

# Last Stop Lending

BY STEPHEN SLIVINSKI

How a railroad  
bankruptcy helped  
form modern  
Fed policy

If you walked into the lobby of a Federal Reserve Bank in the early part of the 20th century, you'd see a teller window. If you were a bank manager, walking up to that window would literally allow you to borrow money from the Fed under certain conditions. Eventually, these windows would disappear from Fed lobbies. But their function — the power of the Fed to lend through figurative versions of that window — wouldn't disappear.

This window, called the “discount window,” was originally conceived as the means by which the Federal Reserve would serve as a lender of last resort to its member banks. The idea was to provide an outlet by which the Fed could supply liquidity to banks in the event of a credit-tightening economic shock.

Yet, within that seemingly simple mission is a bundle of implications and policy approaches that are still being debated by economists and policy-makers today. And, as an unpredictable turn of history would have it, the precedent for the modern version of that debate is, at least in part, the bankruptcy of a railroad company in 1970.

The history of the Fed's role here is important to understand first. For this we

have to look back 200 years and across the Atlantic Ocean. The central bank's role as lender of last resort has, as former Richmond Fed economist Thomas Humphrey points out, its first “and in many respects still its most rigorous, complete, and systematic” explanation in the early 19th

century writings of British economist Henry Thornton. When his best-known work on the subject was published in 1802 (*An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain*), he was a member of Parliament with a particular expertise on matters of monetary policy. Not only was his brother one of the directors of the Bank of England, but he was also a member of the various legislative committees that oversaw the operations of the banking system in Great Britain.

In Thornton's conception of an independent central bank's role, the main focus should be the stability of the money supply. An element of that role was the need to serve as a lender to banks in a case of economic shock for the purposes of meeting an increase in demand for money. In what economist Joseph Schumpeter later called the “Magna Carta of central banking,” Thornton outlined the need to make this sort of lending by the central bank temporary in nature and restrained enough not to interfere with the Bank's main goal of price stability. To violate this rule would invite political gaming of monetary policy by interest groups: “To suffer either the solicitations of merchants, or the wishes of government, to determine the measure of the bank issues, is unquestionably to adopt a very false principle of conduct.”

Thornton clearly realized that allowing the central bank to be an emergency lender made it that much more important to remember that its primary responsibility is to the market generally and not to individual banks. Indeed, he was quite concerned about the “moral hazard” that such a lending arrangement might produce in the form of risky practices at individual banks. Thornton's view was that the



*In the early years of the Federal Reserve, bankers could literally walk up to the discount window in the lobby of their regional Fed bank to borrow funds.*

lender of last resort should not try to prevent economic shocks. Instead, the central bank should aim to neutralize the secondary repercussions of those shocks.

Roughly 70 years later, Thornton's intuition was elaborated by Walter Bagehot, the British writer and editor-in-chief of the *Economist* from 1861 to 1877. In doing so, he advanced Thornton's analysis and set up the framework that economists still use today to discuss these issues.

In his famous book, *Lombard Street* (1873), Bagehot laid out the broad rules by which the lender of last resort role would best function, summed up by the dictum, "lend freely at a high rate, on good collateral." The penalty interest rate would encourage not just the speedy repayment of the debt but also would encourage banks to look for private financing before resorting to the central bank loan as a true last resort. The collateral requirement would help weed out those banks that were not just facing a temporary liquidity crunch but were indeed insolvent.

It was also important that the emergency lending policy be announced in advance of the economic shock so there would be certainty in the market about the backstop measures the central bank would be willing to take. Like Thornton, however, Bagehot was concerned about political pressures on central banks and the temptation to lend to specific institutions as a means to prop them up in an economic crisis. As Humphrey explains, "the job of the central bank is not to prevent failure at all costs but rather to confine the impact of such failure to the unsound institutions."

### **The Early Federal Reserve and the Rise of Crisis Lending**

Such was the thinking of some economists when the Federal Reserve was created. The men who constructed the U.S. central banking system indeed looked at the British experience for guidance on how best to approach the conduct of monetary institutions and how these institutions should be designed.

They envisioned the Fed's role of banker to the banks as being decentralized. The 12 regional Fed banks would allow the banks in their area to borrow reserve funds against the security of their business loans, an act known as "rediscounting." Presumably this sort of operation would best be handled by a bank closest to the borrowers where the local knowledge of business conditions could best be utilized. Indeed, specialized knowledge of local conditions was especially important in an economy where, in certain areas, credit demand was heavily influenced by the seasonal nature of agriculture. In this way, the demand for money in the economy as a whole could be satisfied at a dozen "discount windows." (In a world before modern open market opera-

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tions of buying and selling Treasury bills were the preferred tools of monetary policy, the discount window was an important mechanism in controlling the money supply.)

