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A Secretive Committee of Wall Street Insiders Is the Least of the New York Fed's Concerns

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On July 17, Mary Callahan Erdoes, head of JPMorgan Chase & Co.'s $2.2 trillion asset and wealth management division, walked into the wood-paneled tenth-floor conference room at the Federal Reserve Bank of New York to address some fellow Wall Street luminaries — Bridgewater Associates' Ray Dalio, Dawn Fitzpatrick of Soros Fund Management, short-seller Jim Chanos, and LBO kingpin David Rubenstein among them.

All are members of the Investor Advisory Committee on Financial Markets (IACFM) — a forum to provide financial insight to the New York Fed. Chairing the meeting was New York Fed president John C. Williams, vice chair of the powerful, rate-setting Federal Open Market Committee, who was a year into his tenure.

Erdoes held forth at the meeting, which included a buffet lunch.

Global markets, she warned, had been assuming rate increases but were now expecting cuts. U.S. inflation was trending downward, her research showed. There was downside risk to growth and the market might even be pricing in a recession in the medium term.

One boldfaced headline from Erdoes's deck: "Expectations for easing by major central banks continue to build." In the discussion that ensued, according to minutes from the meeting, her fellow IACFM members warned of market volatility if the Federal Reserve did not act — and fast.

Less than two weeks later, the FOMC did just that. For the first time in more than a decade, the committee cut the federal funds target rate, reducing the lower end of the range to 2 percent from 2.25 percent.

Presentations like Erdoes's have critics calling foul. They say these quarterly committee meetings are a prime example of the privileged access and lack of transparency that subvert the New York Fed and, by extension, the Federal Reserve System as a whole.

"Too often, so-called 'advisory committees' are just special-access vehicles for industry to covertly and secretly influence and connect with important regulators under the guise of gathering information or some other innocent-sounding purpose," says Dennis Kelleher, co-founder of Better Markets, a Washington, D.C.-based advocacy group that promotes financial reform. "All such interactions should only be allowed under careful rules of transparency and accountability, which is the exact opposite of what the New York Fed is doing here."

Through a spokesman, the New York Fed said the charters of such advisory groups detail rules concerning antitrust and other concerns. “Through our formal advisory and sponsored groups and board, as well as through our extensive outreach efforts, we seek to include as wide a range of perspectives and insights as possible,” the bank said in a statement.

Invitation-only committees aren’t the critics’ only targets. The New York Fed today faces a vortex of issues: unprecedented low interest rates, an overreaching and weaponized executive branch, and a fusillade of criticism from actors ranging from crackpot gold bugs to raging socialists. Governance, oversight, and disclosure practices are on all their agendas.

So what’s new? The New York Fed, after all, has been a lightning rod for controversy since its creation as part of the Federal Reserve System in 1914. The bank has faced withering criticism and attacks throughout the years, most notably for its handling of the 2008-09 financial crisis.

There is this: An election year is approaching, with virulent strains of populism cropping up on the left and right. Democratic presidential candidate Senator Elizabeth Warren has been bashing the Federal Reserve System’s oversight. And Donald Trump himself is all in, tweeting that Federal Reserve chair Jerome Powell is an “enemy” of America, threatening to fire him, and even personally singling out Williams for ridicule. Last month, Trump called the Fed “boneheads” for not reducing the target rate to zero or less.

“The spotlight is on the Fed from different directions,” says Dartmouth College economics professor Andrew Levin. “Twenty years ago, this would have put everybody to sleep.”

Cutting through the sturm und drang, the complaints center on one issue: accountability at an opaque organization that operates in a netherworld between the public and private spheres.

“One of the things is that to be legitimate in the eyes of the public, there’s got to be more accountability and more transparency,” says Columbia Law School professor Kathryn Judge.

One seemingly arcane topic: regional reserve bank board elections. These congressionally mandated votes are integral to the oversight of not just the New York Fed, but also the other 11 regional reserve banks. Yet they are often shrouded in secrecy, and the vetting and selection criteria for prospective directors is a mystery to the public.

