

The Regulatory Record of the Greenspan Fed

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I. Introduction

The Fed's two main roles in the economy are (1) setting monetary policy and (2) regulating the financial system via both the regulation and supervision of Fed member banks (which are supervised by the regional Feds) and the regulation and supervision of bank holding companies (which are supervised by the Board of Governors, which Alan Greenspan has chaired since 1987). The structure and authority of the Fed in performing its monetary function is well understood and often commented upon (e.g., the timing, membership, voting rules, and press releases related to FOMC meetings). The Fed's role in banking regulation, or more broadly in financial regulation, receives less attention, is not as well understood, and has been much more subject to change over time.

The Fed plays an important role as a regulatory policy advocate in Washington, as a writer of regulations, and as a supervisor. It also represents the United States at the Basel Committee, which sets international prudential regulatory standards for banks. These regulatory functions are performed by the Fed alongside many other (sometimes "competing") financial regulators – the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Securities Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and the state banking and insurance authorities, as well as the courts. This is an activity that has occupied a great deal of time and energy at the Fed, as the structure and rules of the financial regulation

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game have changed dramatically and much more frequently in the U.S. over the past two decades than the structure and rules for monetary policy.

Alan Greenspan and the Fed have played an important, and I will argue, overall, a very constructive, role in shaping major changes in the structure and rules of financial regulation over the past two decades. Indeed, it is in this realm that Chairman Greenspan has made his most important contributions as an institutional innovator.

An exhaustive review of Fed regulatory policy is not possible here; indeed, one could easily spend an entire article describing just one or two of the scores of changes that have occurred in financial regulation since 1987 and the way that Chairman Greenspan influenced those changes. For example, just describing how the Greenspan Fed made possible the expansion of commercial banks' powers to permit them to engage in investment banking could occupy this entire essay.

That change occurred in several discrete stages over the period 1987-1999, beginning with the Fed's discretionary decision in 1987 to allow small inroads by banks into investment banking. Those changes created a favorable track record, which laid the groundwork for the Administration's and Congress's willingness to eliminate restrictions entirely in 1999 (a policy change the Fed actively advocated in the 1990s). The growth in the market shares of commercial banks in investment banking has been dramatic in recent years. As of 1992, only 10 percent of corporate debt and less than one percent of corporate equity flotations were underwritten either solely or jointly by commercial banks. By 2002, 66 percent of corporate debt and 36 percent of corporate equity flotations were underwritten either solely or jointly by commercial banks (Calomiris and Pornrojngkool 2006).

Rather than provide a summary of regulatory change, I want to use this opportunity to focus on a bigger question that I believe gets to the heart of Alan Greenspan's contribution to the history of American bank regulation, and which is relevant for addressing questions about the Fed's future role in regulation. I want to ask whether one can identify a "philosophy of regulation" that underlay the regulatory advocacy of the Fed and Chairman Greenspan during the last two decades. Did the Greenspan Fed have a point of view on regulatory matters? I think it did and I want to try to explain and evaluate it. I will show that, although the Fed's advocacy on various matters may appear somewhat contradictory, or at least, philosophically heterodox, the Fed has behaved in a manner that is remarkably predictable, once one takes account of the political arena in which both regulatory and monetary policy are made.

My central thesis is that the Greenspan years did not illustrate a pure economic philosophy of financial regulation, but rather a politico-economic philosophy, which one might term "pragmatic and biased deregulation." I would not argue that his regulatory advocacy has been optimal, either from the unconstrained standpoint of an ideal regulatory system, or from the constrained (realistic) standpoint of what is possible in the real world. But my main goal is not to highlight errors so much as to make the positive claim that there is a fairly straightforward logic implicit in the Fed's regulatory advocacy, a fairly simple algorithm of advocacy. To understand its logic, one must begin with an understanding of the Fed as a political player in the Washington drama, as a creature of Congress subject to its oversight, as a competitor with other regulators for influence within the financial services industry and within the political realm, and as a prioritizing agent that decides which battles (monetary or regulatory) to fight when, and how hard.

One lesson of this overview of Fed regulatory advocacy during the Greenspan years is that the central algorithm of Fed advocacy (the decision process that decides which position the Fed will advocate) has not changed under Chairman Greenspan, although some of the specific policy advocacy has. My predecessor in this endeavor, John Hawke (1988), wrote an evaluation of Chairman Volcker's regulatory policy during his years at the Fed, which was presented at the December 1988 AEA Meetings. Hawke described an approach to policy that is essentially identical to the one suggested here. In that sense, Chairman Greenspan did not change the Fed; indeed, it is probably more correct to say that his personal advocacy was changed by being at the Fed. But that does not imply an irrelevance to his leadership. What emerges from this account is an appreciation of Chairman Greenspan's skill as a Beltway warrior, particularly with respect to his success in facilitating the geographical expansion of banks, and the broadening of bank powers, and his success in securing a prominent role for the Fed under the Gramm-Leach-Bliley Act of 1999.

I will also conclude that a proper understanding of the Fed's advocacy algorithm provides support for the longstanding arguments in favor of removing the Fed from its position as a bank regulator, a change that would align the U.S. with the rest of the financially developed world (see Table 1). During the 1980s and 1990s, the Fed's regulatory advocacy on balance did more good than harm; but looking forward, that is not likely to be the case. The important directions for future financial regulatory reform do not coincide with the Fed's regulatory agenda. While Chairman Greenspan's skills in managing the political battles of Washington have boosted the power and reputation of the Fed, affording it more of an opportunity to advocate beneficial reforms than any other

party to the regulatory debates in Washington, looking forward we cannot rely on the Fed to push in the necessary directions. Although removing regulatory powers from the Fed has little political support today, Chairman Greenspan's departure may facilitate the renewed discussion of the need to separate monetary policy from regulatory policy, now that the Fed will be deprived of his personal stature, which has been used as a powerful weapon to defeat opponents of the Fed's agenda, and to defy the logic of necessary reforms in several crucial areas.

