really—I don't think you could just point to one thing that led to the housing bubble. There were a lot of accelerates and a lot of contributors to it, but it's a dozen different factors all intertwined, in my humble opinion.

Mr. FOSTER. Thank you.

Mr. GERHART. Would you be kind enough to repeat the question?

Mr. FOSTER. Where are you on the debate over the extent to which monetary policy was responsible for the crisis we just went through versus regulatory failure?

Mr. GERHART. Honestly, that is not an area as a day-to-day banker that I dwell on very often. So I would respectfully take a pass on that. Thank you.

Mr. FOSTER. Okay. Let's see. I guess I would like to first make a couple comments on the Squam Lake Group, which actually led me to discover the concept of contingent capital, which I thought was one of the really positive lessons that I think we're going to carry out of this. And I was wondering what the status of work in the academic sector is on contingent capital or on the commercial sector. Is there a baseline implementation that people are talking about? Are there ongoing series of conferences? What is the actual status of that concept besides sort of secret deliberations in the Federal Reserve?

Mr. KASHYAP. Well, I pointed a member of your staff earlier today towards one working paper I know that has been written on this, but I think there is still active discussion over what the trigger should be. I understood your question to Chairman Bernanke to be asking whether or not should there be a regulatory trigger that would convert the debt. Was the Fed to be the regulator to pull the trigger? I don't think that's the way he answered it, but that's what I thought you were asking.

I know that the rating agencies have said that if that trigger is enacted, they may not be willing to rate the debt. So there has been some discussion about what other triggers could be used with convertible debt that would still preserve the features that would add to the loss bearing capacity of the debt, but maybe not prevent rating agencies from being able to assess the risk. So that's one area. But generally, I think, there's a holding pattern until some of the regulatory bodies, namely the Financial Stability Board in Basel, come out with their assessments, which I understand to be coming soon.

Mr. FOSTER. And I understand a couple of European banks have actually issued some of those what they call CoCo securities?

Mr. KASHYAP. Yes. Well, the first issue was a U.K. bank, but that was a bank that was under the control of the British government. And so there was some skepticism as to whether those terms were indicative and informative. I'm not sure if any continental banks have issued any in the last month or two, but—

Mr. FOSTER. Okay. So as of yet, you don't think there is any relevant market experience with them.

Mr. KASHYAP. No. There were actually some issued in Canada in around 1999, but ironically, the Canadian regulators decided it shouldn't count as capital. So it was done on a small scale and they were ready to issue it en masse, and they couldn't get the regulatory treatment they needed.

Mr. FOSTER. Okay. Thank you. I yield back.

Mr. WATT. I thank the gentleman for being here all day, and for his good questions.

I recognize myself for 5 minutes. I have to apologize for Mr. Paul having to leave. He had another commitment.

Mr. Gerhart, I know the hearing today is about the Fed's supervisory role and the impact it has on monetary policy, but from your perspective as the supervised bank, could you tell me how your life would change if your supervisor were the FDIC or the OCC or somebody other than the Fed, as you perceive it?

Mr. GERHART. I have been a national bank. So I have been examined and supervised by the Comptroller of the Currency. We converted to a State charter in 2005, made the choice that we would like to remain a Fed member bank, so we applied with the Nebraska Department of Banking and Finance, along with the Federal Reserve Bank of Kansas City, and that is who our regulators are. What it does is it takes away from the dual banking system if you remove the Federal Reserve system from regulating us. They are—

Mr. WATT. I understand that from—

Mr. GERHART. Okay.

Mr. WATT. —the bank's—from the Fed's side. But from your perspective, what difference would it make?

Mr. GERHART. Well, it takes away choice because right now, I have a choice. Do I want to have the FDIC? Do I want to have the Federal Reserve Bank? I can pick one of the two, which both do a good job. A State member bank either has a choice of remaining with just the FDIC as their other Fed regulator or they can choose the Federal Reserve. So taking away choices is very important. Or I could go back to being a national bank and apply for a national bank charter.

So that's extremely important. I can tell you, honestly, in fact, we just had an examination last week. The Fed is extremely thorough, the State is extremely thorough, and the OCC was extremely thorough. They look under every rock, and we are very well supervised in my book.

Mr. WATT. I don't have any question about that. I'm just trying to figure out what, I mean, what difference would it make to you, other than you wouldn't have a choice between the Fed and some other regulator. Would the level of regulation and supervision be any different as you perceive it?

Mr. GERHART. Well, taking away choices is a pretty big—

Mr. WATT. I understand that.

Mr. GERHART. Okay.

Mr. WATT. But would the level of supervision and regulation be any different if you had a different regulator?

Mr. GERHART. I think it could be.

Mr. WATT. How so?

Mr. GERHART. If I go back to my days as a national bank, those folks, the Comptroller's office, did a good job, but having the State as our—one of our regulators allows me to have somebody that is a little bit better fit, a little bit more in tune with rural agricultural economy. And I think that goes along with our choice for the Federal Reserve Bank of Kansas City. Their tenth district encompasses a lot of agriculture. And again, it was an option, and it gives us a good choice, and I think that needs to remain out there. I don't—

Mr. WATT. Do you have a particular position on the consumer financial protection agency, whether it should exist, and if so, where it should exist.

Mr. GERHART. We would like to see that at $10 billion or above, and if there's a cutoff for the community banks, we feel like we're very well taken care of protecting consumers for all the products that come out. And for the most part, it wasn't community banks that had products to their consumers that people got in trouble with.

Mr. WATT. You're nicely avoiding my question. Do you have an opinion of whether it should exist?

Mr. GERHART. It could exist.

Mr. WATT. Regardless of who—I mean, I assume you're saying it doesn't—it really wouldn't have any impact on your bank because you wouldn't be under the House bill; we exempted you. But—

Mr. GERHART. We may be exempt, but I think in the end, yes, it will have some impact as far as that goes. And we're certainly comfortable—

Mr. WATT. I need your opinion on whether it should exist, and if so, where it should exist.

Mr. GERHART. In the Fed.

Mr. WATT. And if now, why it shouldn't exist.

Mr. GERHART. In the Fed or the FDIC, but it should—it needs to be fair to everybody.

Mr. WATT. But you do think there is a need for a consumer financial protection agency somewhere.

Mr. GERHART. Somewhere.

Mr. WATT. Okay. All right.

Mr. Nichols, what's your opinion on the CFPA and where it should exist, whether it should exist?

Mr. NICHOLS. Sure, Mr. Chairman. We are—as we have discussed before—in heated agreement with you that we need to enhance consumer protections. I think among the many, many, many lessons learned from the crisis, that's certainly one of them.

We are—I mean, our view, candidly, is that probably tethering the enhanced consumer protections with the safety and soundness a prudential regulator does—is sensible. We're interested to learn more about the proposal that's being—that was unveiled a couple of days ago. So but with regard to the overall goal of enhancing consumer protections, as identified in this testimony, that's a critical, critical issue that we think absolutely has to happen.

Mr. WATT. You haven't—you are giving me trouble getting you pinned down on this issue.

You have been pretty direct about this, Professor. In your oral testimony, you said that you did not really think it had any par-

ticular reason that it needed to be in the Fed and they ought to jettison it. Elaborate on your position on that, if you would.

Mr. KASHYAP. Well, first of all, I think some aspects of it are inherently politicized. And the Fed has enough political troubles, as we have seen from the questions and answers today, I don't see why they need to be borrowing other issues to be testifying about and arguing with when it's not central to being the Central Bank. There is no synergy between deciding whether or not a mortgage is abusive or a credit card shouldn't be able to have certain add-on fees and deciding anything about monetary policy or deciding anything, frankly, about the stability of the financial system.

Mr. WATT. Where would you put it and what authority would you give it?

Mr. KASHYAP. I don't have a strong view as to whether it needs to be completely independent or it could go into another agency. I think whoever is supervising that staff has to be accountable to Congress and should be a specialist. Like Chairman Volcker said, maybe the Fed should have a vice chairman for financial stability. If this was to go into another organization, I think there should be a special designee to sit on top of it and have to come to talk to you. But whether it should be set up from scratch, I don't know.

I think the staff would largely be lawyers. And that's another reason why the culture of the Fed is more one of economists. There is no reason to put the two together. So I would house it in an organization where you can get the right staff and where they are going to be suitably accountable.

Mr. WATT. Mr. Nichols, if you tethered it, as you said, with the supervisory agency, how would you avoid the potential of three inconsistent consumer protection attitudes if you had three different supervisory agencies?

Mr. NICHOLS. Well, that's the key question. One of the things that policymakers have been grappling with, and we are grappling with ourselves, is how do you deal with, if there is a—how do you come up with a reconciliation mechanism between the safety and soundness regulator and the consumer protections? So I don't know today precisely how—

Mr. WATT. I'm dwelling on how you reconcile the three consumer protection agencies now, not even the safety and soundness part of it, if you have three different consumer protection agencies: one at FDIC; one at the Fed; and one at the OCC. How would you avoid having three different consumer protection standards, aside from the safety and soundness aspects of it?

Mr. NICHOLS. Right. Well, we think—well, with regard to—first, one thing. With regard to national standards, we actually think we should come up with—during this policymaking process, it's probably a sensible thing to come up with a strong national standard with regard to consumer protection. So that is one—that is a side issue, but one that is probably worth sharing.

But I do think part of it, when—your specific question with regard to the individual regulators and the consumer protections housed within them, you know, obviously, for example, what is happening at the SEC, the products that are overseen by the SEC are a little different at times and within the banking regulator. So I think the fact that you do have—

Mr. WATT. Now Mr. Gerhart just told me, you know, yes, but supervisors are a little bit different for financial institutions. You have banks and you have banks. They are not securities. Why would you have three different consumer protection agencies?

Mr. NICHOLS. Well, I wouldn't propose having three different agencies. I'm just thinking—I'm suggesting just tethering them, if that makes sense.

Mr. WATT. I don't know what you mean by tethering. That is why I asked the question. I thought you were saying if you needed to tether them to their—to the particular regulator, which would mean to me, if I'm reading what you say correctly or if I'm understanding what you say correctly, you would have one tethered to the FDIC, one tethered to the Fed, and one tethered to the OCC. That is three different regulators. How would—maybe I don't understand the word "tethered."

Mr. NICHOLS. I'm sorry. I'm doing my best to answer your question. I do think pairing them makes sense. And so is your question to me is, will you have inconsistent standards if you have different groups of different regulators?

Mr. WATT. Yes. How can you avoid that if you have three different tethered—

Mr. NICHOLS. Right. One idea—

Mr. WATT. —consumer protection?

Mr. NICHOLS. One idea that was explored in this body is to have a council of, you know, an office—a council of consumer protection offices within the different regulatory bodies that would perhaps report to Congress, directly to you, that they would share best practices, that they would gather together and talk about and communicate and coordinate and consult with one another to see what's happening.

Walt Minnick from Idaho had a concept that was obviously debated before this body—and I think there was some merit to that—which would get directly to your question. Sorry I didn't hit on it earlier.

Mr. WATT. Why would you do that with consumer protection and not do it with safety and soundness? You have the FDIC. You have the Fed responsible for safety and soundness of Mr. Gerhart's bank, the FDIC dibbling and dabbling in safety and soundness with respect to his bank. The OCC is not dibbling and dabbling in safety and soundness with respect to his bank. Why would you want two different agencies dibbling and dabbling in the consumer protection part of it?

Mr. NICHOLS. Well, to some extent, on safety and soundness, that proposal is being considered. Both this—both your body, as well as the Senate, are talking about proposing the creation, which I think is a sensible idea, of a systemic stability council.

Mr. WATT. That's the great big guys. I'm talking about the smaller banks. For systemic people, you are looking across a whole array of financial institutions. You are big enough to have a significant adverse systemic impact on the whole economy. I have jumped across that hurdle. I'm talking about the guys that don't fall into the systemic risk category. Why would you set up a different standard when it comes to consumer protection than the standard you would apply to safety and soundness?

Mr. NICHOLS. I take your question, Congressman, and I would be glad to get back to you on a further answer. I just—

Mr. WATT. Okay. I mean, these are not trick questions.

Mr. NICHOLS. Sure.

Mr. WATT. At every hearing, I have been very transparent in what I have said. I want a consumer protection agency that is just as robust, just as independent as the safety and soundness people. I think that is what the consumers deserve. And if you are going to make compromises on consumer protection, then those same compromises ought to be considered for the safety and soundness.

I'm not suggesting that, but I think it's the—you know, I'm good with Mr. Gerhart having only one safety and soundness regulator, but I don't know why we would set up a three-party consumer protection agency, if we're not setting up a three-party safety and soundness person. It seems to me that would just signal to the public that we are treating consumer interest as second-class, and I think it sends the wrong signal.

Mr. NICHOLS. I do agree with you that we cannot send a signal that consumer protections are not utterly, utterly important.

Mr. WATT. Think about it. I'm well over my time. Of course, nobody is objecting, except the staff who want to go home. So I'm delighted to have all of you here. I really apologize that we got caught in a bind and you had to be here all day and—but that is the cost of doing business, or whatever it is called.

The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for you to respond to in writing, if you would like, to this question that I posed to you, and for other members to submit written questions to these witnesses and to place their responses in the record.

I thank you all so much for your patience and for your persistence and for being here, and the hearing is adjourned.

[Whereupon, at 5:55 p.m., the hearing was adjourned.]

A P P E N D I X

March 17, 2010

U.S. House of Representatives
Committee on Financial Services
Hearing: Examining the Link Between Fed Bank Supervision and Monetary Policy
March 17, 2010

Statement for the Record
Congressman Ron Paul

Mr. Chairman, we have been hearing much recently about the Senate's financial reform package. It is an issue with which the House will deal in the coming weeks. The most frightening thing about this legislation is that it gives the Federal Reserve more power over the economy, while still maintaining the secrecy behind its financial transactions.

