# Consumer Finance Monitor (Season 7, Episode 26): Consumer Financial Protection Bureau Wins in Supreme Court But Can the Fed Continue to Fund the CFPB Without Earnings?

Speakers: Alan Kaplinsky and Alex Pollock

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services group at the Ballard Spahr law firm, and I'm your host, Alan Kaplinsky. I'm the former practice group leader for 25 years, and now, senior counsel of the Consumer Financial Services group at Ballard Spahr. And I am very pleased to be moderating today's program. For those of you who want even more information, don't forget to consult our blog, which also goes under the name of consumerfinancemonitor.com. We've hosted our blog since July 21, 2011 when the CFPB became operational. So there's a lot of relevant industry content there. We also regularly host webinars and subjects of interest to those in the industry.

So to subscribe to our blog, or to get on the list for our webinars, please visit us at ballardspahr.com. And if you like our podcast, please let us know about it. You can leave us a review on Apple Podcasts, YouTube, Spotify, or wherever you access your podcast shows. Also, please let us know if you have any idea for other topics that we should be covering, or other speakers that we should consider inviting this guest on our show. So today, I am joined by Alex Pollock, and I will give Alex a formal introduction, but I want to set the table for all of our listeners before going through Alex's very impressive CV. So on May 16th, the Supreme Court came down with a very, very important opinion called Consumer Financial Protection Bureau versus Community Financial Services Association of America, or we call it the CFSA case. CFSA is a trade association of payday lenders.

This is a lawsuit that originally got filed in 2017. It got filed in federal court in Texas, it went up to the Fifth Circuit. And eventually, the issue upon which the US Supreme Court granted review was the question of whether the CFPB... whether the language, I should say, in the Dodd-Frank, which specified that the CFPB would receive its funding out of earnings generated by the Federal Reserve System each year up to a statutory cap equal to a percentage of the budgeted expenses of the Federal Reserve System, whether or not that complied with the Appropriations Clause of the US Constitution. Article 1, Section 9, Clause 7 of the Constitution states in relevant part, it's very simple, "No money shall be drawn from the Treasury, but in Consequence of Appropriations made by law." That's really the beginning and the end of the relevant language that the Supreme Court was charged with interpreting.

In a 7-2 opinion written by Justice Thomas, he held that there's no need for an annual, or for that matter, any other actual appropriation to be made by Congress that goes beyond what's already in the language of Dodd-Frank. And he concluded, after writing a rather lengthy opinion that really gets into the weeds about the history of our constitution... not only our Constitution, but the governing structure in England, goes back to how the king would fund it. And what he said was that, "Under the Appropriations Clause, an appropriation is simply a law that authorizes expenditures from a specified source of public money for designated purposes. The statute," he's talking about Dodd-Frank, "that provides the Bureau's funding meets those requirements." Well, what did Dodd-Frank have to say about funding the CFPB? Section 10 17 of Dodd-Frank says, "Each year... or quarter of each year, the Board of Governors shall transfer to the CFPB, from the combined earnings of the Federal Reserve System, the amount determined by the director to be reasonably necessary to conduct its operations," or whatever may be necessary in the eyes of the CFPB director.

Well, on May 20th, Professor Emeritus Hal Scott of Harvard Law School published an op-ed in the Wall Street Journal titled The CFPB's Pyrrhic Victory in the Supreme Court. And he basically advocated the position that beginning in September 2022,

the Federal Reserve System had losses, it started incurring losses. Something that had not happened, I'm told, since 1950, which was the very first year that the Federal Reserve System became operational. And that beginning at that point, there were losses, and therefore, there were no earnings, out of which the Federal Reserve System could draw money from the Treasury, to pay for the CFPB's expenses. It's as simple as that. Well, you might say, "Well, how come that issue didn't get raised in the CFSA case?" The answer to that is that in 2017, when that lawsuit got brought, the Federal Reserve System had plenty of earnings. So there was no issue at that point to raise, the sole issue that was raised was the constitutional issue.

But there was no discussion of whether or not there was earnings, because there was earnings, and there was earnings throughout that litigation until September 2022, when this Federal Reserve started sustaining losses. And I'm not talking about small losses, I'm talking about gigunda losses, very large losses, in the billions of dollars, that continues to this day and is likely to continue into the future. Some people say they won't have earnings again until 2027. So my guest today, Alex Pollock, published an article on the website of the Federalist Society, it was published on May 21. And in that article, he basically took the same position that Hal Scott took. So on May 22, we published an article on our blog, Consumer Finance Monitor. So if you go on our blog, you'll see an article we published and you'll see a reference in a link to Hal Scott's op-ed, and also, to the article written by our guest today, Alex Pollock.

