



RETHINKING THE FEDERAL RESERVE'S MANY MANDATES ON ITS 100-YEAR ANNIVERSARY

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Chairman Hensarling, Ranking Member Waters, and members of the Committee, thank you for the opportunity to testify at today's hearing. As the title of this hearing aptly notes, the Federal Reserve has many mandates. I will focus my remarks on only one of those—the regulatory mandate of the Board of Governors of the Federal Reserve System (Board). Specifically, I will briefly discuss the recent growth of the Board's regulatory mandate, the adoption earlier this week of the Volcker Rule, and the Board's persistent refusal to use economic analysis and other good government tools.

THE BOARD'S INCREASING REGULATORY MANDATE

When the Dodd-Frank Act was being developed, one issue under consideration was whether the Board should lose some of its regulatory powers in view of its poor regulatory performance prior to the crisis. Instead, Dodd-Frank substantially increased the Board's regulatory powers.¹ One of the most important new powers is the authority to regulate nonbank financial institutions designated systemically important by the Financial Stability Oversight Council.² So far, General Electric Capital Corporation, American International Group, and Prudential have been so designated, with additional entities likely to follow. These financial institutions will present the bank-focused Board with new regulatory challenges. It is important that the Board respond with well-vetted, tailored regulations that recognize that these entities are not banks and cannot be effectively regulated as if they were.

The Board also has new regulatory authority over other entities. These include financial market utilities (FMUs) designated by the Council. Two designated FMUs—The Clearing House Payments Company and CLS Bank International—are supervised by the Board, and it has back-up authority with respect to other FMUs. Dodd-Frank transferred regulatory authority over savings-and-loan holding companies from the now-defunct Office of Thrift

1. For an overview and graphic illustration of this expansion, see Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank" (Mercatus Center at George Mason University, Arlington, VA, November 13, 2013), <http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank>.

2. Dodd-Frank § 113 [12 U.S.C. § 5323].

Supervision to the Board.³ Securities holding companies that opt for consolidated supervision will also be supervised by the Board.⁴ Dodd-Frank also strengthened the Board's regulatory hand with respect to bank holding companies and foreign banks operating in the United States. Time will tell how the Board exercises these authorities, but other regulators have expressed concerns about the Board's unwillingness to recognize the role that these regulators already play in overseeing some of these institutions or their subsidiaries."⁵

Dodd-Frank also arms the Board with explicit mandates to consider financial stability,⁶ something that could be found by an imaginative or hopeful reader only "in the penumbra of the Federal Reserve Act" prior to Dodd-Frank.⁷ Financial stability defies precise definition, which means that there are no clear constraints on how the Board can exercise this authority.

Despite the broad new grants of authority it now exercises, Board governors and other Federal Reserve officials have expressed an interest in accumulating additional regulatory authority. Areas of regulatory interest include money-market funds,⁸ short-term securities financing markets,⁹ and broker-dealers.¹⁰ Sometimes the regulatory expansion is contemplated as the price of entry into the Federal Reserve's safety net.¹¹ These officials should not be faulted for thinking broadly about potential risks in the financial markets, but implicit in these comments seems to be a belief that the Board's regulatory reach must be comprehensive. There is a danger in having a single regulator that applies a uniform regulatory approach to the whole financial marketplace.¹² If that regulator is wrong, the entire market will bear the effects. Even if the regulator's choices are reasonable, a common regulatory approach raises the risk of homogenization across financial institutions—and thus greater susceptibility to common shocks.

