The Heritage Foundation

BACKGROUNDER

No. 3060 | SEPTEMBER 29, 2015

Dodd–Frank's Title XI Does Not End Federal Reserve Bailouts

Norbert J. Michel, PhD

Abstract

Monetary scholars have long recognized that the too-big-to-fail doctrine has roots in the Federal Reserve's so-called emergency lending. While a main purpose of Dodd–Frank was to protect taxpayers by restricting the Fed's ability to provide emergency loans, the bill failed to accomplish this goal. Even after these changes, many of the emergency loans extended during the 2008 crisis would still be allowed. Given the historical precedent of previous financial crises, nothing short of an outright prohibition of emergency Fed lending should be expected to mitigate those bailouts. Title XI of Dodd–Frank fails to end the too-big-to-fail problem largely because it allows the Fed to rescue firms during so-called emergencies. The changes to Fed emergency lending implemented by Title XI ignore that the central bank's function is already to provide system-wide liquidity. If the central bank provides such liquidity, there is no need for an additional set of rules to provide system-wide liquidity in special circumstances.

A stated purpose of the Dodd–Frank Wall Street Reform and Consumer Protection Act was to end the too-big-to-fail problem. In other words, the Dodd–Frank Act was supposed to protect taxpayers from saving insolvent financial firms in the future as they did during the 2008 financial crisis. Title XI of Dodd–Frank amended the Federal Reserve's emergency lending authority to curb its ability to save insolvent financial institutions. However, Dodd–Frank still allows many of the emergency lending programs that were conducted during the 2008 crisis. Perhaps the biggest mistake of Dodd–Frank is that it leaves intact the notion that the Fed should make emergency loans to firms during a financial crisis, even though there

This paper, in its entirety, can be found at **http://report.heritage.org/bg3060**

The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Key Points

- Throughout its history, the Federal Reserve's direct lending policies have jeopardized its operational independence and put taxpayers at risk.
- No clear economic rationale calls for the Fed to provide emergency loans to private firms. Monetary policy simply does not require the Fed to make these loans.
- The classic motivation for last resort lending is often misunderstood and inappropriately applied to the Fed's emergency loan policies. The classic prescription itself was, in fact, largely offered as a second-best solution to private markets fulfilling the lending role.
- If allowed, all modern financial firms would gladly lend under the classic prescription terms of making short-term loans at high interest rates only to solvent firms with good collateral.
- Private lenders' widespread refusal to make such loans likely indicates a solvency crisis, not a liquidity crisis. In this context, the only loans that private markets refuse to make are those that should not be made under any circumstances.

is no clear economic rationale for providing these loans. Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. The Fed does not need emergency lending authority to conduct monetary policy.

The Federal Reserve: Lender of Last Resort

A stated purpose of Title XI of Dodd–Frank was to protect taxpayers by restricting the Federal Reserve's ability to provide emergency loans. Many of the changes instituted by Title XI essentially force the Fed to adhere to the classic prescription for a lender of last resort (LLR). The classic LLR prescription was mainly developed in the 19th century by Walter Bagehot, longtime editor of *The Economist*.[1]

Throughout its history, the Fed has been criticized for helping failing firms to stay afloat largely because it has failed to follow this prescription. Two norms summarize the essence of this classic LLR policy:

1. The central bank should prevent panic-induced contractions of the economy's stock of money.

2. During a crisis, the central bank should provide short-term loans to all solvent institutions, on good collateral at a high rate of interest.

The main focus is to prevent a short-term shrinkage of the money supply from becoming a full-blown economic contraction. A central bank accomplishes this by managing the monetary base, a measure that consists of all currency in circulation plus commercial banks' reserves. Economists refer to the base as high-powered money because the central bank controls how much of this money exists and because the base ultimately determines the maximum quantity of money that can be created in the banking system.[2]

Put differently, the central bank ensures that the entire banking system has enough liquidity (base money) to prevent a panic from spreading to the broader economy. However, the classic prescription made clear that a central bank had no duty to save specific firms. To avoid sustaining insolvent private banks, the central bank was to provide temporary, high-interest-rate loans only to borrowers who could post sound collateral.

However, policymakers should recognize that even the classic LLR prescription is a second-best solution to private banks (under the threat of failure) providing all of the lending that markets need. Thus, the classic LLR prescription is a flawed concept upon which to base emergency loan restrictions.

Problems with the Classic Prescription

One concern with central banks providing direct loans is a basic moral hazard problem. Namely, if central banks provide liberal credit to private banks (or other private firms) on a regular basis, the knowledge of having easy access to these loans would likely encourage private companies to take on additional risk.[3] However, the moral hazard problem is only one issue that casts doubt on the wisdom of allowing central banks to make loans directly to firms.

If central banks provide liberal credit to private banks (or other private firms) on a regular basis, the knowledge of having easy access to these loans would likely encourage private companies to take on additional risk.

In fact, Bagehot offered his ideas as a second-best solution to private markets fulfilling this lending

1. See Thomas M. Humphrey, "Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It," *The Cato Journal*, Vol. 30, No. 2 (Spring/Summer 2010), pp. 333–364, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/5/cj30n2-7.pdf (accessed July 2, 2014).
2. Commercial banks are required to hold reserves in an account at their district Federal Reserve bank, and these reserves ultimately determine how much money banks can lend (that is, how much new money that banks can create) to their customers. See Norbert J. Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation *Backgrounder* No. 2876, January 29, 2014, http://www.heritage.org/research/reports/2014/01/the-fed-at-100-a-primer-on-monetary-policy.
3. At least one of Bagehot's contemporaries recognized this basic moral hazard problem. See Humphrey, "Lender of Last Resort," p. 340.

role. He even viewed central banking as an undesirable, destabilizing[4] force:

> I know it will be said that in this work I have pointed out a deep malady, and only suggested a superficial remedy. I have tediously insisted that the natural system of banking is that of many banks keeping their own cash [i.e., specie] reserve, with the penalty of failure before them if they neglect it. I have shown that our system is that of a single bank keeping the whole reserve under no effectual penalty of failure. And yet I propose to retain that system, and only attempt to mend and palliate it.
>
> I can only reply that I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it.... You might as well, or better, try to alter the English monarchy and substitute a republic.[5]

Aside from Bagehot's own views, upon close inspection the classic LLR prescription is clearly a flawed standard with respect to preventing bailouts. With everything else constant, any modern financial institution would normally make short-term loans to solvent firms—even at market rates of interest—on good collateral.[6] Thus, the widespread refusal by private lenders to make such loans would likely indicate the existence of a solvency crisis, not a liquidity crisis. Put differently, the only loans that would not be made during a crisis are the loans that should not be made under any circumstances.[7] Interestingly, the Fed has successfully provided system-wide liquidity and avoided bailouts several times without using its emergency lending authority.

Liquidity and Open Market Operations

Throughout its history, the Federal Reserve has used several different methods to fulfill its LLR function. The principal method has been open market operations that the Fed uses to manage the monetary base. Through these operations, the Fed has regularly maintained liquidity in the entire market by purchasing Treasury securities, and these operations can be temporarily expanded in the event of a crisis. At all times, these purchases add reserves to the banking system, thus flooding the federal funds market—a private market where banks lend reserves to each other—with additional funds.

An injection of reserves tends to lower the federal funds rate (the rate that banks charge each other for overnight loans in this market), thus providing banks with easier access to a highly liquid source of borrowing. Therefore, the federal funds market provides a way for the Fed to add to the monetary base—even if only temporarily—and to allow banks to allocate credit to specific institutions as they see fit. In several earlier crises the Fed successfully provided system-wide liquidity by temporarily expanding its open market purchases. Yet these successful examples are outnumbered by many instances of the Fed providing direct loans to firms with poor financial health.[8]

4. See George Selgin, "Central Banks as Sources of Financial Instability," *The Independent Review*, Vol. 14, No. 4 (Spring 2010), pp. 485–496, http://object.cato.org/sites/cato.org/files/articles/tir_14_04_01_selgin.pdf (accessed June 2, 2015).
5. Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873; New York: John Wiley & Sons, 1999), p. 329.
6. Alternatively, strict reserve or regulatory requirements could prevent private firms from making loans, in which case removing these restrictions would allow private lenders to provide loans. This sort of problem has several historical precedents. For instance, regulations prohibited even the temporary relief from strict reserve requirements during the panic of 1907. One prominent banker involved in the 1907 crisis noted, "While one thousand millions of dollars were lying idle in our banks and trust companies as so-called reserves, this money, by virtue of the law, could scarcely be touched!" See Richard Timberlake, "Clearing House Currency," *The Cato Journal*, Vol. 34, No. 2 (Spring/Summer 2014), p. 309, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2014/5/cato-journal-v34n2-6.pdf (accessed July 24, 2014).
7. Even protecting central bank emergency loans with strict collateral requirements—assuming it can be valued properly—could add to moral hazard by allowing creditors of a failing bank to escape any losses. See Marvin Goodfriend and Jeffrey M. Lacker, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond *Economic Quarterly*, Vol. 85, No. 4 (Fall 1999), pp. 1–27, https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/1999/fall/pdf/goodfriend.pdf (accessed August 2, 2015).
8. For a complete overview, see Norbert J. Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation *Backgrounder* No. 2943, August 20, 2014, http://www.heritage.org/research/reports/2014/08/the-feds-failure-as-a-lender-of-last-resort-what-to-do-about-it.

The Discount Window and Emergency Lending

The Fed principally lends directly to banks through its discount window, a method of lending that was originally envisioned as the main tool of monetary policy.[9] Initially, each District Reserve Bank had a physical discount window in its lobby to make these loans to member banks, and the provision of such credit has always been controversial.[10] The term now refers more generally to the regular provision of credit, as opposed to emergency credit, by the central bank to individual depository institutions on predefined terms.[11]

In 1932, the Glass–Steagall Act significantly expanded the Fed's ability to provide direct loans by adding Section 13(3) to the Federal Reserve Act.[12] This change opened the Fed's discount window to nonbanks—individuals, partnerships, and corporations—in "unusual and exigent circumstances."[13] In 1934, the Industrial Advances Act created Section 13(b) of the Federal Reserve Act, authorizing the District Banks to provide working capital loans directly to industrial and commercial businesses for up to five years without any collateral restrictions.[14] By 1939, the District Banks had provided nearly $200 million in working capital loans to nearly 3,000 applicants.[15]

The Small Business Investment Act of 1958 repealed Section 13(b). During the congressional debate on the 1958 bill, Fed Chairman William McChesney Martin testified to Congress that the Fed should not provide capital to institutions and that its primary objective should be "guiding monetary and credit policy."[16] Roughly 20 years later, the Fed appropriately refused to open the discount window when the Nixon Administration asked the New York Fed to provide loans to the financially troubled Penn Central Railroad.

That success was short-lived, and the Fed immediately followed its refusal with what monetary scholar Anna Schwartz called "the 'too-big-to-fail' doctrine in embryo."[17] Ostensibly worried about fallout from Penn Central's bankruptcy—particularly its default on $82 million in commercial paper—the Fed announced that it would provide discount window lending to banks to assist in meeting the needs of all businesses that could not issue new commercial paper. Thus, the Fed showed that it would go to great lengths to stem a financial crisis in the event a large firm, not even a financial firm, might fail. This action implied that the bankruptcy of a large firm would cause a financial crisis, although only conjecture—no analysis—supports such a position.