Shortly after that, we recorded a podcast show with Professor Hal Scott, and on June 6th, we released that show on our podcast. And if you haven't listened to that interview, I would suggest you go into the archives of our podcast show and you'll be able to listen to it. Now, Alex's article of May 21, which I didn't realize it at the time, but I realized that shortly, this was not something new to Alex Pollock, he has written about this issue on several other occasions. Let me just enumerate them for you. The first is, "The Fed is in the red, should it still pay the CFPB's bills?" This was published on October 27th, 2022. This is about a month after this Fed started losing money, and it was published in The Hill, along with the co-author Paul Kupiec.

Another article, "The Fed is losing tens of billions, how are individual Federal Reserve banks doing?" It was an op-ed in the Mises Institute and RealClear Markets on August 23rd, along with Daniel Semelsberger. Third article, Locks of Red Ink at the Fed, publishes a blog on September 15, 2023 in the Mises Institute and RealClear Markets. And then, Federal Reserve Losses and Monetary policy. It appears on SSRN, I'm not sure if it's been published anywhere else yet, co-published with Paul Kupiec, on February 20th, 2024. And then finally, the most recent article about this, Can the Fed Fund the CFPB? Published in the June 5th edition of Law & Liberty, co-authored again with Paul Kupiec.

So now, I've given you some of the introduction of Alex Pollock, but let me tell you a little bit more about his background. He's a senior fellow with the Mises Institute. He has been the principal deputy director of the Office of Financial Research in the US Treasury, a distinguished senior fellow at the R Street Institute in Washington, DC, a resident fellow at the American Enterprise Institute, and president and chief executive officer of the Federal Home Loan Bank of Chicago. Alex focuses on financial policy issues, including financial cycles, housing, finance, banking, central banking, uncertainty and risk, retirement finance, corporate governance, financial crises, the CV goes on, and on, and on. I'm not going to get into any more of it because I want to save plenty of time for a lot of questions I have for Alex. But Alex, a very warm welcome to you.

Alex Pollock:

Thank you very much, Alan, and thank you very much for having me on this podcast. I'm delighted to be able to discuss this with you, and the most kind in your introductory comments. So thanks for those two.

Alan Kaplinsky:

Well, let's get to it. So the first question I have for you... Well, the first thing I'd like to have you describe for our listeners, because they may not have listened to the Hal Scott interview, and you probably come at it from a slightly different standpoint, because Hal, of course, is a law professor and you are not a lawyer.

Alex Pollock:

Very true.

Alan Kaplinsky:

And congratulations to you for that. If you could describe what your thesis is in the op-ed that you published on May 21?

Alex Pollock:

This is a most important issue, viewed from a financial angle as well as from a legal angle. My thought is that you can completely accept the judgment of the Supreme Court, which you nicely summarized, as correct, and still find that the Fed cannot, under current circumstances, pay the expenses of the CFPB, exactly for the reason you said, statute says, very clearly, "The Board of Governors shall transfer to the Consumer Financial Protection Bureau, from the combined earnings of the Federal Reserve System, the amount that the CFPB wants up to a cap." Now, as you rightly said, at the time Dodd-Frank was written, and at the time this lawsuit commenced, and throughout all the legal argumentation, it appears that nobody brought up the fact that now, starting, as you rightly say, in September 2022, there are no earnings.

So it could be completely correct, as the court found that the Fed is constitutionally authorized... or that Congress is constitutionally authorized to tell the Fed to share its earnings with the CFPB. But the fact is there are no earnings and as you also said, Alan, the losses are stupendous. The aggregate losses, so far, are $172 billion, $172 billion, in the most recent week of Fed reporting. And something very important is if you're interested in this topic, you can see the financial statements of the Federal Reserve, or at least the balance sheet, and the current profit and loss results of the Federal Reserve every week, it's called the Federal Reserve H.4.1 release. And it's a key document for all of us who study this. And we wish the timing had been such that this could have been more apparent in the legal argumentation.