3. Dodd-Frank § 312(b) [12 U.S.C. § 5412(b)].

4. Dodd-Frank § 618(b) [12 U.S.C. § 1850a(b)].

5. See, for example, Daniel A. Gallagher, Commissioner, Securities and Exchange Commission, Remarks at "The SEC Speaks in 2013" (February 22, 2013), https://www.sec.gov/News/Speech/Detail/Speech/1365171492342#_UqfRqCfWv_Y. Commissioner Gallagher explained that under the Board's proposal to require large foreign banking organizations to set up intermediate holding companies, the Board would effectively usurp regulatory control over broker-dealers already regulated by the Securities and Exchange Commission. The Financial Services Commission of Korea wrote to object to the Board's proposed approach to regulating foreign banking organizations that "are already regulated by home country authorities (on a consolidated base which covers both U.S. branches and firms)" and explained, "admittedly, I do not see a strong need for enhanced standards. In fact, the proposed rule may only result in inconsistent and overlapping regulations among regulatory authorities. And this, in turn, is likely to undermine regulatory effectiveness." Letter from Chairman, Financial Services Commission, Korea, to Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System (April 30, 2013), 2, http://www.federalreserve.gov/SECRS/2013/June/20130605/R-1438/R-1438_043013_111111_562692058481_1.pdf.

6. See, for example, Dodd-Frank § 604(d) (adding 12 U.S.C. § 1842(c)(7)).

7. See Thomas C. Baxter Jr., Executive Vice President and General Counsel, Federal Reserve Bank of New York, "Financial Stability—the Role of the Federal Reserve System" (speech at the Future of Banking Regulation and Supervision in the EU Conference, Frankfurt am Main, Germany, November 15, 2013), <http://www.bis.org/review/r131125e.pdf> 78.

8. See, for example, Eric S. Rosengren, President & CEO, Federal Reserve Bank of Boston, "Flirting with Money Market Madness: SEC Proposals that Would Increase Instability Are Worse than No Reform At All," *Wall Street Journal*, November 28, 2013), <http://online.wsj.com/news/articles/SB10001424052702304243904579195901233996552>.

9. Janet Yellen, Vice-Chair, Federal Reserve Board, "Regulatory Landscapes: A U.S. Perspective" (speech at the International Monetary Conference, Shanghai, China, June 2, 2013), <http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm>. Ms. Yellen explained that "more work will remain to reduce systemic risk in the short-term wholesale funding markets that shadow banking relies on. A major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs)—repos, reverse repos, securities borrowing and lending transactions, and margin loans—engaged in by broker-dealers, money market funds, hedge funds, and other shadow banks."

10. See, for example, William Dudley, President, Federal Reserve Bank of New York, "Fixing Wholesale Funding to Build a More Stable Financial System" (speech at New York Bankers Association's 2013 Annual Meeting and Economic Forum, New York City, New York, February 1, 2013), <http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html>. Mr. Dudley remarked that, under an expanded notion of the proper reach of the lender of last resort function, "substantial prudential regulation of entities—such as broker-dealers—that might gain access to an expanded lender of last resort would be required to mitigate moral hazard problems."

11. *Ibid.* Mr. Dudley "imagined a mechanism that was funded by tri-party repo market participants and potentially backstopped by the central bank."

12. Centralizing regulatory power in the Board also may aggravate conflict-of-interest issues as it may use its regulatory power to achieve monetary policy ends. David VanHoose, "Evaluating the Centralized-Layers Approach to US Federal Financial Regulation" (Working Paper No. 13-08, Mercatus Center at George Mason University, Arlington, VA, April 2013), 33, http://mercatus.org/sites/default/files/VanHoose_Centralized-LayersApproach_v1.pdf.

THE VOLCKER RULE

The Board has numerous specific rulemaking mandates under Dodd-Frank. It completed one of these—the Volcker Rule—on Tuesday, in conjunction with four other agencies.¹³ The final rule spans nearly one thousand pages, so analysis of its contents will take some time. A number of concerns, however, have already come to light, and it is likely that the rule will pose significant compliance challenges for affected financial institutions and materially impede liquidity in the financial markets.

