



## ENDING THE FEDERAL RESERVE SYSTEM'S OVERREACH INTO CREDIT ALLOCATION

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Chairman Campbell, Ranking Member Clay, and members of the Subcommittee, thank you for inviting me to testify on “Federal Reserve Oversight: Examining the Central Bank’s Role in Credit Allocation.” In my testimony I will argue that the Federal Reserve’s attempts to direct the allocation of credit are overreaching, wasteful, and fraught with serious governance problems. A central bank charged with the crucial task of conducting monetary policy should focus on monetary policy. Accordingly, the Fed should be removed from the formulation and implementation of credit policy.

Prior to 2007, the Federal Reserve System undertook five main roles: (1) clearing and settlement of checks, (2) issue of paper currency, (3) supervision and regulation of commercial banks, (4) “lender of last resort,” and (5) monetary policy. Since 2007, at its own initiative, the Fed has expanded its range of activities by undertaking unprecedented *credit allocation policies* that do not fit into any of these traditional categories.

### A LIST OF RECENT CREDIT ALLOCATION POLICIES AND THEIR BENEFICIARIES

By “credit allocation policies” I mean efforts to redistribute financial funds toward uses that Federal Reserve policymakers prefer and (implicitly) away from other uses that market actors prefer. Based on a compilation by the Government Accountability Office (2011), with two additions, here is a list of twenty-two Fed credit allocation initiatives in recent years, the dates they commenced, and their beneficiaries:

- Term Auction Facility (Dec. 2007): depository institutions
- Dollar Swap Lines (Dec. 2007): foreign-domiciled commercial banks doing US dollar business
- Term Securities Lending Facility (Mar. 2008): primary dealers, a set of select Wall Street securities firms (numbering 20 at the time) from whom the New York Fed trading desk routinely buys bonds, and to whom it sells bonds, in the execution of monetary policy operations
- Primary Dealer Credit Facility (Mar. 2008): primary dealers
- Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Sept. 2008): money market mutual funds (MMMFs)

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- Commercial Paper Funding Facility (Oct. 2008): issuers and holders of commercial paper
- Money Market Investor Funding Facility (Oct. 2008, but never used): MMMFs
- Term Asset-Backed Securities Loan Facility (Nov. 2008): holders of mortgage-backed securities (MBS)
- Bridge Loan to JP Morgan Chase (Mar. 2008): JP Morgan Chase; Bear Stearns shareholders, bondholders, and counterparties
- Maiden Lane LLC (Mar. 2008): JP Morgan Chase; Bear Stearns shareholders, bondholders, and counterparties
- Revolving AIG Credit Facility (Sept. 2008): AIG and its counterparties
- Securities Borrowing Facility (Oct. 2008): holders of MBS
- Maiden Lane II LLC (Nov. 2008): AIG counterparties, esp. Goldman Sachs
- Maiden Lane III LLC (Nov.10, 2008): AIG counterparties, esp. Goldman Sachs
- Life Insurance Securitization (March 2009, but never used): AIG counterparties
- Credit extensions to affiliates of some primary dealers (Sept. 2008): four broker-dealer firms
- Citigroup non-recourse lending commitment (Nov. 2008): Citigroup
- Bank of America non-recourse lending commitment (Jan. 2009): Bank of America
- Agency Mortgage-Backed Securities Purchase Program (Nov. 2008): bondholders of Fannie Mae and Freddie Mac
- Operation Twist (Sept. 2011; enlarged June 2012), replacing short-term securities with long-term securities in the Fed's portfolio to reduce long-term interest rates relative to short-term rates: holders and guarantors of long-term MBS, housing finance firms that originate long-term fixed-rate mortgages, and housing construction firms
- Quantitative Easing 1 (Jan. 2009), \$1250 billion in MBS purchases, but with its effects on broader monetary aggregates (M2) offset by paying interest on reserves: holders and guarantors of MBS housing finance firms, and housing construction firms
- Quantitative Easing 3 (Sept. 2012), ongoing MBS purchases of \$40 billion per month, similarly offset by interest on reserves: holders and guarantors of MBS, housing finance firms, and housing construction firms