II. The Fed's Regulatory Advocacy Algorithm: Ten Examples

I list ten of the main regulatory changes and issues that the Fed has grappled with in the past two decades in Table 2 (by no means a complete list), along with a brief summary of the Fed's position on those issues. The data used to construct Table 2 include records of regulatory decisions, speeches, other writings and testimony by Fed officials, mainly by Chairman Greenspan, but occasionally those of other Fed governors, and research pertaining to financial regulation produced and published by the Federal Reserve Board, as well as my first-hand observations of, and conversations with, Fed officials and Fed researchers.

I categorize financial regulatory issues into four categories, according to my interpretation of the Fed's actions and the dominant motives for those actions: One category is labeled "Fed advocacy of beneficial deregulation," and three other categories include cases where the Fed has opposed beneficial regulatory policies, which I attribute to three reasons: "Too politically hot to handle," or "Not in the interest of the big banks," or a "Fed regulatory power play" to boost its own political influence.

My proposed regulatory advocacy algorithm for the Fed is fairly simple. The Fed supports beneficial deregulation so long as doing so does not (1) stir up significant political opposition to the Fed within Congress or the Administration, which might threaten its monetary policy independence, (2) harm the large commercial banks (who are key allies of the Fed in its political battles in Washington), or (3) undermine the Fed's competitive position vis a vis other regulators. Furthermore, these three constraints (opposition by politicians, opposition by big banks, and erosion of Fed regulatory power) may lead the Fed not only to fail to support beneficial deregulation, but to actively support harmful regulation, or in the case of antitrust regulation, to fail to enforce beneficial regulation (i.e., against undesirable anticompetitive mergers).

Underlying this categorization are two sets of substantive claims on my part: first, claims about what constitutes beneficial regulation, and second, claims about the interests that are served by supporting or opposing regulation. In this section, I will review both sets of claims for the ten regulatory examples in Table 2 (Interstate Branching, Mergers and Acquisitions, Fannie and Freddie, Investment Banking Powers, Permitting Investment Banking Subsidiaries vs. Affiliates, Umbrella Supervision by the Fed, Banking and Commerce, Requiring Large Banks to Issue Subordinated Debt, the Community Reinvestment Act, and Real Estate Brokerage).

Interstate Branching

The Greenspan Fed was a frequent and consistent supporter of permitting interstate branching. This deregulatory movement had been underway for nearly a decade prior to the Greenspan era, and gained strength during the late 1980s and early 1990s,

culminating in the 1994 Riegel-Neal Act permitting nationwide branching. Chairman Greenspan was an active proponent of branching deregulation. On May 3, 1997, for example, in a speech before the Conference of State Bank Supervisors, he advocated Congressional action to place state banks on an equal footing with national banks with respect to the permissible activities of branches located outside the state in which their headquarters are located. Advocates of eliminating branching restrictions, including myself, have long pointed to the gains from greater competitiveness and greater diversification of risk that comes from permitting banks to branch freely.

It is noteworthy that Chairman Greenspan's May 1997 speech was directed toward enhancing the scope and powers of state-chartered bank branches. That is, his recommendation would have increased the importance of the regional Feds relative to the OCC as regulators of banks (as opposed to holding companies). One of the concerns that Fed officials had about bank branching, which the Chairman recognized in his testimony before the Congress on June 17, 1998, was that interstate branching was expected to "induce shifts from state to national bank charters, reducing the Fed's supervisory role." Improving the powers of state-chartered branches would have offset some of those expected defections.

In his June 1998 testimony, Chairman Greenspan argued that the Board of Governors' position in support of interstate branching was a piece of evidence that directly contradicted theories of Fed advocacy that emphasized political turf battles. He pointed with some pride to the fact that the Board of Governors supported interstate branching despite its anticipated effect of inducing shifts toward the national banking system. But that argument is not convincing for two reasons.

First, the Fed Board, as opposed to the regional Feds, regulates bank holding companies. Interstate banking, by enhancing the size and scope of bank holding companies, and by ushering in the era of universal banking, set the stage for the shift in regulatory power away from both the OCC and the regional Feds and toward the Federal Reserve Board, and as we shall see, Chairman Greenspan was already advocating such a shift in authority toward the Board alongside his support for interstate branching (see the discussion below of umbrella financial supervision). Second, the Fed's advocacy algorithm takes into account the interests of its strongest political allies, the big banks, who surely stood to gain greatly from interstate banking. Thus, despite the possibility of local charter switching toward national banks, interstate branching was a predictable big win for enhancing the power of the Federal Reserve Board.

Interestingly, the Greenspan Fed's role in promoting interstate branching was a departure from that of the Volcker Fed. Indeed, the change in the Fed's advocacy of interstate branching stands out as the most significant change in Fed advocacy between the Volcker and Greenspan eras. Hawke (1988) summarizes the Volcker Fed's attitude toward relaxation of branching laws:

The Federal Reserve under Volcker was largely a bystander in this profound change in the structure of American banking. While Volcker consistently supported very limited intrusions into state authority to facilitate the interstate takeover of large failing and failed banks, his Board did nothing whatsoever to encourage broader interstate banking. On the contrary, in its grudging and suspicious treatment of the desires of banking organizations to acquire thrifts; in its response to such developments as "stake-out" investments – nonvoting equity investments in banks by bank holding companies not yet permitted to make full-scale acquisitions in the target bank's state; and in its pinched and niggling approvals of requests by bank holding companies to use nonbank banks as a means of interstate expansion, the Board seemed to view itself as the little Dutch boy of interstate banking, with a duty to plug each supposed leak in the dike as it appeared. Its perverse attitude was exemplified by its treatment of the credit-card bank "usury haven" cases.

Why the change in Fed advocacy on branching? The political landscape in Congress regarding branching changed completely in the late 1980s. The weakened state of banks in the 1980s, as in the 1920s, set the stage for dramatic changes in many state laws permitting branching within states (Calomiris 2000). There was continuing opposition by some small banks to the branching deregulation effort, but that opposition was weakened by a variety of forces that favored branching, both economically and politically (for a review, see Calomiris 2000). Consequently, the Fed's advocacy here was consistent with a broader political movement throughout the country and threatened to cause it little difficulty with Congress or the Administration.

