When the Fed Conducts Credit Policy

BY DAVID A. PRICE

As the Fed targets lending to help specific sectors or institutions, does it jeopardize its independence?

The U.S. Constitution states, "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." The power to appropriate money, which James Madison called "the power over the purse," seemingly gives Congress the sole control of fiscal policy.

But just what is fiscal policy? In the view of some, the Fed has made and carried out what amounts to fiscal policy on a significant scale at various times in the past half-century, most recently in response to the 2008 financial crisis. In particular, the Fed has engaged in fiscal policy in credit markets, also known as "credit policy," in which it directly or indirectly channels credit to private entities and foreign central banks — in contrast with monetary policy, in which the Fed creates bank reserves by purchasing only Treasury securities from the public and holding them while turning the interest over to the Treasury.

To be sure, the Fed has long extended credit to private banks through its discount window. The scale of that lending has been quite limited, however, in comparison to the Fed's actions following the financial crisis. Fed lending to private entities and other central banks reached $1.5 trillion by the end of 2008. Lending to foreign central banks had a modest resurgence earlier this year, peaking at $109 billion in mid-February.

The Fed has legal authority to carry out such activities thanks to emergency powers that Congress granted it in 1932 and expanded in 1991. In the eyes of some critics, however, that authority is problematic because it more appropriately belongs to the Treasury than the Fed.

"In fall 2008, the Treasury could have issued debt to fund emergency actions, but that would have been politically difficult," says Richmond Fed economist Robert Hetzel. "If you think that fiscal policy should be subject to democratic monitoring because it's in the spirit of the Constitution, that's exactly the sort of political debate you want to have. But it's painful."

Moreover, there is concern that such activities could make it more difficult for the Fed to maintain its independence when conducting its core functions, especially the setting of monetary policy. "The Fed basically made itself an active player in fiscal policy," says Charles Calomiris of the Columbia University Graduate School of Business. "The consequence is that the Fed loses its ability to have itself viewed as outside the political process of spending and taxing."

Discount-Window Lending to Troubled Institutions

Discount-window lending by Federal Reserve district banks provides liquidity on a short-term basis, usually overnight, to depository institutions. The longtime dictum of central banking has been that the discount window should be open only to illiquid banks, not insolvent ones — that is, only to banks that are sound, but which are facing a temporary liquidity crunch. The extent to which the Fed carries out lending through the discount window has been limited by its short-term nature, by the constraint on the types of institutions with access to the window (supervised depository institutions), and, in theory, by the requirement that the institution not be in distress.

A rationale for closing the discount window to distressed institutions is to avoid putting taxpayer funds at risk. Institutions that borrow at the discount window must pledge collateral, but such lending still creates risk indirectly: By enabling a distressed bank to make payments to uninsured depositors and unsecured creditors, loans to a distressed bank effectively move the deposit insurer — the Federal Deposit Insurance Corporation — to the back of the line if the bank's distress reaches a point when the FDIC must intervene.

The Fed's district banks have not always heeded the dictum to lend only to illiquid institutions, however. A 1992 paper by Anna J. Schwartz of the National Bureau of Economic Research looked at discount-window lending from January 1, 1985, to May 10, 1991, including the financial-strength scores that regulators had assigned to the institutions. The scores were so-called CAMEL ratings (for Capital adequacy, Asset quality, Management, Earnings, Liquidity). Of the 530 borrowers that failed within three years of the start of their discount-window borrowing, more than 82 percent had a CAMEL rating of 5 at the time of their borrowing, the rating reserved for "institutions with an extremely high immediate or near-term probability of failure." More than 90 percent had a rating of 4 or 5.

"These loans were granted almost daily to institutions with a high probability of insolvency in the near term, new borrowings rolling over balances due," Schwartz observed. "In aggregate, the loans of this group at the time of failure amounted to $8.3 billion, of which $7.9 billion was extended when the institutions were operating with a CAMEL 5 rating."

Earlier in the Fed's history, two of the most famous instances of Fed credit policymaking took place through the discount window. The distress of Continental Illinois National Bank and Trust Company in 1984, then the seventh-largest bank in the country, worried policymakers who perceived the bank as too big to fail. Despite the bank's effective insolvency, the Fed granted the bank and its holding company access to the discount window from May 1984 through February 1985 to keep its doors open, with the total loan balances reaching as high as $8 billion ($17 billion in present-day dollars).