But in the most recent week, which was the week ended May 29th, 2024, the Federal Reserve lost $1.6 billion, in a week... well, a billion and a half a week. As Everett Dirksen, at least is supposed to have said, "Pretty soon, you're talking about real money." And in the year 2023, the Fed lost $114 billion. A $100 billion, it would qualify as real money. But it especially qualifies as real money because last year, the billion and a half a week, currently, the aggregate losses of $172 billion in September must be compared to the retained earnings of the Fed. Now, what are the retained earnings of the Fed? If you believe their books, there are about $6 billion. So 6 billion retained earnings minus 172 billion losses gives you actual retained earnings of negative $166 billion.

Now, in ordinary circumstances, you're not paying out any earnings when not only don't you have any, but the losses have wiped out your retained earnings, and on top of that, they have wiped out the paid-in capital of the Federal Reserve. Now, the Federal Reserve Board is not an operating entity, it has no balance sheet, all the operations are in the 12 Federal Reserve Banks. Each Federal Reserve Bank is a separate corporation, it has its own management, its own financial statements, its own board, and its own shareholders. And who are those shareholders? They are the private banks, who are members of the Federal Reserve. Federal Reserve Banks are privately-owned banks.

Alan Kaplinsky:

Owned by national banks and state charter banks that are members of the Federal Reserve System. National banks are required to join, and they have to pay in certain capital to join. Am I right?

Alex Pollock:

Yeah, that's right. Well, how much have they paid in? Well, they've paid in $36 billion of paid-in capital. So if you add $36 billion of paid-in capital, and the capital comes from the private banks, to the $6 billion that they retained, and then you correct for rounding, that turns out to be $43 billion of total capital on the books of the Fed, but the real capital is $43 billion minus $172 billion, so far. Give it one more week, it'll be another 1 or $2 billion bigger. So in other words, they've lost four times their total capital already. So if you've lost four times your total capital, with correct accounting, you are technically insolvent, you have no earnings for the CFPB to share in, you have no retained earnings to pass out after the fact, and you don't even have any paid-in capital.

So in sum, the first point... I'll make quickly a second point, the first point is that even if you completely accept the constitutional argument of the court, that it's okay for Congress to say the CFPB gets some of the earnings, they have a slight problem, there are not any earnings, and in fact, there are gigantic losses, and then there are no retained earnings, and there is

no capital. So there's nothing to pay with. Now, the second part, I just want to mention quickly, is another argument, the court holds that these monies, if they're public monies, can be spent in this way. But that's why I mentioned the fact that the Federal Reserve Banks are privately... at least the stock of the Federal Reserve Banks is privately owned by private banks and their borrowings, which if you're losing money and you still are paying money over to the CFPB, you're borrowing the money. Federal Reserve Banks are borrowing the money to make the payment to the CFPB because they're losing.

Those borrowings, it is our view, Paul Kupiec, my longtime co-author and great friend and colleague, that by no stretch of the imagination could you consider those public monies, the only public monies are the earnings of the Federal Reserve, which they have to give over to the Treasury. We agree with the court there, you could make an argument that if the Fed has to turn over not all of their earnings, but almost all their earnings, because they also pay dividends to the private shareholders first, that after paying those dividends and in getting to your cap of retained earnings, 6 billion or so dollars, everything else would have to be given to the Treasury. Well, you could say substantively, that's public money, but they're not earning anything, they're not giving anything to the Treasury, they're borrowing money from private sources to pay the CFPB. So a secondary argument is that those are not public monies.

Alan Kaplinsky:

Yeah. So Basically, it's not only a statutory problem under Dodd-Frank, but it's also a constitutional problem. It's both.

Alex Pollock:

Yes. And a statutory problem, we think under the Federal Reserve Act as well, which defines the structure of the Federal Reserve banks, and the Federal Reserve System and its finances.

Alan Kaplinsky:

Yeah. And by the way, for those people who want to do more research in the area, I think it's section 7 of the Federal Reserve Act that talks about stockholder dividends, depositing net earnings to a surplus fund, and then turning over monies to the Treasury, the net earnings. But let me ask you this, we're dealing with some relatively smart people who drafted the Dodd-Frank Act, the architect of it. Politically, many people may not agree with her, but I think people will agree she's a pretty smart senator, Elizabeth Warren. Used to be a colleague of Hal Scott's at Harvard, a little bit of trivia for you. Do you think that this was an issue that anybody thought about, anybody was concerned about? In the years leading up to the enactment of Dodd-Frank, we had just gone through this economic recession, that was the whole impetus for the enactment of Dodd-Frank.