But the Thornton-Bagehot synthesis would soon meet the political realities of hard economic times. On the heels of the national bank crisis of the early 1930s, Congress passed an amendment to the Federal Reserve Act which was approved by President

Franklin Roosevelt on June 19, 1934. It added a new section — 13(b) — that removed most of the conditions constraining the Fed's ability to lend in a crisis. It essentially authorized the Fed to extend credit to nonbank business enterprises directly for up to five years without any limitations as to the type of asset that could be offered as collateral and without limits on any single loan.

Originally, Fed lending was targeted toward banks that would then lend to distressed businesses. Now the Fed could provide working capital directly to established businesses. The genesis of this role was a 1932 amendment to paragraph 3 of section 13 that allowed the Fed to award loans to nonbanks in "unusual and exigent circumstances."

In the first year after the creation of section 13(b), Fed lending spiked. It became less popular over time because the federal government's Reconstruction Finance Corporation was a much more generous lender.

The Fed's role as banker to a variety of industries continued until the 1950s. Fed policymakers, however, were beginning to sour a bit on their new role by then. In 1951, a bill to further the ability of the Fed to lend to nonbank businesses was not supported by the Fed's Board of Governors because of their concerns about the inflationary impact of expanded lending. Chairman William McChesney Martin's public statement in opposition to an expanded lending role for the Fed helped repeal section 13(b) in 1958. But thanks to the still-intact paragraph 3, the ability to lend to nonbanks in "unusual and exigent circumstances" remained as long as five members of the Board of Governors concurred with the decision to provide such liquidity.

### **The Penn Central Bankruptcy**

Despite this, some critics argue that the assumptions of the Fed as a crisis lender to all sorts of businesses would thereafter be baked into the market's expectations. And there were indeed other changes to federal law that kept the Fed in the lending game after 1958. Of particular note is the Defense Production Act's "v-loans" program, a carryover from World War II and utilized during the Korean War, in which the Federal Reserve served as guarantor of defense production loans made by the federal government. Keeping the possibility of lending to nonbank industries temporarily

open in this way would, in 1970, converge with a recession and a potentially disruptive corporate bankruptcy that would nudge the Fed into a return to its Depression-era role.

Many firms fell on hard times in the recession of 1969-1970, but one of the biggest was the Penn Central railroad. The company had issued a substantial amount of debt, or “commercial paper,” more than \$84 million in outstanding debt at the time, much of which was coming due between June and August of 1970. The firm appealed to the Nixon administration for a loan in May 1970, claiming it could not survive without federal support.

The White House was sympathetic and proposed to a syndicate of about 70 banks a federal guarantee for a \$200 million, two-year loan. The administration proposed to Congress that the loan guarantee would fit under the umbrella of the v-loan program. The implication of the White House seemed to be that keeping Penn Central alive was vital to national security interests even though the company had no explicitly defense-related business.

On Friday, June 19, after six weeks of debate, Congress refused to approve the loan guarantee. On the heels of that defeat, the Nixon administration asked the Federal Reserve Board to authorize the New York Fed to lend directly to Penn Central. After it ran through its procedures to determine the firm’s creditworthiness, the New York Fed reported back to the Board that Penn Central would likely not be able to repay any credit it received. That’s when the Board declined President Nixon’s request. The company declared bankruptcy on Sunday, June 21. (It would operate under bankruptcy protection for the next five years. Some of their rail routes were assumed by Amtrak upon its creation in 1971. By 1976, Penn Central was unable to emerge from bankruptcy as a reorganized company and was basically nationalized when Congress folded it and five other failed small railroads into the federally chartered Consolidated Rail Corporation, also known as Conrail.)

In 1970, however, many inside the Fed were concerned about the consequences of Penn Central’s bankruptcy filing. It was thought that the default of the company’s commercial paper could spur a contagion where other large companies that relied on the Penn Central debt contracts as a source of funds for their daily operations might default on their debts, and so on. There was also a concern that the market would be rattled by uncertainty and investors would be unable to discern which commercial paper issuers were likely to default next if at all. The sense among some was that the discount window should be used to head off these potential ripple effects.

