The Washington Post

Financial reform would shift Fed's authority away from regional banks

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Wednesday, March 17, 2010; A01

In the details of the financial reform legislation introduced this week are fundamental changes to the Federal Reserve that would shift power from the regional Fed banks around the country and concentrate it in Washington and New York.

By altering the traditional balance of power, the bill put forward by the Senate banking committee's chairman Christopher J. Dodd (D-Conn.) would recast the workings of the Federal Reserve System, a unique structure set up a century ago to distribute authority and ensure the central bank was not dominated by the nation's political and financial capitals.

That is why the Senate bill is provoking dismay among many officials at the regional Fed banks even as the Fed, on the surface, appears to be a big winner. The legislation allows the Fed to maintain its role in overseeing the country's largest banks while awarding it even more power to protect consumers and monitor the financial system for emerging risks. The central bank would also continue its most prominent job of managing the nation's monetary policy.

The Fed, however, would be stripped of its role in regulating all but the few dozen largest financial firms. The oversight of almost 6,000 small and midsize banks, one of the major tasks carried out at the 12 regional Fed banks, would be taken over by other federal agencies.

Regional Fed banks that do not have many large banks in their districts could see their staff and authority shrink, reducing these banks to something akin to regional economic think tanks rather than powerful overseers of the financial system.

"This is kind of the sum of all fears of regional bank presidents that this would happen," said Gerald P. O'Driscoll, a former vice president at the Dallas Fed who is a senior fellow at the Cato Institute. "If the regional banks lose their employment base and lose their contact with smaller banks, they're going to have less influence over monetary policy as well. Over time it will tend to centralize the influence of New York and Washington relative to the regional banks."

The Federal Reserve Bank of New York, already the largest and most powerful of the 12 reserve banks, could gain clout under Dodd's legislation, which the Senate banking committee is scheduled to debate next week. The New York Fed would continue overseeing many of the largest banks and could ultimately come to regulate some other major financial firms, such as insurance companies and hedge funds.

Presidential appointee

The top official of the New York Fed would also become appointed by the president. That official is now selected by the board of directors of the New York Fed, which includes bankers and others selected by banks, with approval from the Fed Board of Governors in Washington. The other regional Fed banks follow the same process.

Dodd's rationale for making the New York Fed chief a presidential appointee is that the head of the New York Fed has a remarkable amount of power by virtue of supervising the largest banks and holding a permanent seat as vice chairman of the Fed's committee to set interest rate policy. By contrast, the heads of the other regional Fed banks rotate onto the committee about every three years.

Fed leaders inside and outside Washington chafe at turning the New York Fed position into a presidential appointment, worrying this could make the job too political. And the change could accentuate tensions that routinely exist among the New York Fed, which monitors Wall Street and carries out the nation's monetary policy by buying and selling securities, and others in the Fed system that are more focused on their community banks and local economies.

The New York Fed "already has a special role, and it would become more special," said Susan M. Phillips, dean of the George Washington University School of Business and a former Fed governor.

No Fed officials have spoken publicly about the specifics of Dodd legislation. But Chairman Ben S. Bernanke is scheduled to testify Wednesday before the House Financial Services Committee on bank supervision.

Regional chiefs rally

The regional Fed chiefs, known as presidents, and their allies have made their case on Capitol Hill privately in recent weeks, urging lawmakers to keep bank supervision for all 5,000 bank holding companies and 850 state-chartered banks at the Fed -- not just the 35 or so largest ones.

Bernanke and others have long argued that the relationships born of supervision help inform Fed policy more broadly -- by giving policymakers insights into economic conditions facing small businesses around the country. The Fed's ties with thousands of community banks around the country also give it a reserve of political backing when confronted with hostility in Washington.

"They need or think they need protection from the populists in Congress," said Allan Meltzer, a Carnegie Mellon University economist and leading historian of the Fed. "The Fed wants to be able to regulate the banks, so that the banks will support them politically when they need support."

For example, earlier this month, the Independent Community Bankers of America sent a letter to Dodd and Sen. Richard C. Shelby (R-Ala.), the ranking Republican on the Senate banking committee, urging them in part to keep the Fed as the regulator of small banks. But the letter also delved into matters beyond the daily affairs of community banks -- but of grave concern to Fed leaders -- by encouraging the senators to refrain from any steps that could undermine the central bank's ability to independently manage monetary policy.

Besides the steps that would shift power away from the regional Fed banks, other aspects of Dodd's bill are viewed with considerable skepticism at the central bank.

In a compromise between Dodd and Sen. Bob Corker (R-Tenn.), the plan would create a new, more powerful regulator of mortgages, credit cards and other financial products and place it inside the Fed. But the proposal does not allow the Fed chairman or its top leadership to direct the regulator. That restriction is meant to ensure that the consumer regulator is independent. But Fed leaders worry that they could be blamed for any mistakes the agency makes yet lack the authority to control it.

The Obama administration also has some qualms about the Fed's proposed role. Administration officials pressed Dodd to include more banks under the Fed's supervision. Ultimately, Dodd decided that banks with more than $50 billion in assets, rather than his initial proposal of $100 billion, would be placed under the central bank. Still, senior administration officials wanted the bill to give the Fed even more authority.

The fate of Dodd's legislation is unclear as it has yet to win public support from any Republicans and even some centrist Democrats have been noncommittal. The House has passed a separate bill to overhaul financial regulation that would have less dramatic impact on the balance of power in the Fed system.

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