“The decision-making process is still something of a black box in governance,” says George Selgin, director of the Center for Monetary and Financial Alternatives at the Cato Institute in Washington, D.C. “The rules allow for a lot of wheeling and dealing to take place.”

At the New York Fed, for example, director candidates have almost always run unopposed. “Frankly, it’s embarrassing because it’s like a Soviet election,” says Dartmouth’s Levin.

That wheeling and dealing was on display in the selection of New York Fed president Williams in April 2018, a particularly fraught exercise that might have provoked a ruckus if its specifics had surfaced at the time.

The exercise started with seemingly good intentions. The New York Fed board set up an especially transparent selection process, with chair Sara Horowitz, a Class C director, and Silver Lake Partners co-founder Glenn Hutchins, a Class B director, co-heading the search. (Current rules state regional bank presidents are selected by the banks’ Class B and Class C directors,

specifically those who are not connected to banks and who are designated to represent the public, not banks.)

They even created a website disclosing the qualifications they sought and the search firms they hired — Spencer Stuart and Bridge Partners — to find the right candidate.

Congressional Democrats were publicly calling for qualified diversity candidates, as was advocacy group Fed Up. The New York Fed committee was game, apparently, as long as the prospect had the chops for the job.

By March, the committee had vetted a shortlist of qualified executives, according to three sources familiar with the situation. One favored candidate: Mary John Miller, a widely respected former T. Rowe Price Group fixed income executive and ex-Treasury Department undersecretary for domestic finance. Miller would have been the first female New York Fed president.

It was not to be. Fed chair Powell stepped in, sources say. Allying with New York Fed director Hutchins, he directed the selection of Williams, then president of the San Francisco Fed, who had scant private market experience. Williams had also been panned for poor oversight of Wells Fargo & Co., whose account fraud scandal took place under his watch. Nevertheless, Horowitz and her fellow New York Fed board members ratified Williams, as required by law.

"It may well be the [Federal Reserve] board pushed John Williams down the throat of the New York Fed," says the Cato Institute's Selgin, who adds that he is not directly privy to the board's deliberations. The most powerful regional reserve bank, some say, was being brought to heel by Washington.

Horowitz, who declined requests to be interviewed, said in a statement it was the consensus view of the board that Williams was the best candidate.

"Any notion that I was somehow sidelined by [Jerome Powell] and Glenn [Hutchins] is simply not true and frankly condescending to me as a woman," the statement read. "I find this attempt to minimize my role as chair of the New York Fed's board insulting and wrong."

Today, some critics are calling Williams a disaster. New York Fed insiders were shocked by the abrupt departures, announced on May 28, of two long-time and well-regarded deputies — markets head Simon Potter, who oversaw the trading desk that buys and sells Treasuries on behalf of the Federal Reserve, and financial services chief Richard Dzina. Both had worked shoulder to shoulder with former president Timothy Geithner during the financial crisis, and later with Williams's predecessor, William Dudley.

The reasons for their departures were not disclosed.

"Geithner, Dudley, and Potter were a club that said, 'We can step up and do a good job,'" says one former New York Fed employee. "They did a lot of things that seemed to work in the depths of the crisis." Cutting loose Potter and Dzina had the effect, planned or not, of cutting the New York Fed down to size.

The pair's defenestration was followed by more tumult. On July 18, just after the IACFM meeting and shortly before the Federal Reserve System entered its blackout period ahead of the meeting of the FOMC, Williams gave a speech to the Central Bank Research Association about

how to implement monetary policy during a period of exceedingly low interest rates — near the zero lower bound, or ZLB, in Fed-speak.

"*Don't* keep your powder dry," he told the association, according to a copy of the speech. "You want to do the opposite, and vaccinate against further ills. When you only have so much stimulus at your disposal, it pays to act quickly to lower rates at the first sign of economic distress."