The new bill creates a Consumer Financial Protection Bureau within the Federal Reserve System. The new bureaucracy would be funded by the Federal Reserve. The Fed would become the de facto systemic risk regulator, would gain the ability to regulate non-bank financial companies, and could even break up large companies deemed to be systemically risky. Given the opaque nature of everything the Fed has done over the past two and a half years to shore up a shaky economy and the repeated difficulty in obtaining a full, effective audit of the Federal Reserve System, I believe it to be unwise to grant any further sweeping powers to the Fed until issues of oversight are resolved.

The creation of a Consumer Financial Protection Agency is itself problematic. This agency would have such broad power to regulate companies outside those normally considered part of the financial system that even companies such as McDonald's or Starbucks would be subject to the CFPA's regulatory scope.

The most effective regulation is market regulation. CFPA approval of financial products will cause a further regulatory hurdle for American businesses, adding extra cost and causing companies to cut jobs. CFPA approval will not prevent any further financial crises, nor will it prevent fraud. The Fed's loose monetary policy caused the financial crisis, the SEC failed to detect Bernie Madoff, and the FDIC is nearly bankrupt. Yet the response after every failure is not to peel back the layers of arcane regulation but rather to give even more power to the same failed agencies and to create additional layers of bureaucracy. As Chairman Volcker mentioned in his written testimony, this economic crisis is:

> "only the latest of a string of financial disturbances that seem to have been growing in both intensity and frequency. Plainly, we should learn from this experience, drawing appropriate conclusions about the role and responsibilities of the Federal Reserve."

Indeed, future crises will in fact become more severe if we continue down the path of more government regulation. Instead of repeating the same failed policies, we need to understand the cause of the crisis, the Fed's loose monetary policy, and work to ensure that its unelected bureaucrats do not imperil the health of the US economy.

OPENING STATEMENT OF REP. MELVIN WATT

Hearing Entitled, "Examining the Link Between Fed Bank Supervision and Monetary Policy"

Wednesday March 17, 2010

Today's hearing is another in a series of steps in Congress' ongoing effort to examine the consequences of the global economic crisis and appropriate policy responses. Today we examine the Federal Reserve and whether it should retain its role as supervisor over many financial institutions and, if not, the potential effect on the effective execution of monetary policy.

The Federal Reserve currently has the authority to regulate and supervise bank holding companies, state banks that are members of the Federal Reserve System and foreign branches of member banks, among others. Last year, the House passed financial reform legislation that preserved the Fed's power to supervise these financial institutions. The Senate bill recently introduced by Senator Dodd would strip the Fed's authority to supervise all but the largest financial institutions (over $50 billion in assets, which is roughly 40 institutions). This hearing will

examine the potential policy implications of stripping regulatory and supervisory powers over most banks from the Fed and the potential impact this could have on the Fed's ability to conduct monetary policy effectively.

Proponents of preserving existing Fed bank supervision authority cite three main points to support their position that the Fed should retain broad supervisory powers. They say first that as a consequence of carrying out central bank responsibilities the Fed has built up over the years deep expertise in macroeconomic forecasting, financial markets and payment systems which allows effective consolidated supervision of financial institutions of all sizes and allows effective macroprudential supervision across the financial system. Proponents of retaining Fed supervision say that this expertise would be costly and difficult (if not impossible) to replicate in other agencies.

Second, proponents say that the Fed's oversight of the banking system improves its ability to carry out its central bank responsibilities, including the responsibility for responding to financial crises and making informed decisions about banks seeking to use the Fed's discount window and lender of last resort services. In particular, proponents say that knowledge gained

from direct bank supervision enhances the safety and soundness of the financial system because the Fed can independently evaluate the financial condition of individual institutions seeking to borrow from the discount window, including the quality and value of these institutions' collateral and their overall loan portfolios. A related point here is that bank supervision yields clues to the health of the markets generally and allows the Fed to make informed policy responses, particularly in times of crisis. For example, many credit the Fed with launching innovative emergency liquidity programs, including TALF, which arrested the economic free-fall of the last two years and restored liquidity to markets.

Third, and finally, proponents say that the Fed's supervisory activities provide the Fed information about the current state of the economy and the financial system that influences the FOMC in its execution of monetary policy, including interest rate setting. Recently, the federal funds rate has been set at 0 – 0.25% in response to ongoing weakness in market conditions – weakness that the Fed asserts that it observed partly from its supervision of financial institutions.

On the flip side, there obviously are many critics of the Fed's role in bank supervision. Some of these critics blast the Fed for keeping interest rates too low for too long in the early 2000's, which some say fueled an asset-price bubble in the housing market and the resulting subprime mortgage crisis. Consumer advocates and other critics accuse the Fed of turning a blind-eye to predatory lending throughout the 1990's and 2000's. They remind us that Congress passed the Home Owners Equity Protection Act (HOEPA) in 1994 to counteract predatory lending, but the Fed did not issue final HOEPA rules until 2008, well after the subprime crisis was out of control and only after this Committee threatened further legislation.

Other critics accuse the Fed of ignoring its consumer protection role during supervisory examinations of banks and other financial institutions across a wide range of financial products (including bank overdraft fees and credit card fees) which allowed big banks to reap big profits on the backs of ordinary Americans.

Perhaps the appropriate policy response lies somewhere between the proponents and critics of Fed bank supervision. I've tried to keep an open mind about the role of the Fed going forward and hope to use today's

hearing to get some answers and to inform myself better as we move forward to discussions with the Senate, if the Senate ever passes a bill. We are fortunate to have the current Chairman of the Fed, Ben Bernanke, and former Fed Chairman Paul Volcker, who is appearing today as Chairman of the President's Economic Recovery Advisory Board. I plan to question both about how, exactly, bank supervision informs monetary policy. I would also like to hear about the potential policy consequences for prudential bank regulation and effective monetary policy if the Fed is stripped of its power to supervise all but the largest financial institutions. Additionally, I'd like to know if there are any positive (or negative) examples from the international arena of removing the central bank from direct bank supervision.

For release on delivery
2:00 p.m. EDT
March 17, 2010

The Federal Reserve's Role in Bank Supervision

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

March 17, 2010

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to have the opportunity to discuss the Federal Reserve's role in bank supervision and the actions that we are taking to strengthen our supervisory oversight.

The Federal Reserve's Role in Supervision

Like many central banks around the world, the Federal Reserve cooperates with other agencies in regulating and supervising the banking system.[1] Our specific responsibilities include the oversight of about 5,000 bank holding companies, including the umbrella supervision of large, complex financial firms; the supervision of about 850 banks nationwide that are both state-chartered and members of the Federal Reserve System (state member banks); and the oversight of foreign banking organizations operating in the United States.

The Federal Reserve's involvement in regulation and supervision confers two broad sets of benefits to the country. *First*, because of its wide range of expertise, the Federal Reserve is uniquely suited to supervise large, complex financial organizations and to address both safety and soundness risks and risks to the stability of the financial system as a whole. *Second*, the Federal Reserve's participation in the oversight of banks of all sizes significantly improves its ability to carry out its central banking functions, including making monetary policy, lending through the discount window, and fostering financial stability.[2]

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[1] In the aftermath of the crisis, the view that the involvement of central banks in bank supervision strongly complements their roles as lender of last resort, guardian of financial stability, and monetary policymaker has received increasing international support. For example, following the problems at Northern Rock in the United Kingdom, the Bank of England was given statutory responsibilities in the area of financial stability, its powers to collect information from banks were augmented, and many have called for it to be given increased supervisory authority. In Germany, plans to shift bank supervisory powers from the financial services regulator to the Bundesbank have received significant attention. In the European Union, a new European Systemic Risk Board is being established under which national central banks and the European Central Bank will play a key role in efforts to protect the financial system from systemic risk. More broadly, in most industrial countries today the central bank has substantial bank supervisory authorities, is responsible for broad financial stability, or both.

[2] See Ben S. Bernanke (2010), letter to Christopher J. Dodd and Richard C. Shelby (with enclosure, "The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation"), January 13, www.federalreserve.gov/BoardDocs/RptCongress/supervision/supervision_report.pdf.

The financial crisis has made clear that all financial institutions that are so large and interconnected that their failure could threaten the stability of the financial system and the economy must be subject to strong consolidated supervision. Promoting the safety and soundness of individual banking organizations requires the traditional skills of bank supervisors, such as expertise in examinations of risk-management practices; the Federal Reserve has developed such expertise in its long experience supervising banks of all sizes, including community banks and regional banks. But the supervision of large, complex financial institutions and the analysis of potential risks to the financial system as a whole require not only traditional examination skills, but also a number of other forms of expertise, including macroeconomic analysis and forecasting; insight into sectoral, regional, and global economic developments; knowledge of a range of domestic and international financial markets, including money markets, capital markets, and foreign exchange and derivatives markets; and a close working knowledge of the financial infrastructure, including payment systems and systems for clearing and settlement of financial instruments.

In the course of carrying out its central banking duties, the Federal Reserve has developed extensive knowledge and experience in each of these areas critical for effective consolidated supervision. For example, Federal Reserve staff members have expertise in macroeconomic forecasting for the making of monetary policy, which is important for helping to identify economic risks to institutions and markets. In addition, they acquire in-depth market knowledge through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury. Similarly, the Federal Reserve's extensive knowledge of payment and settlement systems has been developed through its operation of some of the world's largest such systems, its supervision of key providers of

payment and settlement services, and its long-standing leadership in the international Committee on Payment and Settlement Systems. No other agency can, or is likely to be able to, replicate the breadth and depth of relevant expertise that the Federal Reserve brings to the supervision of large, complex banking organizations and the identification and analysis of systemic risks.

Even as the Federal Reserve's central banking functions enhance its supervisory expertise, its involvement in supervising banks of all sizes across the country significantly improves the Federal Reserve's ability to effectively carry out its central-bank responsibilities. Perhaps most important, as this crisis has once again demonstrated, the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has as both a bank supervisor and a central bank. Not only in this crisis, but also in episodes such as the 1987 stock market crash and the terrorist attacks of September 11, 2001, the Federal Reserve's supervisory role was essential for it to contain threats to financial stability.[3]

The Federal Reserve's making of monetary policy and its management of the discount window also benefit from its supervisory experience.[4] Notably, the Federal Reserve's role as a supervisor of state member banks of all sizes, including community banks, offers insights about conditions and prospects across the full range of financial institutions, not just the very largest, and provides useful information about the economy and financial conditions throughout the nation. Such information greatly assists in the making of monetary policy. The legislation passed by the House last December would preserve the supervisory authority that the Federal Reserve needs to carry out its central banking functions effectively.

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[3] For further discussion, see the Bernanke letter to Dodd and Shelby in note 2.

[4] Our ability to monitor key payment and settlement systems also depends critically on our supervisory powers, as several key institutions involved in payments and settlements have state member bank or Edge charters. Without bank supervisory authority, the Federal Reserve would have no ability to examine or regulate such institutions.

Improving the Federal Reserve's Supervision of Banking Organizations

The Federal Reserve strongly supports ongoing efforts in the Congress to reform financial regulation and close existing gaps in the regulatory framework.[5] While we await passage of comprehensive reform legislation, we have been conducting an intensive self-examination of our regulatory and supervisory performance and have been actively implementing improvements.

On the regulatory side, we have played a key role in international efforts to ensure that systemically critical financial institutions hold more and higher-quality capital, have enough liquidity to survive highly stressed conditions, and meet demanding standards for company-wide risk management. We have also been taking the lead in addressing flawed compensation practices by issuing proposed guidance to help ensure that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking.[6] Less formally, but equally important, since 2005 the Federal Reserve has been leading cooperative efforts by market participants and regulators to strengthen the infrastructure of a number of key markets, including the market for securities repurchase agreements and the markets for credit derivatives and other over-the-counter derivative instruments.

To improve both our consolidated supervision and our ability to identify potential risks to the financial system, we have made substantial changes to our supervisory framework. So that

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[5] Lack of strong consolidated supervision of systemically critical firms not organized as bank holding companies proved to be the most serious regulatory gap. In addition, under the Gramm-Leach-Bliley Act of 1999, the Federal Reserve's consolidated supervision of bank holding companies was both narrowly focused on the safety and soundness of their bank subsidiaries and heavily reliant on functional supervisors of the bank and regulated nonbank subsidiaries of these companies; in turn, the functional supervisors themselves were statutorily focused only on the safety and soundness of the specific entities they regulated. None of the federal regulators had sufficient authority to focus on the systemic risk that large banking organizations posed.

[6] For additional information, see Board of Governors of the Federal Reserve System (2009), "Federal Reserve Issues Proposed Guidance on Incentive Compensation," press release, October 22, www.federalreserve.gov/newsevents/press/bcreg/20091022a.htm. We are currently conducting a horizontal review of compensation practices at the largest firms.

we can better understand linkages among firms and markets that have the potential to undermine the stability of the financial system, we have adopted a more explicitly multidisciplinary approach, making use of the Federal Reserve's broad expertise in economics, financial markets, payment systems, and bank supervision to which I alluded earlier. We are also augmenting our traditional supervisory approach that focuses on firm-by-firm examinations with greater use of horizontal reviews that look across a group of firms to identify common sources of risks and best practices for managing those risks. To supplement information from examiners in the field, we are developing an off-site, enhanced quantitative surveillance program for large bank holding companies that will use data analysis and formal modeling to help identify vulnerabilities at both the firm level and for the financial sector as a whole. This analysis will be supported by the collection of more timely, detailed, and consistent data from regulated firms.

Many of these changes draw on the successful experience of the Supervisory Capital Assessment Program (SCAP), also known as the banking stress test, which the Federal Reserve led last year. As in the SCAP, representatives of primary and functional supervisors will be fully integrated in the process, participating in the planning and execution of horizontal exams and consolidated supervisory activities.

