

DODD-FRANK'S EXPANSION OF FED POWER: A HISTORICAL PERSPECTIVE

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It has become somewhat fashionable to refer to the vast expansion of the Federal Reserve's power under the 2010 Dodd-Frank Act. This Act certainly expanded the Fed's authority and its reach into markets, but the vastness of these changes should be kept in perspective. The Fed now has a full 100-year history to judge, and to a large extent its past exemplifies what we see with virtually all government bureaucracies: incessant mission creep. Glossing over this fact contributes to the general misunderstanding of what the Fed is and how it functions.

From the very beginning, this institution has grown in terms of its scope and general authority over both banking and the broader economy. Many of the changes have taken place through legislation, but others have come about by virtue of assertive Board members. The line between these two methods has become somewhat blurred now that the Board of Governors has a Congressional Liaison Office to actively lobby Congress for what the Board wants, but the distinction was much clearer at the Fed's founding. This article highlights two of the major changes in the Fed's early years to provide context for several of the major Dodd-Frank-mandated expansions in the Federal Reserve's power.

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The Decentralized Central Bank

The Federal Reserve Act of 1913 created a sleepy little institution by today's standard. The Fed's original purpose was to provide an "elastic currency" to stem seasonal fluctuations in reserve requirements and provide liquidity to member banks. These problems ebbed and flowed mainly with the agricultural seasons. Of course, the Fed was supposed to carry out its functions within the framework of the gold standard. Initially, the Federal Reserve System was designed primarily around the 12 District Reserve Banks, with a relatively weak federal oversight.

The Reserve System was created largely by nationalizing private clearing-houses and turning them into the Reserve Banks, which held gold reserves and operated fairly autonomously. The original Reserve Banks could be thought of as super-commercial banks that provided clearing functions to the system's member banks and served as their members' lender of last resort.

The original Federal Reserve Board was rather weak and served as a sort of liaison between the District Reserve Banks and Congress. The Board had agents situated in the Reserve Banks essentially to make sure the district managers were not breaking the law. It sounds paradoxical, but we really did have a decentralized central bank.

The lack of a strong central authority was by design. Some members of Congress, as well as members of the financial industry, were scared to death of a federally controlled central bank. For instance, Frank Vanderlip, president of National City Bank of New York, advised Rep. Carter Glass (D-Va.) and Sen. Robert Owen (D-Okla.) against creating a federal board in Washington. Before legislation was completed, Vanderlip predicted that a Washington-based Board would "very rapidly lose the power to direct wisely," because it would be "subject to all the vicissitudes of political pressure and party trading" (Livingston 1986: 219).

After the law was passed, some in the congressional majority staunchly denied they had created a central bank, likening the institution instead to the (supposedly benign) Interstate Commerce Commission (Timberlake 1993: chap. 15). Some members genuinely believed they had created a system of autonomous, regional Reserve Banks with a benevolent federal regulator.

Others in Congress, though, understood exactly what they had created. Sen. Gilbert Hitchcock (D-Neb.), for example, argued that

“the central bank does not consist of a vault. The central bank does not consist of a mass of money. . . . The central bank consists of central control, and that is provided in this bill. The control is centralized [in the Federal Reserve Board], and when you get your control centralized you have a central bank (Timberlake 1993: 231–32).

Hitchcock recognized that the essence of a central bank existed in the Federal Reserve Act, but others did more to point out the long-term dangers and philosophical contradictions of the 1913 Act. Rep. Charles Lindbergh Sr. (R-Minn.), for instance, noted: “This Act establishes the most gigantic trust on earth, such as the Sherman Antitrust Act would dissolve if Congress did not by this Act expressly create what by that Act it prohibited” (Timberlake 1993: 233). Taking a broader view, Rep. Frank Mondell (R-Wyo.) presciently warned:

The Federal Reserve Board under this bill is an organization of vastly wider power, authority, and control over currency [and] banks . . . than the reserve associations contemplated by the National Monetary Commission. . . . [I]t is of a character which in practical operation would tend to increase and centralize. . . . In your frantic efforts to escape the bogey man of a central bank . . . you have come perilously near establishing the most powerful banking institution in the world [Timberlake 1993: 223].

Mondell was certainly on the right side of history, and it didn't take long for the Fed to start evolving into the powerful central authority he feared.

