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VIEWPOINT

Preserve, Audit Fed's Regulatory Role

■ BY ROBERT E. MANNION

One of the issues still to be resolved in financial reform is the future regulatory role of the Federal Reserve Board. How that plays out in the Senate conference with the House is crucial to the future of the Federal Reserve System.

The staffs of the Fed banks have been downsized. The volume of checks has been reduced and many payments are handled electronically. Check clearing is no longer a major function of the Reserve banks. If its regulatory role were reduced, the need for the bank supervisory staff at Reserve banks and the Fed's staff would be impacted.

There is some opposition to the Fed's regulatory role. Chairman Bernanke has admitted that the Fed made mistakes in regulating banks and protecting consumers, and he has told Congress that the Fed is addressing past weaknesses and will be a more vigilant regulator.

A regulatory role for the Fed should be maintained, but changes should be made. Fed members devote significant attention to monetary policy and the financial crisis, but less attention to bank regulation and consumer issues. The Fed needs to become a more active and effective regulator.

The Fed's interest in regulation and protecting consumers has evolved. In "The Age of Turbulence," a memoir of his time at the Fed, Alan Greenspan admitted with no apologies that he had little interest in regulation and consumer issues when he became Fed chairman. He wrote that he was passive on those matters and was content to leave regulatory issues to other Fed members and staff while he attended to monetary policy.

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Greenspan wrote that the Fed staff had a free-market orientation similar to his views and reliance on the free market was a widespread view held by the staff.

During the reappointment process, Bernanke suggested that he had gotten the message that regulation and consumer issues matter. In recommending his reappointment, Professor Alan Blinder, a colleague of Bernanke's at Princeton University and former vice chairman of the Fed,??? stated in an January op-ed in the New York Times that Bernanke deserved reappointment because of the intellect and creativity he showed in helping to avert an economic catastrophe. Blinder observed, however, that Bernanke continued the regulatory laxity bequeathed him by Greenspan.

The regulatory laxity is reflected in the Fed's delegation of authority to staff and to the Reserve banks to act on a variety of matters. Fed members have largely withdrawn from active participation in banking applications and enforcement matters. Fed members use to have weekly meetings closed to the public because bank examination and confidential financial or market information were discussed. Available minutes show that Fed members were briefed by the staff and discussed the financial and management of the institutions involved. Written orders were then issued giving the reasons for the Fed's decision.

The Fed used denial orders to convey its views on capital, management, banks expanding too rapidly, and regulatory issues. Denied applicants were advised not to submit expansion proposals until they resolved regulatory issues or achieved a stronger financial condition. The Fed no longer denies applications. The reason offered by the staff is that many applications are now withdrawn (at the suggestion of staff) rather than being denied in a public release.

The current process for most applications does not involve a discussion of regulatory issues by Fed members. Applications not withdrawn are presented to the Fed through an impersonal system of notation voting by circulating staff memoranda containing routine approval recommendations. Fed members do not delve into the condition of the banking system and issues facing consumers. This may be one of the reasons for the increase in the concentration of banking resources. The largest banks have gotten too big to fail and too big to manage because the Fed allowed them to expand without meaningful oversight. The Fed could have stopped the dangerous increase in concentration if it had been diligent in monitoring developments in the banking system . Fed members should be reviewing any sizable transaction involving the largest banking organizations.

In carrying out monetary policy, the Federal Open Market Committee minutes reveal that there are staff presentations and FOMC members discuss economic conditions and the developments in the Fed districts. Fed members and Reserve bank presidents have indicated that the frank exchange at FOMC meetings is essential in formulating monetary policy. If such dialog is helpful in establishing monetary policy, the Fed should benefit by having regular discussions on bank regulatory matters by returning to meetings at which significant applications and enforcement actions are discussed by the Fed members.

The Fed staff is very talented. Many employees come to the Fed early in their career, stay, and retire, but few senior staff members have significant investment or commercial banking experience. Fed employees are able to do their banking at a captive FRB federal credit union.

The Fed also offers a thrift plan with independent trustees for employees to invest in stock and bond mutual funds. These benefits are helpful in preventing conflicts of interests but employees are isolated from the institutions they regulate. Staff can achieve a diversified portfolio through the thrift plan and receive excellent banking services from their own credit union without the hassle of high fees or misleading practices that the public may endure in their investment and banking activities. Receiving financial services within the walls of the Fed may distance the staff from what is happening in the market and on Wall Street.

Congress should review the Fed's regulatory performance just as it monitors monetary policy through the semiannual reports the Fed provides under Section 2B of the Federal Reserve Act. A twice-yearly update on the Fed's regulatory activities would be an excellent way for keeping informed on the condition of the banking system so Congress and the American public are not surprised by another 2008-type crisis. The Fed should welcome that oversight as the price for maintaining a major regulatory role.

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