Another major break with traditional LLR lending occurred in 1974 when the Fed provided discount window loans to Franklin National Bank until the Federal Deposit Insurance Corporation (FDIC) found a buyer for the *failed* bank. For five months, the New York Fed lent continuously to Franklin for a total of $1.75 billion, approximately 50 percent of Franklin's assets. The Fed took a similar approach with Continental Illinois, lending as much as $8 billion over the course of one year until the FDIC resolved the *failed* bank in 1985. Evidence also suggests that the Fed continuously provided capital loans to many troubled banks during the late 1980s and early 1990s.

9. The term "discount" refers to the practice of discounting and rediscounting (that is, lending). At the time of the Fed's founding, bills of exchange and banker's acceptances (forms of short-term credit) were frequently used as collateral in lending. This practice formed the idea behind the Fed's discount window: Banks could borrow (discount and rediscount) from the Fed to obtain currency against the private loans (bills of exchange) that they were holding.
10. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review*, Vol. 74, No. 5 (September/October 1992), pp. 58–69, http://research.stlouisfed.org/publications/review/article/2582 (accessed July 3, 2014).
11. The authority for discount window lending is mostly in Section 10B of the Federal Reserve Act. 12 U.S. Code §§ 341–364. See Federal Reserve Board, "Discount Window Lending," http://www.federalreserve.gov/newsevents/reform_discount_window.htm (accessed July 9, 2014).
12. It is convenient to make a distinction between discount window loans and emergency loans, but technically even discount window loans are made under primary, secondary, and seasonal lending programs. Furthermore, under the current U.S. Code, Section 13(3) of the Federal Reserve Act authorizes the Fed to provide "discounts." 12 U.S. Code § 343.
13. David Fettig, ed., "Lender of More Than Last Resort," Federal Reserve Bank of Minneapolis *The Region*, December 2002, https://www.minneapolisfed.org/publications/the-region/lender-of-more-than-last-resort (accessed August 21, 2015).
14. Ibid., p. 19.
15. Schwartz, "The Misuse of the Fed's Discount Window," p. 61.
16. Ibid., p. 62.
17. Ibid.

The House Banking Committee reported that, of the 530 depository institutions that failed from January 1985 to May 1991, 437 had been formally rated with the poorest CAMEL rating[18] of "five" (most problem-ridden), and 51 had the next poorest rating of "four." The whole class of "five"-rated banks had been allowed to operate for a mean period of one year. At the time of actual failure, 60 percent of the banks had outstanding discount window loans for an aggregate of roughly $8 billion.[19] Given these banks' poor CAMEL ratings, it is difficult to argue that the Fed believed it was making loans only to solvent banks.

Fed Lending Programs During the 2008 Financial Crisis. During the 2008 crisis the Fed allocated credit directly to firms and provided loans through several broad lending programs. For instance, on March 14, 2008, the Fed provided a $13 billion loan to Bear Stearns, one of the Fed's largest primary dealers. Bear Stearns repaid the loan in days, but then the Fed provided a $30 billion loan to facilitate J. P. Morgan Chase's acquisition of Bear Stearns via a special purpose vehicle named Maiden Lane LLC. Shortly after this deal was completed, former Fed chairman Paul Volcker remarked that this loan was "at the very edge" of the Fed's legal authority.[20] In September 2008, the Fed loaned American International Group (AIG) $85 billion and, as a condition of the loan, took 79.9 percent equity ownership in AIG.[21] In June 2015, a U.S. District Court ruled that "Section 13(3) did not authorize the Federal Reserve Bank to acquire a borrower's equity as consideration for the loan."[22]

Separately, the U.S. Government Accountability Office (GAO) estimated that the Federal Reserve lent financial firms more than $16 trillion through its Broad-Based Emergency Programs from December 1, 2007, through July 21, 2010.[23] In comparison, U.S. annual gross domestic product (GDP) reached $16.8 trillion in 2013—an all-time high for U.S. non-inflation-adjusted GDP. During the crisis, the Fed created more than a dozen special lending programs by invoking its emergency authority under Section 13(3).

The Fed shut down most of these special programs by 2010, although approximately $2 billion from some of the lending facilities remains on the Fed's balance sheet.[24] The following list[25] provides just a few examples of the Fed's emergency lending in the wake of the 2008 crisis:

- **Term Securities Lending Facility (TSLF).** The TSLF was created on March 11, 2008, to provide

18. In 1996, the Federal Reserve formally updated the CAMEL rating system to the CAMELS system. Banking regulators now use CAMELS ratings to rate the strength of banks based on six (rather than five) factors: (C) capital adequacy, (A) asset quality, (M) management quality, (E) earnings, (L) liquidity, and (S) sensitivity to market risk. See press release, Federal Reserve Board of Governors, December 24, 1996, http://www.federalreserve.gov/BoardDocs/press/general/1996/19961224/default.htm (accessed July 12, 2014).
19. Schwartz, "The Misuse of the Fed's Discount Window," pp. 58–59.
20. John Brinsley and Anthony Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power," Bloomberg News, April 8, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c (accessed July 8, 2014). Similarly, former New York Fed lawyer Walker Todd argued, "Much less of [the Federal Reserve's emergency] lending is based on clear statutory authority than one might prefer if one cared about the rule of law and the potential for tyrannical government. The Fed interprets 13(3) as essentially giving it carte blanche. One has to read between the lines and off the edge of the page, however, to find authority for the Fed to purchase assets that are not 'notes, drafts, and bills of exchange,' or authority to create special subsidiaries to do so." Lawrence H. White, "The Rule of Law or the Rule of Central Banks?" *The Cato Journal*, Vol. 30, No. 3 (Fall 2010), pp. 451–456, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2010/11/cj30n3-3.pdf (accessed August 2, 2015).
21. The Fed created two additional Maiden Lane entities to complete the AIG bailout. The combined net holdings of the three Maiden Lane LLCs are currently more than $1.7 billion, and the original Maiden Lane LLC accounts for nearly all of this total.
22. *Starr International Company v. U.S.*, No. 11-779C, at 2 (Fed. Cl., June 15, 2015), https://ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2011cv0779-443-0 (accessed June 22, 2015).
23. U.S. Government Accountability Office, "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," GAO–11–696, July 2011, p. 131, http://www.gao.gov/new.items/d11696.pdf (accessed July 3, 2014).
24. See Federal Reserve Board of Governors, "Factors Affecting Reserve Balances," May 28, 2015, http://www.federalreserve.gov/releases/h41/current/h41.htm (accessed June 4, 2015).
25. For a complete list, see U.S. Government Accountability Office, "Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency," GAO–12–18, October 2011, p. 76, http://www.gao.gov/new.items/d1218.pdf (accessed July 3, 2014). See also Lawrence H. White, testimony before the Subcommittee on Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, March 12, 2014, http://mercatus.org/publication/ending-federal-reserve-system-s-overreach-credit-allocation (accessed July 1, 2014).

