Fed versus Market Regulation

Jeb Hensarling

Before I get into the body of the remarks, I want to thank the Cato Institute for everything it stands for and everything it has meant to me. As I was walking in the foyer, I noticed a copy of the *Cato Journal* on a table there. I recall as an undergraduate student at Texas A&M University in the 1970s that I took $25 dollars—and I'm a guy who worked my way through college—of my hard-earned money to invest in the *Cato Journal.* That was money I could have invested in long necks at the Dixie Chicken, our local watering hole. Also, I would like to thank John Allison. If you have not read his book, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism Is the World Economy's Only Hope,* I commend it to you. Finally, I would like to tell you that as chairman of the House Financial Services Committee, before I decide to move out on any particular issue, I certainly glean the scholarship of Cato in general and Mark Calabria in particular.

Before I speak about the topic of the market versus the Fed as regulator, I just want to give a little context to my comments, which is to broaden them out to regulators and regulation in general, because I think many of us have concluded that the great tragedy of the financial crisis was not necessarily that our federal regulators failed to prevent the crisis, but in many respects helped precipitate the crisis (see, e.g., Calabria 2013, Wallison 2013).

Cato Journal, Vol. 34, No. 2 (Spring/Summer 2014). Copyright © Cato Institute. All rights reserved.

Jeb Hensarling (R-TX) is Chairman of the House Financial Services Committee. This article is based on his remarks at the Cato Institute's 31st Annual Monetary Conference, November 14, 2013.

How Federal Regulators Helped Create the Financial Crisis

Many of you are familiar with the narrative, but in brief, we had a government sanctioned duopoly in Fannie Mae and Freddie Mac. Their leverage ratios were miniscule compared to community banks in the Fifth Congressional District of Texas. We know that the so-called affordable housing goals, which started at 30 percent eventually went to 56 percent. The Community Reinvestment Act essentially mandated that financial institutions loan people money to buy homes that they ultimately could not afford to keep.

Speaking of duopolies, or oligopolies, there are the credit-rating agencies. One of the few good things that the Dodd-Frank Act did, and there are very few of them, was to attempt to bring more competition into the credit-rating agency business.

There are a number of reasons why the 2008 financial crisis happened, but it was not due to lack of regulatory authority. The Securities and Exchange Commission had the ability to prevent much of what we saw. I certainly remember the head of the now-defunct Office of Thrift Supervision saying under oath that his agency had all the regulatory authority it needed to prevent the failure of American International Group.

The Fed's Role in the Crisis

Turning to what the Fed did, we obviously know that there was a decision made in early 2008 to bail out Bear Stearns and then, later in 2008, let Lehman fail—so much for forward guidance and the precedent that set. We also know that since the 1970s the Fed had oversight over bank holding companies and was certainly in the position to influence all the lending practices of the bank subsidiaries. Certainly, we know the Fed made a bad prediction on the direction of the housing markets, and we know for many of us who have paid very careful attention to the Taylor Rule that there was a great deviation from that rule leading up to the 2008 financial crisis. We all recall the "Greenspan put," and we know the Fed was given extraordinary statutory guidance with respect to the Basel capital standards, where sovereign debt (think Greek bonds) were treated as essentially risk-free, as were agency mortgage-backed securities (think Fannie and Freddie).

The Fed's Dual Mandate

We often hear discussion of the Fed's "dual mandate." I would respectfully submit, however, that the Fed has multiple mandates: namely, to achieve long-run price stability, attain maximum employment under Humphrey-Hawkins, promote moderate long-term interest rates, act as regulator of market stability and lender of last resort, and —need I add—is now landlord to the consumer financial protection bureau, just to name a few.

I would respectfully suggest that under divided government, it is going to be challenging to make dramatic changes in the way the Fed conducts its business. Nonetheless, we dream bold dreams in America, so let me offer a handful of policies that the House Financial Services Committee will look at in the short term to try to inject more market confidence and discipline.

Policies Needed to Create Confidence and Market Discipline

First, the Fed needs real transparency. People have to understand what the Fed is doing and on what basis it is making its decisions. I would respectfully suggest that there could be room for improvement in this area. Greater transparency will always be healthy for the Fed, and that is why, under my chairmanship, the House Financial Services Committee will continue our commitment to legislation to audit the Fed, which in this Congress, without former Rep. Ron Paul, has been introduced by Rep. Paul Broun of Georgia.

The Committee wants to ensure that the Fed operates under careful cost-benefit analysis in the exercise of its regulatory authority. It is something that theoretically the SEC and the CFTC are supposed to follow. Thirty years ago, the Fed published guidance in the Code of Federal Regulations suggesting it would abide by cost-benefit analysis requirements promulgated by the White House Office of Management and Budget. Many of us have not seen that in practice and instead conclude that the Fed's outdated and nonbinding guidance is no substitute for a binding statutory requirement.

Second, the Fed must maintain its independence. I submit this need for independence is with respect to monetary policy, not the exercise of fiscal policy, which is what we have seen the Fed exercising recently. Nor does the Fed's need for independence call for independence from the legislative or judicial branches of government.

