# From the “Lender of Last Resort” to “Too Big to Fail” to “Financial System Savior”: Federal Reserve Credit Policy and the Shadow Open Market Committee

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# Definitions: Monetary and Credit policy

- **Monetary policy** = actions that change the *quantity* of central bank monetary liabilities via purchases or sales of government securities
  - Example: Fed purchase of U.S. Treasury securities on the open market
  - On the consolidated Fed-Treasury balance sheet, only Fed's monetary liabilities remain

- **Credit policy** = changes in the *composition* of central bank *assets* between government securities and credit to the private sector or banking industry
  - Example: Fed loan to a bank, with effect offset ("sterilized") through sale of Treasuries
  - Example: purchase of GSE debt, financed by sale of Treasuries

- **Agenda:**
  1. Evolution of ideas ("doctrines") about Fed credit policy
  2. SOMC commentary on Fed credit policy

# Fed Lending Doctrine 1: Monetary Stability

- The Fed was founded to solve a *monetary* problem
    - When the public shifts from deposits to notes, the money stock shrinks
    - Monetary stability requires an offsetting increase in high-powered money by the central bank
- The Fed was founded to expand HPM in crises: *"**to furnish an elastic currency**"*
- Design influenced by British experience
    - Bank of England had effective monopoly on note issue
- Bank's monetary liabilities were managed through its lending (discount) policy
- Assumed by Henry Thornton (1802) and Walter Bagehot (1873), who described crises as monetary problems not credit market problems
- Their recommendations became known in 20th c. as "lender of last resort"
    - Better name would be ***"monetary instrument supplier of last resort"***
    - Crucial: lending is unsterilized - sterilized lending would be pointless

# Fed Lending Doctrine 2: The Real Bills Doctrine

- Real bills = short-term, self-liquidating commercial paper issued to finance real transactions in goods and services
  - Contrast was with credit instruments associated with “speculation”
- Theory: stability would be ensured if Reserve Banks only made loans secured by “real bills”
  - Aim: steer credit extension away from “speculation” toward “productive” uses
  - Assumed the gold standard and Reserve Bank holdings of a gold reserve
- Understood to be fallacious by some early Fed leaders; Benjamin Strong, for example
  - Funds are fungible, and multiple bills can be backed by the same merchandise
  - Indeterminacy of using a nominal quantity to set a nominal quantity
- Fed formally renounced in 1963
  - Not a factor in GFC response

# Fed Lending Doctrine 3: Warburg’s Mercantilism

- Pre-Fed, U.S. foreign trade financed by issuing bills in Europe, esp. London
- Paul Warburg (and others) envisioned New York City taking over market for the U.S. trade finance bills (“bankers’ acceptances”)
  - Argued that doing so required central bank “backstop” support to counter the support of foreign central banks for their bills markets
  - Essentially an argument for subsidized central bank lending to support the prices of bills in the New York market
  - That is, underpriced insurance for bankers’ acceptances
  - Part of broader Atlanticist agenda; envisioned expanded global role for U.S. dollar
- Market did not really take off, though dollar did achieve hegemony > WWII
- Not a factor in GFC response

