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Reforming the Federal Reserve, Part 7

Shrinking Regulatory Authority

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The Fed's primary focus is monetary policy, with its dual mandate of stable prices and maximum employment. While the Fed has been involved in banking regulation since its founding in 1913, a central bank does not need to be a financial regulator to conduct monetary policy. Moreover, the Fed's role as a financial regulator creates a conflict of interest between its mandates to stabilize the economy and preserve the financial standing of the banks that are under its supervision. For instance, the Fed's regulatory role may increase the likelihood that last resort lending decisions will be compromised as the Fed's employees become embedded in the financial firms they are supposed to be overseeing.[1]

More broadly, banks do not need three federal banking regulators: the Fed, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC). The OCC, for example, has no conflict of interest with monetary policy and could adopt the regulatory powers of the Fed. Simply removing the Fed from its regulatory role would leave at least five other federal agencies that oversee US financial markets. The Fed is now micromanaging even more firms than it was prior to the 2008 crisis, even though it has repeatedly failed to predict, much less prevent, financial turmoil. At the minimum, removing the Fed's regulatory powers would help insulate it from the political pressures that come from regulating the nation's largest financial institutions.

A HISTORY OF FAILURE AS A REGULATOR

The Federal Reserve has been involved in regulating banks since its inception, and with the Banking Act of 1933, commonly known as the Glass–Steagall Act, the Fed became the regulator for all holding companies owning a member bank. When bank holding companies, as well as their permissible activities, became more clearly defined under the Bank Holding Company Act of 1956, the Fed was named the primary regulator for *all* bank holding companies. Under the 1999 Gramm–Leach–Bliley Act, the


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Fed alone approved applications to become a "financial holding company"—and only after certifying that both the holding company and all its subsidiary depository institutions were "well-managed and well-capitalized, and . . . in compliance with the Community Reinvestment Act, among other requirements."[2]

Although the Fed is not solely to blame, the fact remains that the US experienced major bank solvency problems during the Depression era, again in the 1970s and 1980s, during the Great Recession of the late 2000s, and recently with a string of post-pandemic bank failures, including Silicon Valley Bank (SVB) in 2023.[3] At best, the Fed did not see these crises coming, even though it was heavily involved (more so in the later crises) in regulating banks' safety and soundness.[4] Simply being mistaken is one thing, but the Fed played a significant role in developing the capital ratios used to measure that safety and soundness.

In the 1950s, the Fed developed a "risk-bucket" approach to capital requirements. That method became the foundation for the Basel I capital accords, which the Fed and the FDIC adopted for US commercial banks in 1988.[5] Under these capital rules, US commercial banks have been required to maintain several different capital ratios above regulatory minimums in order to be considered well capitalized. In fact, the FDIC reported that US commercial banks exceeded these requirements by an average of 2 to 3 percentage points for the six years leading up to the 2008 financial crisis.[6] Not only did the Basel accords fail to prevent the crisis, they sanctioned and effectively encouraged, via low-risk weights, investing heavily in mortgage-backed securities (MBS) that contributed to the 2008 meltdown. Furthermore, the Fed (in conjunction with the OCC, FDIC, and Office of Thrift Supervision) was directly responsible for the recourse rule, a 2001 change to the Basel capital requirements that applied the same low-risk weight for Fannie Mae– and Freddie Mac–issued MBS to highly rated private-label MBS.[7]

In March 2023, SVB and Signature Bank failed, again triggering much anger toward financial institutions and the "big" banks. But Congress should not absolve federal regulators from major failures. For instance, examiners at the San Francisco Fed, which was the supervisor for SVB, failed to adequately mitigate SVB's interest rate risk. At the same time, the Fed's Federal Open Market Committee was sharply increasing the policy rate to combat post-pandemic inflation. To its credit, the Fed acknowledged its supervisory mistakes leading up to SVB's failure.[8]

CONFLICT WITH MONETARY POLICY

The Fed has a dual mandate to stabilize inflation and support maximum employment using its monetary policy tool kit. But there is a clear conflict of interest when the same institution is both the nation's central bank and a primary regulator of large financial institutions. This conflict can be particularly severe when the Fed's disinflationary policy actions create financial stress within the very institutions the Fed supervises.

Monetary tightening, by its nature, involves creating adverse financial conditions, because increasing the policy rate eventually leads to elevated borrowing costs.[9] To lower inflation, the central bank must reduce aggregate demand, often by tightening credit, sometimes even triggering corrections in asset prices. But such a policy can expose vulnerabilities in financial institutions, particularly those with maturity mismatches or concentrated risk exposures. When the same entity setting policy is also tasked with ensuring institutional stability, the temptation arises to compromise one to protect the other.

The 2023 collapse of SVB provides a clear case study of this dynamic. SVB was a state-chartered member bank supervised by the Fed. It had grown rapidly during the low-rate environment of the COVID-19 pandemic, amassing a large, uninsured deposit base heavily concentrated in the tech sector. At the same time, SVB invested in long-dated securities whose market value was highly sensitive to rising rates, and it failed to hedge that interest rate risk. When the Fed began rapidly tightening in 2022 to combat inflation, SVB's unrealized losses mounted. As depositors began pulling out funds, the bank failed.[10] This failure of supervision intersected directly with the Fed's macroeconomic stance: The same interest rate hikes needed to tame inflation also threatened the stability of an institution under the Fed's regulatory umbrella.

