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The Fed Fights For Its Turf

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by Phil Hall

As part of the roll-up to the current debate over financial regulatory reform, the leaders of the Federal Reserve System went on the offensive with a series of speeches and public comments that aggressively argued for retaining both the sovereignty of the Fed and keeping its regulatory powers intact.

Federal Reserve Chairman Ben Bernanke was front and center in arguing against proposed efforts to minimize the central bank's supervisory role. In March 18 testimony before the House Financial Services Committee, Bernanke stated that any attempt to reduce the Fed's authority would ultimately hurt the financial services industry.

"The insights provided by our role in supervising a range of banks, including community banks, significantly increases our effectiveness in making monetary policy and fostering financial stability," said Bernanke, noting a proposal by Sen. Chris Dodd, D-Conn., to revise the Fed's authority to only cover banks with more than $50 billion in assets. "We are quite concerned by proposals to make the Fed a regulator only of the biggest banks. It makes us essentially the too-big-to-fail regulator. We don't want that responsibility."

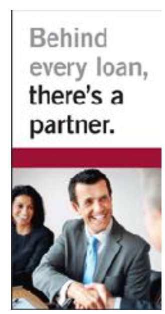
Throughout last month, the presidents of the regional Federal Reserve Banks kept up the pressure with a number of statements that openly challenged the notion that a reconfigured Fed would benefit the economy.

"[This] is absolutely disenfranchising our relationship with a very important - hugely important - sector outside of Wall Street, across the United States," said Kansas City Fed President Thomas Hoenig during a March 18 panel discussion in Washington, D.C., sponsored by the American Bankers Association. "It institutionalizes too-big-to-fail and makes the central bank the central bank of Wall Street and not the United States."

"I would argue that removing the Fed from supervision and regulation of banks of all sizes and complexity would be the equivalent of ripping out [a] patient's heart," said Richard W. Fisher, president of the New York Fed, during a March 3 presentation before the Council on Foreign Relations in New York. "That would surely prevent another heart attack but would likely have serious consequences for the patient. Our job is to keep the patient healthy - to prevent another attack. The best way to do that is to keep the Fed in supervision."

Narayana R. Kocherlakota, president of the Minneapolis Fed, went even further during a March 2 speech before the Allied Executives Business & Economic Outlook Symposium in Minneapolis. In his view, the current Fed schematics separate the nation from a future economic catastrophe.

"Stripping the Federal Reserve of its supervisory role would needlessly put a Great Depression on the menu of possibilities for our country," he said. "In severe financial panics, like the one that took place in the Great Depression, the shortages of liquidity can eliminate large amounts of GDP and large numbers of jobs. It was exactly this possibility that we faced in the fall of 2008; the actions of the Federal Reserve System were instrumental in ensuring that this eventuality did not occur."



But are the tough talk and dire warnings having any effect on the political debate? Dr. Peter Morici, a professor at the University of Maryland's Robert H. Smith School of Business, points to the scaled-back nature of Dodd's financial regulatory reform legislation as evidence of early success by the Fed to sell its argument.

"Dodd's proposals indicate that Bernanke's efforts to maintain Fed independence and its role in monetary policy-making are having traction," he says. "We will have a changed, but not a weaker, Fed."

Richard Rydstrom, chairman of the Coalition for Mortgage Industry Solutions, concurs, noting that the blueprints for the proposed Consumer Financial Protection Agency (CFPA) were significantly reconfigured following the push by the Fed leadership.

"The efforts of Bernanke and the Fed heads are having a great impact on the future structuring of the new regulatory system, including the proposed consumer protection agency," he says. "Those efforts have probably turned the tide against the stand-alone consumer protection agency in favor of a more narrowly defined rules-authority within the Treasury.

"Senator Dodd has already taken a position ostensibly contrary to President Obama's promise of a stand-alone independent consumer financial protection agency," he continues. "The CFPA would be housed under the Federal Reserve - even though Dodd says the Fed would have no authority over it - and would take limited powers from the Federal Reserve to write rules to protect consumers and write regulations to cover products issued by mortgage brokers, payday lenders and nonbanks."

Rydstrom believes that originators and secondary marketing officers will benefit from the Fed's actions. "Retaining greater powers to the Fed and carving out a narrower or more restrictive area of authority for the new protection bureau will generally be positive for the mortgage banking, credit and securitization industries," he adds.

But not everyone shares this confidence. Scott Stern, CEO of St. Louis-based Lenders One Cooperative and head of the Community Mortgage Lenders of America, doesn't see the White House tossing in the towel.

"It seems that the administration is focused on getting a bill passed, even with all of its flaws," he says. "It does not look like comments by the Fed will derail something from passing."

Stern adds that even a smaller CFPA with no control from the Fed will still have a negative effect on mortgage bankers.

"We feel that setting up the mortgage police to evaluate the suitability of loans will effectively create a marketplace where lenders are so scared to do their jobs," he says. "A CFPA with unlimited power is a scary, overreaching initiative by the government to control private enterprise. We believe the CFPA will be good for one industry only: attorneys."

Others argue that the struggle over the Fed's territorial domain distracts from the bigger-picture issues that continue to disrupt the industry and the economy. Frank T. Pallotta, executive vice president and managing partner with Rumson, N.J.-based Loan Value Group LLC, points out that the regulatory system as a whole requires thorough reconsideration.

"Everyone should look what happened: The Fed, the Securities and Exchange Commission and the Federal Deposit Insurance Corp. fell asleep at the switch," he says, adding that even if a downsized Fed were in place in 2007, the current crisis "still would have happened."

Alex Epstein, a fellow with the Ayn Rand Institute in Irvine, Calif., echoes Pallotta's observation. "The debate assumes the free market is guilty and the government is the savior," he says. "The whole discussion of financial market oversight is completely backwards: The Fed and other regulatory agencies are not the solution to the financial crisis; they're the cause of the crisis. The protection we need is not by regulators - the protection should be from the regulators."

"Is it politics or good business?" asks Bob Dorsa, president of the American Credit Union Mortgage Association. "I'm not sure that we know the answer. Maybe out of this we can get some stability and direction. But we really have to ask, what is it going to take to get real stability back into housing?"

Dr. Anthony B. Sanders, professor of finance at George Mason University in Fairfax, Va., worries that no matter who wins the Fed's turf fight, mortgage bankers may stand to lose.

"It all may be a moot point anyway," he warns. "Eventually, [the Fed] will have to inflate [its] way out of the staggering amount of debt that the Treasury has borrowed. This will result in inflation rates of up to 14 percent and mortgage rates of up to 16 percent to 18 percent - it is only a matter of 'when' and not 'if.' If I was a bank or a savings-and-loan, I would be careful about loading up the portfolio with low-interest-rate mortgages."

*(Please address all comments relating to this article to Phil Hall, editor of **Secondary Marketing Executive**, at hallp@sme-online.com)*