Statement for the United States House of Representatives, Committee on Financial Services, Subcommittee on Oversight and Investigations

Fed Oversight: Lack of Transparency and Accountability

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July 14, 2015

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Chairman Duffy, Ranking Member Green, and distinguished members of the Subcommittee, thank you for holding today's hearing and for inviting me to testify.

I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking, regulation, and financial stability. I have included my full resume as an appendix to my testimony, but to summarize my background, I have extensive experience working on banking and financial market policies at the Federal Reserve Board, the International Monetary Fund, the FDIC, and the Bank for International Settlements. It is an honor for me to be able to testify before the subcommittee today.

I will begin by summarizing the main points of my testimony:

- The Federal Reserve (Fed) was created by Congress. Congress retains Fed oversight responsibility and the duty to amend the Federal Reserve Act and related legislation when such amendments are in the national interest. To exercise this duty, the Congress must have the right to assess the Fed's performance and it must have the legal authority to acquire the information that is needed to make such an assessment.

- Numerous court decisions support Congress's investigative authorities. Even in a Supreme Court decision that placed some limits on its investigative powers [*Watkins v United States* 354 U.S. 178], Chief Justice Warren's opinion recognized wide-ranging Congressional investigative powers,
    - "The power of the Congress to conduct investigations is inherent in the legislative process. That power is broad. It encompasses inquiries concerning the administration of existing laws as well as proposed or possibly needed statutes. It includes surveys of defects in our social, economic or political system for the purpose of enabling the Congress to remedy them. It comprehends probes into departments of the Federal Government to expose corruption, inefficiency or waste."

- The Fed's powers and methods of monetary policy operation have undergone dramatic changes since the financial crisis. Congress would be negligent in its duties if it did not strengthen its oversight of the Fed's monetary policy operations and require the Fed to provide evidence that supports the efficacy and economic benefits of its new operating policies. Significant changes in Fed monetary policy operations that merit deeper Congressional investigation include:
    - The FOMC's redefinition of the Fed's "price stability mandate" to mean an annual expected core inflation rate of 2 percent;[1]

[1] See, Narayana Kocherlakota, "Clarifying the Meaning of Price Stability," https://www.minneapolisfed.org/authors/narayana-kocherlakota

- o The practice of continuously re-defining the Fed's target rate of unemployment that is consistent with "maximum employment" and price stability;
  - o Evidence that a continuation of its zero-interest rate policy promotes economic growth without creating conditions that lead to serious financial instabilities; and,
  - o Credible assurances that the Fed's dual mandate of price stability and maximum employment will not be sacrificed to international pressures to offset financial market panics in Europe, Asia, or elsewhere.

- Should Congress decide to use the Government Accountability Office (GAO) to help it assess the Fed's monetary policy performance, it must pass new legislation. To the best of my knowledge, at present, there are no legal barriers that prevent Congress from assessing Fed monetary policy without the use of the GAO.[2]

- Many regulatory initiatives related to the Fed's Dodd-Frank expanded powers merit closer Congressional oversight including:
  - o The Fed' ongoing interactions with international standard-setting bodies including the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision;
  - o The implementation of the Fed's [Board of Governors] stress tests mandated by Section 165 of the Dodd-Frank Act; and,
  - o Conflicts that may be developing between the Fed's expanded powers over the domestic insurance industry and state insurance regulations.

- The Fed is the most opaque of the "independent" Federal financial regulatory agencies. It sets its own accounting standards that are inconsistent with generally accepted accounting practices for financial institutions and it routinely acts as if its independence on monetary policy matters shields it from disclosing information on its operations including staff salaries, benefits, hiring practices and Congressional inquiries regarding internal investigations.[3] Congress must mandate greater transparency.

New Federal Reserve Powers & Behavior Create Demands to "Audit the Fed"

The Fed was created by Congress in 1913 with limited responsibilities. These included: the establishment of regional Federal Reserve banks; the provision of an elastic currency; the rediscounting of commercial paper; and, the supervision of Federal Reserve member banks. Over the years Congress amended the Federal Reserve Act to liberalize constraints on Fed operations, establish a Federal Reserve Open Market Committee, change the Fed's governance structure, require periodic reports by the Fed Chairman to Congress, and assign the Fed specific monetary policy goals.

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[2] The Federal Banking Agency Audit Act of 1978 explicitly restricts the GAO from evaluating Fed activities related to the Fed's monetary policy functions. No new legislation is required for GAO assessments of other Fed activities and process including the expanded regulatory powers granted to the Fed and the Board of Governors by the Dodd-Frank Act.

[3] See Da Costa, "Yellen: Fed Was Advised Against Fully Complying With Subpoena on Leak Probe," *Wall Street Journal*, June 5, 2015.

