

Reforming and Depoliticizing the Federal Reserve

Charles W. Calomiris, Columbia Business School and Shadow Open Market Committee

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Shadow Open Market Committee Meeting
Princeton Club, New York City, New York
September 15, 2017

E21 Manhattan
Institute

ECONOMIC POLICIES FOR THE 21ST CENTURY

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

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

The Fed's discretionary powers – which now encompass monetary, fiscal, regulatory, and supervisory matters on a grand scale – have been growing over the past decades and today are greater than ever. With respect to fiscal policy, the Fed funds a huge portion of the mortgage market with the apparent conscious intent of subsidizing the relative cost of mortgages. It is the most powerful regulatory and supervisory authority with respect to banks and bank holding companies, and exercises an unprecedented degree of unaccountable discretionary authority.

With respect to regulation and supervision, the Fed has the ability not only to institute formal rules, but also to issue informal “guidance,” which maximizes discretion and minimizes regulatory accountability. The combination of vague guidance and the cover of bank examination secrecy mean that banks can neither anticipate nor defend themselves against arbitrary regulatory actions that punish them based on the whims of ex post facto judgments.

Regulation via guidance is an opportunity for mischief which invites politicization of regulation. One recent example was “Operation Chokepoint,” where Attorney General Eric Holder succeeded in enlisting the help of bank regulators to abuse their prudential regulatory powers (to impose higher capital requirements or withhold permission for transactions) to pressure banks into avoiding dealings with enterprises that the Obama Administration found undesirable.

The Fed's administration of “stress tests” adds to its ability to punish or reward banks with full discretion and without any external accountability. Stress tests of large banks are based on secret models, so there is no transparency about the criteria, and the consequences of failing a stress test are dire: they imply costly changes in banks' funding structure and growth prospects, and constrain banks' ability to pay dividends.

With greater discretionary power inevitably comes more attempts by special interests – especially banks and their customers, but also politicians – to manipulate those powers. As the Fed's discretionary power has grown the Fed finds itself increasingly making political deals with special interests and their representatives. The Fed's disgraceful

complicity in “Operation Chokepoint” is only the most recent example. The discretionary powers the Fed was given to approve of bank mergers on the basis of community reinvestment compliance produced trillions of dollars of risky mortgage originations by banks engaged in mega mergers in the 1990s and 2000s, and also led the Fed to purposely understate the risks inherent in risky mortgages and the commensurate capital requirements on those mortgages (Calomiris 2013, Calomiris and Haber 2014, Chapters 7 and 8). After the passage of Dodd-Frank, the Fed and other bank regulators fell prey to new special interest pressures that led them to dilute the Qualified Mortgage (QM) and Qualified Residential Mortgage Standards (QRM) that had been envisioned by the Dodd-Frank Act (Gordon and Rosenthal 2017). The erosion of the QM and QRM standards, along with the decisions to promote greater mortgage risk by the Federal Housing Finance Administration (which regulates Fannie Mae and Freddie Mac) and by the Federal Housing Administration (which sets FHA insurance premia), has resulted in a substantial increase in mortgage market risk since 2013.

The connection between the growing regulatory authority of the Fed and its declining independence was predicted in 2009 by Paul Volcker who presciently warned that the expansion of Fed regulatory and supervisory authority by the Dodd-Frank Act would reduce Fed independence. In response to a question from Ranking Member Shelby, former Federal Reserve Chairman Paul Volcker agreed that the Federal Reserve's conduct of monetary policy could be undermined if the Fed assumed additional responsibilities. Chairman Volcker also testified, “You will have a different Federal Reserve if the Federal Reserve is going to do the main regulation or all the regulation from a prudential standpoint. And you'll have to consider whether that's a wise thing to do, given their primary--what's considered now their primary responsibilities for monetary policy. They obviously have important regulatory functions now, and maybe those functions have not been pursued with sufficient avidity all the time. But if you're going to give them the whole responsibility, for which there are arguments, I do think you have to consider whether that's consistent with the degree of independence that they have to focus on monetary policy.” (U.S. Senate Committee on Banking, Housing and Urban Affairs 2010, pp. 27-28).

In the absence of clear rules that limit political pressures, Fed policy makers that enjoy regulatory and supervisory authority will tend to cede ground to special interests, and they do so in a myopic way, reflecting current political pressures of special interests rather than long-run public interests. Economists routinely discuss this problem in the sphere of monetary policy: when monetary authority is not delegated to an independent central bank acting under clear rules that limit special interest pressures, elected officials and others can pressure central bankers to print money in lieu of taxes to pay for election-year concessions to powerful constituents. The existence of clear monetary policy mandates and the requirement that the monetary authority follow a transparent strategy in exercising its authority are the best way to insulate the central bank from those sorts of undesirable short-term pressures.