Mergers and Acquisitions

It has long been argued by bank policy experts that the U.S. historically has had too many banks, owing to the limitations on branching within and across states. The consolidation process during the 1980s and 1990s was widely welcomed as a necessary physical rationalization of the banking sector. The result has been a barbell structure of banks – very small banks (that serve certain consumers and small borrowers with simple needs very efficiently) and very large banks (which enjoy economies of scale from large networks and the large fixed costs of establishing a wide range of products and services), but few of middling size (which enjoy neither of those advantages). The Fed has supported this process under Chairman Greenspan.

But some advocates of consolidation in the 1980s and 1990s, including myself, are starting to have reservations about the process for approving or disapproving bank mergers. The merger of Fleet and BankBoston in 1999 is a prime example of a merger

that seems to have been motivated in large part by the creation of monopoly rents (particularly, in the market for middle-market loans in New England, as discussed in Calomiris and Pornrojngkool 2005). That merger combined the only two remaining banks of significant size and universal service potential in New England. The merger went forward as proposed despite strong concerns voiced by local businesses, supported by academic research which I had done for the states of Massachusetts and Connecticut, which indicated potentially severe anti-competitive consequences from the merger. The political pressure on the Fed, the states of Massachusetts and Connecticut, and the Justice Department not to oppose the merger was intense, and they demurred. The Fed employed its archaic deposit market share measure to determine that there was no concern related to the level of monopoly power (a measure that is unsuited to measure loan market power, especially when confined to particular segments of the market, like the middle market).

I believe that the Fed's close relationship with large banks, and its reliance on them as long-term political allies, has weakened Fed resolve to prevent mergers that are mainly motivated by the desire to increase market power. In my search for examples of Fed disapprovals of bank mergers during the Greenspan era I have identified no examples of bank mergers between large banks which have been prevented by the Fed. It may be that most or all of those approvals were warranted, but it is time for us to question whether further consolidation would be in the interest of consumers and firms, and whether the Fed is a reliable gatekeeper to prevent undesirable consolidation going forward. I suspect that it is not.

Fannie and Freddie

Chairman Greenspan's evolving positions on the proposed reforms of Fannie Mae and Freddie Mac are among the most interesting examples of Fed regulatory advocacy. The Fed has changed its role in this important debate significantly over the past decade, and those changes are fully consistent with my proposed policy advocacy algorithm.

Wallison (2001) summarizes the case for reforming these Government Sponsored Enterprises (GSEs). The GSEs receive implicit subsidies on their costs of funds from taxpayers, which encourage them to create risk without an appropriate capital buffer to absorb that risk. That raises the return on equity for GSE stockholders, but it also (1) imposes costs on taxpayers, (2) disadvantages banks in competing for mortgage intermediation, and (3) makes the financial system as a whole less stable. Furthermore, while the GSEs justify their subsidy by arguing that they assist low-income individuals to gain access to housing, they have not been, nor are they designed to be, an effective tool to achieve that end (Canner, Passmore and Surette 1996, Calomiris 2001). The push for reforming the GSEs began in earnest in the mid-1990s, and was embraced both by the Clinton Administration and by the current Administration.

By as late as the late 1990s, the Fed remained silent on the issue of GSE reform. Some Fed researchers had produced empirical studies that showed some of the shortcomings of the GSEs, but those researchers never advocated reform of the GSEs. My impression at the time, based on conversations with researchers within the Fed system, was that researchers were being guided away from policy discussion regarding the GSEs, and were told to avoid picking a fight with the GSEs. At that time, Congressional support for Fannie and Freddie was at its height, and they seemed

invincible. Large banks, which sought to improve the competitive landscape in the mortgage market to permit them to compete more effectively with the GSEs, were among the keenest advocates of GSE reform, and often orchestrated, subsidized, and otherwise encouraged research and conferences that showed the various failings of the GSEs. The Fed's silence in the late 1990s reflected a conflict between two elements of its advocacy algorithm. On the one hand, GSE reform was too hot to handle, and threatened to disrupt the Fed's good relations with Congress. On the other hand, its allies, the big banks, were clamoring for GSE reform. These influences offset one another, and the Fed remained silent.

But the political landscape started to change dramatically around the middle of 2000. At that time, Congressman Richard Baker (who occupies a "safe seat" in Louisiana, who has what appears to be a sincere philosophical opposition to the risks and costs posed by the GSEs, and who also may have been searching for an issue of national importance to call his own) began a campaign to bring to light the various GSE abuses. Magazines started to publicize the networks of GSE political connections, and the large amounts of compensation earned by GSE executives (and their lack of banking skills, but strong backgrounds in lobbying). Unseemly power plays and Congressional arm twisting by the GSEs over modest proposed reforms of their capital standards encouraged more scrutiny and opposition, which came from all parts of the political spectrum. And the recent accounting scandals added further fuel to the fire. The White House became particularly interested in GSE reform after 2003, as the result of the accounting scandals.

The growing chorus of academic and political opposition to the GSEs, coupled with the strong push from the large banks, and the new shift in the Administration and

Congress away from supporting the GSE status quo seems to have tipped the balance for Chairman Greenspan. For the past several years, he has been a vocal advocate of GSE reform. On May 19, 2000, he sent an open letter to Chairman Baker, pointing out the risks and costs inherent in the GSEs and supporting the case for reform. Subsequent remarks by Chairman Greenspan have elaborated on his initial May 2000 letter (most recently in his April 6, 2005 testimony to the Senate Banking Committee), and open season on the GSEs has been declared for Fed researchers, who had long been chomping at that bit. Now Chairman Greenspan is practically leading the charge for GSE reform. Thus, a regulatory reform that started off as “too hot to handle” became transformed (as in the fairy tale) to be “just right.”

Investment Banking Powers

There is now a huge literature showing, in theory and in practice, that it can be beneficial for bank customers to permit banks to engage in underwriting of corporate debt and equity (see the summary in Calomiris and Pornrojngkool 2006). In essence, savings of information production costs lie at the heart of this policy. The historical prohibition on combining commercial banking and investment banking was based on faulty premises and a lack of evidence.

By the mid-1980s, the declining international importance and profitability of U.S. banks created a strong economic and political impetus for relaxing regulatory limits on bank powers. Large U.S. banks had made significant profits in the growing areas of credit card lending and private equity investing, and without those profits the losses from nonperforming loans, sovereign defaults, and increasing competition and deposit

disintermediation would have placed most large banks into extreme difficulties (ironically, equity investing by a handful of the largest banks was underway on a large scale long before debt or equity underwriting was permitted).