Congress felt they had to straighten things out, that the federal agencies that were regulating the banking industry had become captured by the industry, or were asleep at the switch, and they allowed a lot of really bad things to go on, and things that were unfair, unfair practices, and they were unsafe and unsound banking practices. Do you mean to tell me, Alex, nobody back then might've said, "Hey, you think we should say the monies ought to be paid out of revenues?" Or maybe we shouldn't say anything about where the monies are being paid out. Why should we put in earnings, because there may not be earnings at some point in the future?

Alex Pollock:

That is a great question, and the answer is, I believe, that it was simply assumed that the Federal Reserve would always have earnings. Now, note that they could have said, as you point out, Alan, "The board of Governors shall assess the Federal Reserve Banks and pay to the CFPB so much money, so just make it a payment." But they didn't say that. They made it dependent on earnings. Now, why? Well, because, in my opinion... now, this is just speculation on my part, but look how much better it looks to say, "Well, if the Fed is making all this money, we're just going to use some of this money that it's making to fund this other agency, which we're so fond of."

Alan Kaplinsky:

Yeah, I can see Congress saying, "Oh, that's no big deal." I don't think it even becomes part of the government's budget. Am I right? An off-budget item?

Alex Pollock:

Federal Reserve is off-budget. There, again, never thinking they'd be losing money, and making the budget deficit bigger.

Alan Kaplinsky:

But nobody will know about that if they should lose money, right? That's probably what people were thinking. And at that time, I guess, if you go back, I don't know if you've got the statistics, but Dodd-Frank was enacted, I think, March 2010. I would guess they were making plenty of money back then because interest rates were very low.

Alex Pollock:

I'm going to give you the numbers here right now, but I'll say that it was easy to assume that the Fed would always be profitable. Now, think about 2010. The Democrats, coming out of the financial disaster of 2008 and the 2008 elections, had total control of the Congress with huge majorities. However, they knew they were going to lose, or they thought it was probable, but they were going to lose in the 2010 elections. That was clear by then, as they did, and house control passed, and they lost a lot of Senate seats. So they were wanting to tie the hands of future Congresses so they wouldn't be able to cut back on the CFPB. So they came up with this clever scheme, "Now, let's just take some of the earnings." Well, the Federal Reserve has plenty of earnings.

Let's take ourselves back to 2009, 2010 when this was being debated, and what could they see? Well, in 2006, the Federal Reserve System made $34 billion of profit. In 2007, they made $38 billion of profit. In 2008, they made $35 billion of profit. In 2009, they made $52 billion of profit. So it was a clear feeling, and they'd been making money for more than a hundred years.

Alan Kaplinsky:

Well, and the other thing of course to look at is that under the formula in Dodd-Frank, I had mentioned, there's a limit on how much they can take down every year, and it's based on the, I believe, the budgeted expenses for a particular year-

Alex Pollock:

Of the combined Federal Reserve. Yes.

Alan Kaplinsky:

Yeah, combined, consolidated Federal Reserve Banks, and it started at around 10%. I think the final figure was something, after maybe starting in the third year, 12%, that was the number, I think, it's... I don't know, 600 million, 700 million, something like that, but way, way below the amount of earnings that the CFPB was earning at that point.

Alex Pollock:

Well, it felt pretty safe, for sure. But let me tell you one story, your Honor, may I introduce a little hearsay into this... this topic apparently never came up, and for the reasons you cited, because the case goes back to the time when the Federal Reserve was reporting big profits, and all the argumentation was apparently never argued. And I have been arguing this point of view, that even if you accept the Supreme Court's ruling as completely correct, still under the act, the Fed is in no position to pay these expenses. And been talking about this with different friends, a lot of, as you say, very smart guys, and one of them who is saying to me, "Well, did they really think about this?" He found a couple of friends of his, unnamed, who actually worked on the text, who told him at the time, they said, "Well, earnings, is this any problem? Can the Fed ever not have earnings?" And they answer themselves, "No, that's ridiculous. The Fed always makes a lot of profit."

Alan Kaplinsky:

So tell the audience, I know I went over this with Hal Scott, but you're the accounting guru here on government accounting, why did the Fed, beginning in September 2022, start losing money? What were they doing wrong in that?

