# Lessons Learned from a Century of Federal Reserve Last Resort Lending

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I am pleased to be invited to testify before the Subcommittee on Monetary Policy and Trade of the House Committee on Financial Services on "The Fed Turns 100: Lessons Learned from a Century of Central Banking." I will emphasize the following five points in my testimony "Lessons Learned from a Century of Federal Reserve Last Resort Lending."

i) The Federal Reserve's last resort lending powers were gradually and vastly expanded during the last century.

ii) Federal Reserve last resort lending is insufficiently disciplined by Walter Bagehot's (1873) advice to the 19th century Bank of England—to lend freely at a high rate against good collateral in a banking crisis.

iii) The reason is that the Bank of England's shareholders earned the profit and bore the losses, while the fiscal authorities receive net Fed income and taxpayers bear any Fed losses.

iv) As the Fed expanded its lending reach in scale and scope, markets expanded the use of inexpensive but fragile short-term finance counting on the protection of last resort lending.

v) Federal Reserve last resort lending should be carefully circumscribed to put a stop to these destabilizing banking and money market dynamics.

## A CENTURY OF LAST RESORT LENDING

The constraints on the Federal Reserve's lending powers were loosened gradually over time.[2] The original Federal Reserve Act of 1913 authorized the Fed to extend credit only to member banks of the Federal Reserve System. Lending to other entities was not permitted at all until 1932, when Section 13 (3) gave the Fed the authority to lend to "individuals, partnerships, and corporations" in "unusual and exigent circumstances" as determined by the vote of at least five members of the Board of Governors. However, Fed credit extended to nonbanks in the 1930s was

[2] Hackley (1973).

relatively insignificant because collateral requirements in 13 (3) were highly restrictive even after being relaxed by a 1935 amendment. Instead, Congress established the Reconstruction Finance Corporation to allocate credit widely to nonbank entities.[3] Apparently, Congress was uncomfortable expanding the credit policy powers of the independent central bank.

Nevertheless, the Fed exhibited a tendency on its own to expand the scope of last resort lending to depositories beyond short-term liquidity assistance, especially whenever it worried that not doing so threatened a systemic financial crisis. For instance, the Fed encouraged depositories in 1970 to borrow from the Fed discount window to support the commercial paper market in the wake of the Penn Central bankruptcy. In 1974, Fed lending supported the insolvent Franklin National Bank until it could be purchased by a group of investors. Similarly, Fed lending from May 1984 to February 1985 supported the undeclared insolvency of Continental Illinois Bank until it was resolved.[4]

The Federal Reserve's lending reach was expanded significantly when the Depository Institutions Deregulation and Monetary Control Act of 1980 gave all depositories access to the Fed discount window, whether or not they were members of the Federal Reserve System. By the end of the decade Schwartz (1992, p. 68) observed:

> "…By the 1980s hundreds of banks rated by regulators as having a high probability of failure in the near term and which ultimately failed were receiving extended accommodation at the discount window…[t]he change in discount window practices, by delaying closure of failed institutions, increased the losses the FDIC and ultimately taxpayers bore."

Motivated by the above record, in the aftermath of the Savings and Loan crisis the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) contained provisions intended to limit

[3] See Jones and Angly (1951).
[4] Schwartz (1992), pp. 62-4.

Fed lending to undercapitalized banks. Unfortunately, the effectiveness of the law would be compromised where capitalization was measured largely on book rather than market valuation.[5]

The Fed made few loans to non-depositories under 13 (3) after the 1935 amendment took effect in 1936. But following the 1987 stock market crash policymakers were persuaded to relax restrictions on Fed lending to nonbank financial firms. And Section 473 of FDICIA amended the Federal Reserve Act so that the only collateral test remaining under 13 (3) was "satisfactory security," the same test that applied to borrowings of depository institutions.[6] Alan Greenspan (2010, p. 17) has written that in 1991

> "…at the urging of the Federal Reserve Board of Governors, Section 13 (3) of the Federal Reserve Act was considered, and amended by Congress. The section grant[ed] virtually unlimited authority to the Board to lend in "unusual and exigent circumstances."