Expansions without Legislative Changes

The Fed has evolved in many ways since it was founded in 1913. Some of these changes were initiated by legislation that amended the Federal Reserve Act; others occurred without any formal amendments. For instance, the Board did not originally have discretionary powers to conduct open market operations by purchasing U.S. government debt. The framers of the 1913 Act wanted to avoid creating an institution perceived as one designed to “lend to the crown,” so they limited the ability of the Fed to buy government debt.

Section 14 of the original Act provided the limited authority to buy U.S. government securities to the District Reserve Banks, not the Board. In other words, the District Reserve Banks could, at their

discretion, buy U.S. bonds but only within certain limits. In particular, they could purchase U.S. securities only when their reserves were not needed for their intended purpose—namely, providing liquidity to member banks. These purchases were to be carried out at the discretion of the Reserve Banks because the system was designed so that member banks would initiate credit needs. The District Reserve Banks were supposed to be on the front lines of the credit markets, so there was no need for them to carry out open market purchases at the direction of a central authority.

Very soon after the System began, though, the Board inserted itself into the middle of these open market purchases. In its 1914 Annual Report, the Board superfluously authorized the District Reserve Banks to purchase government securities “within the limits of prudence as they might see fit” (Meltzer 2003: 142). The 1914 report went on to say that “the scope of open market operations must rest largely with the purchasing [Reserve] bank, subject to suggestions based upon analyses by the credit department of the Federal Reserve Board” (Timberlake 1993: 257). Open market operations, the report concluded, were designed “to give the Federal Reserve Board the necessary economic control of the domestic money market and to preserve a proper equilibrium in international operations.”

Regardless of one’s current perspective on the Fed’s authority, it strains all credibility to argue that the original intent of the 1913 Act was to convey “control of the domestic money market” to the Board. The Board and the Reserve Banks—as well as the Treasury—went back and forth on the nature and necessity of open market operations until the Banking Act of 1933 created the Federal Open Market Committee. In the intervening period, the Treasury unsuccessfully tried to force the Reserve Banks to liquidate their holdings of U.S. securities, and various Fed officials proffered their own justifications for open market operations.

By 1927, the Board’s Annual Reports had provided at least four distinct reasons for the necessity of open market operations (Timberlake 1993: 262). In no particular order, the Board stated that these operations were required to

- Provide income for District Reserve Banks so they could pay expenses and dividends to member banks;
- Lower interest rates and discourage gold imports;

- Build up an inventory for sales that could head off gold inflation; and
- Provide spending stimulus in Europe (through purchases) so that U.S. agricultural products would enjoy healthy demand abroad.

Thus, in a very real sense the Board gave itself the discretionary power to conduct open market operations. By the end of the 1920s, even though the Federal Open Market Committee had not yet been created, it was clear the Federal Reserve System had morphed into much more than an emergency reserve currency facility. Although this early expansion of Fed power took place without new legislation, new laws also helped the Fed's authority grow during its first quarter century.

Expansions through Legislative Changes

Many expansive legislative changes occurred during the Great Depression. One good illustration is the Banking Act of 1935, which created the Federal Reserve structure we have today. This Act stemmed from a behind-the-scenes collaborative effort between the Treasury and the Board. Both wanted a way to better coordinate expansionary fiscal and monetary policies. Some of the key changes made in the 1935 Act were

- Replacing the old Federal Reserve Board with the new Board of Governors;
- Giving the new Board the authority to change reserve requirements for member banks; and
- Giving the new Board the balance of power on the Federal Open Market Committee.

In brief, the 1935 Act centralized the power of the Fed in Washington and ensured that the Open Market Committee would conduct monetary policy at the Board's discretion. Although in the minority, U.S. Senators Gerald Nye (R-N.D.) and William Borah (R-Idaho) fought against this expansion of discretionary power and tried to have some sort of price-index rule written into the 1935 law (Timberlake 1993: 285). The minority obviously lost its battle, but there was real opposition to giving the Board that kind of discretionary power.

