Chairman Bernanke Should Review the Roster of the Fed’s Non-Monetary Policy Activities: Are They a Distraction or Useful for the Conduct of Monetary Policy?

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On taking office a new corporate CEO often examines affiliates of the firm acquired under former CEOs and recommends divestment of some that do not contribute to the bottom line. Chairman Bernanke should follow this course. Over the years the Fed has accumulated responsibilities in areas that seem questionable when judged by their relation to its main, prime responsibility, price stability. Some of these activities were assigned to the Fed by Congress and willingly assumed. Others have been sought by former chairmen, who seemed bent on enlarging Fed powers. Still others were obtained by Fed initiatives.

Examples of some non-monetary policy activities of the Fed are the following:

1. Control over margin requirements on loans for purchase of stocks was given to the Federal Reserve Board by the Securities and Exchange Act of 1934. The Fed was urged to raise margin requirements during the 1990s stock market boom but did not do so. Is regulation of securities markets an appropriate Fed responsibility?

2. Banking supervision and regulation for bank holding companies, banks that are members of the Federal Reserve system, and U.S. branches and agencies of foreign banks. Supervision carries with it the expectation that the Fed will rescue one of those institutions that gets into trouble. The Fed has even been involved in the rescue of a hedge fund that it did not supervise. Will Chairman Bernanke support such expectations for Fed rescue missions? The Fed should not be responsible for the performance of individual financial institutions. Its mission is to assure provision of liquidity to the market.

On the more basic subject of why the Fed or any other agency should be a bank regulator, Chairman Bernanke would do well to read a comprehensive survey of the reasons that have been advanced to justify regulation and the demonstration that these
reasons are no longer valid. Banks are not inherently unstable. In U.S. history, it was regulation prohibiting branching that made bank portfolios undiversified, the underlying cause of instability. So why regulate stable, diversified banks? One reason was that government insurance of deposits exposed the government and taxpayers to the risk of bailing out depositors if insured banks or S&Ls failed. But that reason disappeared when FDICIA was enacted in 1991. It required FDIC to increase premiums whenever the amount in the Bank Insurance Fund or the Savings Insurance Fund falls below 1.25 percent of total insured deposits. The FDIC can tax all insured institutions whenever it needs funds to pay off depositors of a failing bank or S&L. Therefore the capital of insured depository institutions has become the primary guarantor of the deposit insurance system. The government and taxpayers are no longer at risk for insuring deposits.

3. The Board is authorized by statute to serve as the primary regulator of the payments system.

Of the different payment systems the Fed operates, clearing of checks through delivery to paying banks; fully automated clearing-house system for electronic payments among banks; credit and debit card payments; Fed wire, a large value funds transfer system, only Fed wire imposes a liability on the Fed. The Fed makes a payment to a recipient bank at the request of a payor bank, without knowing whether the payor bank will cover the advance when final settlement occurs at the end of the day. If the payor cannot fully repay the Fed, it cannot be recovered from the payee and the Fed has a loss.

The Fed limits its risks in Fed wire by imposing net debit caps on the amount any bank can be indebted to the Fed for overdrafts. There are also overdraft fees that reduce the incentive for overdrafting.
But in fact the Fed and the government need not assume risks for safe and efficient operation of the payment system. CHIPS, the Clearing-House Interbank Payments System operated by the New York Clearing House Association, and Canadian Payments Association System demonstrate that it is possible to achieve payment finality without government exposure to loss. The Fed would no longer be exposed to potential losses on daylight overdrafts and no policy reason for regulating banks would exist. What stance will the Chairman adopt on this matter?

At present, the Fed is supposed to make the payment system more efficient, but at times it appears to act in order to improve bank profitability by extending the period for which checks and other deposits are held before bank customers have access to them. Will the Chairman acquiesce to this Fed practice?

4. The Truth in Lending Act of 1968 gave the Fed the responsibility to regulate consumer finances. Is this function appropriate for the Fed? The Fed established a Consumer Affairs Advisory Council to help it write the rules guiding the consumer finance industry. The Fed has tolerated late payment fees and other fees consumer borrowers are required to pay. There are allegations of predatory mortgage lending through subsidiaries of major bank holding companies. Banks are profiting from high interest rates and high fees on consumer loans. The Consumer Affairs Advisory Council might suggest to Congress that the Fed be relieved of its role as regulator of consumer finance and that it assign the role to the Comptroller of the Currency or the Federal Trade Commission as better fits to the supervision of the consumer finance industry. Necessary monetary policy actions, when tighter credit is required, can affect consumer finance adversely, which is a specific reason for giving supervision of consumer finance to an agency other than the Fed.
5. In 1962 the Fed at the urging of the Treasury agreed to intervene in the foreign exchange market as a partner of the Treasury, despite the fact that the Federal Reserve Act gave it no explicit authorization for intervention. Intervention involves purchase or sale of foreign currencies with identical effects on the monetary base that open market operations in Treasury securities have. To offset this effect intervention is offset by equivalent sales or purchases of Treasury securities. In recent years central banks in the West have displayed diminishing interest in intervening. This should be a stimulus for the Chairman to reopen the debate at the FOMC about the value of intervention under present circumstances.

At his confirmation hearings, Chairman Bernanke was not questioned about his views on the directions he would like the Fed to move with respect to its responsibilities for non-monetary policy activities.

At the start of his leadership of the system, it is timely for him to examine the scope of its activities that are unrelated to its central institutional objective. He will leave his mark on the Fed by the conclusions he reaches on this matter, whether to stand pat or to acknowledge that some changes would be salutary.

Reference