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Capitol Hill efforts to scrutinize Fed expand MarketWatch July 10, 2009 Friday 12:01 PM EST

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BODY:

WASHINGTON (MarketWatch) - The Federal Reserve is facing increasing pressure from a number of fronts as it tries to restore the sickly financial system.

However an effort on Capitol Hill to hike scrutiny of the central bank, once considered unlikely to be approved, are coalescing a large number of lawmakers and could soon have an impact - with or without congressional action.

Two pieces of legislation in the House and one in the Senate would allow the investigative arm of Congress, the Government Accountability Office, to conduct a monetary policy audit at the Federal Reserve and issue a report.

Supporters of the bills believe the Fed is an overly opaque and far-too independent organization, which doesn't let outsiders know about key details such as which institutions are coming to its discount window, a government lending facility through which commercial and, in response to the crisis, investment banks borrow reserves. They worry the Fed may favor some borrowers over others, a conflict of interest situation that might be solved with greater transparency.

Criticism of the Fed's opacity peaked in March when lawmakers expressed outrage that the Fed did not initially disclose that its taxpayer-funded \$190 billion bailout package to keep troubled American International Group Inc. (AIG) afloat included large payments at par to foreign banks in China and Europe.

Columbia Law School Professor John Coffee argues that momentum is building for the legislation at the same time as the Fed hopes lawmakers will back a White House proposal expanding the central bank's power. He said the Fed should accept the audit, or possibly lose new powers the central bank has been seeking.

"The Fed could resist such an audit of monetary policy, but it would be in its best interest to accept it," Coffee said.

But Fed Chairman Ben Bernanke and opponents of a fed audit of monetary policy worry that such scrutiny could be used as a tool of Congress to influence interest rate and other monetary goals, a prospect that could hurt the agency's flexibility in responding to the financial crisis.

"My concern about the legislation is that if the GAO is auditing not only the operational aspects of our programs and the details of the programs, but is making judgments about our policy decisions, that would effectively be a takeover of monetary policy by the Congress, a repudiation of the independence of the Federal Reserve, which would be highly disruptive to the stability of the financial system, the dollar and our national economic situation," Bernanke told lawmakers on June 25.

Backers of the Fed argue also that institutions would be afraid to borrow from the discount window when they need to because they would be stigmatized as a troubled firm.

Nevertheless, lawmakers, concerned, in part, by a White House proposal that would expand the Fed's power, have galvanized behind legislation that would scrutinize the central bank.

One GAO audit bill, introduced by Rep. Ron Paul, R-Texas, has 245 co-sponsors. The legislation, which includes 78 Democratic lawmakers, comprises more than half of all House members. The legislation allows the GAO to complete a policy audit of every aspect of the Fed, including its interest rate policy as well as its wide-variety of programs responding to the financial crisis such as its lender of last resort authority.

The bill has been stagnating before the House Financial Services Committee. The panel's chairman, Rep. Barney Frank, D-Mass., has talked about a lack of accountability when it comes to the Fed's financial crisis lending policy. However, the panel hasn't moved on the Paul legislation.

Frank spokesman Steve Adamske said the committee will consider the Fed's lender-of-last-resort authority, once it completes bank regulatory reform initiatives currently before the panel. The committee also held a hearing Thursday examining the independence of the Fed and plans to have other hearings that will examine the Fed.

A Senate bill introduced by Sen. Jim DeMint, R-S.C., is similar to Paul's legislation in the House, however Democratic leadership in the Senate blocked it from being brought to the Senate floor. The bill would require the GAO by the end of 2010 to audit the Fed's discount window, its crisis-response funding facilities and looked at details of agreements with foreign governments and their central banks.

Another more focused bill, introduced by Rep. Dennis Kucinich, D-Ohio, would allow the GAO to take a look at the special credit facility the Fed established as a lender of last resort in response to the financial crisis.

That legislation would have the GAO scrutinize key aspects of the central bank's crisis-response Money Market Investor Funding Facility, Term Asset-Backed Securities Loan Facility, Commercial Paper Funding Facility, and its program to buy illiquid mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac.