For most of its history, the Fed's battle for independence has been a struggle to formulate monetary policy without interference from the executive branch. Before the Fed won its independence from the U.S. Treasury in the early 1950s, many administrations had run the Fed as if it were a subsidiary of the U.S. Treasury.

Today the battle for Fed independence is a struggle to maintain minimal Congressional oversight over its monetary policy and regulatory activities, and a fight to maintain the legal luxury to carefully manage the Fed's operational transparency. The current struggle is probably less about safeguarding monetary policy from being high-jacked by parochial Congressional interests, but more about safeguarding unique Federal Reserve privacy privileges derived from its monetary policy functions.

Critics of "audit the Fed" proposals argue that the modern Federal Reserve is already transparent regarding its monetary policy deliberations and operations. True, the Fed now releases minutes and transcripts from its FOMC meetings with delay, and it has websites that document the details of its balance sheet and securities holdings. The Dodd-Frank Act pushed the Fed to disclose details about borrowers using the Feds emergency credit facilities[4] and, beginning in in 2012, the Fed was required to release detailed data on discount window borrowing[5] and open market transactions[6] with a two-year lag.

While the Fed has become more transparent in in recent years, the changes have occurred only after extreme legal and public pressure. There has been no sea-change in the Fed's willingness to disclose information that is in the interest of the Congress and the general public if this information might also be damaging to the Federal Reserve's reputation. For example, the Fed's recent decision to ignore a Congressional subpoena from this very Subcommittee for information pertaining to the Fed's internal investigations into a 2012 leak of confidential FOMC information is a clear and appalling example of the Fed's continued belief that its "independence" will ultimately shield it from Congressional oversight.

Moreover, disclosure is not the same thing as oversight. Oversight involves independent evaluation of process and performance,[7] and Congress—by virtue of its power to create the Fed and alter the laws that govern the Fed's operations—has the responsibility for Fed oversight.

In carrying out its many oversight functions, Congress often requests that the GAO undertake an independent assessment and report to Congress. The Federal Banking Agency Audit Act of 1978 gives the GAO audit authority over the Federal Reserve, but it prohibits the GAO from auditing the Fed regarding:[8]

- Transactions with or for foreign central banks, governments, or non-private international financing organizations;
- Deliberations or actions concerning monetary policy;

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[4] http://www.federalreserve.gov/newsevents/reform_transaction.htm
[5] http://www.federalreserve.gov/newsevents/reform_discount_window.htm
[6] http://www.newyorkfed.org/markets/OMO_transaction_data.html
[7] For further discussion, see Marc Labonte, "Federal Reserve: Oversight and Disclosure," Congressional Research Service, September 19, 2014.
[8] 31 U.S. Code Sec. 714. The GAO normally has a number of separate Federal Reserve audits underway in any single year. The Federal Reserve System also has an Office of Inspector General (OIG) that is responsible for detecting and preventing fraud, waste and abuse. The Fed's OIG also issues semiannual reports to Congress.

- Federal Open Market Committee transactions; and,
- Discussions and communications between Federal Reserve members, officers or employees associated with the prior three areas.

Given the uncertainties associated with the long-run economic impacts of the Fed's post-crisis monetary policy, it is not surprising that many seek expanded Congressional oversight over the Fed's monetary policy process. For example, among other legislative features, S.264 (the Federal Reserve Transparency Act of 2015) would remove all restrictions on the GAO's ability to audit the Federal Reserve. An alternative proposal, H.R. 5018 (the Federal Reserve Accountability and Transparency Act of 2014) would remove all GAO audit restrictions and also require the Fed to provide the Congress with detailed information regarding its monetary policy decision rule.

While S.264 and H.R. 5018 would improve Congress's ability to evaluate the Fed's monetary policy operations using the GAO, I do **not** favor open-ended Congressional remits asking the GAO to assess Fed monetary policy. Unless GAO studies are carefully targeted, they rarely produce definitive conclusions.

If the Congress decides to use the GAO, it should employ the agency in a targeted way using very prescriptive terms of reference that are designed to provide appropriate Congressional committees specific information that will allow Congress to assess the Fed's monetary policy performance.

Congress, for example, could ask the GAO to provide an independent assessment of the historical accuracy of the Fed's policy forecasts used by the FOMC. Did the economy respond to the Fed's policy in the way the FOMC anticipated? Or the Congress might ask the GAO to construct a mark-to-market balance sheet for the Fed so Congress can assesses the true consequences of the Fed's "Quantitative Easing" policy actions. This will be especially important once long-term interest rates rise and the Fed experiences unrecognized mark-to-market losses on its huge long-term bond portfolio.