Another episode grew out of the bankruptcy of the Penn Central Transportation Co. in 1970. The Fed believed that a financial crisis might result if the company defaulted on its $82 million in outstanding commercial paper because that might cause lenders to shy away from commercial paper in general. After Congress declined to authorize fiscal action to bail out the company, the Fed channeled credit to commercial paper markets indirectly by, in the words of its 1970 annual report, making clear that "the Federal Reserve discount window would be available to assist banks in meeting the needs of businesses unable to roll over maturing commercial paper."

The Continental Illinois and Penn Central cases remained the high-water marks of Fed credit policy for nearly a quarter-century — until the summer of 2007.

Emergency Lending After the Financial Crisis

On the eve of the 2007 havoc in mortgage-backed securities markets, the Fed had long followed a policy known as "Treasuries only": It held mainly Treasury securities and discount-window collateral. This policy both avoided the exercise of fiscal power and kept risky assets off the Fed's balance sheet.

In response to the emerging financial crisis, the Fed instituted a series of major actions, the first of which was the Term Auction Facility, or TAF. Open only to depository institutions, the TAF was similar in concept to the discount window, except that it relied on an auction mechanism to control the volume of lending and to increase the anonymity of the borrowing banks. (Because the Fed publishes the total weekly lending of each of the district banks, it is possible under some circumstances for banks to surmise which other banks have borrowed from the discount window; some observers believe this may inhibit discount-window borrowing.) TAF loans, which had terms of 28 days or 84 days, were also longer-term than discount-window loans. The total of TAF loans outstanding reached a peak of $493 billion in March 2009.

The Fed used its emergency powers to create a wide-ranging array of additional programs. Some of these programs were based on a belief that certain financial markets were not functioning adequately. From January 2009 to March 2010, to support housing and mortgage markets, the Fed purchased $1.25 trillion of mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. To improve the market for asset-backed securities, such as securitized auto loans and credit-card loans, the Fed created the Term Asset-Backed Securities Loan Facility (TALF) in November 2008 to make loans to owners of those securities. The program peaked in March 2010 with assets of $48.2 billion. The Fed also created lending facilities to provide support to commercial paper, money-market funds, and securities broker-dealers.

Most controversially, the Fed extended credit to rescue the investment bank and securities firm Bear Stearns Companies and the insurance company American International Group (AIG). When Bear Stearns was poised to collapse in March 2008, the Fed concluded that its failure would destabilize the financial system. The Fed, acting through the New York Fed, therefore used its emergency powers to clean up the company's balance sheet and facilitate its acquisition by JPMorgan Chase. The New York Fed created a company called Maiden Lane for the purpose of buying various risky assets from Bear Stearns and loaned Maiden Lane $29 billion with which to do so.

In the case of AIG, the Fed believed that the global financial system would be at risk if the company failed and were unable to make good on its credit-default swap (CDS) agreements. (Roughly speaking, CDS agreements are similar to insurance against a borrower's default.) The Fed announced in September 2008 that it would provide the company an $85 billion line of credit; later that year, it also formed two companies, Maiden Lane II and Maiden Lane III, and extended credit to them so that the former could purchase mortgage-backed securities from AIG and the latter could purchase collateralized debt obligations that AIG had insured with its CDS agreements. Maiden Lane II borrowed $19.5 billion from the Fed and Maiden Lane III borrowed $24.3 billion.

The Fed has since arranged for Maiden Lane II to sell its holdings and repay all of its loans. Although Maiden Lane and Maiden Lane III have repaid most of their loan balances, the Fed still has some loans to those entities on its balance sheet.

The Fed's rescue operations for nonbanks were based on an expansion of its emergency powers by the Federal Deposit Insurance Corporation Improvement Act of 1991, which freed the Fed from longstanding requirements concerning the quality of collateral from nonbanks. Federal law in the past had generally allowed the Fed to provide emergency assistance to nonbanks only if the institutions' intended use of the borrowings fell within a narrow set of eligible purposes or if those institutions pledged collateral of the same type required from member banks at the discount window. The Fed had not used its emergency power to lend to nonbanks since the 1930s. (Shortly after passage of the 1991 law, Walker Todd, then of the Cleveland Fed, expressed concern in an article that "greater potential access to the federal financial safety net could boost the risk-taking incentives for nonbanks.")