None other than Sen. Carter Glass (D-Va.), an original House sponsor of the 1913 Federal Reserve Act, stood against expanding

the Fed's centralized power in the manner of the 1935 Act. Glass complained:

It is now presumed to make the open market committee the supreme power in the determination of the credits of the country. No such thing was intended [by the original FR Act], and no such thing should ever be done [because the Board] does not have a dollar of pecuniary interest in the Reserve funds of the deposits of the FR banks or of member banks [Timberlake 1993: 283].

Strangely enough, Glass's opposition to the 1935 Act put him at odds with Rep. Henry Steagall (D-Ala.), the other half of the famed Glass-Steagall Act. Steagall openly wanted to wrest control of the system away from the Reserve Banks and bring it to Washington. He championed the Act as one that would bring "the system with its vast resources into full harmony with the advanced policies of the present [Roosevelt] administration" (Timberlake 1993: 283). The Banking Act of 1935 finished the job of relegating the Reserve Banks' relevance to the background of the Federal Reserve System, and the Fed's structure has remained virtually unchanged since 1935.

Thus, the Fed was radically transformed—both with and without legislative amendments—during the first 25 years of its existence. That early transformation provides a useful perspective for viewing more recent changes to the Fed.

The 2008 Financial Crisis and the Fed's Emergency Lending

One key aspect of monetary policy has always been a central bank's role as the lender of last resort. The role is somewhat misnamed, though, because now central banks tend to carry out this role by injecting reserves into the system as opposed to lending money to anyone. The Federal Reserve injects reserves into the system through buying U.S. Treasuries on the open market, and thus avoids lending to specific banks through its discount window (Goodfriend and King 1988). During the 2008 financial crisis, however, the Fed went well beyond these norms by invoking its Section 13 (3) emergency lending authority (White 2009: 120–24).

A well-publicized instance involved the investment banking firm Bear Stearns, one of the Fed's largest primary dealers. On March

14, 2008, the day after Bear's management told the Fed they would file for bankruptcy unless they could secure an emergency loan, the Fed announced it would lend Bear \$13 billion (GAO 2011b: 84). This loan was promptly repaid but just two days later the Fed announced it would provide a \$30 billion loan to facilitate J.P. Morgan Chase's acquisition of Bear Stearns. After several days of confusion and negotiation, the Fed ultimately created a special purpose vehicle (SPV) named Maiden Lane, LLC, to carry out the transaction.¹

Shortly after the deal was completed, former Fed chairman Paul Volcker remarked that this loan was "at the very edge" of the Fed's legal authority (Brinsley and Massucci 2008). Regardless, the Bear Stearns deal was only one small part of the Fed's emergency lending in the wake of the 2008 crisis. The Fed initiated at least 22 programs that provided loans to specific firms and groups of companies (White 2014, GAO 2011a).

Rather than avoiding the perception of favoritism, these loans were specifically designed to allocate credit to individual institutions. Initiatives such as the Term Auction Facility were directed to depository institutions, but others, such as the Primary Dealer Credit Facility, were directed to securities dealers. Ultimately, these loans spurred Congress to limit, at least superficially, the Fed's emergency lending authority.

Recent Changes under the 2010 Dodd-Frank Act

An electronic search of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act for the term "Federal Reserve" returns more than 200 matches. Some of these matches reflect relatively minor changes to the Fed's authority, but others dramatically expanded the Fed's reach into the economy. On the relatively minor side, the Fed is now involved in such things as creating rules for compliance with real estate appraisal standards, developing alternatives to credit ratings, creating procedures for securities holding company

¹All of these transactions took place *after* the Fed initiated its Term Securities Lending Facility (TSLF), the goal of which was to provide short-term loans to its primary dealers. The TSLF marked the first time during the crisis that the Fed provided funds to nondepository institutions, and many market participants believed the TSLF had been designed specifically to protect Bear Stearns (GAO 2011b: 84).

registrations, fashioning new reporting requirements for S&L holding companies, and regulating escrow account requirements.

More important, the Fed chairman now sits on the Financial Stability Oversight Council created by Dodd-Frank. This appointment makes the Fed's Board of Governors partly responsible for identifying firms that pose a threat to U.S. financial stability. In addition to singling out these firms, the Fed is ultimately responsible for developing specific rules and regulations for these preidentified companies. This new regulatory framework applies to predesignated non-bank financial firms (both foreign and domestic), as well as some firms that received TARP funds and all bank holding companies with assets of more than \$50 billion. Collectively, these firms are frequently referred to as "systemically important financial institutions" (SIFIs) although Dodd-Frank confers no such legal distinction.