The modern Fed does far more than monetary policy, and the Fed's non-monetary policy duties also raise important accountability concerns. The Dodd-Frank Act (the Act) grants the Fed extensive new powers to formulate supervision, regulation, and bankruptcy reorganization standards for large financial institutions, and yet the Act itself includes no explicit congressional control over these expanded Fed powers. Indeed recent speeches by Fed officials argue that the new Fed "macroprudential powers" are an essential complement to monetary policy, especially in the current zero interest rate environment.

Using its expanded regulatory powers, the Fed has the ability to shape the growth and development of the entire U.S. financial system. Unless the Congress exercises heightened oversight and control over the Fed's use of these expanded regulatory powers, Congress will delegate decisions that determine the future vitality of U.S. financial markets to unelected Fed officials who are at best only weakly accountable to the public.[9]

[9] The Federal Reserve chairman and vice-chairman face Senate confirmation every 4 years. Federal Reserve governors are confirmed by the Senate, but limited to a 14-year term unless they are initially filling a partial term of departing governor. Regional Federal Reserve bank presidents are not confirmed by the Senate.

In subsequent sections, I focus on the need for expanded congressional oversight over the Fed's Dodd-Frank regulatory powers and related operations. Current legal authorities appear adequate and do not appear to restrict Congress ability to audit the Fed's regulatory activities (including use of the GAO).[10]

No Oversight of the Fed's Relationship with International Standard Setting Bodies

A recent GAO report[11] examined the relationship between Financial Stability Oversight Council (FSOC) designations of nonbank financial firms for enhanced supervision and regulation by the Federal Reserve Board (FRB) and prior designations of the same firms (as global systemically important institutions) by the Financial Stability Board (FSB). Since the Treasury and FRB are both members of the FSB designation group, this coincidence raised concern that the FSOC designation decisions were actually made during FSB deliberations, well before the FSOC completed its designation analysis.

The GAO reported that Treasury and FRB officials it interviewed argued that FSB designations imposed no constraint on the FSOC's subsequent designations, but were just "another factor" taken into account in the FSOC deliberations. The GAO report also includes commentary and footnotes that suggest that GAO investigators had a difficult time believing these claims. The GAO noted that FSB documents report that national authorities are fully consulted before the FSB publically designates individual institutions.

A recent letter to G20 Ministers and Central Bank Governors dated February 4, 2015[12] is especially informative on this issue. In this letter, FSB chairman (and governor of the Bank of England) Carney, makes clear to FSB members that the decisions of the FSB are *directives*, which all FSB members are expected to carry out. In this letter, chairman Carney states specifically that FSB members—including the FRB– have agreed to "Full, consistent and prompt implementation of agreed reforms."

FSB chairman Carney's letter notes that "FSB peer reviews" will cover "implementation of the G20 policy framework." Chairman Carney reinforces the point mentioning that the FSB's will use its oversight as a means for achieving its objectives: "The FSB will support the determined efforts of its members through enhanced monitoring of implementation and its effects across all jurisdictions. We will regularly report our key findings to the G20."

The only reasonable interpretation of chairman Carney's letter is that the FRB agreed that US financial regulatory policies and institution designations will be guided by FSB directives. Moreover, the FRB has agreed that its policy implementation can be overseen by a body

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[10] If however, there are legal impediments for GAO audits of which I am unaware, simple amendments to the Dodd-Frank Act, like extending Section 122 powers to other sections of the Act, could explicitly provide the needed powers.

[11] Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, "Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process," GAO, November 2014.

[12] http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf

dominated by European bureaucrats and chaired by the governor of the Bank of England.[13] While the US Treasury was clearly aware of these developments by virtue of their own FSB membership and participation, it does not appear that the US Congress received prior consultation before the FRB and the Treasury made these commitments.

Recent experience raises legitimate concerns that the FRB and the Treasury have been deciding on FSOC designations well before the FSOC finalizes its analysis. Given the unbalanced nature of FSOC member resources, pressure from the Treasury and the FRB on other FSOC members would likely be more than adequate to ensure a specific institution's designation. The November 14 GAO report documents that FRB has by far the largest staff allocated to the FSOC designations process and it is unlikely that few if any of the other FSOC members without a direct regulatory interest would challenge the FRB staff on its designation conclusions.[14] Indeed Federal Reserve influence on FSOC designations goes beyond the FRB as there are reports that Federal Reserve Bank of New York staff has also been heavily involved and influential in the FSOC designation process.[15]

The recent FSOC decision regarding MetLife's designation for heightened prudential standards and supervision by the FRB highlights the overwhelming influence that the FRB and Treasury can have on the FSOC designation process, especially when the FSOC's members have no direct interest in the non-bank industry under consideration. Dissenting from the FSOC's MetLife designation was the council's independent member having insurance expertise and the Council's state insurance commissioner representative.[16] Moreover, the state insurance commissioners from five states—California, Connecticut, Delaware, New York and North Carolina– independently wrote to FSOC Chairman Lew to protest the MetLife designation.