Ironically, although FDICIA is better known for a compromised attempt to restrict Fed lending to insolvent depositories, FDICIA actually expanded the Fed's lending powers well beyond depositories.

Since then, financial innovation and regulatory arbitrage of minimum capital requirements have fueled a huge expansion of securitization and structured finance of longer-term illiquid cash flows for funding in money markets via shadow banking.[7] By 2007, money markets accounted for a share of financial intermediation that rivaled depository intermediation in scale. Importantly, potential Fed lending in support of money markets was not accompanied by Fed supervision and regulation as it was for depositories with access to the Fed discount window. The fact that money markets could expect support from expansive Fed credit policy in a crisis directly, or indirectly via lending to depositories, probably encouraged the vast expansion of money market finance.

[5] The Fed's lending to insolvent banks is discussed in Clouse (1994) and Schwartz (1992). Goodfriend (1994), p. 574 proposes a Fed-Treasury "Accord" so that Fed lending does not keep insolvent banks open at taxpayer expense.
[6] Todd (1993), p. 20.
[7] Goodfriend (2011b).

In the 2007-8 credit turmoil the Fed was put in an untenable position given its wide powers to lend—disappoint expectations of accommodation and risk a systemic financial collapse, or lend expansively and feed expectations of even more expansive lending. Fed last resort lending again exhibited the tendency evident earlier to expand its lending reach in time of crisis, this time in an unprecedented enormous increase in reach, scale, maturity, and eligible collateral.[8] Unbridled last resort lending drew the Fed into a massive expansion of credit "with the implied promise of similar actions in times of future turmoil."[9]

The problem confronting independent Fed credit policy is this: last resort lending has the capacity to create ever-greater boom and bust cycles in banking and money markets while simultaneously undermining the Fed's independent legitimacy within government. The nature of the problem is explored and a solution is proposed below.

## BAGEHOT'S RULE, THE BANK OF ENGLAND, AND THE FEDERAL RESERVE

Federal Reserve last resort lending is widely regarded as a natural extension of 19th century last resort lending by the Bank of England famously encouraged by Walter Bagehot (1873). However, the Federal Reserve and the 19th century Bank of England have pursued their last resort lending powers very differently as a result of their governance. When Bagehot urged the Bank of England to lend in a banking crisis against good collateral at a penalty rate, he needn't say more. Bagehot's problem was to encourage the Bank to pre-announce the lending policy that it would follow in a banking crisis once the U.K. Treasury temporarily suspended the gold reserve requirement against its paper banknotes. Bagehot could be sure that the Bank would lend at a profitable penalty rate, since the Bank was a private, profit-maximizing institution whose shareholders earned the profit and bore the risk of loss. Likewise, Bagehot could be sure that the

[8] See Goodfriend (2011a), and Goodfriend and Lacker (1999), pp. 14-15.
[9] The quote is from Volcker (2008), page 2.

Bank would lend against good collateral so as not to take on credit risk. Bagehot needn't be concerned that last resort lending could subsidize and distort credit flows. There was no need, since it was the monetary features of last resort lending (the elastic provision of banknotes) at a modestly elevated interest rate ceiling that mattered for stabilizing banking and financial markets.

The problem with regard to Federal Reserve last resort lending today is just the opposite—it is to limit the Fed's lending reach. The independent Fed is inclined to lend rather than risk a panic by not lending, even if forced to take relatively poor collateral at inordinately low interest, because its own funds are not at stake—the fiscal authorities receive net Fed income after operating expenses and taxpayers bear any Fed losses. Moreover, the Fed puts taxpayers at risk even if it protects itself by taking good collateral. The reason is this: If the entity to which the Fed lends fails with a Fed loan outstanding, the Fed takes collateral at the expense of taxpayers exposed to losses from backstopping the deposit insurance fund, or from other financial guarantees that the government may have put in place. The set-up facilitates lending laxity and moral hazard.