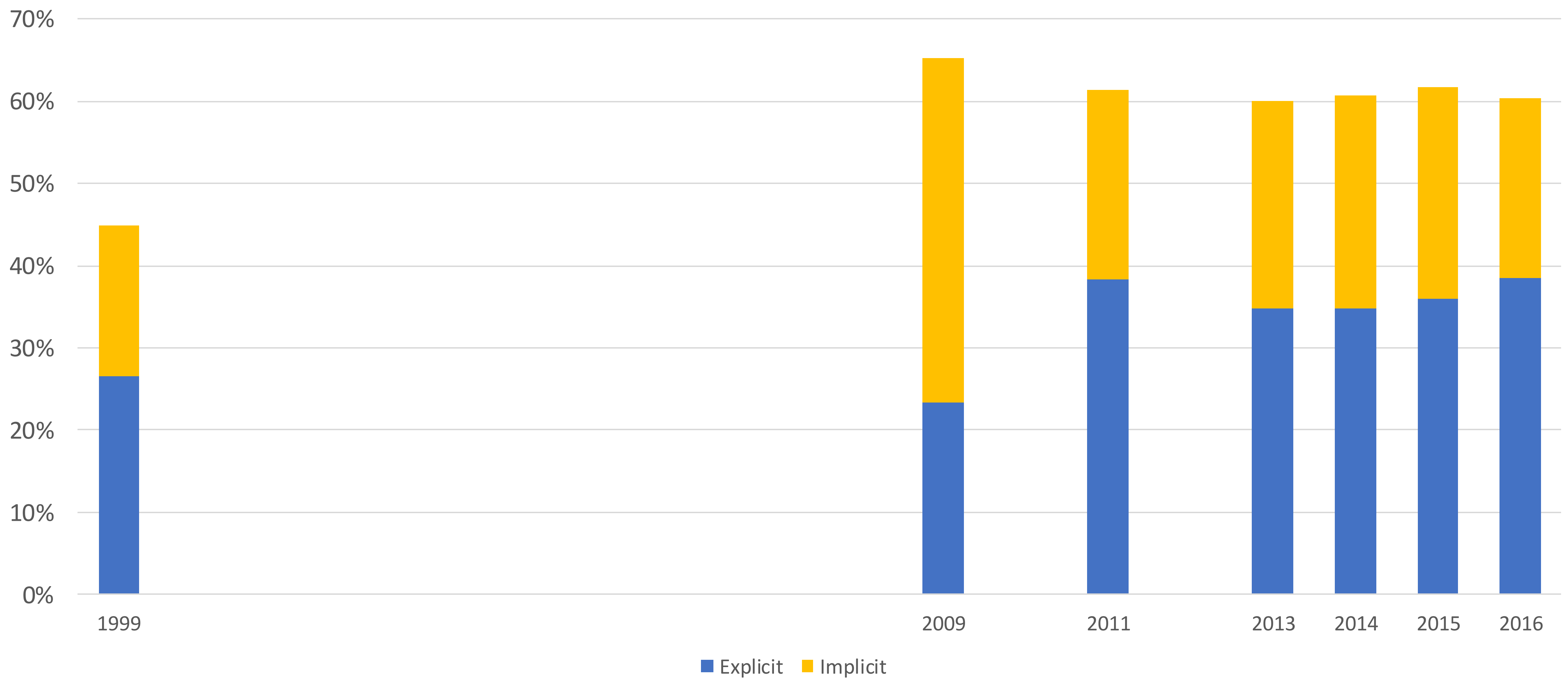
# Early history of Fed lending: The Great Contraction

- Fed leaders misread indicators, viewed conditions as accommodative
    - Real Bills thinking still prevalent
- Allowed a disastrous contraction in the monetary stock
    - Money multiplier was collapsing
    - Fed did not fully offset by expanding high-powered money
    - Open market purchases in 1932 (after Congressional prodding) worked while they lasted, but were abandoned too soon
- Role of bank failures?
    - Bernanke (1983): bank failures destroyed valuable lending relationships
    - *"If [the bank failures] had occurred to precisely the same extent without producing a drastic decline in the stock of money, they would have been notable but not crucial. If they had not occurred, but a correspondingly sharp decline had been produced in the stock of money by some other means, the contraction would have been at least equally severe and probably even more so."* (Friedman and Schwartz p. 352)

# Late 20th century Fed lending: the Rise of Too Big to Fail

- After 1951 Treasury-Fed Accord, OMOs are primary monetary policy tool
  - Fed lending authority becomes a vestigial appendage, extraneous to monetary policy
  - After mid-1980s, FOMC targets overnight FFR, borrowing routinely sterilized
- In bank distress/failures, Fed often lends to facilitate delayed FDIC closing
  - Allows uninsured short-term creditors to exit and avoid loss/resolution process
  - Shifts losses to longer-term creditors and/or FDIC
  - No flight from deposits to currency, loans sterilized, thus not LOLR crisis
  - Fed staff (1971) starts referring to these as “lender of last resort” lending
- Constructive ambiguity—no announced policy, preserving discretion
- Many varieties of moral hazard
  - Funding cost advantage
  - Encouraged reliance on short-term wholesale funding, the most likely to induce intervention

# Bailout Barometer$^{TM}$: Fraction of financial sector debt that is government guaranteed



Source: Federal Reserve Bank of Richmond

# The SOMC and Too Big To Fail

- Allan Meltzer (SOMC 9/6/74) urges Fed to issue clear statement re LOLR policy
    - Argues against preventing failure and for preventing spread through financial markets
- Anna J. Schwartz, SOMC co-founder
    - Distinguishes between “real” (monetary) and “pseudo” (TBTF) financial crises (1986 conf vol)
        - Real crises = multiple contraction in deposits due to inability to acquire high-powered money
        - “No real financial crisis has occurred in the United States since 1933”
        - “Loss of wealth is not synonymous with a financial crisis”
        - “Pseudo-financial crises in recent years have generated expectations ‘that no monetary authority will allow any key financial actor to fail’” (quoting Wojnilower, *BPEA* 1980)
        - “The bugaboo of financial crisis has been created to divert attention from true remedies that the present financial situation demand.”
    - Documents “The Misuse of the Fed’s Discount Window” (FRB St. Louis conference 1992)
        - Recent lending represents a “major departure from its historic mandate to provide loans to illiquid but not insolvent depository institutions.”
        - “The time has come for a truly basic change: *eliminate the discount window and restrict the Fed to open market operations*.”