Improvements in the supervisory framework will lead to better outcomes only if day-to-day supervision is well executed, with risks identified early and promptly remediated. Our internal reviews have identified a number of directions for improvement. In the future, to facilitate swifter, more-effective supervisory responses, the oversight and control of our supervisory function will be more centralized, with shared accountability by senior Board and Reserve Bank supervisory staff and active oversight by the Board of Governors. Supervisory concerns will be communicated to firms promptly and at a high level, with more-frequent

involvement of senior bank managers and boards of directors and senior Federal Reserve officials. Greater involvement of senior Federal Reserve officials and strong, systematic follow-through will facilitate more vigorous remediation by firms. Where necessary, we will increase the use of formal and informal enforcement actions to ensure prompt and effective remediation of serious issues.

In summary, the Federal Reserve's wide range of expertise makes it uniquely suited to supervise large, complex financial institutions and to help identify risks to the financial system as a whole. Moreover, the insights provided by our role in supervising a range of banks, including community banks, significantly increases our effectiveness in making monetary policy and fostering financial stability. While we await enactment of comprehensive financial reform legislation, we have undertaken an intensive self-examination of our regulatory and supervisory performance. We are strengthening regulation and overhauling our supervisory framework to improve consolidated supervision as well as our ability to identify potential threats to the stability of the financial system. And we are taking steps to strengthen the oversight and effectiveness of our supervisory activities.

Thank you. I'd be pleased to respond to your questions.

Testimony
of
Jeffrey L. Gerhart
President, Bank of Newman Grove

On behalf of the
Independent Community Bankers of America

Before the

Congress of the United States
House of Representatives
Committee on Financial Services

Hearing on
"Examining the Link between Fed Bank Supervision and Monetary Policy"

March 17, 2010
Washington, D.C.

Chairman Frank, Ranking Member Bachus, Members of the Committee, I am Jeffrey Gerhart, President of the Bank of Newman Grove, Newman Grove, Nebraska. The Bank of Newman Grove is a state member bank, supervised by the Federal Reserve, with $32 million in assets. Newman Grove is an agricultural community of 800 in the rolling hills of Northeast, Nebraska. We work hard to make Newman Grove a strong and vibrant community through loans to the community's farmers, small businesses and consumers. The bank was chartered in 1891, and I am the fourth generation of my family to serve as bank president. The fifth generation is already represented on our board of directors.

I am pleased to testify on behalf of the Independent Community Bankers of America and its 5,000 community bank members nationwide at this important hearing on the link between the Federal Reserve's bank supervision and monetary policy.

During the financial regulation restructuring debate, some in Congress have proposed the Federal Reserve's supervision of state member banks be eliminated and that its supervision of holding companies be eliminated or limited to the very largest holding companies. Although the primary responsibility of the Federal Reserve is to conduct monetary policy, the ICBA opposes separating the Federal Reserve's monetary policy role from its role as financial supervisor. We support maintaining the Federal Reserve's authority to supervise state member banks and holding companies.

Supervision of State Member Banks and Holding Companies

For decades, the Federal Reserve has played a critical role in the banking regulatory system as the supervisor of state member banks and holding companies. ICBA believes the local nature of the regional Federal Reserve Banks, working in harmony with state bank regulators, gives them a unique ability to serve as the primary regulator for state member banks, the vast majority of which are community banks serving consumers and small businesses. This also gives the Federal Reserve an efficient means for gauging the soundness of the banking sector and local economies, information that is critical to developing and implementing sound monetary policy.

Importance of Community Bank Supervision for Monetary Policy

In testimony before Congress recently, Federal Reserve Chairman Ben Bernanke noted the importance of the Federal Reserve's relationship with community banks. "The Federal Reserve – although we've been very focused on large institutions over the last couple of years because of the crisis – that (sic) we also supervise a large number of community banks, state member banks, and they provide us very important information about the economy," he said. "We can learn from them what's happening at the grassroots level, what's happening to lending, and that kind of information is very valuable for us as we try to understand what's going on in the economy."

Federal Reserve Needs a Comprehensive View of the Small Business Lending Environment

The supervision of community banks provides the Federal Reserve important information on the small business sector, which is vital to our economic recovery. Small businesses represent 99% of all employer firms and employ half of the private sector workers. The more than 26 million small businesses in the U.S. have created the bulk of new jobs over the past decade. With many of the largest firms stumbling and the U.S. unemployment rate at nearly 10 percent, the viability of the small business sector is more important than ever.

Community banks serve a vital role in small business lending and local economic activity not supported by Wall Street. For their size, community banks are prolific small business lenders. While community banks represent about 12 percent of all bank assets, they make 40 percent of the dollar amount of all small business loans less than $1 million made by banks. Notably, nearly half of all small business loans under $100,000 are made by community banks. In contrast, banks with more than $100 billion in assets -- the nation's largest financial firms -- make only 22 percent of small business loans. By supervising community banks, in addition to larger institutions, the Federal Reserve has a more comprehensive view of the availability of small business credit and the health of the small business sector. If Federal Reserve monetary policy is to promote this important sector of the economy, the Federal Reserve's supervision of community banks must be maintained.

Community Bank Supervision Provides a View of Local Economies

One of the strengths of the community banking industry is its geographic diversity. Community banks have played a vital role in the stability and growth of each of the fifty states by providing a decentralized source of capital and lending. Through supervision of community banks throughout the country, the Federal Reserve is better able to determine the health of the vast array of local economies served by community banks. Large banks do not operate in many of the communities served by community banks. If the Federal Reserve no longer supervised community banks, it would lose valuable information about local economies needed to formulate comprehensive and effective monetary and economic policies.

Limiting the Federal Reserve's Supervision Authority to the Largest Institutions would Bias Monetary Policy

The unique insight gained from supervising both large and small banks and holding companies allows the Federal Reserve to identify disruptions in all sectors of the financial system in order to meet its statutory goal of ensuring stability of the financial system. ICBA is very concerned that limiting the Federal Reserve's oversight to only the largest or systemically dangerous holding companies could lead to a bias in monetary and regulatory policy in favor of the largest financial institutions. This is a risky approach to financial reorganization.

Federal Reserve's Track Record as Community Bank Supervisor

Moreover, state chartered community banks played no role in the current financial crisis, and no one has criticized the Federal Reserve's supervision of community banks as lax. It is not logical to strip the Federal Reserve of its authority over community banks and their holding companies when the record shows it has been a very effective regulator of community banks.

Expertise of the Federal Reserve Bank of Kansas City

My bank was a national bank for over one hundred years until **2005,** when it became a state chartered bank, maintaining its membership in the Federal Reserve Bank of Kansas City. The bank was well-regulated by the Comptroller of the Currency and is well regulated today by the Nebraska State Department of Banking and the Federal Reserve Bank of Kansas City. The Federal Reserve Bank of Kansas City brings to its bank supervisory role a highly regarded expertise in the agriculture economy of Nebraska and other Midwestern states. The Federal Reserve's expertise in the agriculture economy of the Midwest enhances its ability to supervise Midwestern community banks, like mine, with a significant farm loan portfolio. It would be a mistake to remove the Federal Reserve Bank's economic expertise from the country's financial supervisory structure.

Federal Reserve Supervision Enhances Important Regulatory Diversity

Having multiple federal agencies supervising depository institutions provides valuable regulatory checks and balances and promotes best practices among

those agencies. The collaboration that is required by these agencies on each interagency regulation insures that all perspectives and interests are represented, that no one type of institution will benefit over another, and that the resulting regulatory or supervisory product is superior. The contributions and views of the Federal Reserve have been an important part of this regulatory diversity, which would be significantly diminished if the Federal Reserve were stripped of all or most of its current supervisory authority.

I appreciate the opportunity to testify on this important subject. I would be glad to answer any of your questions.

Testimony on "Examining the Link Between Fed Bank Supervision and Monetary Policy"

House Financial Services Committee
March 17, 2010

Anil K Kashyap[1]

Chairman Frank, Ranking Member Bachus, members of the committee, thank you for the chance to testify today. My name is Anil Kashyap. I am the Edward Eagle Brown Professor of Economics and Finance at the University of Chicago Booth School of Business. Much of my research and teaching focuses on monetary policy and banking. In the context of today's hearing you should know that twenty years ago I was on the staff of the Federal Reserve Board of Governors and that I serve as a consultant to the Federal Reserve Banks of Chicago and New York. But I also serve as an advisor/consultant for a number of other organizations, public and private, including the Congressional Budget Office (CBO) and most importantly for my remarks today the Squam Lake Group.[2]

In my brief time today I will consider whether and how the Fed's supervisory role should change by considering three specific questions. First, I will ask how the most costly mistakes regarding individual institutions in the United States during last crisis might have differed if the Fed had been stripped of its supervisory powers. Second, I will review the most prominent (and relevant) foreign case where the central bank was not involved in bank supervision, and ask if those outcomes were especially good. Third, I will look at the overall financial system, and ask what might have been done to protect the whole system better. Here my thinking has been strongly influenced by what the Squam Lake Group has proposed.[3]

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[1] These remarks reflect only my own opinions and should not be attributed to any of the organizations with which I am affiliated. I also wish to thank, again without necessarily associating with my conclusions, Richard Berner, Douglas Diamond, Charles Goodhart and Jeremy Stein for helpful conversations on these issues.

[2] Among these other entities are the Clearinghouse Corporation and the Cabinet Office of Japanese Government, but obviously the views expressed here are mine alone and do not reflect those of any of these organizations.

[3] The Squam Lake Group is comprised of 13 leading financial economists who came together to offer guidance on the reform of financial regulation. Members include eight of the nine most recent presidents of the American Finance Association (including the current president and the president-elect), a former Federal Reserve Governor, a former Chief Economist of the International Monetary Fund, and former members of the Council of Economic Advisers under President Bill Clinton and President George W. Bush. See www.squamlakeworkinggroup.org.

Preliminary Observations:

Let me start with a couple of preliminary statements of fact. First, there were many causes of the crisis including poor risk controls at major financial institutions, a regulatory architecture that did not keep up with developments in the financial system, and inadequate supervision. No credible analysis of the crisis suggests that a single fix could have prevented what we saw and making sure that the next crisis can be handled better will require many changes to the system. Today, we are going to focus on supervisory reform but we should not pretend that perfect supervision, if there is such a thing, will be enough to prevent another crisis or keep its costs small—I will come back to this point at the end of my remarks.

Second, I am going to emphasize the intimate connections between supervision and lender of last resort duties. But there are also well-established synergies between bank supervision and other responsibilities of the central bank. This includes the making of monetary policy but also extends to the design of special lending facilities that the Fed set up as a result of the unusual and exigent circumstances that prevailed in this crisis. I do not want to minimize these considerations but given the time constraints for my presentation, and my anticipation of what the Fed's representative will cover, I will not focus on these issues; I welcome questions on these topics and also present a brief summary of these arguments in the Appendix to this testimony.

Finally, the best way to assess potential supervisory reforms is to go through a counterfactual exercise about how things would have been different this time (and in the future) under a different supervisory regime. This kind of exercise is obviously speculative but there some things that historical experience teaches us and I will try to focus on those lessons. Given the short time today I want to focus on three of these thought exercises.

Question #1 Could the Biggest Individual Supervisory Failures Been Avoided By Getting the Fed Out of Supervision?

We now have some sense that as far as the US taxpayer is concerned it is straightforward to rank the costs of the various bailouts for individual institutions. In an ideal world, each of these institutions would have been shut down or sold with no expense to the taxpayer. The debt and equity holders of these institutions should have borne the costs of the mismanagement. But in each case that did not happen and instead taxpayer funds were committed. Here is brief review of the rogue's gallery.

By far the most expensive rescue was for Fannie Mae and Freddie Mac. The CBO's latest estimates put the cost to the taxpayer at over $200 billion dollars.[4] The problems at these

[4] See "CBO's Budgetary Treatment of Fannie Mae and Freddie Mac" Background paper (January 2010), for the methodology, with updated estimates in the CBO's "The Budget and Economic Outlook: Fiscal Years 2010 to 2020" (January 2010).

institutions were well known and the Chairman of the Federal Reserve testified as early as 2004 about the risked that they posed.[5] Thus, it seems hard to put the blame for these two on the Fed.

The next most expensive rescue was for AIG. The cost of this intervention is estimated to be at least $30 billion. The Federal Reserve wrote the check for this rescue and the Fed actions, particularly regarding the transparency around the transaction, have been legitimately (and heavily) criticized. AIG's primary regulator, the Office of Thrift Supervision, had no expertise in understanding what was happening inside AIG Financial Products and so when the decisions had to be made the Fed was flying blind.

Chairman Bernanke has said that the AIG case troubles him more than anything else in this crisis. It also provides the best example of why stripping the central bank of supervisory authority would likely make problems such as what happened with AIG more probable in the future.

No one thinks that it is possible, let alone responsible, to have a modern economy without a lender of last resort for financial firms. Likewise, a lender of last resort has to be able to provide liquidity on demand, and hence the central bank is the only credible lender of last resort.

Below, I will outline some other suggestions for improving options regarding impaired firms, but it would be irresponsible to assume that we will not need the lender of last resort to act again. So the question is whether we want a lender of last resort that is guaranteed to be ignorant about the firms it is deciding whether to assist or whether it will have some first-hand familiarity with the institution.

One of my friends has a nice analogy. As the lender of last resort, you are never sure who is going to come through the door and ask for a date. When you meet your date on a Friday night and your date is AIG, the question at hand is whether you'd like to know something about them before you have to pay $85 billion to buy them dinner. If we mandate that the Fed is not involved in supervision then we make hasty, uninformed decisions inevitable when it is called upon as a lender of last resort.

