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# Yellen Hearing Exposes Fed's Regulatory Fault Lines

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Janet Yellen, President Obama's nominee to chair the Federal Reserve, told the Senate Banking Committee on November 14 that she is prepared to exercise a full range of regulatory "tools" to alter the actions of major financial institutions. Her remarks underscored the considerable expansion of the Fed's regulatory powers under the Dodd–Frank law, as well as some of the thorny regulatory issues that await the next chairman.

Yellen has been vice chair of the Fed's Board of Governors since October 2010. If confirmed, she would succeed chairman Ben Bernanke when his term expires on January 31, 2014.

**The Fed's Growing Power.** In the aftermath of the financial crisis, Dodd–Frank imbued the Fed with new responsibilities for maintaining financial stability—chiefly through supervision and regulation of large banking and investment institutions.[1] Financial stability is an understandable goal, although misguided government policy and ill-conceived regulation often exacerbate instability rather than tame it.

The Fed's expanded role and enhanced regulatory authority carry risks for the central bank's independence. But for lawmakers seeking to dramatically increase burdens on the finance sector, there are political benefits to making the central bank the regulator: The Fed's image as nonpartisan and independent has tempered opposition to the new rules.

But regulation is inherently political, and a more politicized Fed threatens to destroy what is left of that image and place partisan concerns above sound monetary policy. This was highlighted during Yellen's confirmation hearing on November 14 before the Senate Banking Committee. With respect to the larger institutions now operating under enhanced supervision, she pledged to use the Fed's expanded powers to "level the playing field" between large banks and small and to "make it tougher for them to compete"—a decidedly populist posture in the service of a political goal.

Indeed, the central bank is now obligated to act on the decisions of the new Financial Stability Oversight Council (FSOC),[2] which is effectively controlled by the Treasury Department, which is headed by a political appointee of the President. At the same time, the Fed's structure as a self-financing entity deprives those it regulates from direct redress through Congress. Yellen also told the Senate panel that she opposes legislation that would expose the Fed to audits by the Government Accountability Office—scrutiny she claimed would "diminish the independence" of the Federal Reserve.

The Senate, in its role in the confirmation process, should consider this collection of concerns—all of which indicate that the Fed is evolving into a powerful political institution unchecked by the oversight imposed on most other federal agencies. The regulatory issues described below demand particular

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attention in weighing the intentions of the next chairman, whoever that turns out to be.

**Too Big to Fail.** Dodd–Frank grants the Federal Reserve supervisory and regulatory powers over bank holding companies with total consolidated assets of $50 billion or more,[3] as well as non-bank "systemically important financial institutions (SIFI)," i.e., businesses considered so important to the economy that their failure could lead to an economic crisis. This new "SIFI" regime is based on the notion that the 2008 crisis was largely a consequence of cascading losses among large, complex financial firms that were over-leveraged in both the capital and mortgage markets.[4]

The Fed has been tasked with setting capital and liquidity standards and reviewing the resolution plans required of the largest financial institutions that detail their strategies for managing a crisis. Dodd–Frank also empowers the Fed, in conjunction with the FSOC, to halt mergers and acquisitions and limit products and services that it deems to pose a "grave threat" to financial stability.

That is a very tall order for a government institution that utterly failed to detect the worst financial crisis since the Great Depression—and played a major role in creating it. In fact, the Fed has actually courted risk of late by purchasing more than $1.7 trillion worth of mortgage-backed securities, which were at the center of the housing market crash and are highly sensitive to changes in interest rates. During the hearing, Yellen acknowledged that the current size of the portfolio is "unprecedented."

The new regulatory regime also entrenches the notion that some firms are simply "too big to fail" and thus require special handling by the government. Yet this is the very outcome that Dodd–Frank was supposed to prevent.

**The Volcker Rule.** As outlined in Dodd–Frank, the Volcker Rule prohibits banks from using customer deposits to engage in proprietary trading.[5] The Fed is one of five regulatory agencies entangled in crafting the regulation.

Difficulties with framing the rule have forced the Fed to delay the effective date by two years—leaving banks suspended in regulatory uncertainty. In some respects, the constraints on investment contradict the Fed's own focus on stimulating private-sector investment.

**The Durbin Amendment.** Dodd–Frank directs the Federal Reserve to regulate the fees that financial institutions may charge retailers to process debit card purchases. The Durbin amendment calls for such "interchange" fees to be "reasonable" and "proportional" to the cost of processing debit card transactions.

Following a lobbying frenzy, the Fed settled on a limit of 24 cents per transaction (on average), or 45 percent less than the customary fee. Subsequently, a federal judge overturned the fee as too generous to banks. Thus, the central bank is mired in a political fight over price controls.

**Consumer Financial Protection Bureau (CFPB).** The CFPB is widely regarded as the most powerful regulatory agency created in decades. Funding for the bureau is set by Dodd–Frank at a fixed percentage of the Fed's operating budget. This budget scheme limits congressional oversight of the agency, and the Federal Reserve is statutorily prohibited from "intervening" in bureau affairs.

Ensconcing the bureau within the Fed is a clumsy attempt to impart the appearance of impartiality to what is actually a highly politicized agency. That leaves the central bank to act as a partisan "fig leaf" for the wholly unaccountable bureau.

1. Originally, the Fed was intended to serve as the "lender of last resort"—i.e., to supply funds to cash-strapped banks. Congress later expanded its role to include moderating inflation and promoting full employment.
2. The council was created by Dodd–Frank to identify and monitor risks to the financial system. The 10-member council is chaired by the Secretary of the Treasury.
3. There were 37 such companies in the first quarter of 2013. See Marc Labonte, "Systemically Important or 'Too Big to Fail' Financial Institutions," Congressional Research Service *Report for Congress*, July 30, 2013, http://www.fas.org/sgp/crs/misc/R42150.pdf (accessed November 15, 2013).
4. Comprehensive analyses of the financial crisis include Christopher L. Foote, Kristopher S. Gerardi, and Paul S. Willen, "Why Did So Many People Make So Many Ex Post Bad Decisions? The Causes of the Foreclosure Crisis," Federal Reserve Bank of Boston, *Public Policy Discussion Papers* No. 12-2, July 20, 2012; John A. Allison, *The Financial Crisis and the Free Market Cure* (New York: McGraw Hill, 2013); and Peter J. Wallison, *Bad History, Worse Policy: How a False Narrative About the Financial Crisis Led to the Dodd-Frank Act* (Washington, DC: AEI Press, 2013).
5. Proprietary trading involves the buying and selling of stocks, bonds, currencies, commodities, or other financial instruments to generate profits for the firm.

**Mission Creep.** In addition to the regulations cited above, the Fed is also responsible for regulating derivatives, real estate appraisals for higher-risk mortgages, credit rating alternatives in market risk capital rules, securities holding company registration procedures, reporting requirements for savings and loan holding companies, and escrow account requirements, among others—all of which are far afield of monetary policy.

Senator Elizabeth Warren (D–MA) unintentionally exposed the unrealistic responsibilities when she recently noted: "The Federal Reserve has much work left to do to accelerate our economic recovery, finish the important work of financial reform that began with the historic passage of the Dodd–Frank Act and dial down the risk of future financial crises."

Ironically, the Fed has emerged from the financial crisis as more powerful than ever despite having supplied much of the capital that fed the housing bubble. And given that its monetary policies are not producing the intended results, it is fair to question whether the central bank's new regulatory responsibilities are appropriate.

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