short-term loans to the Fed's primary dealers. It was the first time during the crisis that the Fed provided funds to nondepository institutions. According to the GAO, many market participants believed that the TSLF was designed primarily to help Bear Stearns.[26]

- **Term Auction Facility (TAF).** The TAF was created on December 12, 2007, to auction one-month and three-month loans to depository institutions so that they could avoid the stigma of borrowing at the discount window. Almost $4 trillion was provided through the TAF between 2007 and 2010.[27]

- **Primary Dealer Credit Facility (PDCF).** Created on March 17, 2008, the PDCF provided overnight cash loans to primary dealers against "eligible collateral," as defined by the Fed. Nearly $9 trillion was loaned through the PDCF by 2010.

Bear Stearns used the PDCF before the Fed facilitated the Bear Stearns–J.P. Morgan merger, but three other primary dealers—Citigroup Global Markets, Merrill Lynch Government Securities, and Morgan Stanley & Company—relied on the PDCF for more than double the amount that Bear Stearns borrowed.[28] Of more than 20 primary dealers, almost 80 percent of the PDCF lending went to these four firms.[29] Furthermore, the Fed made special concessions on the type of collateral accepted for these loans, and it provided PDCF loans at below market rates.[30]

Typically, high-grade bonds and securities for government-sponsored enterprises have accounted for nearly all of the collateral used in these types of borrowings. However, after the 2008 Lehman Brothers failure, the Fed accepted equities and speculative grade debt as collateral for PDCF loans.[31] The Fed clearly relaxed credit standards relative to what was normally accepted in this short-term lending market. Although difficult to gauge exactly, evidence also suggests that the Fed provided favorable rates on most of its emergency lending programs.

The Fed's total emergency loans from 2007 to 2010 charged an estimated $13 billion below market rates. Charging below market rates on suspect collateral is the antithesis of the classic LLR prescription.

For example, Bloomberg Markets estimates that the Fed charged $13 billion below market rates for its emergency loans from 2007 to 2010.[32] Charging below market rates on suspect collateral is the antithesis of the classic LLR prescription. The goal should be to lend as safely as possible at high rates so that firms have every incentive to stop relying on the Fed for funds. Instead, the Fed effectively provided financial institutions with a source of subsidized capital for up to several years. Proponents argue that these crisis loans were necessary because market participants had difficulty determining the value of various securities. The truth is that the Fed did not want many banks to sell securities at the low prices that the market was offering at that time.

26. U.S. Government Accountability Office, "Federal Reserve Bank Governance," p. 84.
27. Because the TAF allowed the Fed to auction a pre-announced amount of credit to firms, it was a way to directly inject liquidity into the market where it was most needed (at market rates). The TAF could even be superior to open market operations for the purpose of providing regular liquidity to the market. See Olivier Armantier, Sandra Krieger, and James McAndrews, "The Federal Reserve's Term Auction Facility," Federal Reserve Bank of New York *Current Issues in Economics and Finance*, Vol. 14, No. 5 (July 2008), http://newyorkfed.org/research/current_issues/ci14-5.html (accessed June 4, 2015).
28. Brian Sheridan, "Lender of Last Resort: An Examination of the Federal Reserve's Primary Dealer Credit Facility," University of Notre Dame *Working Paper*, April 2011, p. 29, https://economics.nd.edu/assets/41471/brian_sheridan_lender_of_last_resort.pdf (accessed July 3, 2014).
29. Ibid.
30. Technically, the PDCF borrowing occurred in the short-term repurchase (repo) market.
31. After the Lehman failure, 26.4 percent of the collateral consisted of equity securities and 16 percent consisted of speculative-grade bonds. See Sheridan, "Lender of Last Resort," p. 16.
32. Bloomberg derived these estimates based on data from a Freedom of Information lawsuit. See Bob Ivry, Bradley Keoun, and Phil Kuntz, "Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress," *Bloomberg Markets Magazine*, November 27, 2011, http://www.bloomberg.com/news/print/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html (accessed July 3, 2014).

This fact also highlights a major problem with attempts to ensure that the Fed can provide emergency loans only to *solvent* companies. For example, if bank assets are marked to market during a crisis, insolvency would likely be widespread. On the other hand, if bank assets are not marked to market during a crisis, nearly all financial institutions will appear sound on paper, leading to widespread emergency loans. Ironically, one of the Fed's special lending programs could be modified to improve the Fed's current open market operations process, making liquidity crises less likely in the first place.