The third most expensive rescue will likely turn out to be Bear Stearns. Here again the primary regulator, the SEC in this case, was clueless about what was going on as Bear's demise approached. The Fed crossed the Rubicon in arranging this rescue, but as with AIG, it was forced to act on short notice, with very imperfect information about Bear's condition, and with

[5] See for example, Alan Greenspan, "Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises" (testimony, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 108th Cong., 1st sess., February 24, 2004), available at www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm

no supervisory authority to shape the outcome. Whatever criticisms one wants to make about the Fed's actions regarding Bear Stearns, the problems did not come because of incompetent Fed supervision of Bear.

In the question period we can discuss Citigroup, if that is of interest to the committee. Citi was the biggest rescue that the Fed had to arrange where it had some direct supervisory responsibility.

My point in reviewing these cases is not to absolve the Fed; as we say in this town plenty of "mistakes were made." But I think this quick summary shows that if another supervisor had taken over the Fed's responsibilities the U.S. taxpayer would still be on the hook for billions of dollars.

Question #2: Were outcomes in other countries where the Central Bank was not a bank supervisor turn out much better?

One obvious objection to the previous analysis is that I took the rest of the environment as given in contemplating a supervisory system without the central bank. Perhaps if the Fed had been out of the picture the other supervisors would have stepped up and built a better system.

Here the experience of the United Kingdom is particularly informative. The UK has deep financial markets, with many large financial institutions, and London is a financial center. The UK separated the central bank from supervision in the 1990s and set up a separate organization, the Financial Services Agency (FSA), to focus on bank supervision. The agreement that was reached required the Treasury, the Central Bank and the FSA to agree on any rescues. The first real test of this system came when Northern Rock got into trouble.[6] The management of Northern Rock notified the FSA of its problems on August 13, 2007 and the Bank of England was notified the next day. It took over a month of haggling between the Bank of England, the Treasury and FSA about what to do before the Bank of England eventually announced its support for Northern Rock. Even that support was not enough to prevent a run on Northern Rock, the first in the UK since 1866. While the distribution of the blame is debated, there is complete agreement that the situation was mismanaged and the lack of coordination was important.

Beyond, Northern Rock, several other large British banks (including Lloyds Banking Group and Royal Bank of Scotland) have required government assistance. The total taxpayer burden from these interventions is uncertain since the UK intends to score the cost based on the final recovery

[6] See Hyun Song Shin, "Reflections on Northern Rock: The Bank Run That Heralded the Global Financial Crisis." *Journal of Economic Perspectives*, 2009, 23(1): 101–19.

on all the securities that have been acquired. But at this point the UK Treasury estimates the cost as likely lying between £20 billion and £50 billion.[7]

I expect that if we formed a council to oversee the U.S. financial system we would arrive at the same arrangement where we need consensus and that information sharing amongst the different agencies would be poor. The events in the UK suggest that when this system was actually adopted, it did NOT perform very well and I see no reason to expect it to work better here.

Counterfactual #3 "What supervisory steps could have been taken to better protect the financial system?"

Even my cursory review of the biggest meltdowns in this crisis point to problems with the existing regulatory structure that go far beyond the question of which organizations do the supervision of individual institutions. The gaps in supervisory coverage were critical. The fact that institutions could change regulators if the regulator became too tough is appalling and let the risks in the system grow for no good reason.[8]

But the crisis has taught us that instability does not only come from the actions of deposit-taking institutions.[9] The buildup in leverage throughout the financial system in non-banks was critical in amplifying the initial losses associated with subprime mortgages.[10] Yet, no regulator was charged with looking across the whole financial system, and when individual regulators did see problems they were often powerless to do anything about them. Thus, a critical step in reforming regulation must be the creation of a systemic risk regulator that is charged with monitoring the whole financial system and has the authority and tools to intervene to preserve the stability of the financial system.

I know Mr Watt's subcommittee held hearings in July on exactly this issue and that Richard Berner and Frederic Mishkin already laid out the logic for why the central bank should be the

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[7] See HM Treasury "Pre-Budget Report 2009," December 6, 2009, particularly Box B4 on page 199. http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm

[8] For example Countrywide Home Loans changed it charter when the Fed finally moved to crack down on subprime lending. See the testimony by Patricia McCoy before a subcommittee of this committee in July 2009. http://www.house.gov/apps/list/hearing/financialsvcs_dem/mccoy_house_testimony--hearing--july_16_2009.pdf

[9] See Paul Tucker, "Shadow Banking, Financing Markets, and Financial Stability," January 21, 2010 for a summary of the many sources of instability coming from the "shadow banking system." http://www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf

[10] See David Greenlaw, Jan Hatzius, Anil Kashyap, and Hyun Song Shin, "Leveraged Losses: Lessons from the Mortgage Market Meltdown," 2008, U.S. Monetary Policy Forum Report No. 2, Rosenberg Institute, Brandeis International Business School and Initiative on Global Markets, University of Chicago Graduate School of Business.

systemic regulator.[11] So I will not repeat the arguments that they have already made for you. I would like to add one additional consideration emphasized by Charles Goodhart: if the central bank were not the systemic regulator, but still operated as the lender of last resort, then the central bank might not be able to control its own balance sheet if the systemic regulator was making independent decisions during a crisis.[12]

But even with a vigilant systemic risk regulator it seems likely most of the problems in this crisis would have appeared. The Squam Lake Group argues that the cost of the AIG rescue could have been substantially reduced by a package of reforms that includes (1) designating the Fed as the systemic risk regulator, (2) increasing the use of centralized clearing of derivatives, (3) creating mandatory living wills for financial institutions and bolstering resolution authority, (4) changing capital rules for systemically important institutions, (5) improving the disclosure of trading positions, and (6) holding back pay at systemically relevant institutions.[13]

I would be glad to discuss the basis for this conjecture, but we will never know whether this might have been possible. I do think I am on safe ground saying that without this type of comprehensive reform the financial system will not be appreciably safer in the future. Moreover, stripping the Fed of its role in bank supervision would be a step in the wrong direction.

Finally, just to make it clear that I hardly think the Fed has a role (or comparative advantage) at all types of financial regulation, I want to reiterate the Squam Lake Group's recommendation to get the Fed get out of the business of consumer protection regulation. This is a case where I see few synergies between the staffing requirements of consumer protection and the other essential central bank duties. I think the Fed would be far better handing off these duties to another regulator.

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[11] The written remarks are available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/hrdmp_070909.shtml

[12] See Charles A.E. Goodhart, "The Role of Macro Prudential Regulation," 2009, mimeo, London School of Economics.

[13] See the The Squam Lake Report: Fixing the Financial System, Princeton University Press, forthcoming.

Appendix: Rehashing the Convention (and Correction) Wisdom about Synergies between Bank Supervision and Central Bank Activities

The body of my testimony concentrates on the implications of excluding the lender of last resort from the supervisory process. But the central bank does many things besides act as lender of last resort and there are at least three important ways that involvement in supervision can improve central bank performance.

First, having direct information on the condition of the banking system can improve the conduct of monetary policy and the central bank's information on the condition of the economy can improve the supervisory process. A pair of papers by Peek, Rosengren and Tootell (1999, 2009) establishes these two-way synergies.[14] Their first paper shows that confidential bank supervisory information could improve the forecasts of inflation and unemployment that are presented at FOMC meetings and are the starting point for many policy discussions. The more recent paper demonstrates that bank supervisory models based on banking data alone can be improved by including the macroeconomic forecasts that are presented to the FOMC in their monetary policy deliberations. The recent stress tests are the kind of example where this could apply.

In addition, there is a long running debate whether the central bank can spot asset price bubbles and what it should try to do if it believes it has identified one. As Rosengren (2010) points out, as long as the central bank has authority over setting both interest rates and supervisory standards the policy options are much better than are often portrayed.[15] In particular, rather than having only the blunt tool of raising short-term rates, the central bank if charged with mandate to deliver financial stability, can adjust prudential policy to prevent the financial system from feeding and amplifying booms. Conversely, as noted by Carney (2009), if some other institution was in charge of macro-prudential regulation and was using its tools to try slow credit creation, the central bank would need to take that into account in making monetary policy decisions.[16]

Finally, there are cases where the supervisory experience was useful to the Fed in designing special lending facilities that were created in the midst of the crisis. For example, the Asset Backed Commercial Paper, Money Market Mutual Fund Liquidity Facility (AMLF) was set up

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[14] See Joe Peek, Eric Rosengren, and Geoffrey Tootell "Is Bank Supervision Central to Central Banking?" Quarterly Journal of Economics, May 1999, Vol. 114, No. 2: 629–653 and "Is Financial Stability Central to Central Banking?" mimeo, 2009, Federal Reserve Bank of Boston.

[15] See Eric Rosengren, Remarks at The Global Interdependence Center's Conference on "Financial Interdependence in the World's Post-Crisis Capital Markets" Philadelphia March 3, 2010 http://www.bos.frb.org/news/speeches/rosengren/2010/030310/index.htm

[16] See Remarks by Mark Carney to a symposium sponsored by the Federal Reserve Bank of Kansas City Jackson Hole, Wyoming, 22 August 2009, "Some Considerations on Using Monetary Policy to Stabilize Economic Activity", http://www.bankofengland.co.uk/publications/speeches/2010/speech420.pdf

in a matter of days following the Lehman bankruptcy. The facility was heavily tapped from its initiation and helped restore confidence and slow the redemptions that been surging at money market mutual funds. The design of this facility was only possible because of the legal and accounting expertise on the Fed's staff and the Fed's familiarity and expertise regarding the workings of clearing banks, money market mutual funds and the structure of financial markets. If the Fed were out of the supervision business, it is not clear whether something like this would be possible.

Testimony, House Financial Services Committee

March 17, 2010

By Allan H. Meltzer

Last year the New York Times ran several articles about the end of capitalism. Others picked up the theme and reinforced it with claims that greedy bankers and deregulated financial markets had brought the world to the brink of another Great Depression. Allegedly we were saved by timely, forceful, and intelligent government actions. And the next phase had to be more government regulation of financial and economic life.

Unbelievable! Certainly there were many mistakes in the financial sector and a massive response by the Federal Reserve. Left out is the government's disastrous mortgage and housing policy. Without the policies followed by Fannie Mae, Freddie Mac, and the destructive changes in government housing and mortgage policies, the crisis would not have happened. Also, without warning, a 30 year policy changed when Lehman Brothers failed, followed by a hesitant and uncertain lead from Treasury Secretary Paulson. These actions converted a garden-variety recession into a world-wide crisis. The Federal Reserve acted forcefully and determinedly to lessen the fallout from its Lehman error, but much damage was done. Let's not overlook government failure. Let's try to prevent more of the same.

Would bankers have made so many errors if there had never been a too-big-to-fail policy? Not all bankers overinvested in mortgages but some "got up to dance" believing that they would profit and the rest of us would pay to prevent failures. Has the government learned from its mistakes by closing Fannie and Freddie and agreeing to put any housing subsidy on the budget, as a proper policy would require? Do you hear the president, the Treasury, or the Federal Reserve insisting on an end to too-big-to-fail?

This is the age of Madoff, Stanford, AIG, and many others. Regulation failed in all these instances. Failure is not unusual. Regulation often fails either because regulators are better at announcing rules than at enforcing them or because the regulated circumvent the regulations.

The Basel Accord was supposed to reduce banking risk. Financial markets circumvented it. Unusual? Not at all. In 1991 Congress passed the FDIC Improvement Act that authorized regulators to close banks before they lost all their capital. Regulators ignored it. Unusual? Not at all. Regulation is static and markets are dynamic. If markets don't circumvent costly regulation at first, they will find a way later. Congress should recall these failures before passing new regulations. It should choose regulations that give the regulated incentives for compliance.

During the Great Depression Congress authorized section 13 (3) that told the Federal Reserve to lend directly to small and medium sized firms that could not get accommodation from the banks. In this crisis, Section 13(3) was used to lend to AIG. This stretched the original purpose beyond any reasonable interpretataion. Congress should remove this authority. It is now a source of large loans to failing

enterprises, an undesirable extension of too-big-to-fail and a misuse of the intent of 13(3).

We cannot have deposit insurance without restricting what banks can do. The right answer is to use regulation to change incentives—making the bankers and their shareholders bear the losses. Beyond some minimum size, perhaps $ 10 billion of assets, Congress should require banks to increase their capital more than in proportion to the increase in their assets. Let the bankers choose their size and asset composition. Trust stockholders' incentives not regulators rules. Incentives are not perfect, but they are better.

Secretaries Geithner and Paulson told the AIG hearing that they faced a choice—a bailout or another Great Depression. Not true. Classical central banking offered a better alternative, used many times in the past. Classical policy called for letting AIG fail and lending to counterparties against good collateral. That policy supports the prudent and lets the failures fail.

I have watched and at times participated in discussions of crisis policy. The issue is almost always decided by those who tell the Treasury Secretary that without a bailout, crisis is likely, and the crisis will go into the history books with his name on it. The result: we make the taxpayers, your constituents, pay the cost of bankers' errors of judgment. And we invite some to choose imprudent behavior knowing they are too-big-to-fail.

The market is not perfect. It is run by humans, who make mistakes. They should pay for them. But the same humans run government where they make different, often more costly mistakes for which the public pays. At the moment, we see excessive spending and promises

to spend that cannot be kept. This is a major problem in California and Greece but soon to be followed by others including the federal government. At all levels of government, promises to pay state and local pensions, old age retirement, and to provide healthcare far outstrip capacity to pay. The Congressional Budget Office and many others have been warning for years about the $50 or $60 trillion dollars of unfunded liability. Government's answer—offer an expensive drug benefit followed currently by a more expensive "reform" that increases the unfunded medicare-medicaid liability. Dissemble about the real costs.

