

## WHY THE FEDERAL RESERVE IS DODD-FRANK'S BIG WINNER

*Evan Schnidman\**

At the height of the financial crisis, pundits and politicians were telling us all to expect an overhaul of financial regulation that would result in a brand new financial system.<sup>1</sup> Those of us who study such matters knew the term “overhaul” was a bit hyperbolic, but genuine reform was certainly anticipated, and some might argue that Dodd-Frank was that genuine reform. Despite all the ink spilled about the impacts of Dodd-Frank, the post-crisis financial structure fails to look dramatically different than before. If anything, the major change in the post-crisis financial regulatory system is an increasingly powerful Federal Reserve.<sup>2</sup>

Recent disclosures<sup>3</sup> have indicated that, at the height of the financial crisis the Fed's balance sheet tripled from about \$800 billion to roughly \$2.5 trillion<sup>4</sup> as it took on an increasingly prominent role as a national lender of last resort; perhaps more striking is the fact that much of these expenditures were loans to foreign banks.<sup>5</sup> This foreign lending illustrates that, in addition to serving as a domestic lender of last resort, the Fed is taking an increasingly prominent role as an international or systemic lender of last resort.<sup>6</sup>

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\* Evan Schnidman is a Government PhD candidate at Harvard University.

<sup>1</sup> See Greg Hitt & Damien Paletta, Senate Passes Finance Bill, <http://online.wsj.com/article/SB10001424052748703559004575256352143175906.html> (last visited June 12, 2011).

<sup>2</sup> For an explanation of the explicit regulatory powers sought by the Fed, see Edmund Andrews & Eric Dash, U.S. Seeks Expanded Power in Seizing Firms, <http://www.nytimes.com/2009/03/25/business/economy/25web-bailout.html> (last visited June 12, 2011). As discussed in this essay, there has been other, less obvious growth in the Fed's power as well.

<sup>3</sup> See Fed To Release More Crisis Lending Data After High Court Order, <http://online.wsj.com/article/BT-CO-20110321-710221.html> (last visited June 12, 2011).

<sup>4</sup> See Board of Governors of the Federal Reserve System: Credit and Liquidity Programs and the Balance Sheet, [http://www.federalreserve.gov/monetarypolicy/bst\\_recenttrends.htm](http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm) (last visited June 13, 2011)

<sup>5</sup> See Bradley Keoun & Craig Torres, Foreign Banks Tapped Fed's Secret Lifeline Most at Crisis Peak, <http://www.bloomberg.com/news/2011-04-01/foreign-banks-tapped-fed-s-lifeline-most-as-bernanke-kept-borrowers-secret.html> (last visited June 12, 2011).

<sup>6</sup> The international role filled by the Fed at the height of the crisis is one that, in theory, the International

Beyond the Fed's increased lender of last resort capacity,<sup>7</sup> and partially as a result of Dodd-Frank, the Fed is newly empowered to take on more regulatory enforcement issues.<sup>8</sup> The significance of the Fed as a regulator is not a result of statutory authority—since many other regulators have similar legal authority to regulate<sup>9</sup>—but the fact that the Federal Reserve is self-funded.<sup>10</sup> No other financial regulator is self-funded.<sup>11</sup> This is of particular significance when it comes to enforcing financial regulations in the wake of a recession.

As the parable goes, “in the land of the blind, the man with one eye is king;” likewise, in the land of underfunded regulatory agencies, the independently funded agency is powerful. As a result of this independent funding the Fed has taken on an increasingly prominent role in the domestic regulatory environment.<sup>12</sup> But this increased power is not all the Fed's doing; much of it is tied to the compromise reached over Dodd-Frank.

In their effort to reach common ground on a central piece of the legislation, moderate Republicans compromised with the Democratic leadership of the 111<sup>th</sup> Congress, agreeing to a weaker Consumer Financial Protection Bureau (CFPB) housed in the Federal Reserve rather than as a stand-alone agency. The Republican opposition did not account for the fact that a CFPB housed in the Fed would be completely self-funded and thus relatively autonomous from Congress.<sup>13</sup> In the effort to create a weaker agency, Congress largely gave up its power of the purse over the new regulatory body.

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Monetary Fund holds. Although the IMF is capable of acting as a lender of last resort to smaller, developing economies in crisis, it does not have the funds to buoy a major developed economy, let alone several of them simultaneously. This is where a central bank capable of monetizing must step in, as the Federal Reserve did. These foreign lending actions have caused several members of Congress to publicly berate Fed personnel at Congressional hearings for over-utilizing foreign bank swaps and not knowing what private sector borrowers benefited from the dollars flowing into foreign central banks.