Chairman Greenspan championed the argument that profitability and global competitiveness required continuing modernization and expansion of bank powers. In 1988, at the Chicago Fed's Annual Conference on Bank Structure and Competition (at which he regularly gave the keynote speech), he argued that "The ability of banks to continue to hold their position by operating on the margins of customer services is limited. Existing constraints, in conjunction with the continued undermining of the bank franchise by the new technology, are likely to limit the future profitability of banking...If the aforementioned trends continue banking will contract either relatively or absolutely." In 1990, again at the Chicago Bank Structure Conference, he similarly argued that "In an environment of global competition, rapid financial innovation, and technological change, bankers understandably feel that the old portfolio and affiliate rules and the constraints on permissible activities of affiliates are no longer meaningful and likely to result in a shrinking banking system."

In this atmosphere, there was little opposition to relaxing commercial bank powers limits, particularly if it was done in a gradual way (an effective means of compromising with Congressional skeptics). The initial opening resulted from a Supreme Court change in the 1980s, which suggested that the Court would adopt a more limited interpretation of the Glass-Steagall restrictions on mixing investment banking and commercial banking, thus opening the door to some investment banking by commercial banks. Limitations were relaxed slowly, however, and many so-called "firewalls" were

established initially to isolate investment banking affiliates' underwriting activities from the activities of the core banking enterprise. The first investment banking (Section 20) affiliates were established in 1987. There was a further relaxation of the extent of activity by these affiliates in 1989. In 1997, the Fed eliminated firewalls that it had established to keep the operations of Section 20 affiliates separate from the other operations of the bank. In 1999, Gramm-Leach-Bliley eliminated any restrictions on the amount of investment banking activities in commercial banks. Over time, the Fed was able to build the case that the fears of some policy makers about conflicts of interest arising from the combination of investment and commercial banking were ill-founded, and that the presumed benefits from the combination were real.

Clearly, this was an area where the logic of deregulation was aligned with the political economy of deregulation. Gradual relaxations of bank powers restrictions were not opposed by powerful political forces in Washington (although the investment bankers tried to stir such opposition), and the Fed's support for a measure that added to the size, profitability and power of the money center banks served to buttress its allies (the big banks) while also broadening the Fed's regulatory sphere into securities markets. Thus all four factors shaping Fed regulatory advocacy pushed in the direction of beneficial deregulation.

Investment Banking Subsidiaries vs. Affiliates

The growth of commercial bank involvement in underwriting created a regulatory turf battle in the mid-1990s between the Fed and the OCC. The OCC sought to allow national banks (for which it is the primary regulator) to underwrite securities through

bank subsidiaries (which the OCC regulated) rather than through affiliates of the bank (subsidiaries of the bank holding company, which were regulated by the Fed).

Economists, including myself, backed the proposal to permit bank subsidiaries to underwrite based on the simple, time-tested argument that regulatory competition has been beneficial for preventing abuse of power and over-regulation. Ultimately, despite Fed opposition, the Gramm-Leach-Bliley Act did permit bank subsidiaries to engage in underwriting and most other activities in which affiliates are permitted to engage.

The Fed opposed this proposal on the grounds that there was a possibility of conflict and a risk of bank instability arising from underwriting occurring within bank subsidiaries. Chairman Greenspan testified in Congress on April 28, 1999 that allowing investment banking to occur in bank subsidiaries “would be especially risky.” This argument is hard to fathom (indeed, if anything, the opposite should be true, since some problems of asset substitution risk cannot occur between banks and their subsidiaries, but can occur between banks and their affiliates). It was a pure Fed power play.

One of Chairman Greenspan’s great rhetorical skills, which this and many other cases where he opposed deregulation illustrate, is to shift the burden of proof to suit his argument. When he advocated deregulation (as in the case of expanding underwriting powers via affiliates), he argued that there was no clear evidence that deregulation would cause harm. When he opposed deregulation, he argued that there was no clear evidence that deregulation would *not* cause harm. In the case of permitting underwriting, he used gradualism to compromise with worrisome critics, and build a record of performance on which to base further relaxation of constraints. But he did not advocate gradualism and experimentation as a means to overcome uncertainties on the party of policy makers in

other areas (notably, with respect to permitting underwriting in subsidiaries, or as discussed below, with respect to allowing commercial firms to provide financial services). Chairman Greenspan knew how to overcome Congressional fears of change when he wanted to, and he also knew how to use Congress's fear of change as a tool to limit deregulation. Which Congressman would want to bear the responsibility of having ignored Alan Greenspan's warning? Fortunately, in the case of the debate over subs vs. affiliates, those tactics did not win the day.

Umbrella Financial Supervision by the Fed

The Fed also sought to enhance its regulatory authority by asking to be designated as the umbrella supervisor of financial holding companies, a role it was granted under Gramm-Leach-Bliley in 1999. The argument made by Chairman Greenspan in support of an umbrella supervisory role for the Fed had two parts: (1) the necessity of consolidated supervision of financial holding companies, and (2) the appropriateness of the Fed to fill that role.

Greenspan's argument for the necessity of consolidated supervision had two parts: (1) consolidated supervision would allow the Fed to better manage risks (and prevent FDIC losses) when banks got into trouble, and (2) changes in technology within banking that promoted centralized risk management heightened the need to monitor risk on a consolidated basis (see his testimony of May 22, 1997 before the House Banking Committee).

The Fed's argument for its playing the role of consolidated supervisor rested on the view that the Fed's monetary policy role made it the appropriate choice. There are

two parts to that argument. First, Chairman Greenspan argued that Fed decisions regarding the supply of money and credit would be better informed if it could monitor financial organizations closely to see the effects of its policy on the economy. “This was especially important during the ‘credit crunch’ of 1990. Our supervisory responsibilities give us important qualitative and quantitative information that not only helps us in the design of monetary policy, but provides important feedback on how our policy stance is affecting bank actions” (Chairman Greenspan’s testimony before the House Banking Committee, March 19, 1997). Second, the Fed argued that its role as a lender of last resort and payment clearer via Fedwire place it at risk if a bank abuses the safety net, and therefore makes it an appropriate consolidated supervisor. A related argument the Fed made at this time was that the safety net offered a net subsidy to banks, and that consolidated supervision was the price of receiving that subsidy (see Chairman Greenspan’s testimony before the House Banking Committee, March 19, 1997, speech at the Conference of State Bank Supervisors, May 3, 1997). A final related argument for umbrella supervisory authority was that monitoring of bank condition would help the Fed ensure smooth operation of the payment system (see Chairman Greenspan’s testimony before the Subcommittee on Finance and Hazardous Materials of the Commerce Committee of the House, July 17, 1997).