Regulators talk a lot about systemic risk. They do not, and I believe cannot, give a tight operational definition. Setting up an agency to prevent systemic risk without a precise, operational definition is just another way to pick the public's purse. Systemic risk will forever remain in the eye of the viewer. Instead of shifting losses onto those that caused them, systemic risk regulation will continue to transfer cost to the taxpayers. The regulators protect the bankers. They continue to lose sight of their responsibility to protect the public. Your responsibility is to stop that. Protect the public. Let's go back to a system that required imprudent bankers to fail. Failure does not mean eradication. It transfers management and ownership to more prudent owners and managers. That should be our aim.

Senate Banking is considering putting the Secretary of the Treasury in charge of a systemic risk council. Treasury Secretaries are the officials who authorized all or most of the bailouts since bailouts began with the mistaken policy to save First Pennsylvania in the 1970s. This is not financial reform; it puts the biggest wolf in charge of the henhouse. Real financial reform requires that bankers, not regulators, monitor the

risk on their balance sheet and accept their losses from mistakes. We will not get sound banking until the CEOs of the large banks and their shareholders make prudent decisions and are forced to pay for the mistakes. That will make for more prudence. I repeat my frequent comment: Capitalism without failure is like religion without sin. It doesn't work well.

The Federal Reserve as Regulator

Issues about bank regulation go back at least until the 1930s. Do we want several regulators? Can the Federal Reserve manage both monetary policy and bank supervision or regulation? Should regulation be placed elsewhere? What is best?

Congress should recall that multiple regulators were important for developing the progressive, innovative, competive U.S. financial system. That system helps the United States to finance innovation, new industries, new products, growth in living standards, and jobs. In the 1960s, President Kennedy appointed an innovative regulator, Mr. Saxon, as Comptroller of the Currency. He pushed, prodded, and pulled a reluctant Federal Reserve to innovate by permitting banks to sell certificates of deposit and to compete effectively with investment banks. That strength that comes from multiple regulators should be encouraged not discarded.

Countries differ about whether regulation, supervision and monetary policy should be separated or in the same institution. A few years ago Britain separated them, but it did not make clear how the system would work in a crisis. It may reverse its decision. Germany and many others separate regulation and supervision from monetary policy. The

European Central Bank leaves regulation and supervision to the members.

It does not seem to matter much, if at all. A principle reason is that none of the arrangements has shown much ability to regulate systemic risks. A main reason is that large permanent changes are difficult to foresee and even harder to act against in a timely way. The principals at Long-term Capital Management did not see the Russian default as a major change. Although many warned about housing prices, only a very few profited from their decline. Most financial managers said that a housing price decline was unlikely.

These are not isolated examples. Sudden, permanent changes are a main reason why we have financial crises. We will not eliminate crises, or even reduce them, unless we impose prudence on the bankers and their stockholders.

Monetary Policy.

Congress gave the Federal Reserve a dual mandate. It generally ignores that mandate and works on one objective at a time. This is an inefficient way to achieve both objectives. And with rare exceptions, such as most of 1985-2003, the Federal Reserve has not given the public both low inflation and low unemployment.

I believe we are headed for high inflation, not immediately, but later. The Federal Reserve has issued more than $ 1 trillion of excess reserves. It does NOT have a coherent, operational plan to reduce the excess. Federal Reserve officials suggest that it can get banks to hold most of the excess reserves by raising the interest rate on reserves. I have asked them repeatedly how high the rate would have to go.

Silence. At your recent hearing, one of your members, Congressman Hensarling asked Mr. Bernanke "how much one might have to pay on the interest rate on bank reserves?" I quote Mr. Bernanke's answer in full.

"We think that the interest rate we pay on reserves will bring along with it the federal funds rate. Within tens of basis points. Not a tremendous difference."

This is not an answer. It doesn't come close. I suspect that the Federal Reserve does not know the answer.

The correct answer is close to the crux of the issue about whether we can avoid inflation. The history of the 1970s has many examples of complaints from the business community, labor unions, Congress, the administration and the public about raising interest rates when the unemployment rate is about 7% or more. That makes me very skeptical that the Federal Reserve has a coherent, workable plan in the present circumstances and sufficient independence to persist in pursuit of both parts of the dual mandate. I do not doubt that at some interest rate, the banks will hold the excess reserves. I doubt very much that the interest rate is consistent with continued recovery and is politically acceptable.

You should be skeptical also. You should require the Federal Reserve to tell you how high they believe the interest rate would have to rise to get banks to hold more than $ 1 trillion of excess reserves. If they cannot answer, you should insist on a more complete plan. Now is the time to do that planning.

Finally, this committee has accepted Cong. Paul's proposal to audit Federal Reserve decisions. This is a mistake. Your constituents do not care how or why the Federal Reserve decides. They care about the outcomes—inflation and unemployment. You should require a rule or quasi-rule that enforces outcomes. That's the way you can best improve Federal Reserve policy. I will be glad to expand on the rule in the question period.

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Statement of Robert S. Nichols
President and COO
The Financial Services Forum

before the
Committee on Financial Services
U.S. House of Representatives

March 17, 2010

Chairman Frank, Ranking Member Bachus, subcommittee Chairman Watt and Ranking Member Paul, thank you for the opportunity to participate in today's hearing and to share the Financial Services Forum's views regarding the Federal Reserve and, specifically, the critical importance of supervisory authority to the central bank's effective discharge of its duties as the nation's monetary authority.

As you may know, the Forum is a nonpartisan financial and economic policy organization comprised of the chief executives of 18 of the largest and most diversified financial institutions with business operations in the United States. The purpose of the Forum is to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace.

Reform and modernization of our nation's framework of financial supervision is critically important. The Forum thanks you, Mr. Chairman, and all the members of the Committee for their tireless work over the past 15 months. To reclaim its position of financial and economic leadership, the United States needs a 21st century supervisory framework that is effective and efficient, ensures institutional safety and soundness and systemic stability, promotes the competitive and innovative capacity of the U.S. capital markets, and protects the interests of depositors, consumers, investors, and policyholders.

In the Forum's view, the essential elements of meaningful reform are enhanced consumer protections including strong national standards, systemic supervision, ending "too-big-to-fail" by establishing the authority and procedural framework for winding down any financial institution in an orderly way, and a strong, effective, and credible central bank — which requires supervisory authority.

On Dec. 11th, this Committee passed a financial reform bill that would preserve and even expand the Federal Reserve's role as a supervisor of financial institutions. On Monday, Senator Dodd, Chairman of the Senate Banking Committee, released a draft bill that would assign supervision of bank and thrift holding companies with assets greater than $50 billion to the Fed. While we are pleased that the Fed retains meaningful supervisory authority in the Senate bill, we also believe that the Fed and the U.S. financial system would benefit from the Fed also having a supervisory dialogue with small- and medium-sized institutions.

As this 15-month debate regarding the modernization our supervisory architecture has unfolded, some policymakers have held the view that the Fed should be stripped of all supervisory powers. In the Forum's view, stripping the Fed would severely undermine the strength, effectiveness, and credibility of the central bank, with very negative implications for monetary policy, the stability of the U.S. financial system and, therefore, the productive capacity of the U.S. economy.
As a means of demonstrating the importance of supervision to monetary policy, I'd like to touch on two notions that are most frequently cited by those who argue that the Fed should not be a supervisor of financial institutions:

- first, that the Fed's supervisory record during the recent financial crisis was one of "utter failure;" and,

- second, that supervisory duties are a burden to the Fed and distract the central bank from its core responsibility as the monetary authority and lender-of-last-resort.

In our respectful view, these notions do not hold up under examination and thus should not drive policymakers' reform deliberations.

The notion that the Federal Reserve is a supervisory failure is refuted by numerous facts. Most of the institutions most frequently referenced in the context of the financial crisis — namely, Bear Sterns, Lehman Brothers, Merrill Lynch, Countrywide, IndyMac, Washington Mutual, AIG, Freddie Mac, and Fannie Mae — were not supervised by the Fed, at either the subsidiary or the holding company level.

The Fed supervises state-chartered banks that are members of the Federal Reserve System and all bank holding companies. Of the more than 5,500 bank holding companies, only two sustained losses during the crisis that threatened their survival. Indeed, three of the largest Fed-supervised bank holding companies served as instruments of stabilization and recovery by absorbing other failing institutions — Wells Fargo absorbed Wachovia; JPMorgan Chase absorbed Bear Stearns and Washington Mutual; and Bank of America absorbed Countrywide and Merrill Lynch.

Since January of 2009, Mr. Chairman, 170 banks have failed in the United States — the highest rate of failure since 1991. 98 of those failures were FDIC-supervised banks, 28 were OCC-supervised banks, 23 were OTS-supervised thrifts, and 21 were Fed-supervised banks. This is not to argue that any particular supervisor is better than the others — all have performed at sub-par levels, and significant improvement is necessary. Yet, while no regulatory agency batted a thousand leading up to the crisis, characterizations of the Federal Reserve as an "utter failure" as a safety and soundness supervisor are simply incorrect.

The argument that supervisory activities overburden or distract the Fed from its duties as the monetary authority is also a notion we do not share. Far from a distraction, supervision is altogether consistent with and supportive of the Fed's critical role as the monetary authority and lender-of-last-resort for the very simple and straightforward reason that financial institutions are the transmission belt of monetary policy.

First-hand knowledge and understanding of the activities, condition, and risk profiles of the financial institutions *through* which it conducts open-market operations — or *to* which it might extend discount window lending — is critical to the Fed's effectiveness as the monetary authority and lender-of-last-resort.

And experience has repeatedly shown that it is in times of turmoil — in the deep recession of 1991, in the difficult months following 9/11, in the darkest days of the most recent crisis, and currently as the economy struggles to find its footing — that such detailed, first-hand knowledge of circumstances within banks becomes especially critical. It must be kept in mind that the banking system is the mechanical gearing that connects the lever of monetary policy to the wheels of economic activity. If that critical gearing is broken or defective, monetary policy changes by the Fed will have little or even none of the intended impact on the broader economy.

In addition, in order for the Federal Reserve to look across financial institutions, and the interactions between them and the markets for emerging risks, as it currently does, it is vital that the Fed have an accurate picture of circumstances within banks. By playing a supervisory role during crises, the Fed has a first-hand view of banks, is a provider of short-term liquidity support, and oversees vital clearing and settlement systems.

When Chairman Bernanke testified before this Committee on February 24th, the question he was asked most frequently was, "What can be done to increase bank lending to small businesses?" Unless the Federal Reserve maintains supervisory authority over a substantial portion of the nation's banking companies, it would have no authority, no leverage, at its disposal to work with banks to ensure that creditworthy businesses have access to the capital and credit they need to expand and create jobs.

On the topic of the Fed's lender-of-last-resort role, Mr. Chairman, I'd like to pause briefly to make an important point. Many are mistakenly of the view that discount window lending by the Fed is either equivalent with, or leads to, bank bail-outs. Such assertions are inaccurate. A bail-out is lending, or injecting capital into, a failing — that is, insolvent — institution. By stark contrast, the Federal Reserve Act explicitly restricts discount window lending to solvent institutions who find themselves temporarily illiquid. Such loans are short-term — usually over night — extended on fully collateralized terms, with the value of the offered collateral steeply discounted. In nearly 100 years of discount window lending, the Federal Reserve has never lost a dime. Such strictly prescribed liquidity lending by the Fed is essential to financial system stability and is, therefore, a perfectly legitimate activity of any central bank.

There are other reasons, Mr. Chairman, to ensure that the Fed remains a supervisor of financial institutions. For example, the Fed has unrivaled institutional experience as a supervisor. It has been a supervisor of financial institutions since its creation by Congress in 1913, has supervised bank holding companies since those entities first became subject to federal supervision in 1956, and was designated by the Gramm-Leach-Bliley Act of 1999 as the "umbrella supervisor" of financial conglomerates that include banking, securities, and insurance entities.

And since the Fall of 2008, a number of major non-bank financial institutions — Goldman Sachs, Morgan Stanley, American Express, and even GMAC — have become bank holding companies and submitted to consolidated oversight by the Fed.

U.S. policymakers should also be mindful of international trends in the wake of the financial crisis. In the United Kingdom, for example, serious consideration is being given to shifting bank supervision back to the Bank of England, which had been stripped of such powers when the Financial Services Authority was created in 2001. It has been acknowledged that the lack of supervisory authority, and the detailed knowledge and information derived from such authority, likely undermined the Bank of England's ability to swiftly and effectively respond to the recent financial crisis.

Similarly, in Germany, the new coalition government announced in October that significant supervisory powers would be shifted to the Bundesbank from the financial market regulator, known as BaFin. And while the Bank of Japan has no statutorily expressed supervisory powers, the Bank examines any organization that has access to its credit facilities.

Mr. Chairman, Americans are justifiably angry about the financial crisis and its impact on the broader economy. The Fed is a convenient target for that anger, given the central role it played in combating the recent financial crisis. But punishing the Fed would be like attacking the fire department for water damage caused while saving the neighborhood from a catastrophic fire.

More fundamentally, the goal of financial reform is a supervisory framework that makes our financial system more stable, flexible, and resilient. Achieving that goal requires a central bank that is strong and independent, and an effective and credible monetary authority — and supervisory power is essential to that important objective.

Again, thank you for the opportunity to appear before the Committee today.

STATEMENT
OF
PAUL A. VOLCKER
BEFORE
THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
WASHINGTON, DC
MARCH 17, 2010

Mr. Chairman, Members of the Committee:

I appreciate your invitation to address important questions concerning the link between monetary policy and Federal Reserve responsibilities for the supervision and regulation of financial institutions. Those questions are particularly relevant in the light of the recent breakdown in our financial markets and the important role of the Fed as the crisis developed and in dealing with its consequences.