Third, to ensure greater market discipline, the Committee is looking at the ratio of attorneys to economists among federal agencies. There has been a call to have the Fed engage in "macro-prudential policy" and place more attorneys on the Fed Board of Governors. Indeed, the Conference of State Bank Supervisors has recently issued a report asking President Obama to place more nominees with legal experience on the Federal Reserve Board. I maintain that the Fed must always be led by experts trained in the science of economics, especially those who have some training in the Austrian and Chicago schools of economics.

Fourth, we need to recognize that there are tradeoffs between the Fed's role as bank regulator and as guardian of monetary stability. The Volcker Rule, for example, will make it more difficult for institutions to serve as "market makers" in corporate bonds and thereby maintain liquidity in that market. If the market for corporate bonds becomes less efficient, the Fed's ability to translate lower interest rates on Treasury bonds into lower rates throughout the economy will be diminished as this transmission mechanism of monetary policy is disrupted. In short, the Fed must always consider how its regulatory decisions can have negative consequences for its monetary policy objectives.

Fifth, the Committee will look very seriously at the Taylor Rule as a way to improve forward guidance in the conduct of monetary policy. We are very familiar with this rule, which has been around for at least 25 years, and think it can significantly improve Fed policy. In the pages of the *Cato Journal* in 2011, Professor Taylor offered a measured and careful recommendation to encourage the Fed to adopt and communicate monetary policy using a clear rule. That recommendation, representing the culmination of decades of thinking and research in monetary policy rules by Professor Taylor and others in the economics profession, will be the focus of a hearing at our Committee.

Last but not least, I would like to say, the Dodd-Frank Act attempted to constrain the Fed's emergency authority under Section 13 (3) to bail out nonbanks. The Fed used that authority excessively in 2008, in ways that many have argued overreached its legal authority (see White 2010). Though the Fed has always served as a lender of last resort, it used Section 13 (3) to do two things that we need to ensure the Fed can never do again: it provided support to insolvent firms and it provided support at generous rates. The Dodd-Frank

Act's Section 1101 was intended to address that problem, but it didn't get the job done (see Carnell, Macey, and Miller 2013).

Reexamining the Fed

I was privileged to have breakfast with Chairman Bernanke a couple of months ago and told him we would offer a 100th birthday present to the Fed—namely, the most rigorous oversight plan they have seen in their entire history.

So, I wish to tell you—and we will have the formal rollout in the month of December, which is the Fed's true 100th anniversary—that the House Financial Services Committee intends to reexamine all conventional wisdom dealing with the Federal Reserve without necessarily preordaining the conclusion. William McChesney Martin (1968: 92), a former Fed chairman, once observed that the Fed should "always be engaged in a ruthless examination of its own record." We plan to help the Fed in that regard. Indeed, we had a hearing yesterday (November 13, 2013) dealing with alternative models of different international central banks. We will be examining the Fed's independence, exactly where that should be properly respected and where it has no proper place. QE3, I assure you, is high on our list of priorities. The impact of picking winners and losers through quantitative easing, in this case seniors and savers being losers, needs to be examined.

Conclusion

The Fed's role in enabling the massive debt that threatens our nation, our future, and our economy will be part of what we examine. We will look at the Fed's contingency planning for the debt ceiling and consider rules to guide monetary policy, including the Taylor Rule. We also will examine the Fed's lender-of-last-resort function (whether or not it has ever been defined), the proper boundaries between monetary and fiscal policy, the Fed's multiple mandates, the entirety of the Fed's 100-year history, and what America looks like since adopting a fiat currency.

The Fed can be a more effective institution if it learns to operate guided by the simple wisdom of Hayek, Friedman, and Von Mises, that markets are ultimately more efficient and effective than central regulators at processing information about value and financial risk. The Federal Reserve Centennial Oversight Project that the Financial

Services Committee undertakes this Congress will help the Fed incorporate this lesson into its work. We will constrain, where appropriate, the Fed's lender-of-last-resort role to help credit and equity markets regulate excessive risk through the pricing system by reducing moral hazard. We will bring greater market transparency to the Fed's process for setting and communicating monetary policy through requiring the use of clear rules, so that markets can better predict and plan for the Fed's future policy course. We will require the Fed to conduct formal cost-benefit economic analyses when it develops new regulations to ensure that the unintended consequences of regulations do not impede market innovations in managing financial risk.

References

Allison, J. A. (2013) *The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope*. New York: McGraw Hill.

Calabria, M. A. (2013) "An End to Bailouts." *National Review* 65 (1): 33–35. Available at www.nationalreview.com/nrd/articles/337357/end-bailouts.

Carnell, R. S.; Macey, J. R.; and Miller, G. P. (2013) *The Law of Financial Institutions* (Aspen Casebook Series). 5th ed. New York: Wolters Kluwer.

Martin, W. McChesney Jr. (1968) "Memorandum of Discussion" (26 November). Federal Open Market Committee. Available at www.federalreserve.gov/monetarypolicy/files/fomcmod19681126.pdf.

Taylor, J. B. (2011) "Legislating a Rule for Monetary Policy." *Cato Journal* 31 (3): 407–15.

Wallison, P. J. (2013) *Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act*. Washington: AEI Press.

White, L. H. (2010) "The Rule of Law or the Rule of Central Bankers?" *Cato Journal* 30 (3): 451–63.