FedFin Client Report

Friday, November 21, 2014

Too Big to Regulate Added to Hit List

Client Report: **FEDERALRESERVE18**

Executive Summary

The Senate Banking Financial Institutions Subcommittee held a contentious hearing grilling the president of the Federal Reserve Bank of New York, William Dudley, on the extent to which his Bank has been "captured" by big financial institutions and has a revolving door that poses serious conflicts of interest. As we anticipated, FRB efforts late Thursday to deflect criticism with a sweeping self-review did not satisfy critics like subcommittee chairman Sherrod Brown (D-OH), Elizabeth Warren (D-MA), and Jeff Merkley (D-OR). Chairman Brown suggested that all of the FRB-NY's lapses suggest big banks now are "too big to regulate," adding this to his ongoing view that big banks are too big to fail and Sen. Warren's that they are too big to jail. Sen. Shelby (R-AL) was not present at the hearing, but GOP-invited witnesses were at least as critical of the Federal Reserve as the Democratic senators.

Analysis

Opening statements

Senator Brown was very critical of recent events at the New York Fed, quoting Mr. Dudley in 2011 saying financial stability regulations will be effective only when supervision is good. Although he noted that agencies and Congress are also captured at times by the banks, he was especially critical of the FRB-NY as public servants who directly tried to curry favor with those they regulate. He questioned whether the biggest banks are too big to regulate, and noted the message being sent by the Fed's vacant vice chair for supervision position.

Senator Reed (D-RI) pushed for legislation to require the FRB-NY president to be nominated by the president and confirmed by the Senate. He noted that the NY Fed is one of the biggest U.S. regulators, and its president is the only permanent member of the Federal Open Market Committee not confirmed by the

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Senate.

Senator Merkley joined in the criticism, saying that consumer protection was a low priority before the crisis, while also pointing at the recent issues at the FRB-NY, the scandal over LIBOR rates, and oversight of commodity holdings.

Senator Manchin (D-WV) joined the subcommittee to make a statement that criticized both regulatory overreach and the FRB-NY's "lax supervision." Although he is encouraged by the Fed's review of its practices, he felt there is an opportunity to do more by joining Senator Warren (D-MA) in calling President Obama to fill the last two seats on the Fed's Board of Governors with experienced regulators.

Testimony for the first panel

Mr. Dudley argued that the system was much stronger than five years ago, citing new capital regulations and punishments for failing stress tests. He noted the focus on corporate governance, citing criminal decisions involving Credit Suisse and BNP-Paribas as ending too big to jail. He then discussed reforms to change the incentives for individual bankers, noted that the large-bank supervision process at the Fed brought together many Federal Reserve banks to conduct cross-firm horizontal reviews, and then spoke on the laws that attempt to prevent regulatory capture.

Q&A for the first panel

Sen. Brown first asked whether there were serious problems at the New York Fed. Although Mr. Dudley conceded that regulation is not where it needed to be (citing bank culture and improving incentives for bankers as areas to improve) he felt the financial system as a whole is significantly safer. Sen. Brown pressed on the recent events at the Fed, and Mr. Dudley argued the transactions Carmen Segarra exposed were legal and the Fed had determined they would not risk reputational harm, though he made it clear the FRB-NY did not approve the transaction. Sen. Brown noted that, after the Enron scandal, a Fed regulator argued that banks should not engage in actions that cause them reputational harm even if legal, and asked how the standards deteriorated to "legal but shady," a characterization Mr. Dudley disagreed with. Sen. Brown then moved on to commodities, a focus of a parallel hearing by Sen. Levin (see Client Report **COMTRADE5**). Mr. Dudley said these activities are a serious concern and that his Bank's work was used in the Permanent Investigations Subcommittee's report, and also that the Fed would shortly be releasing something on the matter. Sen. Brown felt that lawyers were overruling examiners in both the Segarra case and in the commodities case, and Mr. Dudley disagreed. When asked about the recent incident involving a Goldman employee who accessed confidential supervisory information Mr. Dudley made it clear the FRB-NY had referred the case to criminal authorities and had zero tolerance for such behavior. Sen. Brown then asked why financial stability took a backseat to monetary policy, pointing out that in the past Mr. Dudley had questioned a capital regulation on the basis that it may inhibit monetary policy. Mr. Dudley took great exception to that, noting it was a very technical disagreement and that he merely wanted to make sure that all implications are understood as rules are adopted, and also that he had repeatedly supported higher capital standards.

Sen. Reed asked how they could change the perception of regulatory capture when Mr. Dudley is hired by the people he regulates, an assertion with which Mr. Dudley disagreed even as he deferred to Congress on this question.

