

VIEWPOINT

How The Fed Should Be Reorganized

By **MIKE COSGROVE**

The fastest way to destroy U.S. capital markets is to give Congress more control of the U.S. financial system. And yet Sen. Dodd is proposing to create a new agency in charge of supervising banks and bank-holding companies, led by a White House appointee.

The leader of that agency and no doubt a number of other management people would likely be political appointees and would change as the White House occupant changed and the political winds in Congress shifted. It is the worst possible solution.

Dodd's proposal is a method for Congress and the administration to gain more control of the U.S. financial system and ration credit to those parts of the economy members of Congress think worthy.

It is an anti-economic growth proposal at a time when the federal deficit is 10% of GDP and the outstanding federal debt burden is \$12 trillion. Fed independence has been hurt by the financial meltdown, but to change the Fed's role by stripping away its regulatory function is to make the Fed dependent upon Congress.

The Federal Reserve has 2 directives — low inflation and supervision of the banking system, as Chairman Bernanke outlined in a recent op-ed. Clearly a large part of the financial system supervision and regulatory function belongs at the Fed, with the FDIC maintaining its role of insuring deposits and handling the dismantling of failed financial entities.

Yes, Chairman Bernanke and, before him, Chairman Greenspan missed the risk to the banking system of the explosion of mortgage-backed securities, derivative build and counterparty risk. Bernanke as late as a May 2007 talk didn't expect any "significant spillovers from the subprime market to the rest of the economy or to the financial system."

One reason the Fed failed in its regulatory effort is lack of an adequate internal structure and organization.

The Federal Reserve needs to internally organize its structure into a dual strategy-structure framework for achieving its goals of: 1) stable prices and 2) financial entity supervision, with the vice chairman of each division reporting to Chairman Bernanke.

Currently the 12 regional Fed banks and the board of governors are set up in what appears to be a haphazard fashion.

There are well over 500 economists in the Federal Reserve system, including those in the D.C. headquarters and 12 regional banks. These economists generate research on areas that may or may not be related to the main Fed functions

The fact that all of these economists failed to do their job and inform Bernanke of the impending financial problems once he became chairman screams out that there is lack of accountability and proper organization within the Federal Reserve.

The focus of the Fed's research needs to be directed to its two major functions of the Federal Reserve and that research needs to be actionable.

The fact that the Federal Reserve System and hundreds of researchers allowed Chairman Bernanke to be uninformed about the impending financial meltdown is inexcusable. Bernanke needs to quickly reorganize the Fed so it can achieve its objectives and implement accountability, which may mean some people lose their jobs.

Patrick Parkinson was recently named the head of bank supervision. He can be vice chairman of financial entity supervision if Bernanke has confidence that Parkinson can organize that function so that people in it are accountable.

Mr. Kohn is already Vice Chairman so he can be Vice Chairman of the monetary division. Is he the one to develop and implement the Fed's exit strategy from the over \$1 trillion increase in the Fed's balance sheet? The chairman needs to get this exit strategy right so that inflation remains low or he will have failed as Fed chairman.

Chairman Bernanke can help himself in this process if he and his inner circle of advisors implement this dual strategy-structure framework for the Federal Reserve System, fill the boxes in each division and implement accountability. That will strengthen perceived Fed independence both at home and abroad and increase Bernanke's chances of success.

- Cosgrove, principal at Econoclast, a Dallas-based capital markets firm, is a professor at the University of Dallas.