However timely this hearing, I want to emphasize the issues posed are not new. The latest crisis - frequently cited as a once in a generation or even once in a century affair - has had a devastating effect. It is, however, only the latest of a string of financial disturbances that seem to have been growing in both intensity and frequency. Plainly, we should learn from this experience, drawing appropriate conclusions about the role and responsibilities of the Federal Reserve. That institution, I think it is fair to say, has been generally viewed as the principal, if far from the only, Federal financial regulator and supervisor.

Before addressing the specific questions you have posed, I should make clear my long-held view - a view developed and sustained by years of experience in the Treasury, in the Federal Reserve and in private finance. Monetary policy and concerns about the structure and condition of banks

and the financial system more generally are inextricably intertwined. Other agencies, certainly including the Treasury, have legitimate interests in regulatory policy. But I do insist that neither monetary policy nor the financial system will be well served if our central bank is deprived from interest in, and influence over, the structure and performance of the financial system.

Today, conceptual and practical concerns about the extent, the frequency, and the repercussions of economic and financial speculative excesses have come to occupy our attention. If so-called "bubbles" are indeed potentially disruptive of economic activity, then important and interrelated questions arise for both monetary and supervisory policies. Judgment is required about if and when an official response - some form of intervention - is warranted. If so, is there a role for monetary policy, for regulatory actions, or both? How can

those judgments and responses be coordinated and implemented in real time - in the midst of crisis in a matter of days?

The practical fact is that the Federal Reserve must be involved in those judgments and that decision-making. Beyond its broad responsibility for monetary policy and its influence on interest rates, it is the agency that has the relevant technical experience growing out of working in the financial markets virtually every day. As potential lender of last resort, the Fed must be familiar with the condition of those to whom it lends. It oversees and participates in the basic payments system, domestically and internationally.

In sum, there is no other official institution that has the breadth of institutional knowledge, the expertise, and the experience to identify market and institutional vulnerabilities. It also

has the capability to act on very short notice. And the Federal Reserve after all, is the only agency that has financial resources at hand in amounts capable of emergency response.

More broadly, I believe the experience demonstrates conclusively that the responsibilities of the Federal Reserve with respect to maintaining economic and financial stability require close attention to matters beyond the specific confines of "monetary policy", if narrowly defined as influencing monetary aggregates and short-term interest rates. For instance, one recurring challenge in the conduct of monetary policy is to take account of the attitudes and approaches of banking supervisors as they act to stimulate or restrain bank lending, and to adjust capital standards of financial institutions.

The need to keep abreast of rapidly developing activity in other financial markets, certainly including the markets for mortgages and derivatives, has been driven home by the recent crisis.

None of this, to my mind, suggests a need for regulatory and supervisory authority to lie exclusively in the Federal Reserve. There may be advantages in some division of responsibilities. A simple regulator may be excessively rigid and insensitive to market developments. But equally clearly we do not want competition in laxity among regulators aligned with particular constituencies or exposed to narrow political pressures.

We are all familiar, in the light of all that has happened, with weaknesses in supervisory oversight, with failures to respond to financial excesses in a timely way, and with gaps in

authority. Those failings spread in one way or another among all the relevant agencies, not excepting the Federal Reserve. Both law and practice need reform. But, however those issues are resolved, I do believe the Federal Reserve, our central bank, with the broadest economic responsibilities, with a perceived mandate for maintaining financial stability, with the strongest insulation against special political or industry pressures, must maintain a significant presence with real authority in regulatory and supervisory matters.

Against that background, I will respond to the particular points you raised in your invitation.

I believe it is apparent that regulatory arbitrage and the fragmentary nature of our regulatory system did contribute to the nature and extent of the financial crisis.

That crisis exploded with a vengeance outside the banking system, involving investment banks, the world's largest insurance company and Government - sponsored agencies. Regulatory and supervisory agencies were neither reasonably equipped nor conscious of the extent of their responsibilities. Money market funds growing over several decades, are essentially a pure manifestation of regulatory arbitrage. Attracting little supervisory attention they broke down under pressure, a point of significant systemic weakness. The remarkable rise of the sub-prime mortgage market developed through a variety of channels, some without official oversight. There are large questions about the role and supervision of the two hybrid public/private organizations that came to dominate the largest of all our capital markets, that for residential mortgages.

Undeniably, in hindsight there were weaknesses and gaps in the supervision of well-established financial institutions, including banking institutions, major parts of which the Federal Reserved carries direct responsibility. Some of those weaknesses might have been - should have been - closed by more aggressive regulatory approaches. But some gaps in effective supervision - institutions owning individual banks or small thrifts were loopholes explicitly permitted by legislation.

As implied by my earlier comments, the Federal Reserve, by the nature of its core responsibilities, is thrust into direct operational contact with financial institutions and markets. Beyond those contacts, the twelve Federal Reserve Banks exercising supervisory responsibilities provide a window into both banking developments and economic tendencies in all regions of the country.

In more ordinary circumstances, intelligence gleaned on the ground about banking attitudes and trends will supplement and color forecasts and judgments emerging from other indicators of economic activity. When the issue is timely identification of highly speculative and destabilizing bubbles - a matter that is both important and difficult - then there are implications for both monetary and supervisory policy.

Finally, the Committee has asked about the potential impact of stripping the Federal Reserve of direct supervisory and regulatory power over banks and other financial institutions, and whether something can be learned about the practices of other nations. Those are not matters that permit categorical answers, good for all time.

International experience varies. Most countries maintain a position - often a strong position - for central banks on financial supervision. In some countries, there has been a formal separation. At the extreme, and contrary to earlier approaches, all formal supervisory and regulatory authority over financial institutions was consolidated in the U.K. into one authority, with rather loose consultative links to the central bank. The approach was considered attractive as a more efficient arrangement, avoiding both agency rivalries and gaps of inconsistencies in approach.

The sudden pressures of the developing crisis revealed a problem in coordinating between the agency responsible for supervision, the central bank which needed to take action, and the Treasury. The Bank of England had to consider intervention with financial support without close and confident appraisals of the vulnerability of affected

institutions. As a result, I believe the U.K. government is reviewing the need to modify the present arrangement.

For reasons that I discussed earlier, I do believe it would be a really grievous mistake to insulate the Federal Reserve from direct supervision of systemically important financial institutions. Something important, if less obvious would also be lost if the present limited responsibilities for smaller member banks were to be ended. The Fed's regional roots would be weaker and a useful source of information lost.

I conclude with one further thought. In debating regulatory arrangements and responsibilities appropriate for our national markets, we should not lose sight of the implications for the role of the United States in what is, in fact, a global financial system. We

necessarily must work with other nations and their financial authorities. The United States should and does still have substantial influence in those matters including agreement on essential elements of regulatory and supervisory policies. It is the Federal Reserve, as much as and sometimes even more than the Treasury, that carries a special weight in reaching the necessary understandings. That is a matter of tradition, of experience and of the perceived competence and authority of our central bank. There is a sense of respect and confidence right around the world - matter that cannot be prescribed by law or easily replaced.

Clearly, changes need to be made in the status quo. That is certainly true within the Federal Reserve. I believe regulatory responsibilities should be more clearly focused and supported. The crisis has revealed need for change within other agencies as well. Consideration of broader

reorganization of the regulatory and supervisory arrangements is timely.

At the same time, I urge in your deliberations that you recognize what would be lost - lost not just in the safety and soundness of our national financial system but in influencing and shaping the global system - if the Federal Reserve were to be stripped of its regulatory and supervisory responsibilities and be no longer recognized here and abroad as "primus inter pares" among the agencies concerned with the safety and soundness of our financial institutions. Let us instead strengthen what needs to be strengthened, and demand the high levels of competence and performance that for the too long we have taken for granted.

January 13, 2010

The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation

Like many other central banks around the world, the Federal Reserve participates with other agencies in supervising and regulating the banking system. The Federal Reserve's involvement in supervision and regulation confers two broad sets of benefits to the country.

First, the financial crisis has made clear that an effective framework for financial supervision and regulation must address both safety-and-soundness risks at individual institutions and macroprudential risks--that is, risks to the financial system as a whole. All individual financial institutions that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision. Both effective consolidated supervision and addressing macroprudential risks require a deep expertise in the areas of macroeconomic forecasting, financial markets, and payments systems. As a result of its central banking responsibilities, the Federal Reserve possesses expertise in those areas that is unmatched in government and that would be difficult and costly for another agency to replicate.

Second, the Federal Reserve's participation in the oversight of the banking system significantly improves its ability to carry out its central banking functions. Most importantly, the Federal Reserve's ability to effectively address actual and potential financial crises depends critically on the information, expertise, and powers that it gains by virtue of being both a bank supervisor and a central bank. In addition, supervisory information and expertise significantly enhance the safety and soundness of the credit the Federal Reserve provides to depository institutions by allowing the Federal Reserve to independently evaluate the financial condition of institutions that want to borrow from the discount window as well as the quality and value of the collateral pledged by such institutions. Finally, its supervisory activities provide the Federal Reserve information about the current state of the economy and the financial system that, particularly during periods of financial crisis, is valuable in aiding the Federal Reserve to determine the appropriate stance of monetary policy. These benefits of the Federal Reserve's supervisory role proved particularly important during the financial crisis that emerged in 2007.

We recognize, of course, that bank supervision, including ours, needs to be more effective than in the past, and we have reviewed our performance and are making improvements at multiple levels. The Federal Reserve is working with other supervisors here and abroad to improve capital and liquidity regulation. In addition, we have begun to make changes to our oversight of large banking organizations, including the development of an enhanced quantitative surveillance program, improving data collection, strengthening financial infrastructure, and implementing a new, centralized approach to supervision that better supports identification and analysis of interconnected risks. These changes are intended to ensure that we fully employ our expertise to implement a more systemic and effective approach to our supervisory activities going forward.

The Benefits to Effective Supervision of the Federal Reserve's Unique Expertise

Two important lessons learned from the current financial crisis are that all financial firms that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision; and that supervision of financial firms must take account of systemic, or "macroprudential" risks as well as the more traditional safety-and-soundness risks affecting individual firms.

Many of the large, complex, and interconnected financial firms whose collapse contributed importantly to the financial crisis avoided the more stringent consolidated supervision that is imposed on bank holding companies by the Federal Reserve. These firms--which included American International Group, Washington Mutual, Countrywide, Bear Stearns, and Lehman Brothers--were instead subject to consolidated supervision under statutory or regulatory schemes that were far less comprehensive than that applicable to bank holding companies. In addition, an unregulated shadow banking system (including, for example, unregulated mortgage brokers, structured investment vehicles, other asset-backed commercial paper conduits, and securities lenders) had emerged that generated mortgages for distribution, funded highly rated senior tranches of securitizations, and engaged in maturity transformation and other financial activities outside the view of any federal supervisor.

The system for regulating bank holding companies was, in important ways, inadequate as well. One issue of concern was that the Federal Reserve's consolidated supervision of such companies was, by statute, both narrowly focused on the safety and soundness of their bank subsidiaries and heavily reliant on functional supervisors of the bank and regulated nonbank subsidiaries of these companies; in turn, the functional supervisors themselves were statutorily focused only on the safety and soundness of the specific entities they regulated. None of the federal regulators had sufficient authority to focus on the systemic risk that large banking organizations posed.

While it is clear that the framework for financial supervision must address macroprudential risks, the Federal Reserve cannot and should not be responsible for oversight of the financial system as a whole; no agency has the breadth of expertise and information needed to survey the entire system. However, by virtue of the combination of experience and expertise it has developed as consolidated supervisor of bank holding companies and state member banks and as a central bank, the Federal Reserve is well suited to contribute significantly to an overall scheme of systemic regulation, particularly in the areas of consolidated supervision and macroprudential supervision.

It is especially important that consolidated supervision address *both* safety-and-soundness risks at individual institutions and macroprudential risks. Addressing safety-and-soundness risks requires the traditional skills of bank supervisors, including expertise in examinations and off-site surveillance of complex banking organizations. The Federal Reserve has acquired and maintained that expertise as the primary supervisor of banks of all sizes, including community

banks, regional banks, and large banks that are state-chartered member banks, as the consolidated supervisor of all U.S. bank holding companies, and as the supervisor of the U.S. operations of globally active foreign banks. With many nonbank financial firms having reorganized as bank holding companies during the crisis, the Federal Reserve already is quite familiar with the risk profiles of the vast majority of the large interconnected financial firms.

Beyond traditional bank examination expertise, however, macroprudential supervision will require economic sophistication, including knowledge of the macroeconomic environment, as well as substantial expertise regarding money markets, capital markets, foreign exchange markets, and other financial markets. Expertise in these areas is essential for developing stress scenarios and identifying and addressing vulnerabilities to, and posed by, capital and other markets. The Federal Reserve has developed this expertise in the context of macroeconomic forecasting and monetary policymaking. Market knowledge is acquired through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury and foreign governments and central banks.

Macroprudential supervision also requires extensive knowledge of payment and settlement systems to understand the interconnections between financial institutions and markets. The Federal Reserve has developed this expertise through its operation of some of the world's largest payment and settlement systems (the Fedwire funds and securities transfer systems), its supervision of key providers of payment and settlement systems (the Depository Trust Company, the CLS Bank, and the government securities clearing banks), and its long-standing leadership role in the international Committee on Payment and Settlement Systems.

The Supervisory Capital Assessment Program, or SCAP, also known as the stress test, was critical to restoring confidence in the banking system and was a watershed event for modern macroprudential supervision. The Federal Reserve, which took the lead on the SCAP, drew on its macroeconomic and markets expertise to model potential credit losses and revenues at the SCAP banks. These analyses were essential to assess the amount of capital the SCAP banks would need to absorb potential losses and continue to meet the needs of creditworthy borrowers in a more adverse economic scenario. In the future, macroprudential supervision should feature both increased use of cross-firm, horizontal exams to assess common exposures and vulnerabilities as well as forward-looking stress testing based on alternative projections for the macroeconomy.