The MetLife dissent opinion written by the FSOC's independent member with insurance expertise was particularly informative about the relationship between FSB designation and subsequent FSOC decisions. It is worth quoting at length:

> On July 18, 2013, the Financial Stability Board (FSB), an international organization within the umbrella of the Group of Twenty (G-20), primarily comprising the world's finance ministers and central bankers, including the U.S. Department of the Treasury (Treasury) and the Board of Governors, announced that it had identified MetLife as a global systemically important financial institution (G-SIFI). G-SIFIs are declared by the FSB to be "institutions of such size, market importance, and global interconnectedness

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[13] If the Fed can agree to let European bureaucrats have oversight over the implementation of its regulatory policies, it is outrageous for the Fed to argue that its monetary policy implementation should be protected against additional Congressional scrutiny.

[14] No other agency has a staff as large, technically sophisticated, or as academically credentialed as the Federal Reserve. For example, the FRB has more than 350 economists on its home webpage, http://www.federalreserve.gov/econresdata/theeconomists.htm and virtually all of them have PhDs. This does not include Federal Reserve economists at the Reserve Banks. For example, the New York Fed alone lists 71 PhD economists on its website. In contrast, on their respective websites, the CFTC lists 10 economists, the FDIC lists 19 economists, FHFA lists 15 PhD equivalent economists, and the newly "economist fortified" SEC lists roughly 70 economists.

[15] See the letter dated July 9, 2014, from Representative Garrett to William Dudley expressing concerns and additional information about the New Your Fed's extensive involvement on the FSOC designation process.

[16] http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf

> that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." Thus, MetLife was declared by the FSB as a threat not to just the U.S. financial system, but to the entire global financial system.
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> The FSB's announcement of the identification of MetLife and eight other insurers as G-SIFIs stated that its action had been taken "in collaboration with the standard-setters and national authorities;" and, that as G-SIFIs, these organizations would be subject to policy measures including immediate enhanced group-wide supervision, as well as to recovery and resolution planning requirements. It is clear to me that the consent and agreement by some of the Council's members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S -- ahead of the Council's own decision by all of its members.
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> Despite subsequent assertions by some of the Council's members that the FSB and Council processes are separate and distinct, they are in my mind very much interconnected and not dissimilar. It would seem to follow that FSB members who consent to the FSB's identification of G-SIFIs also commit to impose consolidated supervision, yet-to-be agreed-to capital standards, resolution planning, and other heightened prudential measures on those G-SIFIs that are domiciled in their jurisdictions.

These pointed remarks from FSOC members make it apparent that that the Congress must exercise closer oversight over the Fed's participation in FSB work streams. For example, H.R. 5018 would require the Fed to notify congressional committees with jurisdiction and the general public 90 days prior to its intention to enter into or complete negotiations with international committees or standard setting bodies.

Regardless of the method the Congress selects, it needs to improve oversight of the Fed's involvement in FSB initiatives, especially those regarding the capital regulation of insurance firms including any work streams on capital surcharges for insurance firms designated as global systemically important institutions as well as Fed involvement in FSB work streams focused on the designation of systemically important non-bank non-insurance (aka shadow bank) institutions and the enhanced regulation of "shadow banking" activities.[17]

When Fed officials refer to shadow banking, they are referring to activities that primarily associated with the asset management industry. In January 2014, the FSB issued a consultative document discussing a designation process for non-bank non-insurer systemically important firms.[18] Firms fitting the FSB's consultative document profile are large asset management institutions. In November 2014, the FSB committed to issue policy recommendations that will establish regulatory minimum "haircuts" for securities financing transactions (securities lending and repurchase agreements) among shadow banks. Mirroring these developments, senior Fed officials used recent speeches to telegraph the Fed's intention to impose market-wide minimum haircuts on securities lending and repurchase transactions. Fed officials have also identified high-

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[17] http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

[18] http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf?page_moved=1

yield short-maturity by mutual fund investments as a shadow banking activity that should be discouraged as a potential source systemic risk.