## INEFFICIENCY OF DIRECTED CREDIT ALLOCATION

Credit is fungible and can be re-lent in search of the highest risk-adjusted returns, so some of the lending programs listed above may have had little impact on the final allocation of credit. To the extent that they did alter the allocation of credit, the programs are more likely than not to have been wasteful, directing funds to less than most productive uses, even if Fed policymakers have had the best of intentions. While the beneficiaries of the programs are obvious, a full analysis must also consider the costs. The losers from preferential credit allocations are all those potential users of funds—often difficult to identify with any specificity—who suffer by having credit diverted away from them.

Financial markets generate prices and quantities of financial assets by aggregating the decentralized judgments of millions of market investors, who are staking their own funds, about the most promising avenues for investment. In credit allocation policy, Federal Reserve officials, risking taxpayer funds, substitute their own judgment about the proper prices of various securities and the proper shares of the supply of funds that should go to specific firms or segments of the financial

market. The likelihood that any central committee can improve on a competitive market’s allocation of funds, even if the committee is limited to tinkering around the margins, is vanishingly small. In particular, a committee that allocates funds to prop up insolvent financial firms, making investments that prudent market participants shun, is following a recipe for throwing good money after bad.

The Dodd-Frank Act of 2010 restricts special Fed lending to “broad-based” programs, ruling out any program limited to a single firm. While a step in the right direction, having this rule in place before 2010 would have ruled out only about half of the credit allocation programs listed above.

### QUANTITATIVE EASING PLUS INTEREST ON RESERVES

The Fed has defended the last two items on the list, its massive QE1 and QE3 purchases of mortgage-backed securities, as the conduct of monetary policy. Monetary policy means that the central bank *varies the economy’s stock of money* in pursuit of some ultimate goal (like low inflation or milder business cycles). The Fed’s decisions about *how many* securities to purchase represent monetary policy, because they alter the size of the monetary base, also known as the stock of “high-powered money.” But the Fed’s decision to purchase *mortgage-backed* rather than *Treasury* securities does *not* qualify as monetary policy because it does not affect the impact of securities purchases on the monetary base or broader monetary aggregates.

Furthermore, the QE programs have been deliberately *combined with interest on reserves in order to negate their monetary policy impact*, that is, to minimize their impact on the volume of money stock held by the public. This “sterilization” can be seen in the unaltered path in the broader monetary aggregate M2, even while the monetary base has skyrocketed (figures 1 and 2). Credit allocation policy, by contrast, seeks to redistribute a given volume of credit (say, the bank loans and securities purchases funded by M2 deposits) and to change the relative prices of assets.

Figure 1. Monetary base, total (BOGMBASE)

