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SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 355

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Statement of the Shadow Financial Regulatory Committee on

The New York Fed and Primary Dealers

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To address perceived problems of undue influence of large Wall Street financial institutions over monetary policy and their supervision by the Federal Reserve Bank of New York, several proposals have been made over the past few years to change the way the president of the New York Fed is selected. Instead of being appointed by the Bank's board of directors, it has been proposed that the Bank's president be nominated by the President of the United States and confirmed by the Senate. The Shadow Financial Regulatory Committee believes there is an important structural explanation for the perceived deference paid to large financial institutions by both the NY Bank and the Board of Governors and this is close relationship that New York based primary dealers play in the implementation of monetary policy. This has led to the perception that the Federal Reserve System has unduly favored and supported large New York financial institutions, especially those that are also primary dealers.

The Committee recommends making changes in the way that the System interacts with the primary dealers. Specifically, these involve abandoning the primary dealers as a way of moderating any conflicts of interest that may now exist. In particular the Committee recommends (1) abandoning the primary dealer system and expanding participation in bidding on daily open market operations to include member banks, (2) rotating responsibility for implementing open market operation among the Reserve Banks, and (3)removing the President of the NY Fed as Vice Chairman and permanent member of the FOMC. The rationale for these recommendations is to reduce the influence and importance of the New York Bank within the Federal Reserve System and hence the perceived influence Wall Street financial institutions have on the System.

Presently, federal supervision and regulation of the major Wall Street financial institutions, most of whom have national bank affiliates and are primary dealers, is divided between the Federal Reserve System, and more specifically, the Board of Governors and the Office of the Comptroller of the Currency. The supervisory and examination responsibilities of the Federal Reserve Bank of New York is a delegated function by the Board, but key decisions when it comes to sanctions and policy remain the primary responsibility of the Board of Governors. That supervisory responsibility, together with dependence of the Open Market Desk (the department that implements monetary policy on behalf of the FOMC) on primary dealers, is the source of the perception of influence and regulatory capture.

While the divided supervisory and regulatory responsibility does entail a quasi-set of checks and balances that may serve to reduce regulatory capture, it is also the case that the location of the FOMC's Open Market Desk in the NY Fed and its dependence upon a small group of primary dealers for the effective implementation of day to day monetary policy certainly provided strong incentives for the Bank and Federal Reserve System to support those institutions during the financial crisis. In fact, all of the US domestic primary dealers were bailed out in one way or another, regardless of their financial condition. The institutions not only received injections of capital from the Treasury, but also benefited in terms of their ability to roll over existing and issuing new debt from subsidized liquidity facilities provided through the New York Bank. This only heightens both market perceptions that they are subject to implicit government guarantees. The special position of these institutions created the illusion that they were sound and would be protected should they get into financial difficulty. Despite the System's attempts to dispel this perception, the financial crisis demonstrated that these institutions were treated as being special, and people who were concerned about the associated moral hazard that perception created were validated. Because many of the primary dealers are now also subsidiaries or affiliates of foreign institutions, the current arrangements risk extending the safety net even more than was the case during the financial crisis, if the present structure is retained.

To mitigate the risks, to remove the perception of regulatory capture and special treatment for a select few institutions and to improve market efficiency in the normal course of the implementation of monetary policy, the Committee has identified potential changes to the Federal Reserve System that could be made that would also be responsive to addressing the perceived cultural of regulatory capture. Two of these could be implemented by the Federal Reserve itself without Congressional action.

First, as argued above, the System and FOMC are too dependent upon the small group of New York-based primary dealers when it comes to the implementation of day-to-day monetary policy by the Open Market Desk (the department responsible for implementing the FOMC's policies) in New York. The primary dealer system is an anachronism that evolved when physical proximity to the Open Market Desk was necessary because paper bids were submitted by dealer institutions for the Desk's daily transactions. With the advent of the Desk's electronic bidding system and the electronic trading, clearing and settlement of government securities, all qualified member institutions throughout the country should now be permitted to bid on transactions, instead of the Desk's relying only upon the securities distribution facilities of the primary dealers. This would be similar to what the ECB does, which already deals with over 500 counterparties in its open market operations.

Second, technology also reduces the need for the functions of the Open Market Desk to be located permanently in the New York Bank. Rotating the function between at least two more of the 12 Reserve Banks annually would tend to reduce the clubbiness that concerns many about the present arrangement. Rotation of responsibilities would also create an automatic, fully functioning backup system, thus ensuring that the financial system could continue to function with the flip of a switch should another 9/11-type tragedy occur.

Third, the law could be changed to remove the president of the New York bank as a permanent member of the FOMC, rotate that position on the FOMC among other reserve bank presidents, and to elect the FOMC Vice Chairman in the same way that the Chairman is elected each year.