<sup>7</sup> See Henry Wallich, *Central Banks as Regulators and Lenders of Last Resort in an International Context: A View from the United States*, Federal Reserve Bank of Boston (1977), available at <http://www.bos.frb.org/economic/conf/conf18/conf18d.pdf>.

<sup>8</sup> In some cases the Fed is simply using its existing enforcement powers, but on issues like consumer financial protection, the Fed has gained additional statutory power.

<sup>9</sup> The Fed is not the only entity to gain increased responsibilities from Dodd-Frank. The Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of Currency (OCC), and the Commodity Futures Trading Commission (CFTC) all gained substantial new powers.

<sup>10</sup> See Board of Governors of the Federal Reserve System, What does it mean that the Federal Reserve is “independent within the government”?, [http://www.federalreserve.gov/faqs/about\\_12799.htm](http://www.federalreserve.gov/faqs/about_12799.htm) (last visited June 12, 2011).

<sup>11</sup> Although several other agencies in the U.S. government are “fee-funded,” the Fed is the only true self-funded agency. This means it operates off profits from market operations, not just fees collected from regulatory infractions.

<sup>12</sup> This increased role is particularly obvious with the Fed's explicit new role as a consumer financial protector. See Federal Reserve Consumer Help, Ready to File a Complaint?, <http://www.federalreserveconsumerhelp.gov/about/consumer-complaint.cfm> (last visited June 12, 2011).

<sup>13</sup> The head of the CFPB needs to be confirmed by the Senate, so the agency is not completely autonomous from Congress.

The irony of Congress losing control of the CFPB to the Fed does not stop there; with respect to broader regulatory policy, it is the action (or inaction) of Congress that has continued to empower the Fed.<sup>14</sup> In recent months, the CFTC and the SEC have sought increased funding from Congress to comply with the creation of new regulations mandated by Dodd-Frank.<sup>15</sup> While criticizing the agencies for being ineffectual,<sup>16</sup> the Republican majority in the House responded by offering plans to cut funding to the agencies.<sup>17</sup> Since these agencies are beholden to Congress for funding,<sup>18</sup> they simply do not have the resources to enforce regulations.<sup>19</sup> Therefore, the agencies have fallen behind schedule in their rulemaking and enforcement and have sought other avenues to implement Dodd-Frank.<sup>20</sup>

One such avenue is for each respective agency to pair with the Fed in creating a set of regulations. As the funding problem grows, this is becoming increasingly common and increasingly public.<sup>21</sup> The SEC Chairwoman, Mary Schapiro, testified before the Senate Banking Committee in April 2011 that she was working jointly with the Fed and CFTC to implement derivatives regulation.<sup>22</sup> While some might applaud such coordination, it was clear from her testimony that the Fed is playing a large role here because it is crucial in financially supporting new regulatory efforts. This begs the question, why is the Fed volunteering its resources for these actions? The answer is simple, turf. With Congress unwilling to fund other financial regulators, it has left an opening for the Fed to expand its regulatory turf.<sup>23</sup>

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<sup>14</sup> Many of the same members of Congress who are seeking to underfund regulators are those who heavily criticize the Fed. Chief among these individuals is libertarian Republican Congressman Ron Paul. *See* RON PAUL, *END THE FED* (2010).

<sup>15</sup> *See* SEC, CFTC ask Congress for Budget Increases, <http://online.wsj.com/article/BT-CO-20110504-714062.html> (last visited June 12, 2011).

<sup>16</sup> *See* John J. Curran & Jesse Hamilton, Schapiro SEC Seen Ineffectual Amid Dodd-Frank Funding Curbs, <http://www.bloomberg.com/news/2011-03-31/schapiro-sec-seen-ineffectual-amid-dodd-frank-funding-curbs.html> (last visited June 12, 2011).

<sup>17</sup> *See* Silla Brush, CFTC Budget Scrutinized by House Republicans Seeking 15% Cut, <http://www.bloomberg.com/news/2011-05-23/cftc-budget-scrutinized-by-house-republicans-seeking-15-cut.html> (last visited June 12, 2011).

<sup>18</sup> This is despite calls by many prominent regulators, politicians and lawyers that the SEC should be self-funded. *See e.g.*, Top Securities Lawyers Call for Self-Funded S.E.C., <http://dealbook.nytimes.com/2010/06/11/top-securities-lawyers-call-for-self-funded-s-e-c> (last visited June 12, 2011).

<sup>19</sup> SEC Union NTEU Chapter 293, Kelley Emphasizes Need for SEC Resources as Fiscal 2012 Funding Process Advances, <http://www.secunion.org/KelleySECBudget3182011> (last visited June 12, 2011).