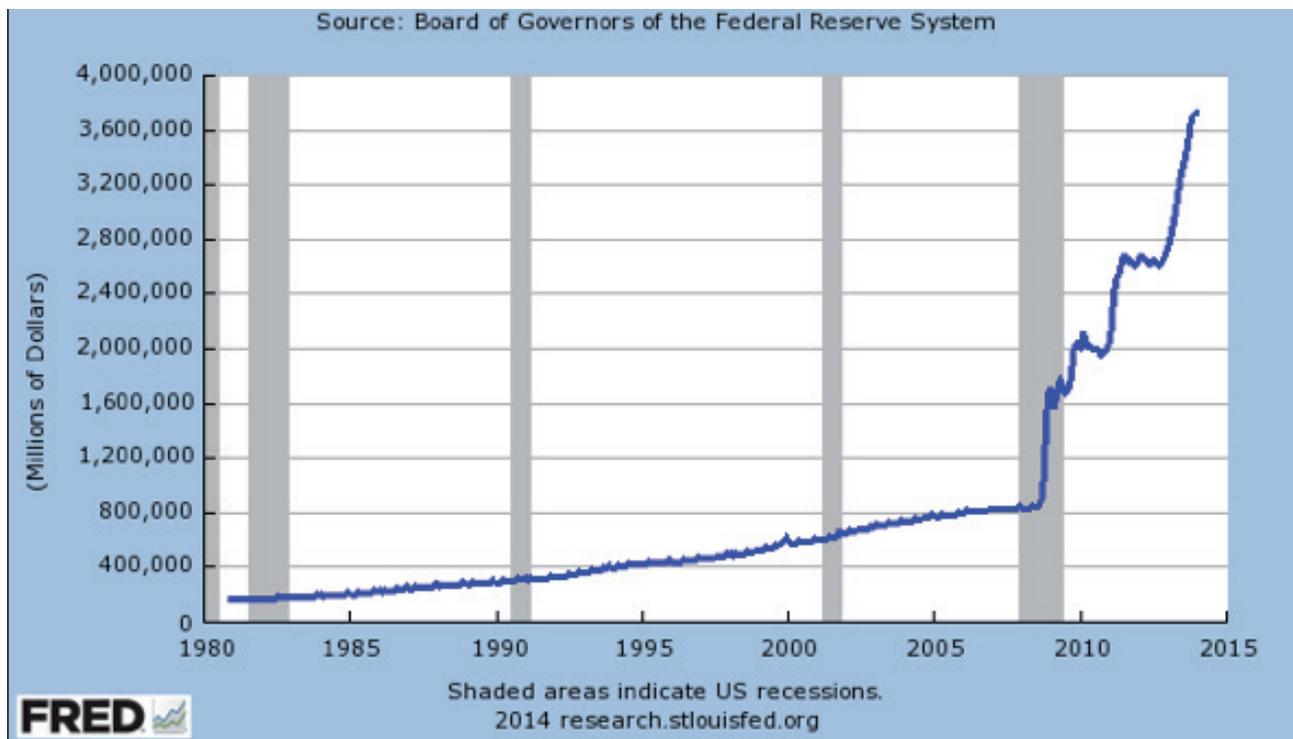
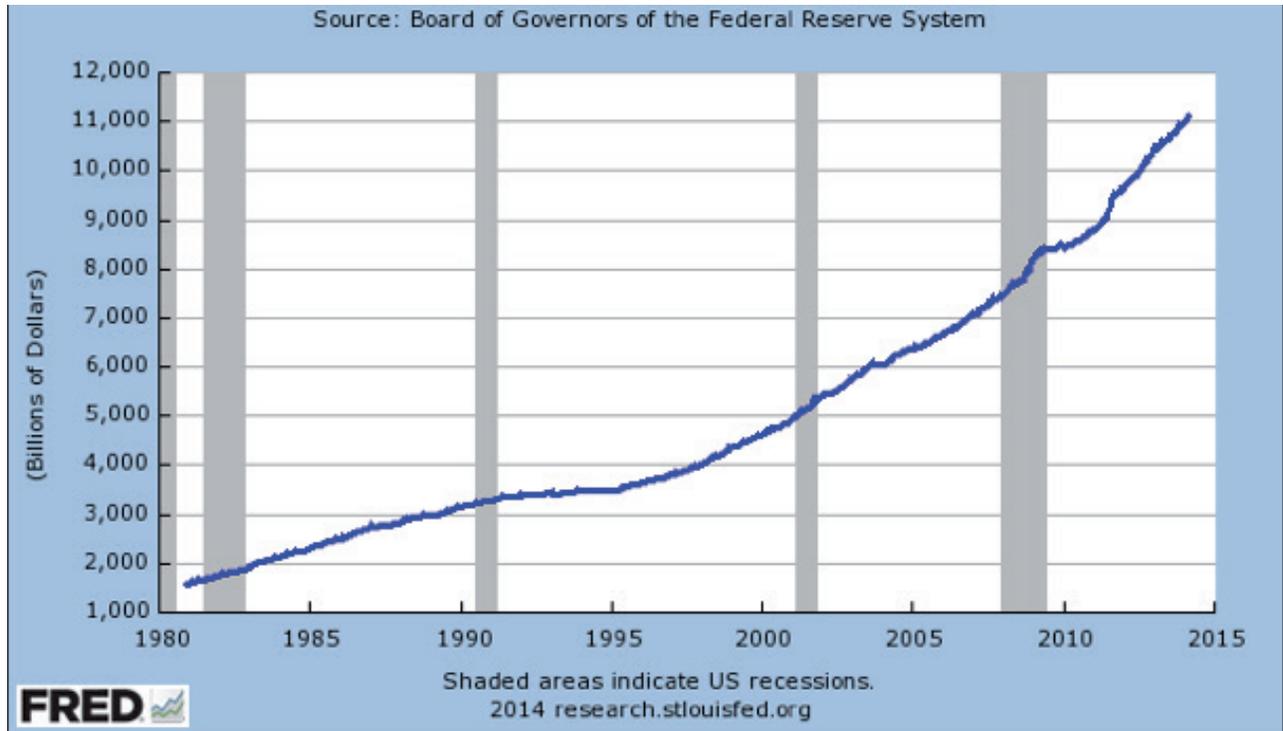