The FSB is also in the process of recommending changes in insurance regulation. In October 2013, the FSB directed the International Association of Insurance Supervisors to develop a comprehensive supervisory and regulatory framework, including a risk-based global insurance capital standard for internationally active insurers as well as basic capital requirements and higher loss absorbency requirements for global systemically important insurance institutions. The FRB is an important member of this FSB insurance work stream and many observers believe that the Fed will eventually try to impose the FSB's insurance regulatory capital standards on state-regulated domestic U.S. insurers. The potential conflict with FSB insurance capital initiatives and U.S. insurance company capital requirements will be discussed in a subsequent section of my testimony.

If recent history is a guide, the policies the Fed develops in these and any other FSB work streams will form the basis of the policies the Fed subsequently attempts to impose as domestic regulations. It is important for Congress to step up its oversight of the Fed's involvement in FSB activities so it can make a timely evaluation of regulatory developments. Once FSB work streams conclude, it becomes more difficult for Congress to intervene and alter US financial regulatory policies.

Who Assesses the Assessor? Congress Must Revisit Section 165 FRB Stress Tests

Section 165 of the Dodd-Frank Act directs the FRB to establish heighted prudential standards that apply to bank holding companies with consolidated assets in excess of $50 billion and non-bank financial firms designated by the FSOC. Included in Section 165 is the requirement that these institutions participate in an annual stress test exercise supervised by the FRB which is required to publish the results of these annual stress tests. In addition, financial institutions with $10 billion in consolidated assets and a primary Federal regulator must conduct annual stress tests similar to the FRB stress test and report the results to their primary Federal regulator.

Congress should consider an extensive audit of the Dodd-Frank mandate for recurring FRB stress tests. The audit should include an independent assessment of the FRB's stress test models and methodology including an assessment of the predictive accuracy (i.e. stress test model prediction confidence bounds) of the Fed's methodology. Assessments should evaluate the consistency with which the FRB applies its quantitative and qualitative stress test assessments both across institutions within a year and the Fed's consistency across time. Independent assessors should identify weaknesses in the methodology and evaluate the FRB's internal approach for identifying and managing stress test methodology weaknesses. The examination should include the remediation process that occurs when a bank disputes the Fed's findings. Assessors should have confidential discussions with the financial institutions that have participated in these stress test exercises and report on these institution's concerns with the Fed's processes. The audit should evaluate the costs and benefits of using this methodology as a primary input in supervision and regulation of individual institutions.

Better yet, Congress should just repeal the Dodd-Frank requirement for annual Section 165 FRB stress test.

The FRB stress tests mandated by Dodd-Frank Act are expensive both for the banks and bank regulatory agencies and these resources could be deployed in other productive activities. These stress tests have dubious predictive power for identifying hidden financial system imbalances or for identifying risks in specific financial institutions that would otherwise remain undetected. The quantitative outcome of these stress tests is arbitrary and completely under the control of the FRB because the stress tests estimates involve an overwhelming amount of judgment on the part of the stress tester. Consequently stress test results cannot be replicated by different independent stress testers. Since banks cannot accurately anticipate the FRB stress test results even when they know the macroeconomic stress scenarios, this mandatory process interjects a costly and unproductive source of uncertainty in the bank planning process.

FRB stress tests are a particularly problematic form of enhanced prudential supervision because there is no objectively correct answer in a FRB stress test. Participants are required to produce specific numerical answers to hypothetical questions that have no single correct answer with full knowledge that the FRB has wide discretion to decide the "correct answer" at will by changing modeling assumptions. Moreover, institutions have no mechanism to challenge the FRB on the accuracy of Board's preferred correct answer.[19]

Many have questioned the value of macroeconomic scenario stress tests for identifying and mitigating financial sector excesses[20]and yet the Fed spends an enormous amount of resources and requires covered institutions to spend significant sums on the activity. Already, Fed stress tests have missed the "London Whale" at JPM Chase and a multibillion dollar hole in Bank of America's balance sheet. Fannie Mae and Freddie Mac both passed government-designed macroeconomic stress right up to the time they failed in September 2008. Before the financial crisis, many countries produced financial stability reports that included bank stress tests and none anticipated the crisis. And there are many additional examples where similar tests failed to identify subsequent problems.

A stress-test based approach for setting bank capital has two gigantic measurement problems. First, the macroeconomic scenario must actually anticipate the next financial crisis. And secondly, regulators must be able to translate the macroeconomic crisis scenario into accurate predictions about actual bank profits and losses.

Few regulators possess the prescience necessary to accomplish this first step. Indeed, after decades of trying, the Fed has yet to develop models that can accurately forecast aggregate

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[19] See Kevin Dowd's discussion in, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve," CATO Policy Analysis No. 754, September 3, 2014.