The Benefits of the Federal Reserve's Supervisory Role for Its Other Central Banking Functions

The Federal Reserve's central banking functions significantly enhance its ability to conduct its supervisory role, and offer considerable benefits for macroprudential supervision going forward. In addition, the complementarity between narrow central banking activities and supervision creates advantages in the other direction. The Federal Reserve's involvement in supervising

banking institutions of a variety of sizes generates information and expertise that significantly improve the Federal Reserve's ability to effectively carry out its central-bank responsibilities and that cannot be obtained reliably through other means, such as relying on reports from other supervisors. Among the central-bank responsibilities that benefit from the Federal Reserve's supervisory role are crisis management, providing liquidity to depository institutions, and monetary policy. Especially since the start of the crisis in the summer of 2007, the information and expertise that the Federal Reserve has had as a result of its supervisory activities have been essential to its successful performance of these responsibilities.

Crisis Management

The Federal Reserve's supervisory authority has been of greatest importance to its management of financial crises. In particular, its ability to deal with diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.[1]

An example of how the Federal Reserve's supervisory role contributed to its management of a crisis came in the context of the October 19, 1987, stock market crash. During that chaotic period, banks began to pull back from lending to major securities firms. However, because of increased demand for financing from their customers and the differences in the timing of payments to and receipts from the exchanges' clearing and settlement systems, those securities firms needed access to substantial bank credit in order to make payments and settle trades. As a result, the availability of bank credit was critical to the functioning of equity and securities markets as well as futures and options exchanges. A freezing up of these critical markets would have caused a deeper and more disruptive financial crisis, likely involving further declines in asset values and, ultimately, tighter credit conditions for households and businesses. To combat those risks, the Federal Reserve announced its willingness "to serve as a source of liquidity to support the economic and financial system." Subsequently, Federal Reserve examiners on-site in major banking organizations assessed funding pressures and potential credit losses to help identify emerging problems. Armed with the resulting knowledge and with the benefit of existing supervisory relationships, senior Federal Reserve officials contacted the managements of the major banks and urged them to use liquidity from the discount window to provide loans to creditworthy securities firms. Bank credit was provided to securities firms as requested, allowing those firms in turn to make required payments to counterparties and clearing houses.

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[1] In addition to the examples discussed here, the Federal Reserve has taken steps to address strains at financial institutions and in financial markets on a number of other occasions in recent decades, including following the bankruptcy of the Penn Central Railroad in 1970, the collapse of a speculative boom in the silver market in 1980, the failure of Continental Illinois in 1985, and the global financial strains that followed the Russian default and the collapse of Long-Term Capital Management in 1998. See Andrew F. Brimmer (1989). "Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets," *Journal of Economic Perspectives*, vol. 3 (Spring), pp. 3-16; and Ben S. Bernanke (2007), "Central Banking and Bank Supervision in the United States," speech delivered at the Allied Social Science Association Annual Meeting, Chicago, Ill., January 5, www.federalreserve.gov/newsevents/speech/bernanke20070105a.htm.

These actions allowed systemically critical stock, futures, and options exchanges to function normally, averting a more prolonged and deeper market crisis with its attendant adverse implications for the broader economy.

A similar example emerged in the case of the failure of Drexel Burnham Lambert in February 1990. Drexel's rapid collapse posed a risk of gridlock in the financial markets. Notably, because of their parent's failure, Drexel's solvent broker-dealer and government securities dealer subsidiaries experienced serious difficulties liquidating their positions. Because of its ongoing supervisory relationships with the banks that provided settlement services to Drexel's subsidiaries and its knowledge of the payment and settlement system's infrastructure, the Federal Reserve had the access, contacts, and in-depth knowledge that enabled it to obtain the information it needed to evaluate this complex problem and formulate a plan to address it. The Federal Reserve understood the potential problems of Drexel's counterparties and clearing banks and was able to work with the banks and securities firms to identify developing problems and fashion procedures that enabled an orderly winding down of Drexel without adverse effects on other market participants or further disruption to financial markets.

In the aftermath of the September 11, 2001, terrorist attacks, supervisory information and supervisory powers to compel the provision of information allowed the Federal Reserve to understand the damage incurred by, and estimate the recovery time for, a large banking institution that played a major role in key financial markets. Following the attacks, Federal Reserve examiners were sent to the institution's contingency site. This on-site supervisory presence proved crucial in helping to obtain necessary information and clarify conflicting information in a highly confused and uncertain situation. Similarly, on-site Federal Reserve examiners at other key institutions proved to be valuable sources of information about the difficulties those institutions were facing. With this information in hand, senior Federal Reserve policymakers took the lead in assessing the damage to specific financial institutions and the implications for the government securities market and in taking remedial actions--including the provision of liquidity by the Federal Reserve--to restore financial market functioning relatively quickly. The ability of the Federal Reserve to respond promptly and effectively mitigated the adverse effects on broader financial conditions and the national economy of those tragic events.

During the current crisis, the Federal Reserve's supervisory role has not only given it timely access to information about the banking sector, payments systems, and capital markets, but also has been essential to its understanding of the emerging strains on financial firms and their possible implications for financial markets and the broader economy. This information has been critical to the Federal Reserve's efforts to identify the difficulties facing depository institutions of all sizes and to take steps to address those problems. In particular, over the course of the crisis, the Federal Reserve has used supervisory information to monitor the liquidity needs of banking organizations in response to the disruptions in a range of short-term funding markets and mounting market pressures on firms perceived to be in a weak financial condition. This information allowed the Federal Reserve to take steps to address pressing liquidity needs with

monetary policy and lending programs, thereby avoiding larger dislocations in financial markets and an even greater deterioration in economic conditions--which the Federal Reserve continues to monitor.

The Federal Reserve's supervisory information also contributed importantly to the design of a number of Federal Reserve credit programs. In particular, the development of the Primary Dealer Credit Facility was greatly aided by the understanding of the triparty repurchase agreement (repo) market and the information regarding its functioning that the Federal Reserve had as a result of its supervision of the banking organizations that handle the clearing and settlement of such transactions. In addition, its understanding of the workings of the credit markets along with its involvement in the supervision of banking institutions helped motivate the Federal Reserve's decision to implement the Term Asset-Backed Securities Loan Facility, which is a broad-based facility that provides liquidity to support auto lending, small business lending, credit card lending, student loans, and commercial real estate lending. The Federal Reserve's credit programs provided significant support to key financial institutions and markets, easing the impact of the financial crisis on the economy.

Liquidity Provision to Depository Institutions

Supervisory information and expertise also contribute to the Federal Reserve's management of the risks that it confronts in its role as liquidity provider to depository institutions, large and small--a critical central-bank function. Reserve Banks must be able to assess the financial condition of the institutions that want to borrow from the Federal Reserve and must be able to assess as well the quality and value of the collateral pledged by borrowing institutions. Active involvement in supervising financial institutions contributes significantly to such assessments because they require substantial knowledge of banking practices as well as the expertise gained from the hands-on review of loans and other assets at banking organizations. In addition, the Federal Reserve's assessment of the condition of an institution or the quality of its collateral may differ from that of other supervisory agencies.

Monetary Policy

The information that the Federal Reserve obtains in its supervisory role has been useful for the making of monetary policy, especially in periods of financial stress. For example, in the early 1990s, the Federal Reserve recognized that elevated loan losses were putting pressure on bank balance sheets, thereby contributing to very weak bank lending that was weighing on spending by households and businesses. In this context, mounting evidence of tightened lending standards and credit concerns at banks, much of it gained through the supervisory process, contributed to the Federal Reserve's decision to ease the stance of monetary policy more aggressively than it otherwise would have.

Supervisory information has played a particularly important role in monetary policymaking since the outbreak of the financial crisis in the summer of 2007. As the crisis intensified, supervisory

information helped the policymaking Federal Open Market Committee (FOMC) to understand the extent of the dislocations in credit markets and led the Federal Reserve's monetary policy response to the crisis to be more timely and decisive than it otherwise might have been. For example, Federal Reserve staff calculated estimates of potential aggregate credit losses under alternative economic scenarios and drew on supervisory information and expertise to evaluate implications for the health of the banking system. This work helped the FOMC to assess the risks to the financial system and the economy arising from worsening credit conditions and to take such risks into account in its policy decisions.

More broadly, information and expertise obtained as a result of the Federal Reserve's supervisory role have been reflected in FOMC meeting discussions of economic conditions and the outlook. Supervisory staff has attended these meetings during the crisis, and in these discussions there have been regular references to information about banking institutions gained both from examination staff and from industry contacts resulting from the Federal Reserve's supervisory role. This information has contributed to the Committee's understanding of likely loan losses, the effects of such losses and other factors on bank lending behavior, and their implications for economic activity. Moreover, given the global nature of the financial crisis, the Federal Reserve's interactions with supervisors abroad, which reflect its role as a U.S. supervisor, have provided helpful information on the health of key foreign banking firms, allowing the FOMC to judge more accurately the likely strains on U.S. financial firms and markets emanating from outside the United States.

The Federal Reserve faces challenging decisions regarding the timing and pace of the exit from the considerable monetary accommodation put in place during the crisis. These critical policy decisions will require particularly careful assessments of developments at financial institutions and in financial markets, and their resulting implications for the real economy. For example, losses on commercial real estate loans may continue to undermine some community and regional banks and will have uneven effects across different regions of the country. At the same time, however, the improving economy may strengthen the balance sheets of other banks and conditions in many financial markets may continue to improve. Information from the supervisory process will help policymakers to assess overall credit conditions and the stability of the financial sector, and so to time appropriately the shift to reduced policy accommodation.

Could the Federal Reserve Obtain What It Needs from Another Supervisor?

A natural question is whether the Federal Reserve could obtain the supervisory information and expertise it needs for its central-bank responsibilities from other agencies. While it seems clear that this is possible to some extent--indeed, the Federal Reserve obtains information regarding the firms to which it lends from their primary supervisors--elimination of the Federal Reserve's role in supervision would severely undermine the Federal Reserve's ability to obtain in a timely way and to evaluate the information it needs to conduct its central banking functions effectively.

First, active involvement in supervision ensures that the Federal Reserve will have experts on its staff with significant knowledge of banking practices and financial instruments gained from the hands-on review of banking organizations and their operations, practices, activities and balance sheets. This expertise is critical to making effective use of information about financial firms and cannot be quickly created when needed. For example, without staff expertise in bank lending practices and evaluating bank asset quality, the Federal Reserve would be unable to assess independently and rapidly the condition of borrowing institutions and the value of the collateral they pledge at the discount window. This capability has been especially valuable since the Federal Reserve began providing credit at longer maturities during the crisis. Indeed, in some cases, it has been necessary for the Federal Reserve to deploy supervisory experts to provide up-to-date assessments of the condition of borrowing firms and to evaluate the collateral they were providing. Owing in part to the supervisory expertise it has been able to bring to bear in its discount window operations, the Federal Reserve has maintained its record of never bearing a loss on credit it has extended to depository institutions, despite the spike in such lending to more than $500 billion in early 2009.

Second, obtaining information from another agency would be slower and more cumbersome than obtaining it directly from financial firms. Information provided by other supervisory agencies may be stale or incomplete, particularly in a crisis, when the condition of institutions and the value of collateral can deteriorate rapidly. An independent supervisor would have its own concerns and priorities on which its supervisory staff would naturally focus, slowing the Federal Reserve's access to information in other areas. Even if the supervisory agency's staff were willing and able to provide assistance, the back-and-forth process in which the Federal Reserve must explain exactly what is needed, evaluate the information that is received, and return to the supervisor with clarifying questions and requests for additional information could slow the process appreciably.

Finally, having the legal authority to directly obtain information--through on-site examinations or otherwise--can prove critical to understanding and responding quickly to a financial crisis. While in some cases financial institutions that the Federal Reserve does not supervise may be willing to provide information to the Federal Reserve on a voluntary basis, in other cases they have not been willing, and there is no guarantee that they will be willing in future crises. For example, senior managers with relevant knowledge about the nature of the problems facing an institution or arising in financial markets may well be focused on those problems and therefore might not want to meet with, or provide information to, the Federal Reserve in a timely manner unless the Federal Reserve had the supervisory authority to require them to do so. Also, an institution may not readily recognize or acknowledge the possible adverse effects of its actions for other market participants or the financial markets and economy more generally, or it may expect the authorities to deal with such adverse effects. In such cases, it can be essential for the Federal Reserve to have the ability to compel the disrupted institution to provide timely

information that would assist the Federal Reserve in addressing the crisis through its monetary policy, lending, and other policy and operational tools.

Besides the experience at the Federal Reserve, international developments suggest that a central-bank role in supervision can be important. For example, many have suggested that the problems with Northern Rock in the United Kingdom were compounded by a lack of clarity regarding the distribution of powers, responsibilities, and information among the Bank of England, the U.K. Financial Services Authority, and the U.K. Treasury. In response, the Bank of England was given statutory responsibilities in the area of financial stability, its powers to collect information from banks were augmented, and many have called for it to be given increased supervisory authority. In the European Union, a new European Systemic Risk Board is being established under which national central banks and the European Central Bank will play a central role in efforts to protect the financial system from systemic risk. More broadly, in most industrial countries today the central bank has substantial bank supervisory authorities, is responsible for broad financial stability, or both.

Steps the Federal Reserve Is Taking to Strengthen its Regulatory and Supervisory Performance

Supervision by financial regulators, including the Federal Reserve, clearly had significant shortcomings in the period leading up to the financial crisis. Among other things, regulators did not insist on sufficiently strong and comprehensive risk management by private firms, and inadequate attention was paid to the risks that could arise from the interactions of firms and markets, such as the collective dependence of many firms on similar wholesale funding sources or hedging strategies. The Federal Reserve has been and continues to be engaged in an intensive self-examination of its supervisory functions with two objectives: to address weaknesses in its supervisory function that became apparent as a result of the financial crisis, and to become a better supervisor in an environment that requires supervisors to be attentive to macroprudential as well as individual-institution safety-and-soundness risks.