Figure 2. M2 money stock (M2)



The Fed's asset purchases since 2009 (QE1, 2, and 3) have dramatically increased the monetary base, but the Fed has paid sufficient interest on reserves to keep the excess bank reserves bottled up and thus the stock of money held by the public (M2) on a nearly undisturbed growth path.

The combination of QE1 and QE3 with interest on reserves is accurately categorized not as monetary policy but as fiscal policy. The Fed's aim has not been to alter monetary aggregates but to raise the price of mortgage-backed securities relative to other securities. The Fed is, in effect, borrowing funds from the commercial banks (inducing them to hold massive excess reserves by paying interest on reserves at a rate comparable to the prevailing rate on short-term Treasury bills) in order to spend the proceeds bidding up the price of MBS. In general, borrowing and spending in pursuit of a policy goal (here, higher MBS prices) is fiscal policy, not monetary policy.

### TARGETED LENDING PROGRAMS

The Fed has defended its extraordinary targeted lending programs, including its bailouts of Bear Stearns and AIG in 2008, as falling under the Fed's traditional role as a "lender of last resort" (LLR). That defense stretches the classical LLR concept beyond all reasonable interpretation. A classical LLR temporarily lends reserves to illiquid banks as copiously as necessary to prevent money and credit from contracting system-wide but avoids moral hazard by lending only at penalty rates and only to solvent banks.<sup>1</sup> In the words of LLR scholar and retired Richmond Fed economist Thomas Humphrey, "the Fed has deviated from the classical model in so many ways as to make a mockery of the notion that it is . . . an LLR in the traditional sense of that term."<sup>2</sup> Referring to the "long-embedded" and "time-honored" classical conception of the LLR role, former Fed chairman Paul Volcker similarly observed in

1. Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Henry S. King and Co., 1873), accessed Mar. 10, 2014, <http://www.econlib.org/library/Bagehot/bagLom2.html>.

2. Thomas M. Humphrey, "Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It," *Cato Journal* 30, no. 2 (Spring/Summer 2010): 33–64.

early April 2008 that in the Bear Stearns bailout the Fed had operated at “the very edge of its lawful and implied powers, transcending in the process certain long-embedded central banking principles and practices. . . . What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time-honored central bank mantra in time of crisis: lend freely at high rates against good collateral; test it to the point of no return.”<sup>3</sup>

A classical lender of last resort does not lend to insolvent banks (nor to insolvent investment houses or insurance companies) and does not lend at below-market rates, even to solvent banks. The Fed’s decisions to create new “loan facilities” for primary dealers and money-market mutual funds likewise had nothing to do with traditional last-resort lending. *Bloomberg News*, based on information that became public only later as a result of their Freedom of Information suit, reported that “during the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008.”<sup>4</sup> Comparing these low Fed loan rates with the borrowers’ earnings on the assets they held (computing the net interest margin), Bloomberg reporters estimated that the subsidy was worth about \$13 billion in the aggregate to its recipients.<sup>5</sup> Again, traditional last-resort lending is supposed to be at a penalty rate, not a subsidy rate. It is supposed to provide emergency liquidity, not boost earnings.