Traders interpreted his speech as a sign that a 50-basis-point rate cut was in the offing and not the 25-basis-point reduction already priced into the market. The Standard & Poor's 500 stock index jumped, and a spokeswoman for the New York Fed clarified the speech for reporters. The index then pulled back.

The irony was not lost at the New York Fed that had Williams submitted his speech for vetting to markets chief Potter, the latter would likely have flagged the leading language. Potter, of course, was gone by then.

Wall Street is hammering Williams. "Historically, the role of the New York Fed president has been to clean up communication snafus, not create them," wrote Ward McCarthy, chief financial economist at investment bank Jefferies, in a July 22 research note. "Until proven otherwise, president Williams will remain a communication liability and a probable source of market volatility."

Says William Poole, former president of the Federal Reserve Bank of St. Louis, who otherwise vouches for Williams's bona fides as an economist: "The question is whether he continues to make mistakes."

Recently, as rates spiked toward 10 percent in the market for overnight repurchase agreements, or repos — part of Potter's former purview — traders have asked whether Williams should have done more to ensure liquidity. "I'm sure that's a question they are asking themselves: 'Should we be doing something different?'" says Brandon Swensen, co-head of U.S. fixed income at RBC Global Asset Management.

An October 1 Fitch Ratings report warns: "Further repo market volatility could exacerbate global liquidity issues."

The scrutiny paid to the New York Fed is understandable. Unique among the regional banks, its president holds a permanent spot on the FOMC, serving as vice chair of the committee. Conducted on behalf of the Federal Reserve, it is the New York Fed's open market desk that is responsible for buying and selling Treasuries in the secondary market. It oversees the repo market, critical to those seeking short-term financing. The list of privileges and responsibilities goes on.

And the New York Fed holds outsize regulatory sway over Wall Street and many of the nation's biggest banks, who paradoxically are technically shareholders in the New York Fed, although they cannot vote or trade their shares.

Some of the vitriol directed at the New York Fed lingers from the controversial role it played in engineering the Wall Street bailouts and, especially, the secretive takeover of American International Group.

Ultimately, Congress demanded changes, and it got them. A provision of the Dodd-Frank Act of 2010 ensured that bank-affiliated New York Fed directors would no longer vote for the president of the very institution that regulated them. And a 2011 General Accounting Office report called for more disclosures about potential conflicts of interest, among other requests.

The New York Fed has begun publishing minutes of its board meetings, although delayed by months and sometimes heavily redacted. It also pulled back the curtain on its balance sheet, revealing in financial statements its holdings of securities held as collateral. It is simply not enough, say some critics.

"They are not transparent about governance or their relationships with different financial institutions," says Johns Hopkins University economics professor Laurence Ball.

In a statement, the New York Fed responded that it is committed to fulfilling its mission in a "transparent and inclusive manner."

"We have and continue to identify opportunities to provide greater information to the public about our operations and governance," the statement said.

"The New York Fed is controlled by the New York banks, and it's performing a public function," says John Coffee, a securities law professor at Columbia Law School. "That's the tension."

The special role stretches back more than a century, to the creation of the Federal Reserve System in 1913. The interests of American farmers were championed by, among others, financial reformer William Jennings Bryan. Those of the banks, particularly the giants of the time like National City Bank of New York, were boosted by Republican Senator Nelson Aldrich of Rhode Island and others.

So was born the system of 12 bank-controlled regional reserve banks, with the New York Fed among them, wedded to a public, Washington-based central bank. Power seesawed between the New York Fed and Washington, perhaps by design.

The jury-rigged system mostly worked — except when it didn't, such as when the Federal Reserve tightened rates instead of easing following the stock market crash of 1929. It also failed utterly to grapple with the galloping inflation of the late 1970s — until Federal Reserve chair Paul Volcker reigned it in with a series of fearsome rate tightenings. And the system's regulatory failures arguably contributed much to the 2008-09 financial crisis.