So, the Fed decided to contact member banks over that weekend and told them that if they made loans “to enable their customers to pay off maturing commercial paper and thus needed more reserves, the Federal Reserve discount window would be available.” Columbia University economist Charles Calomiris has noted that the word “available” is the most important part of this statement. It effectively meant that member banks could borrow from the Fed for

the purposes of “pass through” loans to commercial paper issuers and would be able to do so without incurring any costs other than paying the discount rate — in other words, the sorts of restrictions put on discount window borrowers in the form of additional bank audits or other nonpecuniary penalties would be lifted for this sort of lending. Indeed, the Federal Reserve Board’s Annual Report in 1970 confirmed that the approach to discount window lending at this time was meant to finance borrowing by companies uncertain about whether they could rollover their soon-to-mature commercial debt.

Consequently, borrowing of reserves by large commercial banks — the institutions that were the main source of funds for these companies — tripled between June 24 and July 15. Calomiris estimates that this almost exactly offset the amount of the decline in the value of the commercial paper outstanding in the debt markets.

That wasn’t the only step the Fed took. There were some small actions to increase the money supply through open market operations. The Board also changed what was known as “Regulation Q” which mandated a ceiling on the interest rates banks could pay to depositors. This limit, in place since 1933, had the effect of making bank deposits a less attractive option for investors. The Fed’s action in 1970 exempted deposits above \$100,000 from the interest rate ceilings. The result was a flood of new deposits into commercial banks. This larger pool of loanable funds amounted to an increase from \$14 billion in June 24 (the day after the change to Regulation Q was approved) to \$26 billion by year’s end. Liberalization of this obviously counterproductive policy is perhaps the one thing that economists can agree was a good outcome of the Fed’s response to the Penn Central bankruptcy. It was a formative step in the eventual demise of Regulation Q, which was eliminated altogether in 1986.

As a lender of last resort, however, the approach that was favored by some policymakers at the Fed was one that harkened back to the Depression-era conception of the Fed’s role. The chairman of the Federal Reserve at the time, Arthur Burns, made no secret of his interest in expanding the Fed’s presence. In a statement to Congress on July 23, he revealed that during the events of the previous month, the Fed had prepared “standby procedures” to allow them to make direct loans to all sorts of firms unable to secure credit in private markets.

For the next 20 years, the Fed would assist in the federal government’s awarding of emergency credit, but in a different way. They served as the fiscal agent for the federal government’s loan guarantees to Lockheed in 1971 and Chrysler in 1979. The same goes for the emergency loans that went to the city of New York in 1975. These forms of assistance, however, were launched on an ad hoc basis.

In 1991, more than 30 years after section 13(b) was repealed, a broader conception of the Fed’s role as lender of last resort was finally codified by the Federal Deposit Insurance Corporation Improvement Act. The new amendment to paragraph 3 of section 13 clarified that the Fed could

advance credit directly to nondepository institutions — for example, securities firms.

### The Past and Future of Fed Lending Policy

Even today, debates still occur over whether the Fed made the right decision about its discount window operations in that fateful summer of 1970.

Some argue that it's not immediately clear that the discount window actions were necessary to head off any ripple effects in the Penn Central episode. Open-market operations alone could have expanded the money supply to meet the demand for credit that would have resulted from any commercial paper default. In a case like that, intermediaries in the private banking system, not the Fed, would be the ones determining where the demand for the loanable funds was highest. Some economists, like former Richmond Fed economist Marvin Goodfriend, suggest that the discount window is unnecessary for this reason and is no longer required for maintenance of the money supply as it once might have been.

Nor does everyone buy the contagion argument used to justify the lending actions of the Fed. Anna Schwartz suggested in a speech at St. Louis University in 1992 that commercial paper issuers that faced difficulty in 1970 weren't in that position because of turmoil in the credit

markets. Instead, it was because they were companies that might have deserved to fail for a variety of reasons, all of them particular to the companies themselves. Reliance on commercial paper was a by-product, not a cause, of their troubles. From a policy perspective, Schwartz suggests that the Penn Central episode “fostered the view that bankruptcy proceedings by a large firm [can create] a financial crisis, and that, if possible, bankruptcy should be prevented by loans and loan guarantees: a ‘too big to fail’ doctrine in embryo.”

Meanwhile, economist Allan Meltzer of Carnegie Mellon University, who has written a history of the Federal Reserve, channels Bagehot when he wonders what the Fed policy really is. As he wrote in the *Wall Street Journal* on July 16, 2008, “In its 95-year history, the Fed has never made a clear statement of its policy for dealing with failures. Sometimes it offered assistance to keep the bank or investment bank afloat. Other times it closed the institution. Troubled institutions have no way to know in advance whether they will be saved or strangled.”

The assumptions about a central bank's role as a lender of last resort have come a long way since the days of Thornton and Bagehot. The wisdom of those changes is something economists continue to debate — especially during the current period of financial turmoil. **RF**

### READINGS

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