THE WALL STREET JOURNAL.

Fed's Yellen Says Stance on Banks Hardened

Contender for Fed Chairman Says Crisis Made Her Rethink Views on Regulation

By: Damian Paletta – August 12, 2013

Janet Yellen, a top contender to lead the Federal Reserve, has evolved—in her own words—from a slightly "docile" regional bank regulator into a proponent of hard and clear rules designed to make banks less risky.

The change was prompted by her six years as president of the Federal Reserve Bank of San Francisco during a torrid period in financial history. As part of that job, which she held through 2010, Ms. Yellen oversaw scores of banks, some of which failed as the housing market collapsed.

An examination of her record suggests she pre-emptively warned colleagues about problems in the real-estate market but didn't take aggressive action to address them. While some bankers overseen by Ms. Yellen describe her as a determined regulator, critics note that she had a front-row seat for some of the turbulence that sent the economy into a tailspin and could have done more to prevent rampant real-estate speculation.

"The San Francisco Fed district, which includes Nevada and Arizona, was ground zero for the housing crisis," said Mark Calabria, director of financial regulation studies at the libertarian Cato Institute. If Ms. Yellen is nominated to be Fed chairman, "I think she at least has to answer that."

Janet Yellen is a well-respected economist and Fed veteran and has made good calls on inflation and financial dangers. But WSJ's David Wessel says she lacks strong political connections and some may see her as too dovish on monetary policy.

Ms. Yellen's views on monetary policy, a primary responsibility for any Fed chairman, are well known. She emphasizes the human and economic toll of high unemployment, and has been an architect of the policy under current Chairman Ben Bernanke of printing money to buy long-term bonds with the aim of reducing long-term interest rates.

But her views and track record on banking policy have received less scrutiny. That contrasts with Lawrence Summers, the former Clinton Treasury secretary and adviser to President Barack Obama who is another top Fed chairman candidate.

Mr. Summers long has called for simple regulatory rules for things like lending and risk, but the system remained a regulatory patchwork for years, with different agencies vying for power. Ms. Yellen said disagreements among regulators allowed financial companies to exploit gaps in oversight. She also has criticized the landmark financial bill Mr. Summers helped push into law in 1999 that ended the separation of commercial banks and securities firms, rules that had been in place since the Great Depression.

Ms. Yellen, 66 years old, who is now the Fed's vice chairman, declined to comment through a spokeswoman.

When the Brooklyn, N.Y., native joined the San Francisco Fed as its president in 2004, she sounded alarms with Washington colleagues about banks' heavy concentration in risky construction and home-development loans. Her warnings fell flat, she would later recall, as regulators from multiple agencies bickered about how to craft new rules.

When regulators finally wrote guidelines in December 2006, Ms. Yellen said they were late, diluted and toothless. "You could take this, rip it up, and throw it in the garbage can," Ms. Yellen told the Financial Crisis Inquiry Commission, set up by Congress to investigate the crisis, according to a recording of her 2010 interview.

Despite these warnings, her own agency's examiners had a mixed record. The parent company of Countrywide Financial Corp. was regulated by the San Francisco Fed until 2005, when the firm reorganized in a way that shifted oversight to the Office of Thrift Supervision, a move many saw as a ploy to seek a lighter regulatory touch. Countrywide, then a leading mortgage lender, buckled when the housing market tanked and was acquired under duress by Bank of America Corp. BAC +0.20% in 2008. Bank of America declined to comment.

"I am not going to say that we saw in that institution all the dangers that were lurking there," Ms. Yellen told the FCIC, the crisis-inquiry body. "Did we have a thorough appreciation of the flaws in the securitization process, and so forth, and the way they could affect the financial system as the whole? No. But we certainly saw we had the largest mortgage lender in the United States."

Steven Gardner, chief executive of Pacific Premier Bank in Irvine, Calif., called the San Francisco Fed "very upfront" under Ms. Yellen. His bank had a high concentration of commercial real-estate loans and was under constant scrutiny. "We knew if things went sideways that they would have been on top of us," he said. His bank emerged from the crisis on solid footing.

On other occasions, Ms. Yellen's examiners could have done more to intervene, the Fed's inspector general has reported. The San Francisco Fed discovered a number of "corporate governance weaknesses and other significant deficiencies" at Bank of Whitman in Colfax, Wash., in 2005 but failed to adequately intervene until 2009, the inspector general said in a March 2013 report. The 20-branch bank was closed by state regulators in August 2011, in part due to weak commercial real-estate loans.

The inspector general in a September 2010 report said examiners also missed warning signs at Barnes Banking Co. of Utah, which loaded up on commercial real-estate loans. The 10-branch bank failed in January 2010.

Eighty banks failed in the western U.S. from 2008 through 2010, though due to the fragmented regulatory structure less than half were overseen by the San Francisco Fed.

Few if any regulators emerged from the wreckage of the crisis with clean records. Ms. Yellen, an economist who previously served on the Fed's board in Washington and in the Clinton White House, didn't have an extensive background in bank regulation, but made it a focus in San Francisco. She didn't anticipate, she told the FCIC, that the bursting of the housing bubble that arose in 2005 and 2006 would lead to the havoc in the financial markets.

Ms. Yellen also said she was hesitant to push her examiners to crack down harder on banks, concerned that she lacked the authority. One reason for her hesitance, she told the FCIC in 2010, was the Gramm-Leach-Bliley Act, the bill supported by Mr. Summers that permitted securities firms and commercial banks to unite. She said Fed officials saw the law as giving them oversight of bank holding companies, not subsidiaries that didn't collect deposits.

Ms. Yellen told the FCIC she didn't see it as her place to challenge Fed supervisory policy, saying she was "a little more docile than some of my colleagues who feel, 'the heck with Washington, we know better.' "

"As worried as we were, we never simply went into banks and said, 'We insist you've got to have a higher capital requirement,' " she told the FCIC. "Did we have the power to do that? I think we felt we did not."

One large bank overseen by the San Francisco Fed, Wells Fargo & Co., originated risky mortgages through such a division that didn't accept deposits. Wells Fargo in 2011 paid an $85 million fine to the Fed in response to allegations that certain employees falsified documents and steered borrowers toward costly loans, but the bank didn't admit wrongdoing. Wells's CEO, John Stumpf, said at the time the alleged actions "are not what we stand for."

She said the financial crisis led her to believe that regulators had too much discretion and that the regulatory system needed to be tightened. She described herself as a proponent of tougher capital rules for banks, forcing them to build up reserves during boom years so they would have a larger cushion during downturns.

"This experience has strongly inclined me toward tougher standards and built-in rules that will kick into effect automatically when things like this happen that make tightening up a less discretionary matter," she told the FCIC. She said that would bypass the "kind of process that I think we have had where it takes six different regulators...to negotiate in what I gather is an excruciating process over many years to do something that in the end is probably too little, too late."