The Federal Reserve is seriously engaged in measures to strengthen its regulatory and supervisory performance. For example, working through the Basel Committee on Bank Supervision and the Financial Stability Board, the Federal Reserve has played a key part in efforts to ensure that systemically critical financial institutions hold more and higher-quality capital and employ more robust liquidity management. The Federal Reserve also played a key role in international work to ensure that banks use compensation structures that provide appropriate performance and risk-taking incentives. Domestically, it has taken the lead in addressing flawed compensation practices, issuing proposed guidance that would require banking organizations to review their compensation practices to ensure that they do not encourage excessive risk-taking, are subject to effective controls and risk management, and are supported by strong corporate governance, including oversight by their boards of directors.

In the fall of 2008, the Federal Reserve updated its guidance on consolidated supervision, reaffirming the importance of such supervision, particularly for large complex firms, and emphasizing the importance of bringing a macroprudential perspective as well as an individual-institution safety-and-soundness perspective to consolidated supervision. Of considerable importance, the Federal Reserve has taken steps to ensure that, when risk-management shortcomings are identified, its supervisors hold managers accountable and make sure that weaknesses receive proper attention at senior levels and are resolved promptly. This requires routinely and promptly communicating important supervisory concerns to the highest levels of bank management, including through more frequent involvement of senior bank managers and boards of directors and senior Federal Reserve officials. This approach proved especially effective during the SCAP and in other circumstances when clear expectations for prompt remediation were forcefully communicated to large banking organizations.

The Federal Reserve has also begun to make fundamental changes to its supervision and regulation of large bank holding companies to include a macroprudential, as well as an individual-institution safety-and-soundness, perspective to supervision. For example, the Federal Reserve is developing a program of enhanced quantitative surveillance of large bank holding companies. Enhanced quantitative surveillance combines aggregate economic data, firm-level market-based indicators, and supervisory information to provide a fuller picture of the financial condition of firms, the risks they face, and their potential effects on the broader system. Examples of this approach are the indicative systemwide loss and pre-provision net revenue estimates that were developed for the SCAP and used in the subsequent analysis of Troubled Asset Relief Program redemption requests, and the firm-specific loss and revenue estimates that were developed by combining these systemwide estimates with supervisory information.

The Federal Reserve is working with other domestic and international regulators and market participants to overcome the collective action problems that often plague efforts to strengthen market infrastructure. Since 2005, the Federal Reserve has been leading efforts by market participants and domestic and international regulators to strengthen the infrastructure of the credit derivatives and other over-the-counter derivatives markets. While further progress is needed, without the progress that was achieved since 2005, the failures of major dealers and defaults by some of the very largest names traded in the credit derivatives markets surely would have been far more disruptive than they were. Likewise, this year the Federal Reserve took the lead in organizing a private-sector group that is developing recommendations for cooperative measures to strengthen margin and settlement practices in the triparty repo markets.

The Federal Reserve is also making changes designed to fully employ its expertise to effectively supervise large banking firms. The new supervisory framework will better accommodate a macroprudential orientation that goes beyond the traditional focus on individual institutions and better supports the identification and analysis of interconnected risks and sources of financial contagion. The new approach will implement a more centralized approach to the supervision of large, complex banks that are potentially systemically important.

In particular, strategic and policy direction for the supervision of large, complex financial institutions will be coordinated through a newly formed multidisciplinary committee led by senior officers representing various functions at the Board and Reserve Banks. Supervisors, economists, and market specialists, combined with officials responsible for quantitative surveillance activities, will define supervisory priorities and examination plans for large, complex banking organizations. Supervisory teams will be constructed around portfolios of firms with similar business lines and risks, and cross-firm examinations will consider interconnected risks, such as spillover and feedback effects.

As in the SCAP, representatives of primary and functional supervisors will be fully integrated in the process, participating in the planning and execution of horizontal exams and consolidated supervisory activities. As was evident in the recent crisis, interconnected risks can span several operating entities. Subprime mortgage exposures, for example, were dispersed across mortgage banks, broker-dealers, and off-balance-sheet vehicles, as well as insured depositories. Effective supervision of complex holding company structures must involve greater coordination among consolidated and functional supervisors and an integrated assessment of risks across the holding company, including bank and nonbank subsidiaries.

While supervisory authorities here and abroad are still developing the tools and instruments needed to fully implement a macroprudential approach to supervision, recent experience has shown that such an approach is critical to avoiding financial imbalances that can result in severe financial and economic dislocations. The Federal Reserve will continue to strengthen its supervisory efforts and to learn from events as they unfold, with the goal of doing all in its power to identify and address risks that may imperil the financial system.

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Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Congressman Joe Baca:

1. In your testimony you state your opposition to the Senate proposal to strip the Fed of its regulatory power over small and medium sized banks. You mention the stresses that will be placed on the operation of the Fed and its ability to put forth effective monetary policy. Obviously ineffective policy will have a negative impact on smaller banks, but I was wondering if you could comment on other impacts that may happen as well.

As you know, many smaller institutions are unable to lend and still dealing with tighter restrictions on capital adequacy and liquidity. This has a direct effect on small businesses and job creation. Could we expect to see more of the same if the supervisory authority is transferred to the FDIC or the OCC?

Small and medium-sized banks are an important component of the financial system. It is important for the Federal Reserve to understand their situation and needs. History has shown that crises can arise in smaller institutions (as in the 1930s) if they share risk exposures. The Federal Reserve's role as supervisor of state member banks of all sizes offers important insights about conditions and prospects across the full range of financial institutions, not just the very largest, and provides useful information about the economy and financial conditions throughout the nation. Such information greatly assists in the making of monetary policy. It also informs the manner in which the discount window is managed and enhances the Federal Reserve's ability to identify and address diverse and hard to predict threats to financial stability.

As you note, I have stated that the Federal Reserve's making of monetary policy and its management of the discount window benefit from its supervisory experience. Notably, the Federal Reserve's role as a supervisor of state member banks of all sizes, including community banks, offers insights about conditions and prospects across the full range of financial institutions, not just the very largest, and provides useful information about the economy and financial conditions throughout the nation. Such information greatly assists in the making of monetary policy.

The Federal Reserve's responsibility for supervising smaller, community-based bank holding companies and state member banks ensures ongoing communication with a broad range of financial institutions operating in every state and region of the country and helps the Federal Reserve to understand and effectively respond to economic developments on Main Street. If this responsibility were to be curtailed and limited to only the largest institutions, the Federal Reserve would lose critical vantage points into the condition of the banking system, the variances in economic developments among different regions of the country, the types of activities being conducted at smaller banks, and the potential effects of regulatory actions on the banking industry as a whole. Moreover, its ability to effectively oversee lending to community institutions under its discount window operations would be made more difficult.

The most important step we can take to improve credit availability to small businesses is to achieve a sustainable economic recovery. Over the course of the past two years, the Federal Reserve has taken aggressive action in response to the financial crisis to help improve financial market conditions and strengthen U.S. banking organizations. We have acted on

multiple fronts, instituting accommodative monetary policy, providing market liquidity, and issuing additional supervisory guidance to our bank examiners.

The Federal Reserve has placed particular emphasis on ensuring that its supervision and examination policies do not inadvertently impede sound lending to businesses, both large and small, and we will continue to do so. We have implemented training for examiners and outreach to the banking industry to underscore the importance of sound lending practices. We are aware that bankers, as well as examiners, may become overly conservative in an attempt to ameliorate past weaknesses in lending practices, and are working to emphasize that it is in all parties' best interests to continue making loans to creditworthy borrowers. The February 5 guidance is the latest in a series of actions taken by the Federal Reserve and the other banking agencies to support sound bank lending and the credit intermediation process. Moreover, we will continue our industry outreach, which has already provided us with insight on the issues faced by bankers in working through problem loans, particularly in their commercial real estate (CRE) loan portfolios.

Because of the importance of small business lending, early this year the Federal Reserve formed a working group comprised of staff from the Divisions of Research and Statistics and Banking Supervision and Regulation to develop additional metrics to monitor credit availability trends in the small business sector. Staff has recently completed an examiner survey of banks' workout practices, which will act as a baseline for collecting information to assess the effectiveness of supervisory guidance going forward. We also are asking examiners to capture, where possible, information on troubled debt restructurings and other types of loan workouts and dispositions as part of the ongoing examination process. We are also exploring the feasibility of more formal statistical approaches for measuring and evaluating the effectiveness of the November 2009 interagency CRE workout and restructuring policy statement. In addition, we are considering adjustments to the Consolidated Report of Condition (Call Report), filed quarterly by banks, to obtain more detailed information with respect to their CRE loan restructurings.

In addition to our outreach to banks and bank examiners, the Federal Reserve has conducted several forums in recent months to better understand the difficulties faced by small businesses. In mid-November, the Board and the Federal Reserve Bank of San Francisco, in conjunction with the Small Business Administration, held small business forums in San Francisco and Los Angeles. We are now conducting a series of meetings on small business access to credit hosted by the Reserve Banks. The meetings will be followed by a capstone event at the Board of Governors. These forums examine the evolving difficulties faced by small businesses and will inform additional efforts to help this important sector.

Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Congressman Emanuel Cleaver:

Chairman Bernanke, do you support the change of the New York Federal Reserve Bank President being Presidentially appointed? Do you think that would lead to all Federal Reserve Bank Presidents being Presidentially appointed? Is there a problem with that?

The Regional Bank Presidents and Regional Boards could be viewed as captive of the regional banking industry since the Presidents are chosen by the member banks directors in their regions. Three of the regional bank board directors are chosen by the Federal Reserve Board in D.C.; 3 are regional bank members and 3 are chosen by the regional bank members themselves. What do you think of changing the 3 that are appointed by regional bank members to be appointed by the D.C. Board?

Should bankers be allowed to sit on the Federal Reserve Bank Boards?

Should supervision be carried out at the Board level versus the regional bank level?

The current system for selection of the boards of directors and presidents of the Reserve Banks was established in 1913 in order to ensure that the Federal Reserve received input into its decision-making that reflected the breadth and diversity of our national economy, including information and views from all regions of the nation. In addition, Congress intended that the nation's central bank have access to banking expertise from throughout the country. Over the years, the mission of the Federal Reserve has expanded, in particular, in the area of bank supervision.

The Federal Reserve has over the years taken a number of important steps to address the potential conflicts of interest that could arise from its structure. Responsibility and accountability for bank and bank holding company supervision is vested, by statute, in the Board of Governors, which is composed of individuals appointed by the President and confirmed by the Senate. The Board of Governors retains sole responsibility for establishing the rules and regulations governing bank holding companies, state member banks, and the other banking organizations under our supervisory jurisdiction. Although the Board has delegated authority to the Reserve Banks to conduct the day-to-day supervision of banking organizations, the Board of Governors establishes the guidelines and procedures that must be followed by the Reserve Banks in their examination and supervision and by the banks and bank holding companies subject to supervision. The Board of Governors oversees and monitors the Reserve Banks to ensure adherence to Board policies and consistency across districts. These policies are made publicly available to aid understanding by the banking industry and the public about our supervisory standards. The success of the SCAP, which relied on the expertise of both staff of the Board of Governors and staff of the Reserve Banks as well as staffs of the other federal banking agencies to analyze 19 complex banking firms located throughout the United States, is one recent illustration of the supervisory strength of the Federal Reserve System.

The boards of directors of the Reserve Banks are not involved in any way in the supervision and regulation of banking organizations. They are not consulted regarding bank examination ratings, potential enforcement actions, or similar supervisory issues.

The Federal Reserve continues to review and consider appropriate changes in Federal Reserve governance, and looks forward to working with Congress on these matters.

Chairman Bernanke, I know you are now concerned about macroprudential supervision, as well as the individual-institution safety and soundness risks. But I have to tell you I have a hard time understanding why you want to supervise and regulate a small $50 million dollar state member rural bank. Can you explain that to me?

Small and medium-sized banks are an important component of the financial system. It is important for the Federal Reserve to understand their situation and needs. History has shown that crises can arise in smaller institutions (as in the 1930s and 1980s) if they share risk exposures. The Federal Reserve's role as supervisor of state member banks of all sizes offers important insights about conditions and prospects across the full range of financial institutions, not just the very largest. Importantly, it provides useful information about the economy and financial conditions throughout the nation. This information greatly assists in making monetary policy. It also informs the manner in which the discount window is managed and enhances the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability.

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Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Representative Foster:

1. We would like your general comments on the feasibility and desirability of Mr. Foster's attached proposal to have the Fed play a more active role in regulating real estate bubbles. More specifically, if the Fed were to assume more of a role in this area, how would it affect, if at all, its role as an overall consolidated bank regulator and its historic monetary policy responsibilities?

Your proposal contemplates using regulatory or supervisory authority, rather than monetary policy, as a means of controlling house prices. I agree that a comprehensive and aggressive macroprudential regulatory framework is likely to be a more promising means of preventing and restraining asset-price bubbles than traditional monetary policy on its own.

The set of macroprudential tools that can be used effectively to enhance financial stability is the subject of ongoing debate. That said, a deterioration in mortgage underwriting standards contributed to a build-up of risks in housing markets and such standards may be an appropriate tool for acting against house price bubbles in the future. As you point out, downpayment requirements linked to house price growth in excess of inflation would have required purchasers to put down higher-than-normal downpayments during the peak of the bubble. Higher downpayments would likely have restrained the speculative demand for housing during this period.

However, before using regulatory or supervisory tools to control asset bubbles, we would want to study their interaction with other policy tools and goals, and their robustness relative to alternative policies. For example, it may be that elevated price-to-rent ratios give a sharper indication of overheated housing markets. This is the subject of ongoing research at the Federal Reserve.