The rescue programs created in response to the financial crisis were criticized from across the political spectrum within Congress and elsewhere. In the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Congress responded in part by narrowing the Fed's emergency lending powers. Among other restrictions, the Act requires that any Fed lending programs must have "broad-based eligibility," that they must be for the purpose of providing liquidity to the financial system rather than to aid a failing financial company, and that they must be approved by the Secretary of the Treasury.

Columbia's Calomiris argues that it was proper for the Fed to use its emergency powers in situations where it was not feasible to go to the Treasury or Congress because time was of the essence — but, he says, that this was not the case for most of the emergency programs. "No one can argue that there wasn't enough time for Congress and the Treasury to act on the mortgage-backed securities markets," he says. "That was not a policy that was done over a weekend."

Although such rescue operations could have been carried out by the Treasury, relying on the Fed's emergency powers is attractive from the perspective of policymakers, says Marvin Goodfriend, an economist at Carnegie Mellon University's Tepper School of Business and formerly senior vice president and policy advisor at the Richmond Fed. It avoids the delays and uncertainties of the political process, and it avoids an increase in the federal deficit (since Fed lending does not count in the deficit as it is officially measured). But the very existence of those powers may have fueled the perception that large failing institutions would be rescued. "It was the expansive credit powers granted by Congress that made it virtually inevitable that those powers would be exercised in a crisis in the future," Goodfriend says.

Currency Swaps

To help foreign economies deal with the aftermath of the financial crisis, the Fed established currency swap lines (also known as liquidity swap lines) with numerous other central banks, starting with the European Central Bank in December 2007. The programs enable the foreign central banks to offer short-term dollar loans to banks within their jurisdiction using funds that the Fed has loaned to the central banks. The initial wave of swap programs continued until February 2010. Swap programs with five central banks were relaunched in May of that year and remain in operation. The Federal Open Market Committee (FOMC) voted on November 28, 2011, to authorize the programs through February 1, 2013 and to establish swap arrangements in the currencies of the foreign central banks.

The programs are generally not regarded as a subsidy to the foreign central banks or as a financial risk to the Fed. The Fed charges the central banks a market-based interest rate. The Fed suffers no exchange-rate risk since the exchange rate is the same in both directions of the transaction. The foreign central bank is responsible for covering any defaults.

The programs pose the institutional risk of increased pressure on the Fed's political independence. Some wonder whether the Treasury, rather than the Fed, should fund any such programs.

"There's no reason in theory why it couldn't be done through the Treasury through the Exchange Stabilization Fund, but there are always issues in lending to a foreign country," says Hetzel of the Richmond Fed. "Foreign aid is subject to a lot of debate."

Richmond Fed president Jeffrey Lacker dissented from the November 28 vote by the FOMC to extend the programs. (Lacker voted as an alternate to then-voting member Charles Plosser, president of the Philadelphia Fed.) Lacker explained in a statement that he opposed the currency swap programs because such lending "amounts to fiscal policy, which I believe is the responsibility of the U.S. Treasury."

Maintaining a Boundary

The Fed and the Treasury Department entered into a formal accord in 1951 establishing that the Fed would carry out monetary policy only to stabilize the economy, not to serve the Treasury's borrowing needs. The historic agreement was a reversal of a practice in place since World War II, in which the Fed used monetary policy to reduce the cost of Treasury borrowing. Goodfriend and others have argued that the temptation for policymakers to rely on the Fed to engage in fiscal policy warrants a new Fed-Treasury accord to maintain a boundary between their functions. Goodfriend argued in a 1994 article that among the principles of such an accord should be that liquidity assistance, such as discount-window lending, must not assist insolvent institutions (a principle since incorporated into the Dodd-Frank Act) and that the Fed should not use its balance sheet to "fund expenditures that ought to get explicit Congressional authorization."

The Fed and the Treasury Department did issue a statement in March of 2009 on the delineation of responsibilities of the two institutions. While the statement indicated that "decisions to influence the allocation of credit are the province of the fiscal authorities," and pledged Treasury's help in removing the Maiden Lane assets from the Fed's balance sheet, it largely reaffirmed the Fed's continued long-term use of its emergency lending powers.

What extraordinary steps should the Fed be able to take on its own in the midst of a potential financial catastrophe, and when should policymakers be obliged to trudge, hat in hand, to Capitol Hill to ask elected representatives for approval? In the wake of the worst financial crisis since the Great Depression, these questions remain only partially answered. **RF**

Readings

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Lacker, Jeffrey M. "Government Lending and Monetary Policy." Speech at the Washington Economic Policy Conference in Alexandria, Va., March 2, 2009.