Two of the duties for the Fed in this new role include implementing living wills for the SIFIs and implementing stress tests for several financial firms. In particular, the Fed is now responsible for implementing stress tests for all bank holding companies with at least \$50 billion in assets, all individual banks with at least \$10 billion in assets, and the predesignated nonbank financial institutions. The Federal Reserve remains, as always, the prudential regulator for all bank holding companies as well as all financial holding companies, but Dodd-Frank extended the Fed's reach into financial holding companies' subsidiaries.

Specifically, Section 604 gives the Fed the authority to "write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against subsidiaries, including entities regulated by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) and state-regulated entities." Even more pervasively, Section 120 of Dodd-Frank expanded the Fed's authority over practically every sector of the market. Because the Fed now sits on the Financial Stability Oversight Council, it is involved in requiring new regulations for any financial company it determines poses a threat to "financial markets of the United States, or low-income, minority, or underserved communities."²

²Although the Council's decision to designate large interconnected financial firms for heightened supervision by the Fed requires a two-thirds vote by the members of the Council, these Section 120 regulations do not require a two-thirds vote.

The Fed is now involved in regulating more companies than before the crisis, yet some critics still insist that Dodd-Frank limited the Fed's power (Miller 2011). These critics typically point to Section 1101 of Dodd-Frank, the provision which amended the Fed's emergency lending powers. In particular, Section 1101 provides that the Fed can no longer legally lend to any individual, partnership, or corporation. Instead, the Fed can provide emergency lending only through programs that have broad-based eligibility, and it can provide these loans only with the approval of the Treasury secretary.³

To argue that this amendment actually restrains the Fed is to completely ignore history. Aside from the distant examples of collaboration between the Treasury and the Fed, a large portion of the 2008 government bailouts were financed by the Fed in conjunction with the Treasury. Further, approximately half of these emergency lending facilities were broad-based programs such as the Term Asset-Backed Securities Loan Facility (Office of Financial Stability 2012, White 2014: 3). The notion that Dodd-Frank restricted the Fed's authority is based on an overly narrow view that ignores the fact that the Fed is now in the formal position of being the nation's systemic risk regulator. The Fed now has a mandate to regulate "financial stability"—a concept that lacks an objective definition. This vague charge gives the Fed more reach into both banking and nonbanking institutions than ever before.

Conclusion

Now in its 100th year, the Federal Reserve has a rich history of bureaucratic mission creep. Today's Fed is very different from the institution created in 1913, and it has morphed into something that many of the original sponsors of the Federal Reserve Act never intended it to become. Originally, the Federal Reserve System was a decentralized group of Reserve Banks with a weak oversight presence in Washington. The Fed served as a clearing bank, a lender of last resort, and a regulator for its member banks.

³The Fed's final rules have not been issued, but the proposed rules state that the emergency lending program will be considered to have broad-based eligibility only if it "is designed to provide liquidity to an identifiable market or sector of the financial system" (*Federal Register* 2014: 619).

Through time, each of these functions grew in scope, and the Fed's governing structure became highly centralized. Along the way, the Fed took over as the exclusive issuer of currency and the sole director of the nation's monetary policy. In more recent years, the Fed has officially taken on the role of the U.S. regulator of systemic risk for both banks and nonbank financial companies. Many of these changes have taken place through the legislative process, but the 2008 financial crisis provides a good example of how changes have often arisen extra-legislatively as well.

Much of the Fed's emergency lending, for instance, was done in novel ways that pushed the bounds of the organization's legal authority. Then, in 2010, the Dodd-Frank Act purported to restrict the central bank's emergency lending by preventing it from lending to any one financial company. The law now states that the Fed can offer emergency lending only to a group of companies, but this so-called restriction wouldn't have prevented half the programs the Fed employed during the crisis. What's more, the Dodd-Frank Act provided the Federal Reserve with an ill-defined mandate to regulate financial stability, a directive that is the polar opposite of restrictive.

The Fed has always had trouble fulfilling its main responsibilities, and Congress has continuously responded to those difficulties by expanding the Fed's reach into the economy. Dodd-Frank is no exception to this long-term historical trend.

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