# Marvin Goodfriend on credit policy

- Credit policy is *extraneous* to monetary policy and *inherently distributional*
  - Amounts to selling Treasury securities and lending the funds to private sector
  - Entangles Fed in distributive politics, saps political capital needed to safeguard the independent conduct of monetary policy
- Goodfriend's Credit Accord proposal (1994, 2009) [See also Plosser (2009), Lacker (2009)]
  - Analogous to 1951 Treasury-Fed Accord on monetary policy
  - Fed should buy Treasuries only
- May 2009 Treasury-Fed Joint Statement: The Role of the Federal Reserve in Preserving Financial and Monetary Stability
  - "Fed should not allocate credit to *narrowly-defined sectors* or classes of borrowers. Government decisions to influence the allocation of credit are the province of the fiscal authorities."
  - "Agency MBS" not a "narrowly-defined sector"???

# Limited Commitment and Fed Lending

- Central bank lending faces a commitment problem
  - Same problem faced in private line of credit lending [Goodfriend and Lacker (1999)]
- Ex post central bank incentives in cases of financial distress
  1. Desire to avoid ex post deadweight losses of bank closure or firm bankruptcy
  2. Fear of political blame if turbulence results from not lending
  3. Fear of political criticism for over-reach, lending too far afield
  - "Samaritan's dilemma" (James Buchanan)
- Communication strategy = "Constructive ambiguity"
  - Don't promise rescues, but "preserve optionality": 0 < Prob[*rescue*] < 1
- Cycle: rescue, precedent expands safety net, crackdown, by-pass, distress…
- Fragility induced by expectations of Fed rescues across a widening domain

# Fed Lending Doctrine 4: Reluctant Samaritan

Federal Reserve lending decisions are made case-by-case, at its discretion, to:

- mitigate the ex post costs of resolving failing financial firms, especially banks;
- help the FDIC delay resolution of failing banks;
- avoid the political fallout of financial market turmoil that might arise if lending is withheld;
- and minimize the perceived departure from past precedent.

Communication strives to minimize expectations of future intervention but preserve maximum discretion.

# Lending Doctrines in The Great Financial Crisis (1)

- Monetary Stability in play on August 9, 2007
    - Counterparty risk raises demand for reserve balances
    - In response, Desk expands reserve supply via OMOs to keep fed funds rate near target
    - *Automatically* in accord with Thornton and Bagehot and classic lender of last resort
    - No flight to currency or high-powered money—runs moved money to other banks, MMMFs
- Reluctant Samaritan Doctrine was evident:
    - Focus on ex post costs, rather than compliance with ex ante optimal response function
    - Interventions restored "calm" to markets by raising expectations of future interventions
        - Bear Stearns, e.g.
    - Political considerations evident
        - Lehman, e.g.
    - Moral hazard implications acknowledged but put off

# Lending Doctrines in The Great Financial Crisis (2)

- August 2007: Aggressive Fed effort to encourage DW borrowing
  - Discount rate cut to 50 basis points above FFR target (from 100), August 16, 2007
  - Kohn and Geithner brief Clearing House members on call the next day—urge banks to view discount window as available and stigma-free
  - Geithner organizes coordinated, announced DW borrowing by 4 largest banks
  - *Effort fails: Credit from Federal Home Loan Banks is much cheaper, rises $237B in H2 2007*
- Fed response arguably dampened incentives to take preventative measures
  - Capital markets were open for large banks for the next 12 months: they could have raised more equity, cut dividends, de-levered
    - Lehman offering in early 2008, for example, could have raised $30B in new equity—accepted only $5B
  - Large borrowers in the repo market could have termed out their funding
    - Bear Stearns, for example, continued to fund mortgage-related assets in the overnight RP market
- Credit programs also went far beyond 20th century lending doctrines

