OPENING STATEMENT OF REP. MELVIN WATT

Hearing Entitled, "Examining the Link Between Fed Bank Supervision and Monetary Policy"

Wednesday March 17, 2010

Today's hearing is another in a series of steps in Congress' ongoing effort to examine the consequences of the global economic crisis and appropriate policy responses. Today we examine the Federal Reserve and whether it should retain its role as supervisor over many financial institutions and, if not, the potential effect on the effective execution of monetary policy.

The Federal Reserve currently has the authority to regulate and supervise bank holding companies, state banks that are members of the Federal Reserve System and foreign branches of member banks, among others. Last year, the House passed financial reform legislation that preserved the Fed's power to supervise these financial institutions. The Senate bill recently introduced by Senator Dodd would strip the Fed's authority to supervise all but the largest financial institutions (over $50 billion in assets, which is roughly 40 institutions). This hearing will examine the potential policy implications of stripping regulatory and supervisory powers over most banks from the Fed and the potential impact this could have on the Fed's ability to conduct monetary policy effectively.

Proponents of preserving existing Fed bank supervision authority cite three main points to support their position that the Fed should retain broad supervisory powers. They say first that as a consequence of carrying out central bank responsibilities the Fed has built up over the years deep expertise in macroeconomic forecasting, financial markets and payment systems which allows effective consolidated supervision of financial institutions of all sizes and allows effective macroprudential supervision across the financial system. Proponents of retaining Fed supervision say that this expertise would be costly and difficult (if not impossible) to replicate in other agencies.

Second, proponents say that the Fed's oversight of the banking system improves its ability to carry out its central bank responsibilities, including the responsibility for responding to financial crises and making informed decisions about banks seeking to use the Fed's discount window and lender of last resort services. In particular, proponents say that knowledge gained from direct bank supervision enhances the safety and soundness of the financial system because the Fed can independently evaluate the financial condition of individual institutions seeking to borrow from the discount window, including the quality and value of these institutions' collateral and their overall loan portfolios. A related point here is that bank supervision yields clues to the health of the markets generally and allows the Fed to make informed policy responses, particularly in times of crisis. For example, many credit the Fed with launching innovative emergency liquidity programs, including TALF, which arrested the economic free-fall of the last two years and restored liquidity to markets.

Third, and finally, proponents say that the Fed's supervisory activities provide the Fed information about the current state of the economy and the financial system that influences the FOMC in its execution of monetary policy, including interest rate setting. Recently, the federal funds rate has been set at 0 – 0.25% in response to ongoing weakness in market conditions – weakness that the Fed asserts that it observed partly from its supervision of financial institutions.

On the flip side, there obviously are many critics of the Fed's role in bank supervision. Some of these critics blast the Fed for keeping interest rates too low for too long in the early 2000's, which some say fueled an asset-price bubble in the housing market and the resulting subprime mortgage crisis. Consumer advocates and other critics accuse the Fed of turning a blind-eye to predatory lending throughout the 1990's and 2000's. They remind us that Congress passed the Home Owners Equity Protection Act (HOEPA) in 1994 to counteract predatory lending, but the Fed did not issue final HOEPA rules until 2008, well after the subprime crisis was out of control and only after this Committee threatened further legislation.

Other critics accuse the Fed of ignoring its consumer protection role during supervisory examinations of banks and other financial institutions across a wide range of financial products (including bank overdraft fees and credit card fees) which allowed big banks to reap big profits on the backs of ordinary Americans.

Perhaps the appropriate policy response lies somewhere between the proponents and critics of Fed bank supervision. I've tried to keep an open mind about the role of the Fed going forward and hope to use today's hearing to get some answers and to inform myself better as we move forward to discussions with the Senate, if the Senate ever passes a bill. We are fortunate to have the current Chairman of the Fed, Ben Bernanke, and former Fed Chairman Paul Volcker, who is appearing today as Chairman of the President's Economic Recovery Advisory Board. I plan to question both about how, exactly, bank supervision informs monetary policy. I would also like to hear about the potential policy consequences for prudential bank regulation and effective monetary policy if the Fed is stripped of its power to supervise all but the largest financial institutions. Additionally, I'd like to know if there are any positive (or negative) examples from the international arena of removing the central bank from direct bank supervision.