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Statement of the Shadow Financial Regulatory Committee

Open Letter to Federal Reserve Chairman Ben S. Bernanke

February 13, 2006

In the rapidly changing arena of financial markets, every new chairman has a responsibility to examine afresh the usefulness of the Federal Reserve's longstanding positions on regulatory issues. In past statements, the Shadow Financial Regulatory Committee has challenged the Fed's need to exercise prudential regulatory authority over financial conglomerates (Statement 153, December, 1998) and has criticized Fed reluctance to allow affiliations between commercial firms and banking organizations (Statement 138, May 1997).

These positions enmesh the Fed in efforts by commercial firms to block competition from banks and by banks to avoid competition from nonbanks. The crucial mission of the Fed lies in directing its monetary operations to fighting inflation and maintaining employment. To compromise this mission by undertaking supervisory tasks threatens its prestige and distracts from its proper focus on macroeconomic stability. It also facilitates opaque tradeoffs between supervisory activity and monetary-policy actions that soften desirable countercyclical effects.

Federal supervision of banking organizations does not need to be located in the central bank. In only a few financially developed countries do central banks still combine monetary policy with bank supervisory functions. In the United States, the federal chartering agency (the Office of the Comptroller of the Currency) and the federal insurer (the Federal Deposit Insurance Corporation) could easily take over the Fed's supervisory responsibilities.

Committee Statement 118 (May 1995) articulates several principles that should determine the architecture of financial institution regulation. These principles have even more relevance today, and, to the extent that the Fed retains regulatory responsibilities, we urge you to take these principles into account.

- There should be no limitations on the permissible activities of companies that control banks unless they pose a demonstrated danger to the safety and soundness of the bank.
- There is no reason to have consolidated supervision or to make an "umbrella" regulator responsible for regulatory oversight of banks and their nonbank subsidiaries. The jurisdiction of the bank regulator should be limited to the banking entity and based on concerns about the safety and soundness of the bank.
- Reform should increase efficiency and facilitate entry into and exit from financial lines of business. As technological change occurs, it is important that market-driven reallocations of capital occur within and across industries.
- Under the current regulatory system, deposit insurance and access to the discount window and Fedwire for payments clearance entail implicit subsidies and guarantees to participating banks. These safety-net subsidies must be constrained or bounded by regulation.

Using these principles, the Committee urges you to take a hard look at the rationality of various policy initiatives and regulations that the Fed has traditionally favored. In particular, we urge you to examine critically:

- Settlement risk in the electronic payments system: The Fed's exposure to loss should be minimized by increasing daylight overdraft charges, restricting transfers to good funds, and/or requiring full collateralization for overdrafts (Statement 45, September 1989).
- Restricting bank leverage: The current numerical threshold values set for leverage ratios by the FDIC Improvement Act of 1991 should guide and constrain supervisory action, irrespective of whatever risk-based capital requirements are defined in Basel II (Statement 223, December 2005).
- Enhancing market discipline for large and complex banks: Theory and evidence confirm the benefits of requiring them to issue a minimum amount of subordinated debt (Statement 168, February 2001).
- Securities-market margin requirements (Reg T): The Fed should terminate this authority, which performs no useful economic function (Statement 227, February 2006).
- Limitations on entry into banking: The Fed should recognize that efforts to separate banking and commerce have substantial anticompetitive effects (Statement 138, May 1997).

Finally, we encourage you to continue former Chairman Greenspan's opposition to permitting Fannie Mae and Freddie Mac to invest in mortgage-backed securities or to hold portfolios of mortgages beyond those earmarked for near-term securitization.