# Pandemic response and the aftermath

- In March 2020 uncertainty increased, FOMC cut rates to zero
- Federal Reserve credit policy: GFC playbook
  - Discount window terms eased: ↓ spread, 90-day term
  - Asset purchases: Treasuries and agency MBS "to support smooth market functioning and effective transmission of monetary policy"
  - GFC programs dusted off: CP, MMFs, primary dealers
- Federal Reserve credit policy: "racing through red lines"
  - Corporate bond purchases: new issues, secondary market, ETFs
  - Municipal securities: expanded eligibility after rollout
    - Powell disavowed munis 9 months earlier: "I don't think we want to be picking winners and losers"
  - Main Street Lending Program: negotiated with admin and Congress
- 2023: SVB, First Republic, Signature: TBTF playbook
  - Near the edge of GFC precedents—not clear to markets they were in the safety net
  - New feature was run speed and SVB collateral tied up at FHLB

# SOMC on the Great Financial Crisis and Pandemic

- Warned about accumulation of precedents, increased moral hazard + fragility
- Warned about housing GSEs - “Can We Avert the Next Financial Crisis?” Hess 2004
- Ex post: historical perspective - Fed’s 100 years, classic lender of last resort
- Recurring theme: threats to Fed monetary policy independence
  - Regulatory reform and Fed’s independence
- Credit accord advocacy, even after 3/23/09 Treasury-Fed Joint Statement
  - Advocated “Treasuries only”
- Balance sheet risk
  - Threat to Fed earnings if they need to fight inflation
  - Exit strategy concerns 2009-10 – how to wind down a large balance sheet?
- Housing GSE reform needed
- Clear credit policy rules would be useful
  - *What is the new Lending Doctrine?*

# A New Lending Doctrine for the 21$^{st}$ Century?

*From the Board’s website:*

- A key Fed function is to **promote financial stability**
- In times of **crisis**, the financial markets that businesses and households rely on may experience **severe stress** or, in extreme cases, **effectively cease to function**.
- Because these markets are vital to the economy, the Federal Reserve—like many central banks—is empowered to take actions that can restore the **normal flow of credit** needed to support employment and the broader economy.
- There are a number of ways the Fed can support the **normal flow of credit**, in addition to using its monetary policy tools:
    - U.S. Dollar Funding Facilities
    - Emergency Lending

(Board’s website, terms in bold not defined)

- *How should we interpret this?*

# 21st Century Doctrinal Discontinuity: Ideas?

- Microfoundations literature emerged in the late 20th century
  - Models of financial arrangements under limited information (hidden actions, hidden states)
  - General equilibrium tradition, specifying preferences, endowments and technologies
  - Information constraints, like technological constraints, limit feasible allocations
  - Display recognizable financial contracts (e.g. debt) and arrangements (e.g. banks) as outcomes
- ***Possibility Propositions*** provided examples where central bank lending can help
  - But the case for CB lending is typically sensitive to elements of the model environment
- "Match" between model and reality unclear in many GFC interventions
  - Runs (Diamond-Dybvig multiple equilibria): Depositor isolation? Non-Diamond-Dybvig runs?
  - "Cash-in-the-market" pricing: Segmentation of investors? Banks funding needs?
  - Adverse selection: Quantities? Can a limited lending program reach through to good types?
  - Credit channel: Redistributional, so trade-offs matter – quantitative assessment?

1. ***During the GFC there was no staff work on and virtually no policymaker interest in whether possibility propositions applied to actual banking and financial markets***
2. ***There was no effort to compare inherent fragility to induced fragility***

# 21$^{st}$ Century Doctrinal Discontinuity: Politics?

- Distributional quality of credit actions places Fed between banks and the state
    - Fraught, fluid relationship historically – see Calomiris and Haber (2015)
- Early Fed lending doctrines have reflected both politics and ideas:
    - Politics – Warburg's Mercantilism
    - Ideas – Monetary Stability and the Real Bills Doctrine
- Post-Accord, Fed had an independent balance sheet
    - No monetary policy consequences for sterilized intervention
    - Left Fed politically exposed, with vestigial tool of keen interest to banking industry (+ others)
    - But subject to time consistency problem
    - Financial safety net grew along with bank size, and financial fragility
- Credit view emerged while financial fragility was growing
    - Rationalized broadening central bank interventionism
    - Dovetailed with banking industry interests and perennial special pleading in crises

# Fed Lending Doctrine 5: Sell-Side Savior

The Federal Reserve intervenes in any credit market at its discretion to restore the *normal* flow of credit to borrowers when financial markets experience *stress*. Interventions are designed to be seen as *fair*.

- The term *normal* is taken to mean non-crisis, non-recessionary times
- Interventions chosen ex post, without commitment (or is this the new commitment?)
- Domain is broader than Reluctant Samaritan Doctrine; any debt market in scope
- Limited to when financial markets are in stress, but Fed defines stress ex post
- Political consideration is now that interventions be seen as “fair”
- Limiting political blowback (RSD) omitted—political support for intervention appears broad—reluctance has disappeared