Since the credit turmoil of 2007-8, the Fed has employed expansive credit policy initiatives for purposes beyond boundaries ordinarily regarded as legitimate for an independent central bank. Whether justified by the need to act in a timely manner, or by the need to act in lieu of paralyzed fiscal authorities, expansive credit policy initiatives that reach beyond such boundaries rightly draw scrutiny, in part because they necessarily favor one sector or another. Expansive credit initiatives undermine the Fed's legitimacy and potentially its capacity to pursue stabilization policy effectively. Moreover, expansive independent credit policy that bypasses the legislative process for whatever reason creates complexity and opacity that favors insiders and weakens the public's confidence in government and the rule of law.

## HOW FED CREDIT POLICY WORKS AND HOW IT SHOULD BE CIRCUMSCRIBED[10]

Fed credit policy works by interposing the government's creditworthiness—the power to borrow credibly against future taxes—between private borrowers and lenders to facilitate credit flows to distressed borrowers. Specifically, Fed credit policy involves lending to private institutions (or acquiring non-Treasury securities) with freshly created bank reserves or proceeds from the sale of Treasuries from the Fed's portfolio. To prevent future inflation, the Fed must reverse the reserve creation eventually by selling Treasuries from its portfolio, or else the Fed will have to pay a market interest rate on the reserves. Either way, Fed credit policy involves the lending of public funds to particular borrowers financed by interest-bearing liabilities issued against future taxes. The Fed returns the interest on its credit assets to the Treasury, but all such assets carry credit risk and involve the Fed in potentially controversial disputes regarding credit allocation.

Occasional Fed lending to solvent, supervised depositories on short term, against good collateral is protected against ex post loss and ex ante distortion. Such circumscribed lending deserves a degree of operational independence. However, credit initiatives that extend the Fed's credit reach in scale, maturity, and eligible collateral to unsupervised, or potentially insolvent institutions, or the purchase of non-Treasury securities, inevitably carry credit risk, excite questions of fairness, and threaten the legitimacy of both the Fed and the fiscal authorities. Hence, Congress in its oversight role should clarify the boundary of the Fed's responsibilities for taking expansive credit actions and correspondingly restrict its independence in doing so. Congress should insist that the Fed adhere to a "Treasuries only" asset acquisition policy, except for occasional last resort lending to depositories.[11]

[10] This section draws on themes developed extensively in Goodfriend (2011a).

[11] Goodfriend and King (1988) and Schwartz (1992) explain that the Fed can usually exercise its lender of last resort responsibilities solely through open market operations without the need to lend to individual institutions through the discount window.

The 2010 Dodd-Frank Act recognizes the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower. The Dodd-Frank requirements do not address the problem adequately, however, because the Administration is no more authorized to commit taxpayer resources than the independent central bank--only Congress can do so. And the Treasury is as likely as the Fed has been to favor expansive last resort lending in a financial crisis rather than risk an immediate financial collapse.

To deal effectively with the potential for an expanding and ultimately self-destructive Fed lending reach, taxpayer representatives should be involved more prominently in the oversight of expansive Fed credit policy. Expansive lending should be authorized before the fact by Congress in its oversight role, and only as a “bridge loan” accompanied by a “take out” arranged and guaranteed in advance by Congress. The authorization process should include a clear, explicit, public discussion of the fiscal risks alerting taxpayers in a clear and explicit way to the potential cost of expansive Fed credit initiatives. An expectation of taxpayer reluctance to bear the cost of expansive Fed credit policy could then credibly bend down market expectations of the Fed’s lending reach so that banking and money markets would better insure themselves against liquidity risk. Strong legislative action would defuse the implied promise of expansive Fed credit policy actions in the future, help prevent a repetition of the boom and bust cycle in money market finance, and preserve an important limited role for Fed credit policy.

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