The same logic that explains the desirability of rules for promoting independent monetary policy also applies to regulatory policy. Bank regulation should be vested in an accountable agency that follows rules established by Congress and is subject to Congressional budgetary discipline. That is the best means to protect regulators from myopic or special-interest pressures. Imposing discipline on the process of monetary and regulatory policies in a way that sets clear objectives for both sets of policies and enhances accountability with respect to achieving those objectives can insulate the Fed from undesirable special interest pressure and free it to pursue long-run public interests. When I testified about this issue before the House Financial Services Committee in September 2017, one Representative puzzled over how it could possibly be true that imposing budgetary discipline on a regulator could possibly make it more independent. But the logic of this argument is not so hard to understand. As an analogy, consider a child whose parents give him cash to spend on his lunch at school. The child finds himself confronted by bullies on the playground who force him to buy them all manner of items from the school store. If the parents impose budgetary discipline by requiring that the child use a credit card for all purchases, and use that control to prevent the purchase of some items at the store, then the budgetary discipline imposed on that child will likely free him from the schoolyard bullies. This is precisely how budgetary discipline could protect the Fed from improper influences and result in its greater independence.

It is important to remember that independence, as the term is employed with respect to central banking, does not imply dictatorial power. Fed independence should be understood as independence from the power of *individual* politicians or special interests, not from the authority of the government acting in accordance with the Constitution. In the United States, under our Constitution, checks and balances govern the manner in which the two houses of Congress and the executive pass laws and authorize expenditures. It would be contrary to the principle of popular sovereignty on which our country is founded to argue that some institution other than those created by the Constitution should have the final say on what laws are passed or how much should be spent administering them.

Despite the clear evidence of increased Fed politicization and declining Fed independence, Fed leaders intent on preserving their discretionary power wrongly argue that unlimited flexibility helps them to be more effective. They resist proposed clarification of their mandates or requirements that they follow clear rules when crafting policy despite the compelling economic arguments in favor of those proposals. It is downright unseemly to see Fed leaders go to great pains to defend the status quo of vague and unaccountable mandates placed on their actions. They resist and mischaracterize the proposed establishment of a flexible, rule-based system to enhance Fed monetary policy accountability, as they actively seek new authorities to make and enforce financial regulations without adhering to formal rule making procedures or seeking Congressional approval. They vociferously and successfully resisted efforts

(like those of Senator Dodd in 2009) to transfer powers from the Fed to other less conflicted regulatory entities that might operate more independently.

Fed leaders defending their power also offer distorted and self-interested opinions about important regulatory policy questions, while pretending that their opinions should be viewed as unbiased professional analysis. Fed Chair Janet Yellen's August 2017 Jackson Hole speech was a prime example. It was a full-throated defense of the status quo of financial regulation, and the Fed's status as financial regulator in chief. But Chair Yellen ignored scores of studies that contradict her narrative of the goldilocks status quo. For a literature review, see my May 2017 book, *Reforming Financial Regulation After Dodd-Frank* (Calomiris 2017a), and the forthcoming special issue of the *Journal of Financial Intermediation* containing original empirical studies of regulatory problems arising from post-crisis regulatory policies. Many of the studies she ignored were written by economists working at the Federal Reserve Board, the various Federal Reserve Banks, and the Office for Financial Research, as well as by top academic researchers.

That research has identified three problematic aspects of the regulatory status quo. First, regulatory costs of compliance are high and socially costly. Large banks face an unpredictable and complex regulatory environment, with a host of new costs and risks coming from constantly changing prudential standards, FSOC actions, and stress tests. Small banks face a morass of new rules and compliance burdens, and given their limited scale of operation, the fixed costs of complying with new regulations often puts them at a severe disadvantage and produces consolidation for the wrong reasons. Efficient consolidation, in turn, is sometimes avoided as banks seek to avoid tripping size thresholds that result in new regulatory burdens. These various costs for banks of varying sizes and circumstances are being passed on to bank customers, who find it increasingly difficult to access banking services on favorable terms.