First, although the rule is well intentioned, its reliance on intense regulatory oversight rather than market discipline is likely to undermine its efficacy at achieving its objective of sensibly limiting bank risk-taking. Elaborate compliance programs will be designed primarily to meet regulatory parameters, rather than to effectively monitor, measure, and limit risk-taking. Legislative and regulatory attention should be focused instead on encouraging financial institutions' shareholders and creditors to pay attention to the nature and scope of banks' trading activities. Measures that have been discussed include contingent capital, which would provide incentives for shareholder and creditor monitoring, enhanced liability for shareholders in the event that their financial institution fails, and greater transparency into bank activities.¹⁴

Second, given the nebulous nature of the lines drawn in the rule, banking entities may be reluctant to avail themselves of the rule's exemptions for hedging and market making. As a consequence, trading activity that we would want banks to undertake in order to protect themselves from business risks and contribute to market liquidity will be dampened. Commissioner Daniel Gallagher of the Securities and Exchange Commission explained the concerns with respect to market making this way in his dissent from the rule:

I believe that market making activities will be impacted most by this faulty rule. The importance of market making to our capital markets—all of our capital markets, not just the markets for large cap, well-traded equities—cannot be underestimated. Market makers play a unique role in providing liquidity to investors by buying, selling and building and holding inventory to meet anticipated future customer demand, and often provide the majority of the liquidity for a given security, especially in times of stress.¹⁵

Changes made to the rule since the proposal heighten concerns that the rule's exemptions will be difficult to use. For example, the hedging exemption was narrowed by requiring that a banking entity not only be able to demonstrate that a hedge was designed to reduce or significantly mitigate a risk, but that it does “demonstrably reduce or otherwise significantly mitigate” the risk.¹⁶ Even this small wording change could make financial institutions less likely to use the exemption for fear of being second-guessed with the benefit of hindsight on their determinations about whether a particular hedge is effective.

Third, the rule will be expensive for regulators and banking entities alike. It relies on the establishment of extensive compliance programs, reporting requirements, and oversight by multiple regulators. Financial institutions and their regulators will have to devote substantial resources to ensuring that essentially arbitrary lines are not crossed.

One of the reasons that concerns about the Volcker Rule persist is that it is the product of a flawed regulatory process. Given the difficulty of crafting the rule, regulators should have first issued an advanced notice

13. Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Securities and Exchange Commission, “Agencies Issue Final Rules Implementing the Volcker Rule,” joint news release, December 10, 2013, <http://www.federalreserve.gov/newsevents/press/bcreg/20131210a.htm>. The Volcker Rule is the popular name for Dodd-Frank § 619 [12 U.S.C. § 1851].

14. For a brief discussion of some of these measures, see Hester Peirce and Robert Greene, “Rethinking the Volcker Rule” (Mercatus on Policy, Mercatus Center at George Mason University, Arlington, VA, January 15, 2013), <http://mercatus.org/publication/rethinking-volcker-rule>.

15. See Daniel M. Gallagher, Commissioner, Securities and Exchange Commission, “Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule” (December 10, 2013), http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370540477693#_ftnref7.

16. See Board of Governors of the Federal Reserve System, et al., “Final Rule on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds,” joint news release, December 10, 2013, <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131210a2.pdf>, at note 1282 and accompanying text.

of proposed rulemaking, which would have laid the groundwork for a subsequent more concrete proposing release. Instead, the regulators issued a proposal that was heavily laden with questions—approximately 400 numbered questions, many of which included subquestions—and then adopted a final rule without soliciting comment a second time.¹⁷ Moreover, the final Volcker Rule did not include economic analysis. The Office of the Comptroller of the Currency conducted a regulatory impact analysis with respect to its regulated entities.¹⁸ Because the rule was adopted under the Bank Holding Company Act, the Securities and Exchange Commission and Commodity Futures Trading Commission took the position that economic analysis required by their statutes was not necessary for this rulemaking.¹⁹ The Board does not have a comparable requirement to conduct economic analysis and did not conduct an economic analysis.