<sup>20</sup> Ronald Orol, The Dawdle-Frank Act: Regulators' missed deadlines, [http://www.marketwatch.com/story/the-dawdle-frank-act-regulators-missed-deadlines-2011-05-05?reflink=MW\\_news\\_stmp](http://www.marketwatch.com/story/the-dawdle-frank-act-regulators-missed-deadlines-2011-05-05?reflink=MW_news_stmp) (last visited June 12, 2011).

<sup>21</sup> Bruce Carton, How Can Congress Kill Dodd-Frank? By Underfunding It, <http://www.securitiesdocket.com/2011/01/20/how-can-congress-kill-dodd-frank-by-underfunding-it> (last visited June 12, 2011).

<sup>22</sup> Mary Schapiro, Testimony on "Building the New Derivatives Regulatory Framework: Oversight of Title VII of the Dodd-Frank Act", <http://www.sec.gov/news/testimony/2011/ts041211mls.htm> (last visited June 12, 2011).

<sup>23</sup> There is a large political science literature on turf wars in the U.S. government, but key examples include

Fed officials claim that being a regulator increases the information base upon which they make monetary policy,<sup>24</sup> so it is possible that an increasingly powerful regulatory Fed will actually end up producing better monetary policy.<sup>25</sup> Still, policymakers will continue to debate the wisdom of having our monetary policymaking institution not only focused on inflation (as is common amongst central banks around the world) but also on employment (a much less common practice for central banks) and regulation (a rarity amongst central banks).<sup>26</sup> Some scholarship suggests that central banks with a supervisory role are more able to accurately forecast key variables involved in monetary policy.<sup>27</sup> However, at this juncture, it is not clear whether the Fed will use its new powers to become a more effective and efficient monetary and regulatory player or if the Fed is taking on more than it can handle.

Emerging evidence suggests the Fed may be taking on a bit too much responsibility; rulemaking deadlines are continuously being missed, and Dodd-Frank is being implemented far more slowly than Congress intended.<sup>28</sup> This leads to the conclusion that either the Fed is not making a full effort to gain turf<sup>29</sup> or it is incapable of fulfilling the funding role largely abdicated by Congress. Even as this domestic regulatory story remains unclear, recent statements by the President of the New York Federal Reserve Bank, William Dudley, suggest that the Fed is striving to play an increased role as a global financial regulator.<sup>30</sup> Dudley has made it very clear that the Fed ought to and will fill the regulatory void in international

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food and drug regulation being moved from the USDA to the FDA and intelligence agencies attempting to undercut each other's reach. In the case of financial regulation, several news articles have discussed the role of the Fed in turf wars. See Matthew Jaffe, Turf War: Bernanke Fights for Fed's Powers, <http://blogs.abcnews.com/politicalpunch/2010/03/turf-war-bernanke-fights-for-feds-powers-1.html> (last visited June 12, 2011).

<sup>24</sup> Craig Torres, Bernanke Sees 'Strong Case' for Fed Supervisory Role, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a3YEbR7LEkv0> (last visited June 12, 2011).

<sup>25</sup> When Britain decided to decouple regulation from monetary policy many academics and monetary policymakers engaged in the debate about whether the costs of regulation outweigh the benefits of the information drawn from being a market regulator; most academics and nearly all practicing American monetary policymakers deemed regulation a net benefit to central banks, specifically the Federal Reserve.

<sup>26</sup> Most central banks around the world follow a single mandate to provide price stability (control inflation); very few have a mandated responsibility to deal with unemployment. Since inflation and unemployment are largely at odds with each other (according to a simple Phillip's Curve interpretation) it can be argued that these other banks inherently also deal with employment even though it not part of their mandates, but since it is not part of their mandates, it certainly changes the pressures on the bank in certain economic and political circumstances.

<sup>27</sup> See Joe Peek, Eric S. Rosengren, & Geoffrey M. B. Tootell, *Is Bank Supervision Central to Central Banking?* 114 Q.J. OF ECON. 629, 629-53 (1999).

<sup>28</sup> As the David-Polk scores identify, the agencies are all behind schedule in their rule making. See Davis Polk, *Dodd-Frank Rulemaking Progress Report*, May 1, 2011, available at [http://www.davispolk.com/files/uploads/FIG/050211\\_ProgressReport.pdf](http://www.davispolk.com/files/uploads/FIG/050211_ProgressReport.pdf).

<sup>29</sup> This could be due to limited resources or due to fear of political backlash.