"It's a hundred years later and a lot of things have changed," says Dartmouth's Levin. Still, he adds, "the Federal Reserve Act [of 1913] specified that the regional reserve banks were private institutions."

That's one reason advocates' push for greater transparency has proceeded slowly — or been stonewalled altogether. Professor Ball of Johns Hopkins sued the Federal Reserve in 2013 seeking information on collateral held by American International Group and others during the financial crisis.

A federal court ruled that the information related to the Federal Reserve's supervision of the New York Fed, which is not a government agency, was not subject to the Freedom of Information Act. The New York Fed says it will seek to comply with the spirit of FOIA.

The New York Fed responded to an *Institutional Investor* FOIA request seeking the ownership positions of its member banks by saying it was consulting with another department and would provide an update later this month.

That's right: The bank will not even disclose the ownership stakes of its members.

The New York Fed's reticence extends to the eight advisory groups it currently operates. The first two, including one for small business and agriculture, were started in 1988. The most recent, for fintech developers, was christened earlier this year. Chaired by Williams, they convene representatives from, say, upstate New York or various community groups, and are designed to provide first-hand intelligence on emerging issues.

None, however, have the financial star power of the IACFM, which was launched by Dudley on July 24, 2009.

The group, the press release said, would "strengthen the New York Fed's relationships with a diverse group of market participants." Dudley himself at the time of the announcement said, "Conferring with members of the IACFM is a natural extension of our work at the bank."

That the IACFM was born in the crucible of the financial crisis inflames some critics. "One has to wonder what exactly was the Fed thinking that it needed to [foster] 'relationships' at that very time with 'market participants,'" says Better Markets' Kelleher.

The IACFM's glittering alumni include Democratic presidential candidate Thomas Steyer, founder of Farallon Capital Management; David Tepper of Appaloosa Management; and Alan Howard of Brevan Howard Asset Management.

Though members usually move on and off the committee every three years or so, in any particular month there will be, among others, a private equity executive, an equity manager, a macro-focused trader, and perhaps a pension fund manager. When they gather, they sit around a long central table that seats 20 or so along with New York Fed staff in the tenth-floor conference room.

The agenda for the upcoming meeting is set ahead of time by the New York Fed, with different topics assigned to different committee members.

It's no cakewalk. A committee member — say, a hedge fund manager — is required to put together a thoroughly researched presentation, and expects to be grilled on the subject, if not by fellow committee members then by the dozen or more New York Fed economists, statisticians, and others who attend, questioning the presenter's numbers, sources, and conclusions.

If nonpublic information inadvertently flows to the committee members, which one investor calls "inconceivable," it is not for lack of effort to stamp out possible leakages.

"The Fed does need to know what the market is thinking," says professor Ball. However, he adds: "It seems inevitable there will be give and take and a risk that the information will be misused."

The New York Fed publishes IACFM meeting agendas, minutes, and presentation materials on its website. The IACFM charter requires that a New York Fed lawyer be present at the quarterly meetings, but that's a far cry from the robust oversight powers that an inspector general would bring, as would likely be the case if the bank were a government agency.

“It would not be an outrageous matter to ask for an inspector general to be on hand,” says Boston College economics professor Peter Ireland, a member of the Shadow Open Market Committee, an independent group that monitors the performance of the FOMC. “Appearances matter.”

Indeed, there is evidence that banks reap benefits from having their executives serve as directors at the regional reserve banks. It’s not unreasonable to assume the firms of advisory committee members could benefit as well.

Last year, Lamont Black, an assistant professor of finance at DePaul University in Chicago, and Jennifer Dlugosz, who holds the same title at Washington University in St. Louis, co-authored a study examining the impact on member banks’ financials from 1986 to 2013 when one of their executives is named to a regional reserve bank board.

