

Opinion

The Fed's independence is at risk

AUGUST 20, 2009 by: Glenn Hubbard, Hal Scott and John Thornton

As leaders gather this week for the annual [Jackson Hole](http://www.ft.com/cms/s/o/d013b5c4-8db6-11de-93df-00144feabdco.html) (<http://www.ft.com/cms/s/o/d013b5c4-8db6-11de-93df-00144feabdco.html>) symposium on the economy, they should consider the future of the Federal Reserve as lender of last resort. Over many decades and especially in this financial crisis, the Fed has used its balance sheet to be a classic lender of last resort. But its ability to do so depends upon its economic credibility and political independence, attributes the Fed has compromised in this crisis.

As the crisis worsened at the end of 2007, the Fed created new liquidity facilities, some of which involved new recipients, beyond depository institutions, such as investment banks and corporate commercial paper issuers. In addition, in 2008, the Fed made extraordinary “bail-out” loans to avoid the failure of systemically important institutions – a \$30bn (£18bn, €21bn) non-recourse loan, with a \$1bn deductible, to assist JP Morgan Chase’s [acquisition of Bear Stearns](http://www.ft.com/cms/s/o/43697fa6-f1cb-11dc-9b45-0000779fd2ac.html) (<http://www.ft.com/cms/s/o/43697fa6-f1cb-11dc-9b45-0000779fd2ac.html>) and the creation of a two-year \$85bn credit facility for [AIG](http://www.ft.com/cms/s/o/271257f2-83f1-11dd-bf00-000077b07658.dwp_uuid=11f94e6e-7e94-11dd-b1af-000077b07658.html) (http://www.ft.com/cms/s/o/271257f2-83f1-11dd-bf00-000077b07658.dwp_uuid=11f94e6e-7e94-11dd-b1af-000077b07658.html). Also, the Fed, in partnership with the Treasury and Federal Deposit Insurance Corporation, guaranteed \$424bn of losses on pools of Citigroup and Bank of America bad assets.

These actions have had a big impact on the Fed’s balance sheet. As of June 2009, its total assets had risen to over \$2,000bn compared with \$852bn in 2006, and only 29 per cent of these assets were Treasury securities, compared with 91 per cent in 2006. Traditional loans by a lender of last resort are sufficiently collateralised to prevent moral hazard for borrowers and reduce risk to the central bank. However, the adequacy of the collateral of these new Fed positions is unclear.

These actions have not only increased the Fed’s risk, the shortage of Treasuries has hampered the Fed’s ability to conduct its central mission – monetary policy. In order to counter the potential inflationary impact of its credit expansion, the Fed requested that the Treasury sell special issues of Treasuries under the Supplementary Financing Program –

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with Treasury holdings of about \$475bn, indicating that the Treasury had become a significant player in monetary policy.

Much of the emergency Fed lending was based on Section 13(3) of the Federal Reserve Act, which allows the Fed in “unusual and exigent circumstances” to lend to “any individual, partnership, or corporation,” against “notes” that are “secured to the satisfaction of the Federal Reserve Bank”. Former Fed chairman Paul Volcker, now chair of the president’s Economic Recovery Advisory Board, as well as members of Congress dissatisfied with bailing out the banks, have questioned the Fed’s authority under this section to engage in much of the lending.

Quite apart from the legal issue, the Fed’s assumption of credit risk by lending against insufficient collateral could compromise its independence by: making it more dependent on the Treasury for support in the conduct of monetary policy, as illustrated by the supplemental finance facility; jeopardising the Fed’s ability to finance its own operations and thus require it to seek budgetary support from the government; tarnishing its financial credibility in the event that it incurred big losses; and generally making it more subject to political pressures.

Based on these concerns, the Committee on Capital Markets Regulation has recommended that any existing Fed loans to the private sector that are insufficiently collateralised should be transferred to the federal balance sheet. While the Fed cannot go bankrupt, any Fed losses are ultimately borne by US taxpayers and should be directly and transparently accounted for as part of the federal budget. For the same reason, in the future, only the Treasury should engage in insufficiently collateralised lending.

But rather than reinforcing the Fed’s independence, as our proposal would do, the Obama administration’s reform proposal recommends amending Section 13(3) to require the written approval of the secretary of the Treasury for any emergency extension of credit. This would be a startling expansion of Treasury power over the Fed’s use of liquidity facilities in classic lender of last resort situations – that is, where there was adequate collateral. Instead, the lines of authority should be clear. The Fed should have strengthened authority to loan against adequate collateral in an emergency. And the Fed should have no authority, even with the approval of the Treasury, to lend against insufficient collateral.

The Fed needs authority to lend in a crisis to avoid the chain reaction of failures of financial institutions, which could result in a complete economic collapse. However, this reason to act should not jeopardise the Fed’s credibility and independence. Instead, these goals can be achieved by giving the Fed full authority to lend against good collateral – a traditional

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government more accountable.

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