Fed Lending and Moral Hazard

As many of you know — and as was announced in the last issue of this magazine — Al Broaddus has retired as president of the Federal Reserve Bank of Richmond, after more than 34 years of outstanding service to the Bank and the Federal Reserve System. I am honored and humbled to have been chosen to succeed him. His contributions have been enormous — and his leadership exemplary.

For the past seven years, Al's column has graced the opening pages of *Region Focus*. In this, as in so many other ways, I hope to live up to the high standards that Al has set. There are some very important challenges facing the Fed — including, of course, our ongoing efforts to maintain price stability — that I would like to address in this space. From time to time, I also would like to discuss some broader economic and public-policy issues that may seem to touch only peripherally on the Fed's core functions, but which nevertheless are vitally important. One such topic that comes to mind is the role that technological growth is having on wage inequality.

But for my initial "Noteworthy" column, I would like to stay fairly close to home and discuss a topic that occupies the time and minds of many people throughout this Bank and the Federal Reserve System: how to provide financial institutions with sufficient liquidity without encouraging them to engage in unsound business practices.

By lending through the discount window, the Fed can help stave off financial crises. For instance, in the days immediately following the terrorist attacks of Sept. 11, 2001, the Federal Reserve System loaned about $46 billion from the discount window. This was crucial in helping the nation's financial system cope with the disruptions caused by the attacks. In our financial system, the discount window has a useful role to play — and not just in situations as severe and tragic as 9/11.

But we also need to be wary of the risks that excessive lending can bring. Fed lending to a troubled bank can allow uninsured depositors and creditors to withdraw funds just before the bank fails. This weakens their incentive to monitor a bank's risk-taking and can increase the cost of the bank's failure to the deposit insurance fund. And by weakening this market discipline, we increase the chances that a bank will become insolvent.

Given the substantial financial safety net — and the risks it poses to taxpayers — the Fed must be vigilant in both its lending practices and its supervision of financial institutions. What does this mean in practice? In the past, the Fed typically has lent money to any bank with acceptable collateral, including many troubled banks that soon failed. The Federal Deposit Insurance Corporation Improvement Act of 1991 — better known as FDICIA — placed limits on the Fed's ability to lend to undercapitalized banks, but left the Fed with considerable discretion in extending credit to banks facing potentially critical financial problems.

This presents us with a dilemma: Should the Fed try to help those at-risk banks or instead withhold funds to limit moral-hazard problems? It's not an easy question to answer, but I'm inclined to say that the Fed should avoid lending to unsound banks, even those on the verge of collapse. It would be tempting for the Fed to intervene in such situations but, in my view, it would in many cases be unwise.

None of this is to say that sound, stable banks should be denied funds. In our banking system, discount window lending is important and useful. The Fed should continue to use this tool to help fundamentally healthy banks meet short-term liquidity needs — but it should do so judiciously and probably more sparingly.

As President of this institution, the risks associated with discount window lending is an issue that will occupy my attention much over the coming months and years. As my thoughts evolve — and as events dictate — I will have more to say on the topic. But for now I will close by reiterating what a pleasure it is to lead theRichmond Fed and its tremendous staff. It's a great challenge that I look forward to with great excitement.

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