[20] For some examples, see: C. Borio, M. Drehmann, and K. Tsatsaronis, "Stress-testing macro stress testing: Does it live up to expectations?" Bank for International Settlements, November 2011; or, Til Schuermann, "The Fed's Stress Tests Add Risk to the Financial System," *Wall Street Journal*, March 19, 2013; or, L. Guerrieri and M.. Welch, "Can Macro Variables Used in Stress Testing Forecast the Performance of Banks?" Federal Reserve Board Finance and Economics Discussion Series 2012-49.

economic activity in the near term—the Fed's main job.[21] Why then would anyone expect the Fed to accurately anticipate the next financial crisis?

Even if a stress scenario correctly anticipates a coming crisis, the crisis must be translated into individual bank profits and losses. However, bank profits and losses are not very tightly linked with changes in macroeconomic indicators. Quarter-to-quarter bank profits do not closely follow quarterly changes in GDP, inflation, unemployment, or any other macroeconomic indication. The best macroeconomic stress test models explain maybe 25 percent of the quarterly variation in individual bank profits and losses, meaning that more than 75 percent of the variation in bank profit and losses cannot be predicted using econometric models and projections of GDP, unemployment, or other business cycle indicators.

Because of these measurement issues, bank loss predictions from macroeconomic stress tests have very little objective accuracy. Even the best model estimates have wide range of prediction error uncertainty surrounding forecasts of how each bank may actually perform in the next crisis, presuming the stress scenario anticipates the crisis.

These issues make macroeconomic stress testing more of an art than a science and a tool that is inappropriate for the supervision on an individual institution. There are just too many places to make mistakes. There is no formula or procedure that will lead to a single set of stress test bank loss estimates that can be independently calculated by different stress test modelers. Thus, it is not surprising that the Board of Governors and the US banks rarely agree on stress test results.

Less widely appreciated is that these coordinated macroeconomic stress tests encourage a "group think" approach to risk management that may actually increase the probability of a financial crisis.[22] Stress test crisis scenarios have to be specific so that banks and regulators can model the same event. Moreover, the FRB imposes some uniformity in loss rates across all designated banks by using its own stress test estimates. Perhaps unintentionally, by requiring all firms to approach the stress test problem in the same way as the FRB, the process encourages all large institutions to think and operate the same way.

A final weakness concern is that the stress test process requires the FRB to be intimately involved in modeling the operations and exposures of each large banking institution. The process requires the FRB to use its own judgment to set each large bank holding company's "stress tested" capital plan. These regulations have become so intrusive that the regulator virtually runs the bank. In such a situation, it becomes difficult for the regulator to admit a mistake and allow an institution to fail.

Congress Should Step in Before the Fed Becomes the National Insurance Regulator

The new regulatory powers granted by the Dodd-Frank Act to the Fed could lead to substantial changes in insurance regulation. Since the McCarran-Ferguson Act of 1945, insurance regulation has been conducted by the states and their insurance commissions. The Dodd-Frank Act created

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[21] For example, see Lansing and Pyle (2015), "Persistent Over optimism About Economic Growth," *FRBSF Economic Letter* (Feb 2).

[22] Til Schuermann, op. cit. makes this argument.

a new Federal Insurance Office within the US Treasury, but the Act purposely limited the new office's responsibilities to monitoring and advisory duties; it does not have national supervisory responsibility.

Notwithstanding the fact that the Dodd-Frank Act intentionally avoided the creation of a national insurance regulator, many in the insurance industry believe that the Fed is using its new Dodd-Frank powers to become the *de facto* national insurance supervisor. These developments could lead to wholesale revisions in the supervision and capital regulations that apply to state insurers and result in the imposition of bank-style capital regulation on the insurance industry.

Section 312 of the Dodd-Frank Act transferred regulatory authority and rulemaking over thrift holding companies and insurance holding companies that owned depository institutions from the Office of Thrift Supervision to the Fed. Section 604 of the Act authorizes the Fed to conduct examinations of the non-bank subsidiaries and affiliates of these holding companies even if these institutions have a functional regulator.

Section 312 empowers the Fed to examine insurance companies whereas, prior to the Dodd-Frank Act, bank regulators were prohibited from examining these state-regulated entities. Since acquiring its new powers, the Fed has launched an extensive examinations program for insurance companies owned by thrift and insurance holding companies. These examination often are conducted using newly hired Fed examiners with little or no insurance experience, even though these insurers being examined are already fully regulated and supervised by state insurance commissioners.[23, 24]

These Fed insurance examinations are causing considerable concern for insurers. Industry sources suggest that the Fed examiners are less than fully conversant with state insurance regulations and they frequently find that insurer subsidiaries or affiliates are undercapitalized if their capital levels do not agree with bank capital standards, even when these insurers are well-capitalized according to long-standing state insurance regulations. Representatives of the insurance industry are worried that, unless Congress intervenes, these Fed insurance examinations and associated holding company regulatory capital restrictions will eventually lead to the imposition of bank regulatory capital standards on the entire insurance industry.