<sup>30</sup> See Caroline Salas & Aki Ito, U.S. Fed's Dudley Calls for More Cooperation Among Global Regulators, <http://www.bloomberg.com/news/2011-04-11/fed-s-dudley-calls-for-more-cooperation-among-global-regulators.html> (last visited June 12, 2011).

financial markets,<sup>31</sup> so it stands to reason that the Fed will continue to become an increasingly powerful regulator of U.S. financial markets.<sup>32</sup>

As it has become clear that the Fed is gaining more power relative to other domestic financial regulatory bodies, the Republican Congressional majority have begun to realize their error in compromising on Dodd-Frank. Since Congress has little authority to sanction the Fed, it has sought other ways to curtail Fed power. Chief among these methods has been a series of Congressional oversight hearings. In recent weeks, these hearings have grown extremely acrimonious, ultimately culminating in Sub-Committee Chairman Patrick McHenry's (R-NC) accusation that CFPB adviser Elizabeth Warren lied about a simple scheduling issue.<sup>33</sup> Such an instance highlights how frustrated the new House Majority have become with the law passed in the previous Congress and how dedicated they are to continuing to prevent its implementation.

Although decorum has largely prevailed on the Senate side, the minority party has pursued a strategy of obstructing efforts to appoint a director of the new CFPB. On May 5, 2011, forty-four of the Senate's forty-seven Republican Senators signed a letter indicating they will not confirm anyone to head the new CFPB until the bureau's rules are changed to give Congress control over its funding.<sup>34</sup> These Senators essentially made a public declaration that they were mistaken in passing the legislation as written in the previous Congress and will not comply with it.

While obstructionist tactics might work to mitigate Fed power on the margins, the continued attempts by the 112<sup>th</sup> Congress to use the power of the purse to tie the hands of financial regulators risks further empowering the Federal Reserve.<sup>35</sup> The Fed<sup>36</sup> has gladly accepted this increased power<sup>37</sup> and is unlikely to cede it back to another agency anytime soon.<sup>38</sup> When compounded with the Fed's increased

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<sup>31</sup> This is of particular interest in the context of Basel 3 and the fact that the US has never really taken a strong stance on Basel before. Dudley's comments were significant because he basically says he will support Basel 3 and the U.S. might even want tighter regulations on global banks and their capital requirements.

<sup>32</sup> Even with Dudley's statements, Europe has recently criticized the U.S. for being slow in implementing financial regulatory reform. This demonstrates that, without Congressional funding for other agencies, the Fed has certain limitations. See Peter Spiegel, EU Warns US to Speed Up Bank Reform, <http://www.ft.com/intl/cms/s/0/cc0e7382-8bcb-11e0-854c-00144feab49a.html?ftcamp=rss#axzz1NzgVWu1V> (last visited June 12, 2011).

<sup>33</sup> See Edward Wyatt, *Hearing Over a Consumer Bureau Descends Into Sharp Accusations*, N.Y. TIMES, May 25, 2011, at B1.

<sup>34</sup> See Edward Wyatt & Ben Protess, *Foes Revise Plan to Curb New Agency*, N.Y. TIMES, May 6, 2011, at B1.

<sup>35</sup> See Sharon K. Blei, *If Fed Becomes Super Regulator, Politicians Would Be Its Kryptonite*, <http://stlouisfed.org/publications/re/articles/?id=1323> (last visited June 12, 2011).

<sup>36</sup> At least most officials from the Federal Reserve Board, but possibly not some regional bank personnel.

<sup>37</sup> Consistent with a long history of turf war theories in bureaucratic politics it would be anomalous for a bureaucratic agency to halt its own turf expansion when turf brings them increased power, prestige, and possibly even increased autonomy.

<sup>38</sup> The Fed is unlikely to cede power since Congress cannot force it financially, but rather can only do so through legislation.

global monetary powers that came as a result of the recent crisis, one can only hope that Chairman Bernanke and others were correct in their assertions that central banks gather crucial information from regulatory actions that improve monetary forecasting.<sup>39</sup> If this is indeed the case, then we should see a prolonged period of stable economic growth led by a Federal Reserve that has superior information to that of virtually any other central bank in the world. If this is not the case, then by not funding the implementation of Dodd-Frank, the 112<sup>th</sup> Congress has inadvertently given a great deal of turf to an already powerful independent agency. That agency, the Fed, has yet to demonstrate its ability to effectively harness its new powers to produce superior economic outcomes. At this stage, we can only hope that the economists supporting increased Fed regulatory powers were being sincere and not simply acting as turf warrior. If these hopes prove unfounded, we could be in for a prolonged period of regulatory and central banking mediocrity.

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<sup>39</sup> See Ben Bernanke, The Federal Reserve's Role in Bank Supervision, Testimony before the U.S. House of Rep. Comm. on Fin. Serv., March 17, 2010, *available at* <http://www.federalreserve.gov/newsevents/testimony/bernanke20100317a.htm>.