Improving System-Wide Liquidity

Since the 1930s the Fed's main monetary policy tool has been open market operations, the process of buying and selling (mainly) U.S. Treasuries on the open market.[33] Traditionally, the Fed has conducted these operations via a limited number of financial firms known as primary dealers.[34] In practice, when the Fed wants to expand the monetary base so that banks can lend more, it directs its traders to buy Treasuries from the primary dealers. The Fed then electronically credits the reserve accounts of the dealers' banks, thus leaving it to the primary dealers to distribute credit through the federal funds market.

The federal funds market is essentially a private market where banks regularly lend and borrow excess reserves on an overnight basis. Thus, a main goal of open market operations is to maintain a liquid market for reserves so that private financial firms can provide financing to other private companies as needed. In this sense, the Fed regularly tries to maintain system-wide liquidity to prevent economic slowdowns. During the 2008 crisis, the primary dealer system's reliance on a small number of firms actually hampered the Fed's ability to maintain system-wide liquidity.[35] According to Donald Kohn, former Vice Chairman of the Federal Reserve Board of Governors,

> The fact that primary dealers rather than commercial banks were the regular counterparties of the Federal Reserve in its open market operations, together with the fact that the Federal Reserve ordinarily extended only modest amounts of funding through repo agreements, meant that open market operations were not particularly useful during the crisis for directing funding to where it was most critically needed in the financial system.[36]

One obvious solution to this problem is to discontinue the primary dealer system so that most financial firms can directly participate in open market operations.

One obvious solution to this problem is to discontinue the primary dealer system so that most financial firms can directly participate in open market operations. The European Central Bank (ECB), for instance, conducts its open market operations with more than 500 bank counterparties in the eurozone.[37] Moving to such a system would at least "reduce dependence upon a geographically concentrated set of counter parties, and enhance the monetary policy transmission process."[38]

33. See David Marshall, "Origins of the Use of Treasury Debt in Open Market Operations: Lessons for the Present," Federal Reserve Bank of Chicago *Economic Perspectives* (1st Quarter, 2002), pp. 45–54, https://ideas.repec.org/a/fip/fedhep/y2002iqip45-54nv.26no.1.html (accessed June 15, 2015).
34. Currently, 22 primary dealers serve as counterparties to the Fed's trades. See Federal Reserve Bank of New York, "Primary Dealers List," http://www.newyorkfed.org/markets/pridealers_current.html (accessed June 15, 2015).
35. Several Federal Reserve officials acknowledged the primary dealer system, with its reliance on a small number of firms, hampered the Fed's ability to provide liquidity. See George Selgin, "L Street: Bagehotian Prescriptions for a 21st Century Money Market," *The Cato Journal*, Vol. 32, No. 2 (Spring/Summer 2012), http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2012/7/v32n2-8.pdf (accessed June 15, 2015).
36. Donald L. Kohn, "Policy Challenges for the Federal Reserve," speech at the Kellogg School of Management, Northwestern University, Evanston, IL, November 16, 2009, http://www.federalreserve.gov/newsevents/speech/kohn20091116a.htm (accessed June 15, 2015).
37. Shadow Financial Regulatory Committee, "Reforming the Primary Dealer Structure," American Enterprise Institute *Shadow Committee Statement* No. 280, December 14, 2009, https://www.aei.org/publication/reforming-the-primary-dealer-structure/ (June 15, 2015).
38. Ibid. To force such a change in Fed procedure, Congress would likely need to amend the Federal Reserve Act. Section 14 of the Federal Reserve Act authorizes open market purchases under the "rules and regulations prescribed by the Board of Governors." 12 U.S. Code § 353.

Historically, open market operations have proved superior to the discount window in maintaining system-wide liquidity. In general, market participants have traditionally attached a stigma to discount window loans, and banks rarely use the discount window. Thus, it is not surprising that the Fed's discount window lending proved inadequate during the 2008 crisis.[39] In fact, several monetary scholars had previously recommended that the Fed rely solely on open market operations to provide liquidity rather than on direct credit allocation through emergency and discount window lending.[40] Moreover, in response to rapid declines in the amount of outstanding Treasury debt in the late 1990s, the Fed studied alternative methods to both open market operations and discount window lending to ensure that it could maintain system-wide liquidity.

In 2002, the Fed published a report that discussed an auction-based lending facility as one method for providing liquidity to the banking system.[41] Nonetheless, the Fed maintained its traditional blend of policy tools leading up to the crisis and then, in December 2007, introduced the Term Auction Facility (TAF) to enhance system-wide liquidity. The TAF was a lending program that combined aspects of open market operations and discount window lending. According to Kohn,

> The legal form of the TAF is the same as that of regular discount window loans. But by providing funds through an auction mechanism rather than through a standing facility, the TAF resembles open market operations rather than the standard discount window and, partly as a result, it appears to have largely avoided the stigma problem that limited the effectiveness of the discount window.[42]

Experience from the 2008 crisis therefore suggests a modified TAF program could enhance the Fed's ability to maintain system-wide liquidity and ultimately replace both the discount window and the primary dealer system. Rather than rely on a small number of primary dealers, the Fed could open auctions of regular short-term advances to all banks that have the safest two CAMELS ratings.[43]

Such auctions could become the primary method for the Fed to provide liquidity and could include collateral and lending limit restrictions to mitigate moral hazard problems. Banks could also be allowed to lend these short-term loans in the interbank lending market. While no system is foolproof, such a change would drastically reduce the need to expand the Fed's lending authority on an ad hoc basis, and fear of losing eligibility to participate in these auctions would likely provide further incentive for banks to improve their financial conditions. Dodd–Frank stopped well short of this type of reform and, instead, attempted to increase restrictions on the Fed's emergency lending.