Alex Pollock:

I have written a lot on this, if you would ever want to go back into the records, the Fed Reserve decided that it needed to suppress not only short-term interest rates but long-term interest rates, down to almost zero, to abnormally very low levels. And the way it did this was buying huge amounts... It became the big bid, as we would say, in a market. It became the big bid for mortgage-backed securities, which was a completely radical thing to do for the Fed to buy mortgages, which they started in 2008. I think Chairman Bernanke will go down in history as a truly radical Federal Reserve chairman. So they're buying 30-year fixed rate loans, and they own a lot of them, that yield about 2%. And they also started buying very long-term treasuries. They own a couple of trillions still that have more than 10 years to run, and the average yield on those is around 2%.

All right. Now, in the meantime, another Bernanke strategy was to start paying interest on deposits at the Federal Reserve by the banks. All right, that's something that, historically, they had never done. So they had locked-in free funding by making the banks hold non-interest bearing deposits. That's another reason why nobody ever thought they could lose money, because the whole historical record was based on the Fed having non-interest bearing funding, and on never owning any 30-year fixed rate mortgages, and certainly not splurging on very long-term treasuries. So they own altogether about $7 trillion worth of securities. Of that, more or less, 2 trillion is funded by the issuance of paper money, that is to say, Federal Reserve notes. Now that's zero... The great thing about issuing paper money, if you get the right to do it, is you got this free funding, just cost you the very trivial sum of printing it up.

But the other 5 trillion was now being financed by money they had to pay interest on. Well, how much did they come to be paying? But when they started off this gig, they're buying 2% assets and financing them with maybe one quarter of 1%, or less costing funding, but now, interest rates go back up to their normal levels. By the way, 5% is not a high interest rate, 5% that we have today is, historically speaking, a normal interest rate. So what does the Fed have? It has a huge portfolio of very long term fixed rate assets yielding about 2%. And to finance this, they're paying, let's call it 5%, it's actually more than 5.

Alan Kaplinsky:

Who were they paying the money to?

Alex Pollock:

They're paying the money to the banks who have the deposits at the Fed, and they're paying the money to the repurchase agreement counterparties who were lending money to the Fed. These were short-term floating rate liabilities. All right, so I want you to just picture this business strategy, how about this for an idea, we'll invest at 2% and we'll borrow at 5%, how do you like it?

Alan Kaplinsky:

It's called a negative gap. The accountants call it an enormous negative gap.

Alex Pollock:

3% underwater on $5 trillion of assets costs you $150 billion a year. And then you've got some other earnings, absorbs all of that, but the net of it is you lose more than 100 billion a year. So the Fed, I'm going to say it again, the greatest central bank in the world, build itself a balance sheet which said, "Here's our plan..." Well, it wasn't really the plan because, "Here's the risk we will take. We will invest around $5 trillion at long-term fixed rate assets earning 2% because of the things we did ourselves." We drove the long-term rates down. So now, we're buying them at 2%. And we end up financing them at 5%, so we're 3% underwater. Well, that should make you think of something. It should make you think of a 1980s savings and loan. That's what our Federal Reserve's balance sheet looked like. So now, the aggregate losses from that are $172 billion, as I said, and running, maybe another $100 billion this year. And these assets have very long lives, they're more than 10 year lives.

Now, they're running off, as they mature, the shorter ones, as you get repayments on mortgage-backed securities, they go down a little, but they have a very huge portfolio of very long-term fixed rate assets with very low interest rates. And the losses will continue as long as those assets are there. And short-term interest rates stay high, stay normal.

Alan Kaplinsky:

This might be a very naive question, but in terms of reducing the cost of money that they're paying now, the monies that they're paying on the reverse repos and deposits of the member banks, why can't they just print more treasury notes and put them in circulation... or basically use them to pay off the liabilities that are above what they're earning on their assets?

Alex Pollock:

Now, that's a really, really important and really fundamental question. So all of the money supply are liabilities of the Federal Reserve, of the Central Bank, Federal Reserve, and they come in two flavors, it's Federal Reserve notes, you're thinking... money, the money we carry in our pocket, and more importantly to the United States, in fact, half of those are held overseas, especially, US hundred dollar bills are the currency of the world, and those foreigners are providing nice free funding to the Federal Reserve, and therefore to the United States government. All right. So you can issue Federal Reserve notes by printing them, or you can hold the deposits of the banks and pay them. Now, there's a limit, you would think... First of all, when people talk about printing money, there's literal printing. So the Federal Reserve notes are literally printed, they're literally pieces of paper, and we all own a few.