The Fed’s bailout operations were actually the sort of operations that traditionally have been left to Congress, as in the creation of the Reconstruction Finance Corporation in the 1930s, the Chrysler bailout of the 1970s, or the Resolution Trust Corporation of the 1980s.

The Fed’s defenders sometimes warn that criticism of its lending decisions would violate the independence it needs to operate effectively. The principle of independence for the Federal Reserve, however, applies to its *monetary policy* decisions. Congress does nothing to violate the Fed’s monetary policy independence when it questions the Fed’s credit-allocation or *fiscal policy* decisions. The Fed should not get a free pass from critical scrutiny by miscategorizing its credit allocation policies as monetary policy or last-resort lending.

## THE DANGERS OF FAVORITISM AND CAPTURE

When the Federal Reserve System engages in credit allocation policy—but not monetary policy only—at least two governance problems arise. The first is the potential for conflicts of interest or favoritism. The second is an opening for the government regulator to be captured by the regulated industry.

First, potential conflicts of interest created by credit allocation policies make the governance structure of the twelve Reserve Banks problematic, especially at the Federal Reserve Bank of New York (FRBNY), which has done most of the policy design and implementation. The Reserve Banks are legally owned by their member banks, and their boards of directors are drawn from member bank executives (Class A directors), nonbankers nominated by the member banks (Class B), and other financial industry participants (Class C). As the 2011 GAO report noted:

Some of the institutions that borrowed from the emergency programs had senior executives and stockholders that served on Reserve Banks’ board of directors. . . . We identified at least 18 former and current Class A, B, and C directors from 9 Reserve Banks who were affiliated with institutions that used at least one emergency program.<sup>6</sup>

For example, General Electric’s CEO served as a Class B director while “GE was one of the largest issuers of commercial paper and General Electric was one of the companies FRBNY consulted when creating the emergency program

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3. John Brinsley and Anthony Massucci, “Volcker Says Fed’s Bear Loan Stretches Legal Power (Update4),” *Bloomberg News*, April 8, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c&refer=worldwide>.

4. Bob Ivry, Bradley Keoun, and Phil Kuntz, “Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress,” *Bloomberg News*, November 27, 2011, <http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html>.

5. *Ibid.*

6. Government Accountability Office, *Federal Reserve Bank Governance* (October 2011), <http://www.gao.gov/new.items/d1218.pdf>.

to assist with the commercial paper market.”<sup>7</sup> FRBNY Class A directors included the CEOs of JP Morgan Chase and Lehman Brothers, firms that were beneficiaries of Fed credit allocation programs (Lehman failed anyway). While the board of directors is not directly consulted on credit policy, it hires, interacts familiarly with, and can fire the Reserve Bank president who does make policy.

Most notoriously, the chairman of the FRBNY board was a member of the Goldman Sachs board of directors during the period in which Goldman shareholders (including this individual) benefitted from a not-publicly-disclosed FRBNY credit-allocation decision to have the insolvent AIG (under FRBNY receivership) repay Goldman and others 100 cents on the dollar on collateralized debt obligations that might have been settled for as little as 60 cents on the dollar.<sup>8</sup> The same FRBNY chairman led the search committee seeking a new FRBNY president to replace the departing Timothy Geithner, and chose an individual (William Dudley) who had spent 10 of the previous 12 years as a Goldman Sachs partner, managing director, and chief economist.

In recognition of the potential conflicts of interest, and in accordance with provisions of the Dodd-Frank Act, as the GAO report notes, since 2010 “all of the Reserve Banks have changed the directors’ roles to remove the Class A directors from the process of appointing the bank president.”<sup>9</sup> This attenuates the member banks’ influence over the president, which is unfortunate for the sake of monetary policy.