Title XI Amendments to Emergency Lending

Prior to passage of the Dodd–Frank Act, Section 13(3) of the Federal Reserve Act authorized the Federal Reserve to make loans commonly referred to as emergency lending. In particular, Section 13(3) allowed the Federal Reserve Board of Governors to authorize any of the Federal Reserve District Banks to extend credit to "any individual, partnership, or corporation" in "unusual and exigent circumstances."[44] Overall, these loans were subject to four conditions:

1. The Fed extends such loans in only "unusual and exigent circumstances";

39. Kohn, "Policy Challenges for the Federal Reserve."
40. For example, see Goodfriend and King, "Financial Deregulation, Monetary Policy, and Central Banking."
41. Federal Reserve System Study Group on Alternative Instruments for System Operations, "Alternative Instruments for Open Market and Discount Window Operations," Board of Governors of the Federal Reserve System, December 2002, http://www.federalreserve.gov/boarddocs/surveys/soma/alt_instrmnts.pdf (accessed June 15, 2015).
42. Kohn, "Policy Challenges for the Federal Reserve."
43. For a more detailed plan to end the need for emergency lending and transition to a market-wide auction process, see Selgin, "L Street." American Enterprise Institute scholar Paul Kupiec has suggested (in public forums) a similar idea whereby the Fed would sell options on a regular cycle. Under this sort of plan, any bank that owns an option and the underlying security that it references can "repo" the security back to the Fed at a given repo rate (agreed upon in advance) provided there was no downgrade on the collateral.
44. 12 U.S. Code § 343.

2. At least five members of the Board of Governors vote to allow the loans;

3. The loans be indorsed or otherwise secured to the satisfaction of the District Bank; and

4. The lending District Bank obtains evidence that the borrower is unable to secure adequate financing from private banking institutions.

Title XI of Dodd–Frank amended the Federal Reserve Act to limit the Fed to providing only emergency lending programs that have "broad-based eligibility." In other words, the Fed can no longer provide loans to individual firms. It can make loans available to only *groups* of companies. However, even if these changes had been in place prior to the 2008 crisis, the Fed still could have conducted roughly half of its special lending programs.[45]

Title XI also requires the Federal Reserve Board to consult with the Treasury Secretary to develop its emergency lending policies and procedures, and it further stipulates that the Board cannot establish any such program without the Treasury Secretary's prior approval.[46] Section 1101(a)(6) of Dodd–Frank requires:

> Such policies and procedures shall be designed to ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.[47]

Additionally, Title XI requires the Board to develop rules that prohibit emergency lending to insolvent borrowers and that ban lending programs designed to remove assets from a specific firm's balance sheet to enable that company to avoid insolvency.[48] Aside from the fact that this type of collaboration is wholly contrary to the notion of central bank independence from the executive branch, the new requirements ignore that the central bank's function is already to provide system-wide liquidity. If the central bank provides such liquidity, there is no reason to require an additional set of rules for providing such liquidity in special circumstances. During a crisis, if Congress desires to provide additional taxpayer funds to firms, it can do so directly in a politically accountable manner.

These Dodd–Frank changes were meant to provide stricter rules *before* another financial crisis occurs, but Title XI also included several provisions to increase Congress's post-crisis oversight over the Fed. For instance, no later than seven days after the Fed authorizes an emergency program, it must provide Congress with a detailed report.[49] Additionally, Section 1102 authorizes the U.S. Government Accountability Office (GAO) to audit any of the Fed's emergency lending programs. These GAO audits can investigate nearly all aspects of the programs, including whether they were designed to benefit specific firms and even whether the collateral requirements were effective.[50] Because firms could be hesitant to avail themselves of emergency lending for fear of signaling financial weakness, Title XI also provides for a delayed release of GAO reports on emergency lending.[51]

45. White, testimony before the Subcommittee on Monetary Policy and Trade.
46. Dodd–Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, §1101(a)(6)(B)(iv); 12 U.S. Code § 343(3)(B)(iv). The Federal Reserve issued proposed rules for its new emergency lending policies in January 2014 and is receiving public comments. See Federal Reserve System, "Extensions of Credit by Federal Reserve Banks," *Federal Register*, Vol. 79, No. 3 (January 6, 2014), pp. 615–620, https://www.federalregister.gov/articles/2014/01/06/2013-31025/extensions-of-credit-by-federal-reserve-banks (accessed June 2, 2015). In August, a bipartisan group of lawmakers criticized the proposal for not doing enough to guard against future bailouts. See Jonathan Ernst, "Lawmakers Slam Fed's Crisis Lending Proposal," Reuters, August 18, 2014, http://www.reuters.com/article/2014/08/18/us-financial-regulations-fed-idUSKBN0GI1Z020140818 (accessed June 2, 2015).
47. 12 U.S. Code § 343(3)(B)(i).
48. Dodd–Frank Act, §1101(a)(6)(B)(ii–iii); 12 U.S. Code § 343(3)(B)(ii–iii).
49. Dodd–Frank Act, §1101(a)(6)(C); 12 U.S. Code § 343(3)(C). The Fed also must update Congress on outstanding programs once every 30 days.
50. Dodd–Frank Act, § 1102; 31 U.S. Code § 714(f).
51. The delay is for one year after the program terminates, but the Fed Chair has the discretion to release this information sooner. See 12 U.S. Code § 248(s)(3).

Additional Federal Reserve Changes

Dodd–Frank made several basic improvements to Fed transparency. For instance, Section 1103 requires the Fed to post GAO audit reports of emergency lending on its website. This section also requires the Fed to post its audited financial statements, as well as other information concerning "the borrowers and counterparties participating in…discount window lending programs, and open market operations."[52] Congress should maintain these types of changes in the spirit of providing full Federal Reserve transparency.