ECONOMIC ANALYSIS AND GOOD GOVERNMENT

The Board's failure to use economic analysis in crafting the Volcker Rule is not unusual. As an independent regulatory agency, the Board is not subject to the executive orders requiring regulatory impact analysis or the attendant review by the Office of Information and Regulatory Affairs at the Office of Management and Budget.²⁰ The Board also has showed a persistent reluctance to embrace economic analysis, even though it is a useful tool for identifying the problems the Board is trying to solve, the range of possible solutions, and the costs and benefits of those different options.²¹

In fact, the failure to conduct analysis runs counter to the stated policy of the Board. In 1979, the Board adopted a policy statement intended to "assure that regulations are not unduly burdensome and complex."²² The policy, to which the Board intended to adhere with respect to all rulemakings regardless of significance, pledged that the staff—at the proposal stage—would prepare a "regulatory analysis" that, "at a minimum," would:

discuss the need for and purposes of the regulation, set forth the various options available, discuss, where appropriate, their possible economic implications, evaluate their compliance, recordkeeping, and reporting burdens, and recommend the best course of action based on an evaluation of the alternatives.²³

This analysis would be updated to reflect material changes at the final rule stage.²⁴ Although this policy is decades old, the Board's General Counsel recently cited it as still being controlling for the Board.²⁵ The Board does not closely adhere to this policy or explain departures from it. As a consequence, rules are being proposed and adopted without the careful consideration required.

17. For an in-depth discussion of this issue, see Michael S. Piwowar, Commissioner, Securities and Exchange Commission, "Dissenting Statement Regarding Adoption of Rule Implementing the Volcker Rule" (December 10, 2013), http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1370540476665#_ftnref14.

18. That analysis was not readily available on the OCC's website as of December 11, 2013.

19. See Gallagher, Dissenting Statement. Commissioner Gallagher explained that "our fellow regulators have argued that because this rulemaking is being promulgated under the Bank Holding Company Act, rather than the securities laws, we don't need the detailed economic analysis that our governing statutes and our own internal guidelines require us to perform for all of our rulemakings. Apparently, our lawyers and a majority of the Commission agree with that legal analysis." Commissioner Scott O'Malia of the Commodity Futures Trading Commission similarly objected to his agency's decision "to forgo any cost-benefit analysis by promulgating the Volcker Rule solely under the BHC Act, and has thus limited its enforcement powers." Scott D. O'Malia, Commissioner, Commodity Futures Trading Commission, "Dissenting Statement" (December 10, 2013), <http://www.cftc.gov/PressRoom/SpeechesTestimony/omaliastatement12101>.

20. Executive Order 13,563, 76 Fed. Reg. 3821 (Jan. 18, 2011) and Executive Order 12,866, 58 Fed. Reg. 51,735 (Sept. 30, 1993). Executive Order 12,866 excludes "independent regulatory agencies." *Ibid.*, § 3(b).

21. For a discussion of the Board's use of economic analysis, see Hester Peirce, "Economic Analysis by Federal Financial Regulators," *Journal of Law, Economics, and Policy* 9 (2013): 569–613.

22. Board of Governors of the Federal Reserve System, *Statement of Policy Regarding Expanded Rulemaking Procedures*, 44 Fed. Reg. 3957 (1979).

23. *Ibid.*, 3958.

24. *Ibid.*

25. See Letter from Scott G. Alvarez, General Counsel, Board of Governors, and James M. Lyon, Senior Advisor to the Board for Regulatory Reform Implementation, to A. Nicole Clowers, Director, Financial Markets and Community Investment, Government Accountability Office (October 24, 2011).

Others have noted the inconsistency of the Board's reliance on economic analysis. The Committee on Capital Markets Regulation, for example, recently reported that only slightly more than half of Board rulemakings since July 2011 have included cost-benefit analysis.²⁶ The Board's Inspector General looked at five Dodd-Frank rulemakings and observed "that the nature of the economic analysis also varied according to the applicable rule."²⁷ The Government Accountability Office recommended that the Board and other federal financial regulators "take steps to better ensure that the specific practices in OMB's regulatory analysis guidance are more fully incorporated into their rulemaking policies and consistently applied."²⁸ The Board is correct that "conducting cost-benefit analysis on financial regulations is inherently difficult,"²⁹ but other financial regulators have undertaken the task despite the trouble.³⁰

Particularly in light of the expansion of the Board's regulatory role, a clear requirement that the Board conduct thorough economic analysis before finalizing rules that impose new regulatory obligations is warranted. The Board's unwillingness to adhere to its own stated policy suggests that a mandate is necessary. Conducting good economic analysis is not easy,³¹ but it can help to ensure that regulations are effective and do not carry with them unreasonable costs and unforeseen consequences.