Each of Chairman Greenspan’s arguments for the necessity of consolidated supervision, and for the need for the Fed to play that role, have been disputed by academics, and by the U.S. Shadow Financial Regulatory Committee. First, Sections 23a and 23b of the Federal Reserve Act contain sufficient protections against the shifting of risk into the FDIC-insured bank enterprise from other affiliates. Thus, there is little

reason to argue for the need for an umbrella supervisor to limit risk taking outside the insured portion of the bank. Indeed, Federal Reserve Board Governor Susan Phillips made similar arguments about the sufficiency of Sections 23a and 23b in her March 20, 1997 testimony before Congress explaining the rationale for eliminating Section 20 firewalls.

Second, there is no credible evidence of a safety net subsidy (to justify the quid pro quo of umbrella supervision) after the enactment of deposit insurance reform in 1991, and there is contrary evidence on that point (e.g., Calomiris and Mason 2004).

Third, there is no need for the Fed to have supervisory authority in order for it to have access to necessary information as a monetary policy maker about bank risk, bank condition, or credit supply. The Fed has full access to examination reports of the FDIC and the OCC, and there is no reasonable basis for believing that the Fed's information is limited by having to rely on these primary regulators as its only source of supervisory information. Every official with whom I have spoken about this question privately, including two Federal Reserve Bank Presidents and a former Comptroller of the Currency, agree that there is no link between monitoring capability and supervisory authority. I can find neither logic nor reliable opinion to corroborate Chairman Greenspan's statement that "ensuring the continuing operation of the payments system requires...detailed knowledge *and* authority with respect to the payment and settlement arrangements and their linkages to banking operations. This type of insight and authority – as well as knowledge about the behavior of key participants – cannot be created on an ad hoc basis. It requires broad and sustained involvement in both the payment infrastructure and the operation of the banking system. Supervisory authority over the

major bank participants is a necessary element” (Testimony before the Subcommittee on Finance and Hazardous Materials of the Commerce Committee of the House, July 17, 1997).

The Fed was given a limited role as umbrella supervisor under Gramm-Leach-Bliley, which grants authority to primary regulators unless special circumstances (e.g., systemic risk) create a need for umbrella supervisory intervention. By some accounts, the Fed has been testing the limits of its umbrella supervisory role by trying to intrude on the supervisory authority of primary regulators, but thus far, it has not been able to use its new role to amass significant new supervisory authority.

Banking and Commerce

“In light of the dangers of mixing banking and commerce, the Board supports elimination of the unitary thrift loophole, which currently allows any type of commercial firm to control a federally insured depository institution.” So testified Chairman Greenspan to the Senate Banking Committee on June 17, 1998. On October 5, 1997, Chairman Greenspan gave a speech in which he said: “if we dramatically change the rules now about banking and commerce under circumstances of great uncertainty about future synergies between finance and nonfinance we may well end up doing more harm than good.” Note, here, the shifting of the burden of proof alluded to before, requiring evidence of benefits from deregulation prior to allowing even a little experimental deregulation! Chairman Greenspan’s testimony and speeches helped to ensure the passage of the Gramm-Leach-Bliley Act, which limited competition in financial services

to existing banks, and consolidated the regulatory authority over financial services in the hands of the Fed.

What exactly are the “dangers of mixing banking and commerce”? The U.S. Shadow Financial Regulatory Committee (2005), of which I am a member, concluded that the potential competitive benefits of allowing non-financial firms (like Wal-Mart) to compete with banks are large, and that the alleged dangers are illusory, and that it is logically incoherent to believe in such dangers but allow the mixing of banking firms and other financial firms:

Prior to the passage of the Gramm-Leach-Bliley Act of 1999, advocates of the separation of commerce and banking expressed three justifications for continuing the separation: (1) the possibility that a bank would lend preferentially to its commercial affiliate or parent, (2) the possibility that the bank would not lend to the competitors of its commercial affiliate or parent, and (3) the possibility that the bank’s resources would be inappropriately marshaled in support of a failing commercial parent or affiliate, thus jeopardizing the bank’s safety and soundness and potentially imposing a cost on the deposit insurance fund. For reasons detailed in the earlier statements on this issue, the Committee does not believe that these arguments have merit. More importantly, Congress, through its recent actions, has also rejected these arguments. In the GLB Act, Congress permitted banks to be affiliated with other financial organizations, such as securities firms and insurance companies. Thus, although GLB did not eliminate the separation of banking and commerce, it did ignore all of the three rationales listed above for separating banking and commerce. Since those rationales apply as fully to the affiliation of a bank with a securities firm as to the affiliation of a bank with a retailer or other non-financial firm, it is fair to conclude that Congress agrees with us and sees no policy problem associated with combining banks with users of bank credit. Thus, it is no longer possible reasonably to argue that commercial banks should be able to affiliate with, and lend to, securities firms but not with retail firms.

Why, then, was the Greenspan Fed so resistant to allowing nonfinancial firms to compete with banks? My suggested Fed policy advocacy algorithm explains Fed opposition to mixing banking and commerce. Doing so is not welcomed by the banking industry, which does not want new competition, which could substantially erode existing

banks' market shares. Perhaps more importantly, if Wal-Mart acquired an Industrial Loan Company (the remaining loophole available for entry by nonfinancial firms after the closing of the unitary thrift loophole), its primary prudential banking regulator would be the FDIC, not the Fed. This could lead to a major incursion on the Fed's regulatory turf if nonfinancial firms entered in significant number and were regulated by the FDIC, a form of regulatory competition that would be welcomed by historians of bank regulation, but not by the Fed.