Kucinich's bill was approved by the House Oversight Committee as an amendment to a larger Government Accountability Office Improvement Act of 2009 and now awaits further action.

Compromise = Audit

Coffee argues that there is a good deal of skepticism on Capitol Hill about the White House bank regulatory reform proposal. He points out that one possible result is that Congress could politely ask the Fed to allow the GAO to conduct a policy audit of its monetary policy, to which he imagines the central bank would respond favorably.

Some lawmakers have raised concerns that the Fed's authority to set monetary policy might conflict with its regulatory goal of making sure banks are well capitalized.

One possible consequence is that Congress could take away the Fed's authority to set capital and leverage standards for financial institutions and place it with a council of regulatory agencies, a prospect the central bank argues would hurt its ability to respond to the financial crisis effectively.

A possible compromise, said Coffee, would be to let the Fed maintain its power, but allow lawmakers to have the GAO conduct an audit of its monetary policy.

"One way of doing that compromise is to have the Fed be more accountable to Congress through a GAO audit," Coffee said.

Timing

Lawmakers backing legislation seeking to audit the Fed would like to see such an examination take place before they decide whether to support financial crisis legislation the House Financial Services Committee and Senate Banking Committee are in the process of introducing. Already, the House panel has introduced legislation creating a Consumer Financial Protection Agency, which would approve mortgage and credit card products.

However, should key Democratic lawmakers continue to delay a vote on any of the GAO examination bills, it may be unlikely such an audit would be completed before Congress completes work on its broad regulatory reform legislation.

"A Fed audit would take several months," said Coffee. "I don't know that they will fully get it done in time to affect the regulatory reform legislation."

Criticism

William Poole, former chief executive of the Federal Reserve Bank of St. Louis, said the Fed already has an ample amount of congressional oversight, in part, due to Congress's requirement that the central bank chairman and other Fed officials to testify before Congress on a periodic basis. Poole added that lawmakers are staffed with individuals that are experts on monetary policy. He added that the GAO would need to staff up on experts in this area to be effective.

Poole, a senior fellow at the **CATO institute**, argued that the Fed and regional Fed banks already have many checks and balances, including an outside auditor that looks at the books of the Board of Governors and the 12 regional Federal Reserve banks. The Fed's board of governors also examines the books and operations of the 12 regional Fed banks, he added. The

agency periodically provides information about the characteristics of banks that borrow from the discount window.

A major problem, Poole argues, is that Congress did not take responsibility for many of the crisis-response programs. He said Congress, if it thought the programs wise, should have authorized the Treasury, for example, to buy both commercial paper from large corporations and mortgage securities backed by Fannie and Freddie, instead of having the Fed do it. The purchases would be financed by the Treasury and consequently there would be greater transparency about those transactions, limiting concerns about favoritism.

"Instead, the Fed has determined the characteristics of the programs and has financed them by printing money," said Poole. "This is a consequence of Congress letting the Fed get involved in all these programs. They shouldn't have done it."

However, critics of the Fed argue that there need to be far more checks and balances than that provided by Congress and within the Fed.

Rachel Mills, spokeswoman for Rep. Ron Paul, ranking member of the Domestic Monetary Policy subcommittee, said several house members would like to know more details about which financial institutions are utilizing the Fed's discount window, in part, because there is a possibility there could be favoritism.

"It's a secretive organization," said Paul spokeswoman Rachel Mills. "We don't know who is coming to the discount window, which could be propping up lots of problematic financial institutions."

Interest rates and the Fed

DeMint argues that allowing the Fed to operate the U.S. monetary system in almost complete secrecy leads to abuse, a lower quality of life for Americans and higher interest rates.

"Inflation is a hidden task and we forget about it too often when debating spending bills here in Congress," DeMint said on the Senate floor. "Increased long-term debt will need to be paid for by borrowing new money from an increasingly skeptical world or printing new money."

However, Fed vice chairman Donald Kohn said at a hearing Thursday that congressional interference in the Fed's monetary policy would lead to higher long-term interest rates as investors begin to fear future inflation.

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