The Board can take additional steps to improve the quality and transparency of its rulemaking. One such step would be to increase the number of public meetings it holds. During 2012 and 2013, the Board has only held five open meetings.³² The interaction among the Board members and between the Board and its staff provide valuable insights into why particular policy choices were made.

New challenges for transparency, accountability, and procedural rigor will be posed as the Board deepens its embrace of macroprudential regulation—a regulatory approach that imposes requirements based on what is good for the stability of the financial system as a whole, rather than the safety and soundness of a particular financial institution. As economist John Cochrane explains:

This is not traditional regulation—stable, predictable rules that financial institutions live by to reduce the chance and severity of financial crises. It is active, discretionary micromanagement of the whole financial system. A firm's managers may follow all the rules but still be told how to conduct their business, whenever the Fed thinks the firm's customers are contributing to booms or busts the Fed disapproves of.³³

Vice-Chair Yellen has acknowledged the importance of "fixed rules" but has also admitted that "discretionary interventions will inevitably play a part in macroprudential supervision."³⁴ To the extent the Board uses ad hoc

26. Committee on Capital Markets Regulation, "A Balanced Approach to Cost-Benefit Analysis Reform" (2013), at Appendix A, available at <http://capmkrtsreg.org/2013/10/balanced-approach-to-cost-benefit-analysis-reform/>.

27. Office of Inspector General, Board of Governors of the Federal Reserve System, Response to a Congressional Request Regarding the Economic Analysis Associated with Specified Rulemakings (June 2011), 11, www.federalreserve.gov/oig/files/Congressional_Response_web.pdf.

28. Government Accountability Office, *Dodd-Frank Act Regulations: Implementation Could Benefit from Additional Analyses and Coordination* (GAO Report 12-151, November 2011), 39.

29. Alvarez Letter, 1.

30. For example, the United Kingdom's Financial Conduct Authority (FCA) routinely conducts cost-benefit analysis in connection with its rules. As the FCA's website explains, "we must ensure that any burden or restriction that we impose on a person or activity is proportionate to the benefits we expect as a result. To judge this, we take into account the costs to firms and consumers. One of the main techniques we use is to carry out a cost-benefit analysis of our proposed regulatory requirements." Financial Conduct Authority, Principles of Good Regulation (December 8, 2013), <http://www.fca.org.uk/about/why-we-do-it/our-remit/principles> (last visited December 10, 2013).

31. See, for example, Jerry Ellig, "Improving Regulatory Analysis Through Process Reform," Testimony Before the Joint Economic Committee (June 26, 2013), <http://mercatus.org/publication/improving-regulatory-impact-analysis-through-process-reform>.

32. This count is based on the open meetings listed on the Board's website at <http://www.federalreserve.gov/aboutthefed/boardmeetings/201312.htm> (last visited December 10, 2013).

33. John Cochrane, "Macro-Prudential Policy," Blog, August 26, 2013, <http://johnhcochrane.blogspot.com/2013/08/macro-prudential-policy.html>.

34. Janet Yellen, Vice Chair, Board of Governors of the Federal Reserve System, "Macroprudential Supervision and Monetary Policy in the Post-Crisis World" (speech at the Annual Meeting of the National Association of Business Economists, Denver, Colorado, October 11, 2010), <http://www.federalreserve.gov/newsevents/speech/yellen20101011a.htm>.

decisions to carry out its macroprudential regulatory objectives, they will be difficult to monitor, may evade accountability, and will not allow room for the consideration of public comment or the incorporation of cost-benefit analysis.

CONCLUSION

Thank you for the chance to be part of the discussion of the Federal Reserve in its hundredth year. As with many other aged institutions, it needs to be reformed. That reform needs to reach its regulatory functions as well as its monetary policy functions. Congress should consider whether the Board's regulatory mandate is too big and ways to ensure that the Board crafts its regulation with care and concern for their consequences.

ABOUT THE AUTHOR

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