A Minimum Subordinated Debt Issuance Requirement for Large Banks

Beginning in the 1990s, several advocates of capital standards reform, including myself, argued that neither the Basel minimum capital standards, nor the prompt corrective action rules regulating capital ratios that were established in 1991 were sufficient. As a means of ensuring continuing market discipline (through the presence of credibly uninsured creditors borrowing from banks on a continuing basis), reformers proposed a minimum subordinated debt requirement (see Calomiris 1997, 1999, and U.S. Shadow Financial Regulatory Committee 2000).

The information value of the market pricing of subordinated debt is a topic that numerous researchers had examined in the 1990s, including Federal Reserve Board researchers. The Gramm-Leach-Bliley Act mandated that the Fed study the possibility of imposing a subordinated debt requirement on the largest banks, and the Federal Reserve Board performed a study in response to that mandate (Federal Reserve Board Staff Study #172, December 1999). The study found evidence that it would be beneficial to require subordinated debt, because the signals from its pricing were informative, and because

banks have a tendency to withdraw from the sub debt market when their condition deteriorates (perhaps to avoid a negative signal that would be visible to the market and to the bank's regulators). In other words, the study found strong evidence of the potential value to requiring banks to issue sub debt. But the study concluded, simply, that "no policy conclusions are advanced" and that more research on this topic should be performed, a conclusion that sidestepped the obvious implication of the study's findings, which confirmed the desirability and feasibility of a requirement.

Currently, the possibility of a sub debt requirement is remote, largely because Chairman Greenspan's further comments on the topic indicated he believed that further discussion, or a minimum requirement, would be unnecessary, since the Fed has already decided to monitor sub debt yields. In a speech he gave in September 2001, entitled "Harnessing Market Discipline," Chairman Greenspan said:

On the second goal, using market information in supervision, the Federal Reserve and other regulatory agencies already monitor subordinated debt yields and issuance patterns in evaluating the condition of large banking organizations, virtually all of whom voluntarily issue such debt. And, early this year, the Board and the Treasury Department, in a report to Congress required by the Gramm-Leach-Bliley Act, found evidence supporting the value of monitoring subordinated debt. Significant changes in a banking organization's debt spreads, in absolute terms or compared with peer banks, can prompt more intensive monitoring of the institution.

But it is not possible to monitor sub debt unless it exists, and, as the study he cites indicates, unless a minimum amount of outstanding debt must be maintained, it is likely to disappear when one would most want to monitor it.

Why did the Fed not push for a minimum sub debt requirement? I attended a closed-door meeting of Fed officials, Treasury officials, academics, and bankers around the time this Fed study was being done, to discuss potential advantages and disadvantages

of a requirement. Representatives from the big banks argued at the meeting that it might be cumbersome to require them to come to market at a specific time, but as I pointed out at that meeting, one could give banks a great deal of flexibility to determine when to issue required sub debt. At the coffee break, when I pressed him, the Treasurer of one of the large New York banks admitted that the argument about the need for timing flexibility was not a real stumbling block, but he explained that “we just don’t want another regulation, if we can avoid it; it’s that simple.” Who would want discipline if he could avoid it? And with a friend like the Fed at the table, avoiding it was easy.

The Community Reinvestment Act

The Community Reinvestment Act (CRA) has been decried as an outdated, inefficient, and unfair approach to forcing banks to subsidize certain favored activities within their local market areas. Lawrence J. White (1993), among others, has pointed out that the logical premise on which the implied taxes and transfers mandated by CRA might be defended (that bank charters are a conferral of a special privilege by society) does not hold in today’s environment, where banks compete with credit unions, finance companies, and other intermediaries, and do not generally reap rents from their charters. (Although, as discussed above, there is an argument to be made that bank consolidation has limited competition in some market segments – Calomiris and Pornrojngkool 2005 – that argument does not apply to small business loans and consumer credit, in which banks probably enjoy no “rents” by virtue of their charters.)

Furthermore, CRA is not an effective means to channel assistance to low-income or minority borrowers (for a discussion of alternatives, see Calomiris, Kahn and

Longhofer 1994, and Calomiris 2001). And the CRA invites the worst sort of political rent seeking behavior and extortionist tactics from some advocacy groups.

But the Fed has not had the courage to speak out against the CRA. As a political issue, it is “too hot to handle,” and the Fed does not wish to anger members of Congress or Administration officials who are beholden to the pro-CRA constituencies. Indeed, the Fed is an active enforcer of the CRA, not just through the CRA ratings received by banks from regional Fed supervisors, but also through the merger approval process of the Board of Governors. The Board of Governors frequently refers to CRA ratings in its approval deliberations, and has rejected mergers on the grounds that the banks proposing to merge have paid insufficient attention to CRA. By inviting CRA advocates to speak at Fed hearings, and by giving great weight to the opinions of these advocates, the Fed has willingly cooperated in the process of CRA rent seeking.

Former Senator Phil Gramm believes that the regulations written by the Fed and others to enforce CRA are not in keeping with provisions of the Gramm-Leach-Bliley Act, of which he was the principal architect. In an interview with the *American Banker* on June 9, 2000, Senator Gramm said that regulators were wrong in their assessment of the new financial reform law and “In five major areas, the proposed regulations not only violate the spirit of the law, but they violate the letter of the law.” Gramm is particularly worried about the failure to enforce various sunshine provisions, which require banks and community groups to disclose the terms of CRA-related agreements. Banks must file annual reports and community groups must describe how they use the funds. Senator Gramm believes that regulators are not implementing the details Gramm set forth in the law and are therefore intentionally limiting disclosure. Disclosure is intended to make

extortion more difficult, and thereby reduce the extent of extortion. Why is the Fed not implementing Gramm's rules?

Obviously, the large banks would prefer to limit the costs of the CRA. But the political risks to the Fed are too great in this case to make the Fed take sides with its favorite constituency. Federal Reserve Board research (Canner et al. 2002) on the CRA tends to find a small, statistically insignificant effect from CRA lending on bank profitability. If this research is correct, the costs of compliance are not very large, which may further explain why the Fed and the banks do not actively oppose the CRA. The banks know that a Fed campaign against the CRA would stir up trouble in Congress, and in the current political environment would be quixotic, and they have long ago simply factored CRA costs into their cost of doing business. Indeed, if the Fed did try to repeal the CRA at this point, many banks would probably oppose that effort (fearing the ramifications of having supported it in the likely event that it should fail).

