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If Reform Effort Fails, Shelby May Lose Chance to Clamp Down on Fed

By Stacy Kaper, *American Banker*
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WASHINGTON — Senate Banking Committee Chairman Chris Dodd is not the only lawmaker who stands to lose if a regulatory reform bill is not enacted this year.

His Republican partner, Sen. Richard Shelby, may lose an unprecedented opportunity to dismantle the regulator he blames most for the crisis — the Federal Reserve Board.

The Alabama Republican is intent on cutting the central bank down to size, arguing it failed to stop the financial crisis and should be stripped of its supervisory powers.

Initially a radical notion, the idea has gained substantial traction in the Senate — and observers agree Shelby has a unique chance to accomplish his goal.

"Because the Fed is in its weakest spot ever, there is an advantage for Shelby to strike now," said Mark Calabria, a former Shelby aide who is the director of financial regulation studies at the Cato Institute. "It's hard to imagine the Fed getting much weaker. One thing that is an advantage to him now is that Dodd, for different reasons, shares Shelby's Fed skepticism."

But negotiations between Shelby and Dodd broke down last week, and Dodd said Thursday he instead will now craft a bill with Tennessee Republican Sen. Bob Corker.

Until 2007, the Fed had massive clout on Capitol Hill, and lawmakers wanted chairmen like Ben Bernanke and Alan Greenspan to support their priorities. The financial crisis upended that situation, so much so that Bernanke's renomination received less support in the Senate than any previous Fed chairman.

Ernest Patrikis, a lawyer at White & Case LLP who spent 30 years at the Federal Reserve Bank of New York, said the agency's stature is at an all-time low.

"The Fed has never been bashed like this," he said. "In the worst inflation, the public was really bashing the Fed, but there was enough political support to sustain the Fed. … I don't think the Fed has a lot of friends on either side of the aisle."

Observers said the Senate is very likely to support provisions in the reg reform bill that would strip the central bank of power — but that door won't be open long. As the memory of the financial crisis fades, the political power of the Fed is likely to increase.

"If you have a goal of modifying the Fed's charter, taking away its regulatory power, changing the way the Fed governors are selected, there is no better time to pursue those objectives than when the Fed might be perceived to be politically weaker, and it's fair to say that this is such an opportunity," said former Sen. John Sununu, a New Hampshire Republican who served on the Banking Committee. "If someone wanted to take a wholesale run at the Fed, I think that this is about as good an opportunity as you are going to have."

Shelby has repeatedly made clear that's exactly what he wants to do.

Though Shelby listed myriad problems with Dodd's initial reform bill, he did support provisions that would diminish the role of the Fed. (The original bill would have removed the Fed from banking supervision, leaving only its monetary policy powers intact.)

"We agree that the Federal Reserve should have a limited range of responsibilities and that its main focus should be on conducting monetary policy," Shelby said in November.

At a Dec. 3 hearing on Bernanke's reappointment, Shelby expanded on his views.

"The last few years have provided us with ample evidence to conclude that the current regulatory structure that we have — one in which the Fed serves as the preeminent regulatory body — requires considerable restructuring," he said. The reg reform bill provides "a chance to develop a better, more accountable regulatory structure and enhance the real and perceived independence of the Federal Reserve as a monetary policy-setting entity. But to achieve these ends, I think the Fed would have to give up some of the regulatory authority."

Shelby said the Fed's steady rate cuts fueled the housing bubble, and he criticized its use of emergency stabilization measures, which vastly expanded the Fed's balance sheet.

"Some Fed actions were taken in concert with the Treasury — blurring the distinction between fiscal policy functions of the Congress and Treasury and the central bank's monetary policy and lender of last resort functions," he said. "The Fed's balance sheet has ballooned from a precrisis level of around $800 billion, to more than $2.2 trillion, through credit extensions and purchases of risky private assets, GSE debt and U.S. Treasury debt."

In an interview last week, Shelby said the Fed simply had not done its job.

"I've been greatly disturbed, and a lot of others have, about the role of the Fed as a regulator," he said. "The fact that they have not done their job and they had the tools to do it. And the question is what do we do in the future?"

If Shelby ultimately supports a bill, his desire to weaken the Fed may be why, analysts said.

"It's so tough to handicap and figure out Shelby's motivations," said Brian Gardner, an analyst with KBW Inc. "I do think he would like to rein in the Fed as he sees it, and it's probably an opportunity that may not come around again."

Observers said Shelby is weighing whether he stands to accomplish more of what he wants now or next year.

While Republicans are likely to gain seats in the midterm elections, the political climate for the Fed is also bound to improve as memories of the bailout recede.

"It is probably one of the key motivating factors for him to act now as opposed to acting in a year," said a former Senate aide. "It probably is his best chance to get what he wants on the Fed. Then he has to decide is it more important to get that than all that other stuff."

Among the other factors in play is consumer protection. Shelby has said he does not want most to strengthen protections to come at the expense of safety and soundness. He also wants any bill to prevent the government from bailing out the private sector at the expense of the taxpayer.

Still, this may be Shelby's best year to get the bill he wants. Dodd, who will retire at the end of this Congress, wants to restrict the Fed for his own reasons — he says the central bank's protection of the consumer was inadequate.

But Sen. Tim Johnson, Dodd's likely successor, may not agree.

"If they don't get financial reform done this year, then we start with Tim Johnson as Banking Committee chairman, and that's going to result in a very different bill," said Jaret Seiberg, an analyst with the Washington Research Group unit of Concept Capital.

"We don't really know how much he wants to consolidate regulators. ... One should not assume that Republicans have nothing to lose."