It is desirable to retain member banks’ influence over the president for the sake of monetary policy because Reserve Bank presidents as a group have a better track record in Federal Open Market Committee voting than do members of the Board of Governors. Commercial bankers are inflation hawks because a rise in the expected inflation rate brings a rise in nominal interest rates, which punishes the typical commercial bank that borrows short and lends long. Shorter liabilities means that a bank must roll over its liabilities sooner than its assets, thus paying higher rates on deposits before it starts earning higher rates on loans. Because their constituents are inflation hawks, Reserve Bank presidents tend to be more hawkish on inflation than Governors. In a discretionary monetary policy regime, a more hawkish FOMC is desirable for reasons long ago explained by Kenneth Rogoff: it lowers the public’s inflation-rate expectations, allowing the Fed to achieve low inflation more credibly and thus with less unemployment.<sup>10</sup>

Potential conflicts of interest can be entirely avoided while retaining the FRB member banks’ desirable indirect input into monetary policy via the FRB presidents only by removing the Fed entirely from credit allocation. If the Fed gives no institution favored credit allocation treatment in the form of a bailout or concessionary loan, it does not matter which institutions are represented on an FRB’s board of directors.

The second governance problem, the potential for regulatory capture, arises regardless of which institutions were represented on the FRBNY board of directors. When the FRBNY staff set out to design credit allocation programs to aid favored segments of the financial system, they consulted with the intended beneficiaries. Noted the GAO report:

According to FRBNY officials, FRBNY’s Capital Markets Group contacted representatives from primary dealers, commercial paper issuers, and other institutions to gain a sense of how to design and calibrate some of the emergency programs.<sup>11</sup>

Such a consultation process—“How can we most effectively boost your net worth?”—is clearly ripe for industry capture of its regulator. This episode may already be evidence of such.

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7. GAO, *Bank Governance*, 2011.

8. Richard Teitelbaum and Hugh Son, “New York Fed’s Secret Choice to Pay for Swaps Hits Taxpayers,” *Boomborg News*, October 27, 2009, [http://www.bloomberg.com/apps/news?pid=email\\_en&sid=a7T5HaOgYHpE](http://www.bloomberg.com/apps/news?pid=email_en&sid=a7T5HaOgYHpE).

9. GAO, *Bank Governance*, 2011.

10. Kenneth Rogoff, “The Optimal Degree of Commitment to a Monetary Target,” *Quarterly Journal of Economics* 100, no. 4 (November 1985): 1169–90.

11. GAO, *Bank Governance*, 2011.

## REFORMS

So long as monetary policy is conducted in a discretionary manner, it is important to maintain the independent input of the Reserve Bank presidents on the FOMC. The Reserve Banks should therefore not become mere outposts of the Federal Reserve Board in order to eliminate commercial bankers' representation on their boards of directors. A better way to remove the potential for conflicts of interest is to require the Federal Reserve System to leave the formation of fiscal and credit-allocation policies to Congress and their execution to the US Treasury.

A straightforward way to accomplish this separation is to commit the Fed to holding only US Treasuries on its balance sheet, as recommended by Prof. Marvin Goodfriend at this hearing.<sup>12</sup> Even a "last resort" provision of bank reserves to the market can be provided through open-market purchases of Treasury securities, letting the interbank market allocate the funds to illiquid but solvent banks, rather than by putting loans to favored banks on the Fed's balance sheet.<sup>13</sup>

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### ABOUT THE AUTHOR

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12. Marvin Goodfriend, "The Case for a Treasury-Federal Reserve Accord for Credit Policy," Testimony before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services, US House of Representatives, March 14, 2014.

13. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," in *Restructuring Banking and Financial Services in America*, ed. William S. Haraf and Rose Kushmeider (Washington, DC: American Enterprise Institute, 1988).