“We find that banking organizations are more profitable, in terms of net interest margins and return on assets, when one of their executives sits on the board of directors of a Federal Reserve bank, but only during times of heightened monetary policy uncertainty,” the study says. “This suggests that reserve bank directorships may enable banks to increase lending margins by making better lending or funding decisions during periods of pronounced uncertainty about interest rates.”

Making use of such information could be a game changer for any member bank. “If I get an inside tip on the Treasury market, you’re talking real money,” says Johns Hopkins’ Ball. “The potential for profit is so huge.”

The selection of New York Fed directors is both opaque and byzantine, a Rube Goldberg-like process that is mandated by congressional legislation and is complicated even in simplified form. The three Class A directors are member bank executives “elected” by the banks themselves. Their role is to represent the interests of the New York Fed member banks.

The three Class B directors are also chosen by member banks, but in this case to represent the interests of the public. They can’t be directors or employees of any bank. Class C directors are appointed by the Federal Reserve Board of Governors to also represent the interests of the public. They can be neither directors nor employees of any bank or financial, bank, or thrift holding company. The three Class C directors can’t even own shares in such companies, and the chair of the New York Fed, who must be one of the three, requires prior banking experience.

One vexing matter is that in recent New York Fed elections, there has been only a single candidate for each directorship. There is no publicly disclosed tally of the ballots, or detailed results. “The process is so under wraps,” says Connie Razza, chief of campaigns and policy at the Center for Popular Democracy. “This is part of the transparency issue.”

Razza highlights the lack of diversity on the New York Fed board. In this case, to be clear, she is not referring to race or gender but to the overweighting of financial sector directors. The New York Fed Class B directors are Adena Friedman, CEO of Nasdaq; private equity tycoon Hutchins; and Charles Phillips, former CEO of cloud software firm Infor and a former Morgan Stanley analyst and perennial *Institutional Investor* All-America Research Team winner.

There should be opportunities on the board for academics and representatives of less glamorous service industries, Razza argues. “Those Class B and C directors can represent different sectors

of the economy.” That said, recent Class B directors have included Terry Lundgren of Macy’s and Honeywell International’s David Cote.

This much is clear: Nobody is getting wealthy toiling at the New York Fed. According to a fee schedule that hasn’t been updated in nearly 40 years, directors get a $2,000 annual retainer, $200 for each meeting they attend, and $100 for phoning in to conference calls. The chair receives a $5,000 annual retainer and $300 for each meeting.

The annual salary for the New York Fed president was just $486,600 in 2018, according to the Federal Reserve. That's for running a bank, arguably the keystone of the Federal Reserve System, with 2,462 full-time employees as of year-end.

Sorting the roles played at the New York Fed and its board can resemble an epic session of connect the dots. It's no stretch, however, to say that Hutchins, something of a super director first elected in 2011, is as comfortable in Washington's corridors of power as he is in those of Wall Street. He is co-chair of the board of the Brookings Institution, a director of the Obama Foundation, and a former senior adviser for healthcare and economic policy in the Clinton administration.

Hutchins is a prodigious philanthropist, much of it Washington-centric. His Hutchins Family Foundation bankrolled Brookings’ Hutchins Center on Fiscal and Monetary Policy in 2013 with $10 million. The center currently counts as distinguished fellows former Federal Reserve chairs Ben Bernanke and Janet Yellen. Bernanke also serves on the center’s advisory board, as do ex-New York Fed president Dudley and Hutchins himself.

A Brookings spokeswoman says Hutchins has no operational responsibilities at the center.

During the financial crisis, the New York Fed garnered political capital through its interventions as it crafted fixes to a broken financial system, elevating its influence in the process.

“Geithner and his progeny — Potter, Dzina — were very good at getting power from the Fed,” says one former New York Fed analyst. Williams’s selection seems designed, in part, to rebalance the scales.

“There are a lot of competing interests as to what they want the New York Fed to look like going forward,” the analyst adds.

Today, the New York Fed’s future is in play. The problem for outsiders is that they don’t really know the rules of the game.