Section 606 of the Dodd Frank Act allows the Fed to apply its bank holding company "source of strength doctrine" to the insurance and thrift holding companies which it now regulates. Industry sources suggest that the Fed's erroneous examiner opinions alleging weak capital positions at insurance subsidiaries and affiliates have lead the Fed to conclude that the consolidated capital positons of some holding companies must increase. Again, in the opinion of the insurance industry experts familiar with the specific details of these cases, these mandated capital increases are not addressing true holding company capital weaknesses. Instead they are the result of longstanding and appropriate differences between the capital regulations for insurers (set by the

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[23] Testimony of Thomas Sullivan of the Board of Governors before the House Subcommittee on Housing and Insurance, November 18, 2014.
[24] For official Federal Reserve guidance on these examinations, see http://www.federalreserve.gov/bankinforeg/srletters/sr1111a2.pdf

states), and consolidated capital standards for banks (set by the US bank regulatory agencies in consultation with the Basel Committee on Bank Supervision).

Industry representatives suggest that the Fed's approach for assessing the capital position of thrift and insurance holding companies could lead to new insurance industry constraints on dividend payments or other transactions that return capital to shareholders. The Fed can apply its holding company capital rules even in cases where the holding company is comprised predominately of insurance related activities and includes a subsidiary depository institution that holds only a tiny fraction of the holding companies' assets.[25] Recent congressional testimony by FRB Senior Advisor Thomas Sullivan did not allay industry concerns when he reported, "Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions…"[26]

With the Fed's acquisition of thrift and insurance holding company supervision and the three large FSOC-designated insurance companies now subject to enhanced supervision and regulation by the Federal Reserve Board, the Federal Reserve is now the consolidated supervisor of companies that hold about one-third of the asset in US insurance industry.[27]

Reflecting these new insurance powers, in 2013 the Fed joined the International Association of Insurance Supervisors–the international standard setting body for insurance regulation. The Fed is now a member of the IAIS work stream that is developing global standards for the supervision and regulation internationally active insurers, including regulatory capital standards for insurance groups.[28] This work is part of the overall G20 financial stability initiative coordinated by the FSB. The Fed is also a member of the IAIS group that is responsible for identifying global systemically important insurers and designing the enhanced regulatory and supervisory framework that will apply to these institutions.

The Fed is a member of the IAIS work stream charged with developing group-wide capital standards for insurance groups. These consolidated capital requirements are similar to the consolidated capital requirements for bank holding companies. For some years, Europe has been developing new insurance capital standards called Solvency II. Solvency II standards are in many respects similar to the Basel capital standards for banks and bank holding companies. In fact, Solvency II is often called "Basel for insurers." The similarity between bank and insurance capital requirements in Europe is no accident because European insurance activities are often conducted as part of a universal banking organization. Because the IAIS membership is dominated by European insurance supervisors, many believe that, in the end, any new IAIS group-wide standard will strongly resemble Solvency II.

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[25] For a detailed discussion of the issues that concern the industry see, *Letter to regulatory agencies on behalf of Nationwide Mutual Company regarding 'Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action,* http://www.federalreserve.gov/SECRS/2012/December/20121206/R-1442/R-1442_101712_109102_441597364672_1.pdf

[26] See Thomas Sullivan's testimony.

[27] Ibid.

[28] Ibid.

In contrast to Europe, the United States does not have a consolidated capital standard for insurers. Historically, the U.S. approach to insurer capitalization has served the industry well. It has not resulted in any systemic weaknesses and it likely works to contain contagion risk because it limits interdependencies among insurance companies. US capital standards are set for individual state insurance entities that are incorporated and fully capitalized within a single state. They are licensed, regulated and if need be, liquidated at by the state insurance regulator. Consolidated group capital has not been an important issue in the United States because each state chartered insurance entity must be fully capitalized and cannot rely on capital support from a larger insurance group.

The extent of the Fed's involvement in insurance regulation and the potential for the Fed to impose significant changes on insurance supervision and regulation was unlikely to have been anticipated by Congress. The Fed is now poised to become the *de facto* national insurance regulator that Congress declined to create in the Dodd-Frank Act. The Fed is empowered to exam firms that hold one-third of insurance industry assets even though these firms are examined by state insurance regulators. The Fed is now also the most influential US regulatory member charged with designing new capital and supervisory processes in the IAIS/FSB work stream. The Fed is already showing a preference to impose bank capital regulations on insurance holding companies and there is industry concern that the Fed may agree to Solvency II bank-like capital regulations in its IAIS insurance capital work stream.