Prior to Dodd–Frank, all members of each District Bank's Board of Directors voted to select their new bank president. Section 1107 amends the Federal Reserve Act so that Class A directors—those selected by member banks to represent the stockholding banks—can no longer vote in the election of a new District Bank president.[53] Now, only Class B directors, who are elected by member banks to represent the public rather than the stockholding banks, and Class C directors, who are selected by the Board of Governors to represent the public, can vote in the election.[54] This provision does not appear to solve any existing problem or serve any material purpose other than to increase the Board's influence on the District Banks.

Dodd–Frank also increased the Fed's emphasis on financial regulations by creating the position of Vice Chair for Supervision on the Board of Governors. This position is appointed by the U.S. President with the advice and consent of the Senate. Dodd–Frank requires the Vice Chair to "develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board" and to "oversee the supervision and regulation of such firms."[55] Relative to the overall regulatory authority vested in the Federal Reserve, this change appears rather small. However, Fed Governor Daniel Tarullo has served as the de facto Vice Chair for Supervision since Dodd–Frank was enacted without formally answering to Congress.[56]

Aside from this new position, Dodd–Frank has expanded the Fed's regulatory authority, and many scholars have pointed out that a central bank does not need to be a financial regulator to conduct monetary policy.[57] Allowing the Fed to serve as a financial regulator increases the likelihood that policy decisions will be compromised as the Fed's employees become embedded in the financial firms that they are supposed to oversee. It is also unnecessary in a practical sense because removing the Fed from its regulatory role would leave at least five other federal regulators overseeing U.S. financial markets.

Allowing the Fed to serve as a financial regulator increases the likelihood that policy decisions will be compromised as the Fed's employees become embedded in the financial firms that they are supposed to oversee.

FDIC Guarantees

The government's response to the financial crisis also included various measures by the Federal Deposit Insurance Corporation (FDIC). Separate from an expansion of its normal deposit insurance program, the FDIC implemented a Temporary Liquidity Guarantee Program (TLGP). The TLGP consisted of two components: the Transaction Account Guarantee Program (TAGP) and the Debt Guarantee Program (DGP).

52. See 12 U.S. Code § 248(s).
53. 12 U.S. Code § 341.
54. See 12 U.S. Code § 302.
55. Dodd–Frank Act, § 1108(a)(1); 12 U.S. Code § 242.
56. See Joseph Lawler, "Regulatory Power Has Shifted to Fed's Tarullo," *Washington Examiner*, March 10, 2015, http://www.washingtonexaminer.com/regulatory-power-has-shifted-to-feds-tarullo/article/2561280 (accessed July 31, 2015).
57. See Goodfriend and King, "Financial Deregulation, Monetary Policy, and Central Banking," and Norbert J. Michel, "A Roadmap to Monetary Policy Reforms," *The Cato Journal*, Vol. 35, No. 2 (Spring/Summer 2015), http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2015/5/cj-v35n2-9.pdf (accessed July 31, 2015).

The TAGP guaranteed all domestic non-interest-bearing transaction deposits, low-interest negotiable order of withdrawal (NOW) accounts, and Interest on Lawyers Trust Accounts (IOLTAs). Originally, the guarantee applied to all of these accounts held at participating banks and thrifts through December 31, 2009. The deadline was later extended and ultimately expired on December 31, 2010. In combination with the FDIC's main deposit insurance program, the TAGP allowed the federal government to temporarily guarantee nearly all bank deposits.[58]

The DGP provided a federal guarantee for certain types of new debt issued by private firms. Specifically, these guarantees applied to senior unsecured debt issued between October 14, 2008, and October 31, 2009. The FDIC guarantee for this debt extended through maturity or December 31, 2012, whichever came first.[59] Many large financial firms—such as Citigroup, Bank of America, and Goldman Sachs—used the DGP to issue government-guaranteed debt. Over its entire existence, firms issued $345.8 billion of federally guaranteed debt. The FDIC has collected $10.4 billion in fees under the DGP.[60]

Dodd–Frank includes several provisions that appear to restrict the FDIC's ability to conduct these types of programs in the future. These restrictions are similar to the new restrictions that Dodd–Frank placed on the Fed's emergency lending authority. For instance, Title XI stipulates that the FDIC can only "create a widely available program to guarantee obligations of solvent insured depository institutions or solvent depository institution holding companies (including any affiliates thereof) during times of severe economic distress."[61]

Title XI further stipulates that the FDIC cannot create any such guarantee program without first securing an official determination that a *liquidity event* (i.e., a systemic crisis) exists.[62] This determination is a process that requires an affirmative two-thirds vote of both the FDIC board and the Federal Reserve Board of Governors. Dodd–Frank further stipulates, among other requirements, that this determination include a written evaluation of the evidence that a liquidity event exists.

Title XI also requires the Treasury Secretary and the GAO to provide respective reports to Congress explaining the determination and, in the case of the GAO, its effects.[63] Furthermore, the FDIC cannot actually issue guarantees until Congress formally approves the guarantee program.[64] While the type of collaboration that Title XI now requires between the Fed, the FDIC, and the Treasury Department is similar to the type of collaboration that took place during the 2008 crisis, these particular changes at least provide a process for political accountability. Still, short of explicitly prohibiting these types of FDIC guarantees—the preferred solution—it is doubtful that any formal restrictions will prevent their use in future crises.

58. From December 31, 2010, through December 31, 2012, Dodd–Frank provided temporary *unlimited* deposit insurance coverage for non-interest-bearing transaction accounts and IOLTAs, but not low-interest NOW accounts, regardless of the balance in the account and the ownership capacity of the funds. This coverage essentially replaced the TAGP, which expired on December 31, 2010, and was available to all depositors. The coverage was separate from and in addition to the standard insurance coverage provided for a depositor's other accounts held at an FDIC-insured bank.

