

## Placing Limits on Fed 'Credit Policy'

On July 21, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. At more than 2,300 pages, this is a large and wide-ranging law with implications for virtually every aspect of banking and finance in the United States. It creates new government agencies, new obligations and powers for existing financial regulators, and new limits on the permissible activities of banking firms. The process of fully implementing the Act will stretch over many years and will include more than 240 rule-makings and 60 studies by various agencies.

As the legislation was being crafted, I expressed concerns about the portion of the bill that created a new government-run resolution mechanism for large failing financial institutions. The discretion to shield creditors, especially short-term creditors, if one of these firms were to be closed could produce ambiguity for investors. Lingering belief in the possibility of such protection could dampen the market discipline the Dodd-Frank Act seeks to enhance.

But the new law also does some very good things. For instance, it tightens constraints on risk-taking by large complex financial institutions — and it provides for more consistent consolidated oversight of those entities when different affiliates have different functional regulators. It also creates a stronger and broader mechanism for cooperation and coordination among federal agencies with financial regulatory and supervisory responsibilities.

There's another accomplishment of the Dodd-Frank Act that I think is very important but has gone largely unnoted. The legislation takes a significant step toward diminishing the role of the central bank in the allocation of private credit, and instead placing that responsibility in the hands of the U.S. Treasury and the Congress.

At the Richmond Fed, we have a history of arguing for just such a delineation of those responsibilities. My former colleague Marvin Goodfriend proposed a "credit accord" between the Treasury and the Federal Reserve, analogous to the Treasury-Fed Accord of 1951 that allowed the Fed to conduct interest rate policy independent of government financing needs. The case for a credit accord rests on the fact that the provision of central bank credit to private borrowers, like other public-sector credit provisions, is an act of fiscal policy and should be subject to the normal checks and balances the Constitution provides for the distribution of public funds. In addition, interventions in private credit markets could compromise the central bank's ability to conduct monetary policy independently of the legislative and executive branches. Such independence has been crucial to the Fed's pursuit of price stability since the 1970s, and thus beneficial to the larger economy.

The Dodd-Frank Act reduces the Fed's emergency lending powers by amending the portion of the Federal Reserve Act — Section 13(3) — that allowed the Fed to lend to "individuals, partnerships, and corporations" under "unusual and exigent circumstances." Most of the vast expansion of Fed credit beyond depository institutions was made under this authority — the lending connected with Bear Stearns and AIG, for example, as well as the special credit programs for the commercial paper and asset-backed securities markets. The Dodd-Frank Act only permits lending programs with "broadly based" eligibility that provide liquidity to the financial system, and only with the written consent of the Secretary of the Treasury. Fed lending to aid individual nonbank institutions under Section 13(3) is prohibited.

These provisions, along with a number of new reporting requirements, reduce the scope of Fed emergency lending powers and improve accountability, though they stop short of restricting the Fed from allocating credit entirely. Nonetheless, the Dodd-Frank Act takes an important step toward a credit accord, and any journey begins with but a single step.

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A handwritten signature in black ink, appearing to read "Jeff M Lacker".

JEFFREY M. LACKER  
PRESIDENT  
FEDERAL RESERVE BANK OF RICHMOND