Real Estate Brokerage

Real estate brokerage is another tricky political issue for the Fed. On the one hand, the Fed wants to avoid political fallout in Congress from the influential Realtor lobby. On the other hand, the large banks would like the opportunity to add real estate brokerage to their list of financial services.

Real estate is an asset. Real estate brokerage seems, therefore, to be a financial activity (the brokering of an asset). Under Gramm-Leach-Bliley, banks can engage in financial activities, but real estate brokerage is not specifically enumerated as a financial activity. Can they or can't they? Under Gramm-Leach-Bliley it is up to the Fed, along

with the Treasury, to decide what activities are financial, and therefore, permissible. There seems to be no legitimate public policy objective that could justify limiting bank entry into real estate brokerage.

The Fed has been reluctant to play the role of political arbiter of this issue. In the words of former Fed Governor Lawrence Meyer, who seems to have been handed the unpleasant task of commenting on the permissibility of real estate brokerage (I have found no statements on this issue by Chairman Greenspan as yet): “The GLB Act neither specifically authorizes nor specifically forbids financial holding companies or financial subsidiaries of national banks to engage in real estate brokerage and management activities.””Although some of the comments favor the proposal, the vast majority of the comments have been submitted by individual real estate agents opposed to the proposal.” “These are difficult issues, and both sides feel very strongly about their position. While we do not relish being in the middle, we believe that a debate on these matters is the best way to identify and sort through the issues and to reach an informed decision, and is precisely the type of debate envisioned in the GLB Act.” (Testimony Before the Subcommittee on Financial Institutional and Consumer Credit, House Banking Committee, May 2, 2001). It is noteworthy that this testimony is all about politics, not economics.

This issue remains unresolved, and the Fed seems to be doing its utmost to avoid talking about it, so as to neither disappoint its bank allies nor perturb Congressional advocates of real estate brokers. There is no legitimate reason for the Fed not to permit entry into real estate brokerage by banks. The absence of advocacy by the Fed on this issue is, however, quite consistent with my proposed Fed advocacy algorithm.

The conflict over permitting banks to engage in real estate brokerage illustrates the double-edged triumph of Chairman Greenspan with the enactment of Gramm-Leach-Bliley in 1999. On the one hand, he succeeded in his advocacy in the areas of broadening bank powers, securing umbrella supervisory authority, giving the Fed an ongoing role in deciding which activities would be permissible in financial holding companies, and limiting competition in banking from nonbanks (benefiting his big bank allies, while also limiting competition with the Fed in the regulation of banks). On the other hand, the Fed's new authority to determine permissible financial activities places it more squarely in the middle of political disputes that it does not really want to decide, because of the political risks of having to do so.

III. The Case for Ending the Fed's Role as a Financial Regulator

My goal in Section II was to show that a simple algorithm of Fed regulatory advocacy works well (one might say perfectly) to explain the Fed's positions, and even the changes in those positions over time, in all ten of the examples reviewed there. Of course, no one can "prove" what the intentions or objectives of the Fed or its Chairman are, but one can test simple theories to see if they are consistent with the facts. The view that the Fed tries to do the right thing from a regulatory standpoint subject to its desires to buttress its own power, assist its large bank allies, and avoid confrontations with Congress or the Administration is a powerful theory of Fed decision making. It works well during the Greenspan years, and before the Greenspan years (Hawke 1988), and can explain shifts in Fed advocacy that coincide with shifts in the political landscape of Washington.

During the 1980s and 1990s, the Fed's advocacy role was largely benign. Despite the fact that the Fed was often on the wrong side in the ten areas reviewed in Section II, it was on the right side of the most important controversies, and it made a difference in helping to win some important regulatory changes, most notably the consolidation of the banking industry and the expansion of bank powers into other financial areas.

In the future, however, the Fed is likely not to play a helpful role in resolving the most important regulatory issues. In my view, the most important desirable changes of the next decade will involve permitting the entry of nonbanks into banking, and developing stronger regulatory oversight to limit excessive concentration within the financial sector (not just for banks, but for ratings agencies, accounting firms, and other financial intermediaries). The Fed's political objectives and its strong alliance with the large banks will limit its effectiveness as a reformer in this area. Thus, looking forward, there is an increasing benefit from removing regulatory authority from the Fed.

Calomiris and Litan (2000) review the case for separating monetary and regulatory authority and point out that the vast majority of financially developed countries have removed their monetary authorities from regulating their banking systems (including the EMU member countries of Europe, the United Kingdom, and Japan). Indeed, with the exception of one small financially developed country, New Zealand (an interesting and exceptional case, since it no longer has a significant domestically based banking system to regulate), all of the other countries on the list of countries whose central banks regulate the financial system are developing countries, and they tend to be among the smaller or more politically corrupt developing countries (according to Transparency International's Corruption Index). Among countries that are large,

developed, and not politically corrupt, the United States is the *only one* in which the central bank plays an important bank regulatory and supervisory role.

What is the advantage of separating monetary and regulatory authority? There are several advantages from separation. First and foremost, the Fed views monetary policy as its prime objective, and is concerned primarily about political challenges to its monetary policy independence. That makes the Fed willing to tradeoff undesirable regulatory policy as needed to help form political alliances with large banks, CRA advocates, or other powerful political actors, which will preserve its monetary policy independence. Regulatory policy suffers as a consequence.

Looking forward to the future, one might argue that the Fed's independence as a monetary authority has never been greater than at the current time (Ip 2005), largely as the result of the monetary policy successes of the Greenspan era. Does that mean that the Fed, freed from the risk of political challenges to its independence, might behave differently, and less politically as a regulatory advocate, in the Bernanke era?

I think not, for two reasons. First, I doubt that Congress has permanently given up challenging the Fed on monetary policy, despite the waning of Congressional challenges during the Greenspan years (Ip 2005). Chairman Bernanke's honeymoon with members of Congress will last only as long as members of Congress find that expedient (that is, only until a prolonged downturn occurs in their Congressional district).