59. These periods were extended. The original DGP guarantees applied to debt issued between October 14, 2008, and June 30, 2009, and extended no later than June 30, 2012.

60. See Federal Deposit Insurance Corporation, "TLGP Debt Guarantee Program: Issuer Reported Debt Details," https://www.fdic.gov/regulations/resources/tlgp/total_debt.html (accessed June 3, 2015), and "Temporary Liquidity Guarantee Program," https://www.fdic.gov/regulations/resources/tlgp/ (accessed June 3, 2015).

61. Dodd–Frank Act, § 1105; 12 U.S. Code § 5612. This section also prohibits the FDIC from using any such program to inject any form of equity into a firm.

62. Dodd–Frank Act, § 1104; 12 U.S. Code § 5611. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) largely prohibited the FDIC from protecting uninsured depositors or other uninsured creditors, but it included a *systemic risk* exception that still exists. See 12 U.S. Code § 1823(c)(4)(G). See also Sharon Foster, "Dodd–Frank Wall Street Reform and Consumer Protection Act," *Arkansas Law Review*, September 28, 2010, http://lawreview.law.uark.edu/dodd-frank-wall-street-reform-and-consumer-protection-act.html (accessed August 2, 2015).

63. Dodd–Frank Act, § 1104;12 U.S. Code § 5611.

64. Formally, a request by the President under this section is considered granted by a joint resolution of Congress. Dodd–Frank Act, § 1105(c–d); 12 U.S. Code § 5612(c–d).

What Congress Should Do

The Federal Reserve serves as the U.S. economy's lender of last resort (LLR), a function that it carries out through emergency lending, discount window loans, and open market operations. Throughout its history, the Fed's emergency lending and discount window loan policies have jeopardized its operational independence and put taxpayers at risk. During the 2008 crisis, the Fed lent financial companies more than $16 trillion through broad-based emergency lending programs, at approximately $13 billion below market rates. This type of lending perpetuates the too-big-to-fail problem, yet Dodd–Frank allows the Fed to conduct emergency loans via broad-based programs.

Congress should restrict the Fed to providing system-wide liquidity on an ongoing basis. Emergency lending authority is unnecessary for conducting monetary policy. To this end, Congress should:

- **Revoke Section 13(3) of the Federal Reserve Act.** This section allows the Federal Reserve Board of Governors to authorize Fed District Bank lending to "any participant in any program or facility with broad-based eligibility" in "unusual and exigent circumstances." Dodd–Frank amended this authority after the 2008 crisis, but even if these restrictions had been in place, the Fed still would have been able to conduct many of the lending programs that allowed it to prop up failing institutions.

- **Close the Federal Reserve's discount window.** The discount window is a relic of the Fed's founding and is no longer necessary. As it stands, a stigma is attached to lending through the discount window, and it is simply another way for the Fed to allocate credit directly to firms. The Fed can fulfill its lender-of-last-resort function by focusing on system-wide liquidity.

- **Improve system-wide liquidity by replacing the primary dealer system.** The Fed conducts its open market operations—buying and selling Treasury securities to implement monetary policy—with a limited number of financial firms known as primary dealers. The current primary dealer framework was created in the 1960s when a centralized open market system in New York offered clearer advantages. Now, however, there is good reason to believe that allowing all member banks to participate in open market operations would provide a more liquid interbank lending market. The Fed successfully used the Term Auction Facility to inject liquidity into the market during the 2008 crisis, and this program could be modified to replace the current primary dealer system. The current system requires the Fed to depend on a small number of large financial institutions, thus making system-wide liquidity provision needlessly cumbersome and reinforcing the notion of systemically important firms. The current system perpetuates the too-big-to-fail problem. Congress should formally examine all possible improvements to the framework.

- **End the FDIC's authority to provide guarantees.** The FDIC provided hundreds of billions in loan guarantees in the wake of the 2008 crisis, mainly by invoking its systemic risk exception in Section 13(G) of the Federal Deposit Insurance Act. Congress should eliminate the FDIC's systemic risk exception and prohibit the FDIC from providing any types of loan guarantees.

- **Retain and expand key Dodd–Frank transparency improvements.** Section 1102 of Dodd–Frank authorizes the GAO to audit any of the Fed's emergency lending programs, and Section 1103 requires the Fed to post key GAO audit results on its website. Congress should retain these provisions as long as emergency lending programs exist, and the GAO should be authorized to audit—with appropriate delays regarding the release of sensitive information—all aspects of the Fed's operations.

Conclusion

Overall, the Fed has done a poor job of adhering to the classic lender-of-last-resort (LLR) prescription. Throughout its history, the Fed's LLR policies have jeopardized its operational independence and put taxpayers at risk. These problems are easily avoidable because no clear economic rationale calls for the Fed to provide emergency loans to private firms. Implementing monetary policy involves ensuring that the entire banking system has enough liquidity to prevent panic from spreading to the broader economy. Monetary policy does not require the Fed to make emergency loans.

Little evidence suggests that Federal Reserve emergency lending to individual institutions is either necessary or proper, but such lending clearly politicizes the Fed's monetary policy. Merely restricting the Fed's emergency lending leaves intact the notion that the Fed should bail out firms—a dangerous view, to say the least. Title XI of Dodd–Frank failed to end the too-big-to-fail problem largely because it retained this belief.

Congress can easily fix this problem by prohibiting the Fed from making emergency loans in the first place. Using public funds to bail out private firms in any way for any reason is and should remain a part of the government's fiscal operations. If Members of Congress want to use taxpayer dollars to save troubled firms, they should do so directly so that voters can hold them accountable.

*—**Norbert J. Michel, PhD,** is a Research Fellow in Financial Regulations in the Thomas A. Roe Institute for Economic Policy Studies, of the Institute for Economic Freedom and Opportunity, at The Heritage Foundation.*