And then there's metaphorical printing, which is running up accounts on your books that are the base money deposits of the banks and the Fed. Now, you could say, "Well, why don't we just replace all of these deposits with Federal Reserve notes?" Because there's a limit to how much in notes people want to hold, you have to convince people to hold the notes. And if you print them up, they can go just turn them back in, and the Federal Reserve has to issue deposits. So the Federal Reserve can move back and forth between literally printed money and metaphorically printed money, but metaphorically printed money costs it 5% to issue. So it can't really do this. Now, if you go back to the famous hyperinflations, like those of Germany and Austria, I guess it was one in Hungary too after the Great War, or in Zimbabwe, and Argentina, or Turkey, since they do actually just turn on the printing presses. And of course then, you can get wild inflation if you do that.

So they're really limited. Now, there's one other legal problem, since we're on a legal show here, to issue Federal Reserve notes, the Federal Reserve Banks must put up collateral. Under the Federal Reserve Act, they have to have collateral against the notes. That goes back to the origin of the act in 1913. Now, that collateral in 1913 included a substantial gold requirement, which we don't have anymore. The Federal Reserve is an unusual central bank, in that it owns no gold. Other central banks like, say, the Swiss National Bank, have substantial gold holdings, not the Fed. Anyway, so the Fed is limited by law, but more importantly, by the willingness of the public to hold Federal Reserve notes. So they're really stuck. They've got to pay the interest on these deposits, and this makes them exactly in the position, let's say, of a big savings and loan in the 1980s.

I should tell you, my favorite investment that the Federal Reserve bought for its own portfolio were the one and a quarter percent treasuries of 2050, that's one of the issues they have in portfolio. Well, that's going to be around for a long time yet. So that's the fundamental problem, and that's why they're losing money.

Alan Kaplinsky:

Now, how do they work themselves out of this predicament that they're in? And people are saying by 1927 there'll be-

Alex Pollock:

2027, excuse me.

Alan Kaplinsky:

2027. How do people know that?

Alex Pollock:

They don't know it. But if you believe that interest rates will fall, that will help, because that will take down the cost of the Federal Reserve deposits. They'd have to fall a very long way to make them profitable, maybe two and a half percent.

Alan Kaplinsky:

Well, we know for sure the Fed never wants to get back to 0% interest. I don't know what the new norm is going to be, but it's probably somewhere between 3 to 4%, I would think.

Alex Pollock:

So if you think inflation will be two or 3%, which would be consistent with their behavior, then short-term rates would be 3 or 4%. Now, the long-term Treasury at the moment is yielding about 4.3%. So that gives you the market's guess that short-term rates might come down enough. Now, the other way that they recover is they just sit there and they let the long-term assets mature and slowly pay off, and then they pay off at par. So one of the things that sometimes said is, "Oh, well this is just paper losses." This will be the point to mention, the mark-to-market loss on the Federal Reserve's portfolio.

Alan Kaplinsky:

Tell us about that then. And that doesn't go through the income statement, right?

Alex Pollock:

That does not go through the income statement. It's $1 trillion off. It's all you find it in the notes. In addition to their weekly H.4.1 financial statement, they publish a quarterly financial statement. And if you look in the footnotes... the world only has two kinds of people, those who read the footnotes and those who don't, if you read the footnotes, you'll find the mark-to-market. So you take all your assets, what you paid for them, and you say, "What would they be worth in the market today?" Now, if you really tried to sell them, they'd be worth less than that. Because if the Fed tried to unload its gigantic portfolio, the prices would fall. They couldn't do it. But just say, "What stuff it's trading for today in smaller amounts?" That's called a mark-to-market. And the mark-to-market loss of the Federal Reserve Banks altogether as of March 31st, 2024 was greater than $1 trillion. Now, that's in the footnotes.

Alan Kaplinsky:

Right. That's reflected anywhere in the balance sheet. And I guess, under generally accepted accounting principles, if you're holding the portfolio for investment with no intent of selling it, even under GAAP, you wouldn't have to mark-to-market, right?

Alex Pollock:

That is correct. So that's called held to maturity. The rule is a positive intention and ability to hold to maturity. So some people say, "Oh, well, at the end, they're going to get par." No, they paid a million dollars for this bond, they're going to get a million. But what they fail to see is while you are holding, in the meantime, every year, every quarter, every month, every week, you're earning 2% and losing 5%... I'm sorry, and paying 5%. So you're losing 3%. And so the unrealized mark-to-market, as long as interest rates stay at their current levels or so, the unrealized loss turns into realized cash losses. And that's cash losses, you really paid that interest. It's gone, it's gone forever. So over time, the unreal... and this is true of banks too, people say, "Oh, well, just a mark-to-market." Yeah, but in the meantime, you're losing on this position every minute. So we have that issued out. Can I talk a little more about accounting?