Sen. Merkley jumped on the remark that too-big-to-jail has ended, noting that the Credit Suisse situation involved no Americans being turned over, no people jailed, and that it resulted from Senator Levin's investigation. Mr. Dudley argued that the corporation itself pled guilty, which was a big precedent, but the Senator pointed out corporations could not go to jail. He then asked how the FRB-NY could be doing a good job when it took a Senate committee so far removed from the issue to uncover the arrangement, and Mr. Dudley argued that the FRB-NY focuses on safety and soundness, not tax evasion.

Sen. Merkley then moved to the London Whale incident. Mr. Dudley argued that it was not an issue which had come to him personally, noting the supervision staff at JP Morgan was overtaxed at the time and had to prioritize other issues, and that the OCC had said it was their primary responsibility, before ultimately concluding that the system was stronger because JP Morgan survived the incident without trouble.

Sen. Warren began by describing the long list of supervisory failures at FRB-NY before and now, and Mr. Dudley immediately disagreed with the generalizations of the FRB-NY and the facts of the Segarra case. Sen. Warren noted that Mr. Dudley had castigated banks for their culture in a speech and argued culture was shaped from leadership, and asked how the FRB-NY's culture could be changed when he denied there is a problem. Mr. Dudley responded that he had commissioned the Beim report that looked at the FRB-NY's culture, and that he had implemented most of the changes. Sen. Warren was not convinced, and said if Mr. Dudley couldn't fix his bank's culture, they would find someone who could. When asked about the specifics of bank transactions, Mr. Dudley said that illegal transactions are forbidden, but legal transactions that could threaten a bank's safety and soundness were also something the FRB tried to prevent. Sen. Warren likened the Fed's job to a cop on the beat, but Mr. Dudley demurred and said it was more of a fire warden that

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makes sure buildings are fire-safe. She tried to get a commitment from Mr. Dudley to bring Dr. Beim back for a second review, but Mr. Dudley only promised to think about it.

Testimony for the second panel

David Beim, a professor at Columbia who was one of the authors of the 2009 FRB-NY culture review, felt that Mr. Dudley had the right intentions in focusing on culture. However, existing laws to prevent a “revolving door” are too weak, instead arguing that anyone who had been a regulator should not be able to join a bank for three years. He felt there is still a culture problem, but defended the NY Fed by saying culture is very slow to change and these problems were not unexpected.

Robert Hockett, a professor of Law at Cornell and former FRB-NY employee, noted that he had never personally seen regulatory capture during his time at the Bank and that his superior had specifically asked him to work outside the box and avoid groupthink. He also noted that he had pursued an eminent domain solution to underwater mortgage loans to which banks were very hostile, but the NY Fed gave significant press to his proposal. However, he had heard stories from other departments (noting that he hadn’t worked in examinations) that suggested there was a pattern worth investigating.

Norbert Michel, a research fellow at the Heritage Foundation, argued that regulatory capture was a consistent trend at the Fed and that it was natural for the industry. He criticized macroprudential safeguards as insufficient, noting Spain had implemented much of the same. Instead, he argued that regulations need to be less numerous and less complex, and that macroprudential responsibilities be passed on to the FDIC and OCC.

Q&A for the second panel

Sen. Brown agreed with Dr. Beim’s beliefs that regulators still think about their next job while supervising banks, before asking about the large-bank supervisory committee. Dr. Beim felt it was ineffective, that the problem was not the need for more vetting. Mr. Hockett felt it was a marginal benefit at best and argued for a contrarian thinking department that was on equal footing to the other departments. Dr. Michel felt Dr. Beim’s 3-year rule would simply make the Fed a more engrained bureaucracy.

Sen. Merkley asked about the current rules on banks hiring regulators, and Dr. Beim agreed the situation is complex but that it is also far too easy to get around such rules, noting that Mr. Dudley likely does not have the authority to unilaterally change these rules without Congressional action.

Sen. Warren asked Dr. Beim whether he is open to returning for another study, which he is, and then argued that it was important to also keep Wall Street insiders from regulating their coworkers. Dr. Beim added that almost every other developed country had a professional civil service, and Dr. Michel jumped in by pointing out that all the others underwent a financial crisis as well. Mr. Hockett said the argument in favor of the revolving door was the complexity of the financial sector, but he felt that complexity was self-serving and artificial rent-grabbing, and suggested an FDA-type regime to approve complex products, which was a suggestion Sen. Warren then used to push for her legislation reinstating Glass-Steagall (see FSM Report **FHC21**).

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