Second, the fundamentals of Fed power are weakening institutionally, and I believe that this long-run decline will force the Fed to become more politically risk-averse, and to enter into new political alliances, to the detriment of regulatory policy. As Hawke (1988) recognized, the reason that the Fed and the large banks are natural allies

politically is that the Fed needs the banks' help, and the banks offer it because they want to gain favors from their regulator:

...Fed theologians have felt that preservation of its role in supervision and regulation – as well as its role in operating the payments system – is important to the preservation of its political independence. This view is based on the hybrid public-private nature of the Reserve Banks, six of whose nine directors are elected by member banks. While control of the System rests comfortably with the Board of Governors, the involvement of the System of influential private citizens provides the Fed with significant political resources. Since much of the business of the Reserve Banks is related to their supervisory functions, some fear that if the Fed were to be divested of this role it would substantially diminish the substance and importance of the Banks and lead to a weakening of one important base of independence for the System.

In other words, the Fed's regulatory role boosts its political influence with the banks, which then assist the Fed in maintaining its independence. Hawke points out that much of the political payback that the Fed receives from the banks depends upon the participation of "influential private citizens" throughout the country, who lobby their members of Congress in support of the Fed. I can attest to more than one occasion when a high-ranking regional Fed official has expressed the same opinion to me, and there are many stories about how successful Fed Chairmen and Fed Bank Presidents pride themselves on their ability to mobilize such support.

The willingness of "influential private citizens" throughout the country to heed the call of the Fed, however, is subject to change. The Fed's role in the payment system is waning, as a function of new technology and new competition, and large banks are less beholden to their regional Fed regulators than they used to be (the new interstate branching networks of large banks do not jibe well with the regionally segmented structure of the Federal Reserve Banks). Bankers are interacting less with their regional Feds either as regulators or as service providers, and more than one Fed President has

commented to me that it the composition of regional Fed Boards of Directors has sometimes suffered as a result.

A Federal Reserve System that is losing political clout, while being forced to make more politically charged decisions (about what constitutes a financial activity), is likely to be an increasingly risk-averse and politically sensitive regulator. Thus, the Fed is unlikely to be able to rise to the regulatory challenges that will face it in the Bernanke era, especially the need to support competition in the financial services industry by toughening consolidation rules and allowing entry by nonfinancial firms. There has never been a better time to rethink our bank regulatory structure, and to consider the advantages of removing regulatory authority from the Fed.

Notwithstanding the undesirable consequences for financial regulation of a continuing Fed role, is it possible to justify the Fed's continuing role in regulation purely as a means of giving it the political clout to maintain its independence as a monetary policy maker? That is less clear, and has not been the subject of this essay, but I would point out that increasingly the Fed's regulatory role is creating political risks for Fed, not just clout (the controversy over real estate brokerage is a likely harbinger of things to come). Even from the narrow perspective of preserving monetary policy autonomy it may be worthwhile to let the Fed withdraw from its regulatory distractions and specialize in its primary activity, setting monetary policy to preserve price stability and enhance growth.

TABLE 1

Financial Regulation Within or Outside the Monetary Authority

**Countries for which financial
regulation authority lies outside
the monetary authority**

Australia
Austria
Belgium
Canada
Chile
China
Colombia
Denmark
Finland
France
Germany
Greece
Hungary
India
Ireland
Italy
Japan
Luxembourg
Mexico
Netherlands
Norway
Peru
Poland
Portugal
South Korea
Spain
Sweden
United Kingdom
Venezuela

**Countries for which financial
regulation authority lies within
the monetary authority**

Argentina
Brazil
Czech Republic
Egypt
Indonesia
Israel
Jordan
Kenya
New Zealand
Nigeria
Pakistan
Russia
Saudi Arabia
South Africa
United States

TABLE 2

Ten Examples of Fed Regulatory Advocacy

Fed Advocacy of Beneficial Regulation

Interstate Branching The Greenspan Fed was a much more vocal advocate of interstate branching than the Volcker Fed, owing to changes in the political landscape that allowed the Fed to support branching with little political risk, and with strong support from large banks.

Mergers and Acquisitions The Fed has supported large bank mergers. Although this has largely been beneficial, the merger of Fleet and BankBoston shows that the Fed may be too willing to permit undesirable concentration of power to occur.

Fannie and Freddie Post 2000 Once the political climate had become less risky, in cooperation with reform leadership by Congressman Baker and the White House, the Greenspan Fed becomes a vocal proponent of reform, with strong support from large banks.

Investment Banking Powers The Fed led the efforts to expand banking powers, particularly in the area of underwriting of corporate securities. This was done gradually, and at a time when large banks' international competitiveness was threatened, both of which limited the risk of a political backlash. This was strongly supported by the large banks.

Not in the Interest of the Big Banks

Banking and Commerce The Fed opposes permitting nonbank firms (e.g., WalMart) to compete with banks, a position that supports the interests of large banks, and also limits regulatory competition with the Fed.

A Minimum Subordinated Debt Requirement for Large Banks Despite widespread evidence supporting the view that such a requirement would boost prudential regulatory and supervisory discipline, some of which was produced by Fed staff, the Fed kills this initiative, due to opposition from the large banks.

TABLE 2 (Cont'd)

Ten Examples of Fed Regulatory Advocacy

Too Politically Hot to Handle

Fannie and Freddie Pre 2000

Fed officials and researchers were silent during the early phase of the reform efforts involving these GSEs because of the perceived political risks.

The Community Reinvestment Act

While not an effective or efficient policy, the Fed does not oppose it because of the perceived political risks of doing so.

Real Estate Brokerage

Under Gramm-Leach-Bliley, the Fed shares with the Treasury authority to decide which activities qualify as permissible “financial” activities for financial holding companies. This places the Fed in a difficult position when there is strong political opposition to permitting entry. Despite the absence of any economic argument against permitting banks to act as real estate brokers, the Fed seeks to avoid the political fallout from supporting the effort.

Fed Regulatory Power Play

Investment Banking Subsidiaries vs. Affiliates

The Fed sought to limit the ability of banks to operate securities subsidiaries, and other subsidiaries, of banks, as opposed to affiliates, in a largely unsuccessful power play against the OCC.

Umbrella Financial Supervision By the Fed

The Fed succeeded in having itself appointed as an umbrella supervisor of financial holding companies under Gramm-Leach-Bliley.

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