Alan Kaplinsky:

Well, I'll tell you before you go there, hold the thought for a second because I want to... as I've raised this issue with mostly lawyers in the industry... I did, for example, a webinar very recently where I mentioned this issue, and people wrote in questions to me, and one of the questions was, "Well, yeah, it says earnings of the..." and Dodd-Frank, CFPB can only be funded out of consolidated earnings of the Federal Reserve System, but it doesn't say only out of positive earnings, why couldn't there be negative earnings?

Alex Pollock:

Well, there can be negative earnings, we know that because they've got negative earnings. But you can't pay anything out of negative earnings.

Alan Kaplinsky:

And then I'm saying to myself, "Well, gee, if it could have meant negative earnings, why mention earnings at all? Why say anything about earnings? What's the point?" I mean, of course there haven't been positive earnings. And then I've had other people say to me, "Well, it doesn't say current earnings." So couldn't you take the position that they were earning a lot of money until September 2022? And if you look at how much they had in earnings going back over... you wouldn't really have to go back too far, you'd have plenty of money to legitimately pay for the CFPB's expenses. And I guess my response to that, I'd love to hear yours, Alex, is it says earnings, earnings to me connotes current earnings. It doesn't mean earnings that you had three or four years ago. Right?

Alex Pollock:

That makes sense to me as a natural way to read the language. I do think that you could possibly stretch the term to include retained earnings, say, well, these are earnings that the Federal Reserve Banks, the Federal Reserve banks are banks, and they have balance sheets that are a bank balance sheet, and they could retain earnings. And so maybe it's the earnings they actually kept in the bank. But we've already discussed, the retained earnings of the Federal Reserve System are negative, properly accounted for. There's nothing there.

Alan Kaplinsky:

Right. It's mind-boggling. Now, I want to go back, I wanted to get this point in, but you said you had another accounting issue you wanted to raise?

Alex Pollock:

Yes. If you look at the balance sheet of the Federal Reserve, you'll see that they report positive capital, $43 billion. But they do so only by completely nonstandard accounting, only by doing something that... they would close down any bank, any private bank for [inaudible 00:45:47] the SEC would really come after you. If any SEC registrant did what the Fed is doing, the registrant would be in deep trouble. What they do is they report these losses, and you can see the losses, but then instead of doing the obviously required thing, which is to take the losses and reduce retained earnings with them and reduce capital, that standard, unavoidable, correct accounting without question... For example, or in contrast, the Bank of Canada is required by its act to use international standard accounting standards, and they report, in their capital account, negative capital. That is what the Fed should be doing, if they had books with integrity.

Instead, they're making up, they're claiming, in accounting terms, they have this debit, this debit should go to reduce retained earnings, instead, we pretend that our losses are an asset. I want you to just think about that. We claim that our losses are an asset. And we put them on our balance sheet, the so-called deferred asset. In between, they report them as a negative liability, if you can figure out what that means. It's, in my view, very embarrassing for the greatest central bank in the world to engage in this kind of accounting shenanigans. In fact, on any standard accounting, they have a capital of negative $129 billion. So there's no earnings left over from the past either.

Alan Kaplinsky:

Now, Congress is aware of this issue. I know that there was a congressman, his name is French Hill. He has introduced a bill. Why don't you tell us about that?

Alex Pollock:

He has, and I'm a big supporter of this bill, and Congressman Hill was in the banking business himself in his career, before he was a congressman. So he is quite knowledgeable about this stuff, and he chairs one of the subcommittees of the House

Financial Services Committee. He has introduced HR 5993, 5-9-9-3, in the House of Representatives. And if there is any doubt about the clarity of the language of Dodd-Frank... and personally, I don't think there is, and I just want to stress, again, you can completely accept the Supreme Court's ruling and still say, "Well, but read the act, these payments are not authorized." But to clarify any argumentation about it, French Hill's Bill 5993 provides that the Federal Reserve may not pay the expenses of the CFPB anytime the Federal Reserve has losses, or when its past losses have not been made up. Well, that would be for a long time. I think that's a great, very logical provision. I completely support it. I think, if you believe me, it's already the law, but this would make it completely clear if you could get it.

Alan Kaplinsky:

Yeah. I take it that there's no chance that a bill like that will get through. Right?

Alex Pollock:

It depends on how the elections turn out this year.

