

Viewpoint: Expanding Fed's Power is Wrong Plan

American Banker | Friday, April 4, 2008

[By Christopher Whalen](#)

The plan to overhaul the U.S. financial regulatory structure announced by Treasury Secretary Henry Paulson is a good idea whose time has been coming for several decades.

The United States needs a single safety-and-soundness regulator for all financial institutions, even if they retain their diversity in terms of charters and activities. But Mr. Paulson is dead wrong in proposing to increase the regulatory role of the Federal Reserve Board.

Consider that no other major industrial nation in the world gives its bank of issue responsibility for safety and soundness, and for good reason. The Fed's internal culture is dominated by academic economists whose primary focus is monetary policy and who view bank supervision as a troublesome, secondary task.

The Fed economists to whom I particularly refer believe that markets are efficient, that investors are rational, and that methods such as the "risk-based" approach to capital contained in the Basel II framework are reliable means to ensure bank safety and soundness.

Critics of the Fed are right to say that under Alan Greenspan, it helped foment the subprime mortgage debacle, but not for the reasons most people think.

Yes, the expansive monetary policy followed by the Fed earlier this decade was a big factor, but equally important was the active encouragement by its staff in Washington and other global regulators of over-the-counter derivatives and the use by banks of off-balance-sheet vehicles such as collateralized debt obligations for liability management.

The combination of OTC derivatives, risk-based capital requirements championed by the Fed and authorized by Congress in 1991, and favorable "fair-value" accounting rules blessed by the SEC and the FASB enabled Wall Street to create a de facto assembly line for purchasing, packaging, and selling unregistered, high-risk securities, such as subprime CDOs, to a wide variety of institutional investors around the world. These illiquid, opaque securities now threaten the solvency of banks in the United States, Europe, and Asia.

Observers describe the literally thousands of structured investment vehicles created during the past decade as the "shadow banking system." But few appreciate that this deliberately opaque, unregulated market came into existence and grew with the direct approval and active encouragement of Mr. Greenspan, the Fed's Washington bureaucracy, and the liberal academic research community from which many Fed governors and senior staff officials are drawn.

While the more conservative bank supervision personnel at the 12 regional Federal Reserve banks and agencies such as the FDIC often opposed these ill-considered liberalization efforts, including the abortive Basel II accord, the Fed's powerful Washington staff almost always had its way.

The result is a marketplace where some of the largest U.S. banks are in danger of insolvency, because their balance sheets are laden with illiquid, opaque OTC instruments that nobody can value or trade.

Remember that comments by Mr. Greenspan and other Fed officials lauding these very same instruments are a matter of public record. Given the Fed's manifest failure to put safety and soundness first, Mr. Paulson and Congress need to rethink the proposal to give the Fed even more authority to supervise investment banks and hedge funds.

A far better plan would be to combine the regulatory resources of the reserve banks, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision and create a new safety-and-soundness agency explicitly insulated from meddling by the central bank and Congress.

We can place considerable blame on the Fed for the subprime crisis, but it must be said that an equally important factor was the tendency of Congress to use financial regulatory policy to raise money and win elections. Members of Congress in both parties have freely used the threat of new regulation to extort contributions from the banking and other financial industries, often with little pretense as to their true agenda.

If Mr. Paulson and other proponents of regulatory reform truly want to advance the national interest, attention needs to be given to ways to insulate any consolidated safety-and-soundness regulator from short-term political influence, even if that means placing the agency entirely beyond the reach of Congress.

Whether Washington is capable of such a selfless act of reform is open to question, but it seems clear from the recent past that rather than giving the Fed more regulatory responsibility, Congress should consider stripping the central bank of all involvement in financial regulation and limit the Fed's mission to monetary policy and related liquidity functions.

Mr. Whalen is a co-founder of Institutional Risk Analytics, a Los Angeles unit of Lord, Whalen LLC that provides customized financial analysis and valuation tools.

© 2008 American Banker and SourceMedia, Inc. All Rights Reserved.