Improving the Transparency of Other Federal Reserve Operations

Over time, the Fed has stretched the interpretation of its monetary policy "independence" to reduce its transparency on many other operatizing issues that it prefers not to publically disclose. For example, the Fed decides on its own accounting standards, and it has decided that it will never recognize that Fed operating losses could render the Fed insolvent (i.e. negative capital) if its accounting followed generally accepted accounting standards.[29]

When long-term interest rates begin to rise, the Fed will suffer massive mark-to-market losses on its bond portfolio holdings, and yet the Fed has decide it will not recognize these losses on its financial statements. When the Fed increases short-term interest rates, it will do so by raising the rate it pays banks on their reserves held in Federal Reserve banks. Depending on the level of rates, this will reduce the 'net' income the Fed returns to the Treasury by tens of billions of dollars and indeed it is possible that, should rates revert to "normal long-run levels" the Fed could payout more on reserves than it earns in interest on its bond portfolio.[30] In this case, the Fed would not remit anything to the US Treasury, and would have negative cash flow—cash payouts that exceed cash inflows– but the Fed would not record the loss as a reduction in its capital position. In other words, the Fed's accounting system will never show the Fed to be insolvent, no matter how insolvent it the Fed may be when measured by generally accepted accounting standards. According to the FRB,[31]

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[29] See for example, Alex Pollack, "The Central Bank of Switzerland announces a huge loss: Would the Fed ever be this honest?" https://www.aei.org/publication/the-central-bank-of-switzerland-announces-a-huge-loss-would-the-fed-ever-be-this-honest/

[30] See Paul Kupiec, "Why Taxpayers will be on the hook when it's time to raise rates," *American Banker*, August 27, 2014.

[31] S. Carpenter, J. Ihrig, E. Klee, D. Quinn, and A. Boote," The Federal Reserve's Balance Sheet and Earnings: A primer and projections," Federal Reserve Board, *Finance and Economics Discussion Series: 2013-01*

> "Dividends are paid even if remittances to the Treasury would be zero. As discussed earlier, in the event that earnings fall short of the amount necessary to cover operating costs, pay dividends, and equate surplus to capital paid-in, the Federal Reserve books a liability of "interest on Federal Reserve notes due to U.S. Treasury." This line item is recorded in lieu of reducing the Reserve Bank's surplus, and represents the amount of earnings the Federal Reserve needs to accumulate before it resumes remitting residual earnings to U.S. Treasury."

The lack of Fed transparency extends to areas beyond its accounting statements. Unlike other Federal Government agencies, the Fed refuses to comply with Freedom of Information Act requests on personal salaries and bonus.[32] Federal Reserve district banks apparently argue that they are not part of the Federal government, and so their employee salary information is exempt from FOIA requests. I am unsure how the FRB avoids complying with FOIA requests for salary information but, to the best of my knowledge, no request has been successful in acquiring a complete list of the FRB staff and their salary and bonuses. In contrast, financial regulatory agencies routinely comply with such requests.

Federal Reserve hiring practices also differ markedly from other government agencies in ways that I doubt the public (and perhaps the Congress) is aware of. Before a "normal" federal government agency could even entertain the possibility of hiring a foreign national for a permanent staff position, the agency must seek (and be granted) special permission from the US Office of Personal Management. To gain permission, the agency must establish that it has a requirement for special skills that cannot be meet by US citizens, and it must document the shortage of US citizens with the needed skill. Of the few agencies who gain this approval from OPM, I am not aware that any agency pays for the legal fees the new hire must spend to acquire permits needed to work legally in the US.

For many years now, the Federal Reserve has routinely hired noncitizens into highly paid professional positions without receiving approval from OPM.[33] In the FRB and some district Federal Reserve banks, a large share of the some segments of their professional staffs were hired as non-citizens, and the Fed provided these new employees with legal assistance to acquire the necessary work permits. In my opinion, the general public would be shocked by the number of noncitizens the Fed has hired for relatively senior staff positions during a period of sustained high unemployment among US citizens.

Thank you for the opportunity to testify today.

[32] For further discussion see, Paul Kupiec "The money in banking: Comparing salaries of bank and bank regulatory employees." http://www.aei.org/publication/the-money-in-banking-comparing-salaries-of-bank-and-bank-regulatory-employees/

[33] I managed FDIC new PhD economist recruiting for 10 years. The FDIC was prohibited from hiring non-US citizens for staff economist positions. Many of the new PhD non-US citizens I could not interview ended up employed by the Federal Reserve Board or in a Federal Reserve district bank.