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Here's what's wrong with Rand Paul's 'Audit the Fed' bill

By: Mike Konczal - November 16, 2013

It appears that conservatives are now demanding a vote on Rand Paul's Federal Reserve Transparency Act before they'll consider Janet Yellen's nomination to chair the central bank.

Since everybody likes "transparency," and since misinformation spreads like wildfire when it comes to the Federal Reserve, it's important to understand what this bill does and doesn't do. And if it passes, we should understand how the Federal Reserve itself will be complicit in it.

Let's start by looking at two core activities of the Federal Reserve. The Federal Reserve sets the money supply with the goal of maintaining maximum employment and price stability. It also acts as a lender of last resort to the financial sector during liquidity crises.

So how do audits already work in these areas?

1) Money Supply. The Federal Reserve will tell you it is already one of the most-audited institutions in the government. Still, by law, there are some actions that are exempt from being audited. There are no audits of "transactions for or with a foreign central bank," or of "deliberations, decisions, or actions on monetary policy matters," or of "transactions made under the direction of the Federal Open Market Committee," or of "communication among or between members of the Board." Paul's transparency act would remove these exemptions.

Would more transparency in these areas be a good idea? Here's one way to think about the question. People who study economic policy often distinguish between policy goals and policy instruments. Goals are states of the world that policymakers want to bring about, but that they don't directly control. Instruments are things that the government does control, however, and are used to bring around these goals. Full employment is a goal; the interest rate is an instrument.

Adam Posen, president of the Peterson Institute for International Economics, argues that "central banks should have instrument independence, but not goal independence." That is, the best accountability regime is for Congress to demand certain goals be reached — but then trust the regulators to use their instruments, within the law, to achieve these goals.

If you have ever sat through a Congressional hearing with Chairman Ben Bernanke, you'll see that Congress usually does the exact opposite. They spend all their time complaining about instruments, about this or that purchase. But lawmakers rarely ask, "Why have you failed to bring about full employment?" Or: "Why are you missing your inflation target?"

It’s clear, then, that many of the proponents of Federal Reserve transparency are simply looking for methods to advance a hard-money agenda even though inflation is dangerously low. Instead of a “transparency act,” Paul’s bill will probably be a “harassment act” in practice.

Many people who support transparency in and of itself will think this is a good idea. However this bill could point transparency in the wrong direction, bringing every instrument change into question while leaving the important goal discussions on the sidelines.

2) Lender of Last Resort: The Federal Reserve is also the lender of last resort to the normal banking sector. However, during the crisis, the central bank invoked emergency powers (using an obscure provision titled 13(3)) to become a lender of last resort to the shadow banking sector. This was the underlying logic of the huge network of emergency lending facilities launched in 2008-2009.

The Federal Reserve fought efforts to bring transparency to this emergency lending, even though the public was rightfully concerned about the extraordinary measures that were being taken. Fed officials opposed both lawsuits from Bloomberg and efforts under Dodd-Frank to examine the range of emergency lending that was taking place. But they lost these battles. Indeed Dodd-Frank greatly expands transparency in the lender-of-last-resort area.

So it’s important to look closely at arguments calling for even more transparency here. Take, for example, Tim Carney’s recent piece in the Washington Examiner. He argues that the Federal Reserve has “the power to bail out banks and other financial institutions, free from budgetary constraints or democratic accountability... but the Fed's lending to banks is where added transparency is really needed.”

If you read the piece, you might think that we are in a situation where there is no transparency when it comes to past emergency lending under section 13(3), as well as no transparency when it comes to future discount window lending. But this is entirely wrong.

Dodd-Frank already includes an audit of emergency lending facilities. According to Davis-Polk, “GAO is required to conduct a one-time audit of all loans or other financial assistance provided through the Federal Reserve’s exercise of 13(3) authority between December 1, 2007 and the date of enactment.” As Mark Calabria of the Cato Institute notes, “the audit required by Dodd-Frank goes beyond a simple accounting of what was lent to whom, but also requires GAO to evaluate the effectiveness and policies of the various lending facilities.” You can read this audit here.

Dodd-Frank also now requires public disclosure of the discount window with a two-year delay, and any potential 13(3) lending with a one-year delay. From the Federal Reserve: “The Dodd-Frank Act also established a framework for the delayed disclosure of information on entities that, after July 21, 2010, received a loan from the discount window under Section 10B of the Federal Reserve Act or from a Section 13(3) facility, or participated in OMO transactions.” If interested, you can get discount window lending data here.

If there are issues on the bank accountability side that are necessary, we need a conversation much more sophisticated than what we have. There's already been an overhaul on transparency here, and it's not clear what more is needed.

Bringing it on themselves

There's another interesting piece of policy tucked into Paul's Federal Reserve Transparency Act. It's a call to release "an audit of the review of loan files of homeowners in foreclosure in 2009 or 2010, required as part of the enforcement actions taken by the Board of Governors of the Federal Reserve System against supervised financial institutions."

This is a reference to the Independent Foreclosure Review disaster carried out by regulators that was subsequently never released. As David Dayen notes, the OCC and the Federal Reserve "decided to let the banks hire and pay for their own third-party reviewers." That led to $2 billion for bank consultants and "numerous cases of reviewers deliberately minimizing evidence of borrower harm." (Check out Propublica here for how bad some of these reviews were.)

This is a particularly big deal for financial reformers, because, according to Congressional staff, the Federal Reserve said it couldn't release the results of mortgage servicer violations because these abuses were "industry secrets." (A famous clip of Sen. Elizabeth Warren questioning regulators about this went viral.) This will likely bring significant liberal support to the bill, and the Federal Reserve only has itself to blame.

See the pattern? The Federal Reserve fought against releasing its emergency lending data. It was finally forced to, and the sky didn't fall. It's been fighting to keep evidence of foreclosure abuses secret, making people wonder whose interests it serves. And it doesn't appear to be drafting the rules that would circumvent its own bailout powers, to the worry of many.

These are the abuses that stick with people and make the public think there's more shadiness that they don't know about. These are all self-inflicted wounds, and reflect the choices that the Federal Reserve has made on its own. Reform happens. Whether it comes from people who want to see the Fed do a good job or those who are looking for excuses to be for hard money is a choice that the Fed has helped influence.