Second, regulation also suffers from poor design features that are likely to result in failures to achieve bona fide prudential objectives. The continued reliance by capital regulation on book values of tangible net worth as a measure of loss absorbing capacity is one obvious weakness. That approach is not likely to work better in the future than it has in the past to prevent too-big-to-fail banks from failing because it does not reliably track the true economic value of bank equity. Risk measurement under the Basel approach employed in the U.S. and many other countries notoriously creates opportunities for circumvention through the understatement of risk. New bank liquidity requirements are extremely complex and lacking in any fundamental grounding in economic theory. Title II of Dodd-Frank is viewed by many academic critics as unworkable and unlikely to produce orderly resolution of nonbank institutions or large bank holding companies. Stress tests, under the current regime, in which they are unaccountable to the public and based on very crude financial accounting measures, are a source of risk to the system, and are unlikely to be a meaningful gauge of systemic risks that the banking system actually faces.

Third, and even more troubling, is our regulatory structure's increasingly frequent adoption of processes that are inconsistent with adherence to the rule of law. Process concerns are rarely voiced by academics, and that is a strange omission. Inappropriate regulatory processes not only threaten to undermine the fundamental norms on which our democracy is founded, they also undermine the effectiveness of regulation. The ability of regulation to succeed depends on transparent and accountable processes, because those processes define the incentives of regulators, and are crucial to ensure that regulators act diligently in pursuit of bona fide objectives. Reliance on regulatory processes that avoid transparency, accountability and predictability increases regulatory risk and is likely to lead to poor execution of regulatory responsibilities, as well as to the creation of unnecessary regulatory costs and opportunities for politicized mischief. This is not merely a theoretical concern. Recent regulation has increased regulators' discretionary authority with little regard for predictability, transparency, or accountability. This has resulted in abuses that not only deform our democracy, they also impose unwarranted costs on the financial system and distract from legitimate problems that should be the focus of prudential and consumer protection regulation.

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

To improve regulatory outcomes and boost Fed independence in all its spheres of action, the core problem that must be addressed is the absence of clear rules guiding the procedures followed by the Fed when setting monetary policy or adopting regulations or supervisory practices. Basing decisions on such rules – which could be designed to be flexible and to change as needed over time – would ensure greater effectiveness and accountability of monetary policy and regulatory policy, and enhance Fed independence.

In Calomiris (2017b), I discuss the appropriate way to structure Fed monetary policy using a flexible rules-based approach, and a variety of other changes in the governance structure of the Fed that would enhance the diversity of thinking, quality of analysis, accountability and independence of monetary policy.

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

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

Fed leaders often claim that their role as lender of last resort requires them to maintain regulatory and supervisory authority over banks. That is a fatuous argument. Despite Fed officials' defenses of their growing regulatory powers by arguing for synergies between monetary and regulatory policies, there is no evidence of any synergy between monetary and regulatory policy. Vincent Reinhart (2009), a former high-level Fed official, has questioned the Fed leaders' arguments in favor of such synergies: "There is an easily verifiable test. The arm of the Fed that sets monetary policy, the Federal Open Market Committee (FOMC), has scrupulously kept transcripts of its meetings over the decades. (I should know, as I was the FOMC secretary for a time.)...If the FOMC made materially better decisions because of the Fed's role in supervision, there should be instances of informed discussion of the linkages. Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that historical resource. I don't think they will be able to do so." The information needed by the lender of last resort pertains to examinations and is unrelated to day-to-day regulatory or supervisory power. As the 2008 Treasury blueprint noted, the Fed could participate in examinations, as needed, without having to craft regulations and be responsible for day-to-day supervision.

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

Despite the advantages of avoiding such conflicts by removing regulatory policy from the Fed, a less drastic set of reforms could accomplish a great deal of improvement. Specifically, if it were possible to establish clear rules governing both monetary and regulatory policy and impose administrative and budgetary discipline on the process of regulation, then even if regulatory and supervisory powers remained vested in the Fed,

the problems associated with Fed conflicts and politicization would be substantially reduced. Clear rules and procedures establishing budgetary and administrative discipline would make the location of regulatory authority less important.

Budgetary and administrative discipline over regulation should ensure that Congress retains its Constitutional authority to make laws and control government spending. Not only would such discipline restore the intent of our Constitution, it would also result in many practical advantages.

Requiring Congress to weigh the social costs and benefits that arise in regulation likely would limit special interest manipulation of regulatory discretion after regulations are passed through pressures applied to regulators. Most importantly, to improve and depoliticize regulation, Congress must establish clear rules that limit the use of unaccountable discretion, must establish budgetary authority for regulatory implementation, and must limit the abusive reliance on “guidance” in regulatory actions by requiring a much greater reliance on formal rule making consistent with the Administrative Procedures Act. If this were done alongside the establishment of a flexible monetary policy rule, that would go a long way toward restoring balance in the regulatory process, while also depoliticizing the Fed and ensuring the accountability of monetary and regulatory policy.

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

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