Alan Kaplinsky:

Oh, okay. Yeah, I guess it's conceivable, something like that, if the Republicans ended up getting control of the House and the Senate, and we have a Republican president. I guess, in the Senate, they would have to have a filibuster-proof majority. So they would need 60 Republicans in the Senate to get this.

Alex Pollock:

The hearings would be interesting.

Alan Kaplinsky:

Yeah. The one thing that we haven't gotten into, and I know since you're not a lawyer, I'm not going to burden you with this, but I think it's fair to mention to our listeners that if we are right, if in fact, beginning of September 2022, there were losses at the Federal Reserve System, we know there were, and at that point, under Dodd-Frank and under the Constitution, it was unlawful for the CFPB to request draws or for the Federal Reserve to honor the draws, because there were no earnings, you then wonder, "Well, what are the implications of that? What is the remedy for that?" Well, I think it's the same kind of remedy issue that bedeviled the Fifth Circuit Court of Appeals, and Supreme Court never had a deal with the remedy because they found it was constitutional, but nobody really knew exactly what the remedy would be.

Would it mean, for example, that any regulation that they worked on after September 2022, that that's invalid, that regulation? Because they were spending money unlawfully, and that's the same issue that existed in the CFSA case. And the argument there was that the payday loan rule was unlawful, and people thought every regulation issued by the CFPB, going back to the very beginning, that all the regulations would be unlawful. What about enforcement actions? I guess, anything that's ongoing now really is unlawful. And I would think that if I were representing a client, defending them in an enforcement action, I would immediately assert this defense in court and tee it up for the courts. This has not yet been teed up, at least I'm not aware of it being raised anywhere. Right?

Alex Pollock:

I am not aware of any suit of this argument being formally made legally outside of the intellectual discussions, like we have just been having. But it makes perfect sense, both as a legal strategy and as a, certainly, possible result of the situation. I guess, Congress, if it were legislating, could settle such things with statute. Maybe it would make up its mind that it actually had to appropriate some money here, or might not want to, or not appropriate it.

Alan Kaplinsky:

Because I look at the issue, to me, this is a simpler issue to analyze than the constitutional issue that the Supreme Court looked at. Because they were worried then, I think. It's not in the opinion, but this is just my speculation, they were worried that if

they held that the whole structure was unconstitutional, what would it mean for other federal agencies, the post office, the custom service, the controller of the currency, the FDIC, even the Federal Reserve Board, entities that were self-funded, how could they distinguish them from the CFPB? And of course, since they didn't have to go down, they didn't have to distinguish them because they found it was constitutional. They avoided a hornet's nest. But here, we're talking about it couldn't be simpler, the language of Dodd-Frank says earnings. And no matter how you twist it, and turn it, and try to contort it into old earnings, retained earnings, not to say current earnings, to me, that's a lot of gymnastics that gets you absolutely nowhere.

Alex Pollock:

I completely agree with all of that, and I look forward... it seems like this would be bound to be litigated, as you are suggesting.

Alan Kaplinsky:

I think so. And I just think the strangest thing, at least to me, is that this already hasn't gotten more attention on the hill, that this issue isn't front and center. You would think the Republicans would be making a big deal out of this issue. And so far, I've heard a whimper, but maybe now, with the attention that we are bringing to it, people are going to start focusing on this issue more intensely than they have. So anyway, we've come to the end of our program, Alex, and really want to thank you for sharing your time and your wisdom with our listeners. This was, I thought, a very, very interesting job. So my thanks to you.

Alex Pollock:

And thanks to you for having me. I really enjoyed the conversation, Alan.

Alan Kaplinsky:

Yeah. Well, thank you. So, Alex has told me that any of our listeners that have any questions or concerns about anything that we talked about today, they should feel free to contact him directly. And he's given me permission to give you all his email address, and its alexjpollock, that's A-L-E-X-J-P-O-L-L-O-C-K 43, the number 43, alexjpollock43@gmail.com. So to make sure you don't miss any of our future episodes, please subscribe to our show on your favorite podcast platform, be it Apple Podcasts, YouTube, Spotify, or wherever you obtain your podcasts. And don't forget to check out our blog, consumerfinancemonitor.com, for daily insights on the consumer finance industry. And if you have any questions or suggestions for our show, please email them to us at podcast, that's singular, podcast@ballardspahr.com, and stay tuned each Thursday for a new episode of our show. Thank you very much for listening, and have a good day.