In the aftermath, the Fed—along with the Treasury Department and FDIC—invoked the systemic risk exception to guarantee all of SVB's uninsured deposits.[11] Simultaneously, the Fed introduced the Bank Term Funding Program, offering loans against long-term securities at par, effectively shielding other banks from similar market losses.[12] These crisis interventions, while stabilizing in the short run, led to a strange outcome: The Fed was using emergency liquidity to undo the financial effects of its own disinflationary policy.

This dual role weakens the Fed's credibility. If financial instability routinely triggers backstops and the creation of lending facilities, market participants may reasonably expect that monetary tightening will be partially offset when stress emerges. In effect, the central bank becomes a hostage to its regulatory responsibilities—tempted to ease at the first sign of trouble in the institutions it oversees, thus dampening the effects of disinflationary monetary policy. Separately, the Fed faces pressure to lend to insolvent institutions to enhance its expansionary monetary policies.

SUGGESTIONS FOR REFORM

Given the multiple instances of the Fed's failures as a regulator, the abundance of other regulatory agencies, and the conflict of interest that arises from the Fed supervising banks while conducting monetary policy, the first-best solution is to eliminate the Fed's regulatory authority altogether.[13] If members of Congress are unwilling or unable to enforce such a reboot, here are several other intermediate measures that could be implemented:

- Make the Office of the Comptroller of the Currency the (only) federal regulator for all banks with more than $15 billion in assets. Admittedly, this is an arbitrary cutoff, but it would leave the OCC regulating about 100 banks. The threshold choice could be set and adjusted as desired, preferably with an inflation-adjusted threshold that always places roughly 100 of the largest banks under the OCC's supervision.[14]
- Make Fed district banks the federal regulator for banks in their respective districts with less than the threshold chosen for "large" banks.
- Eliminate the position of the Fed's vice chair for supervision.

CONCLUSION

The Fed has been tasked with regulating financial institutions since its inception. Yet there have been several financial crises and bank failures under its watch. In addition, there is a serious conflict of interest between the Fed's mandate to stabilize prices and its regulatory responsibilities, as tightening credit market conditions to suppress demand and thereby prices can jeopardize the very institutions the Fed oversees. Having the Fed serve as a regulator is particularly unnecessary given that there are several other federal institutions tasked with regulating banks. Optimally, Congress would remove all of the Fed's regulatory powers. In the absence of such a change, Congress could implement intermediate reforms to ensure the fewest spillover effects from the Fed's role as a regulator.

NOTES

1. In practice, regulators build relationships with employees at large banks because teams of regulators work in those institutions literally every day. Additionally, employees from large banks often leave to work for federal regulatory agencies and vice versa.

2. Dafna Avraham et al., "A Structural View of US Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review* 18, no. 2 (July 2012): 65–81. To be fair, this bill was an overall positive as it repealed the parts of the Glass–Steagall Act that prevented banking, securities, and insurance firms from affiliating across sectors.

3. For more on the Fed's regulatory failures, see Norbert Michel, "A Roadmap to Monetary Policy Reforms," *Cato Journal* 35, no. 2 (Spring/Summer 2015): 315–29.

4. In 2008, for example, Fed Chairman Ben Bernanke testified before the Senate that "among the largest banks, the capital ratios remain good and I don't anticipate any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system." See "Fed Chairman: Some Small US Banks May Go Under," CNBC, February 28, 2008.

5. Howard D. Crosse and George H. Hempel, *Management Policies for Commercial Banks*, 2nd ed. (Prentice-Hall, 1962), pp. 169–72.

6. Juliusz Jablecki and Mateusz Machaj, "The Regulated Meltdown of 2008," in "Causes of the Financial Crisis," special issue, *Critical Review* 21, nos. 2–3 (2009): 306–7.

7. See Jeffrey Friedman and Wladimir Kraus, *Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation* (University of Pennsylvania Press, 2011); Norbert Michel and John Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation Backgrounder no. 2905, April 23, 2014; and Stephen Matteo Miller, "The Recourse Rule: How Regulatory Capture Gave Rise to the Financial Crisis," Mercatus Center at George Mason University, January 15, 2019.

8. The Fed and the Government Accountability Office (GAO) each released reports on these bank failures that reveal serious shortcomings of the US regulatory framework, problems that go well beyond the Fed or its role in regulation. See Norbert Michel, "SVB Reports from the Fed and GAO Reveal Regulators Long Knew of Problems," *Cato at Liberty* (blog), Cato Institute, May 3, 2023.

9. The method of transmission is slow, indirect, and less powerful since the GFC, but generally when the Fed uses its tools to raise the policy rate, it tightens credit conditions.

10. Andrew Metrick, "The Failure of Silicon Valley Bank and the Panic of 2023," *Journal of Economic Perspectives* 38, no. 1 (Winter 2024): 133–52.

11. "Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC," Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Department of the Treasury, press release, March 12, 2023.

12. "Bank Term Funding Program," Financial Stability, Board of Governors of the Federal Reserve System, updated April 11, 2025.

13. For more on why it is unnecessary to have so many federal financial regulators, see Norbert Michel and Jennifer J. Schulp, *Financing Opportunity* (Cato Institute, 2024).

14. If this policy prescription is not heeded and the Fed is to continue regulating large banks, then the least policymakers can do is completely overhaul the Fed's capital requirement rules, which are overly complex and redundant. For more on this topic, see Norbert Michel, "From Basel to Baffling: It's Time to Simplify Bank Capital Rules," *Forbes*, July 29, 2025.