From the “Lender of Last Resort” to “Too Big to Fail” to “Financial System Savior”: Federal Reserve Credit Policy and the Shadow Open Market Committee

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Shadow Open Market Committee 50th Anniversary

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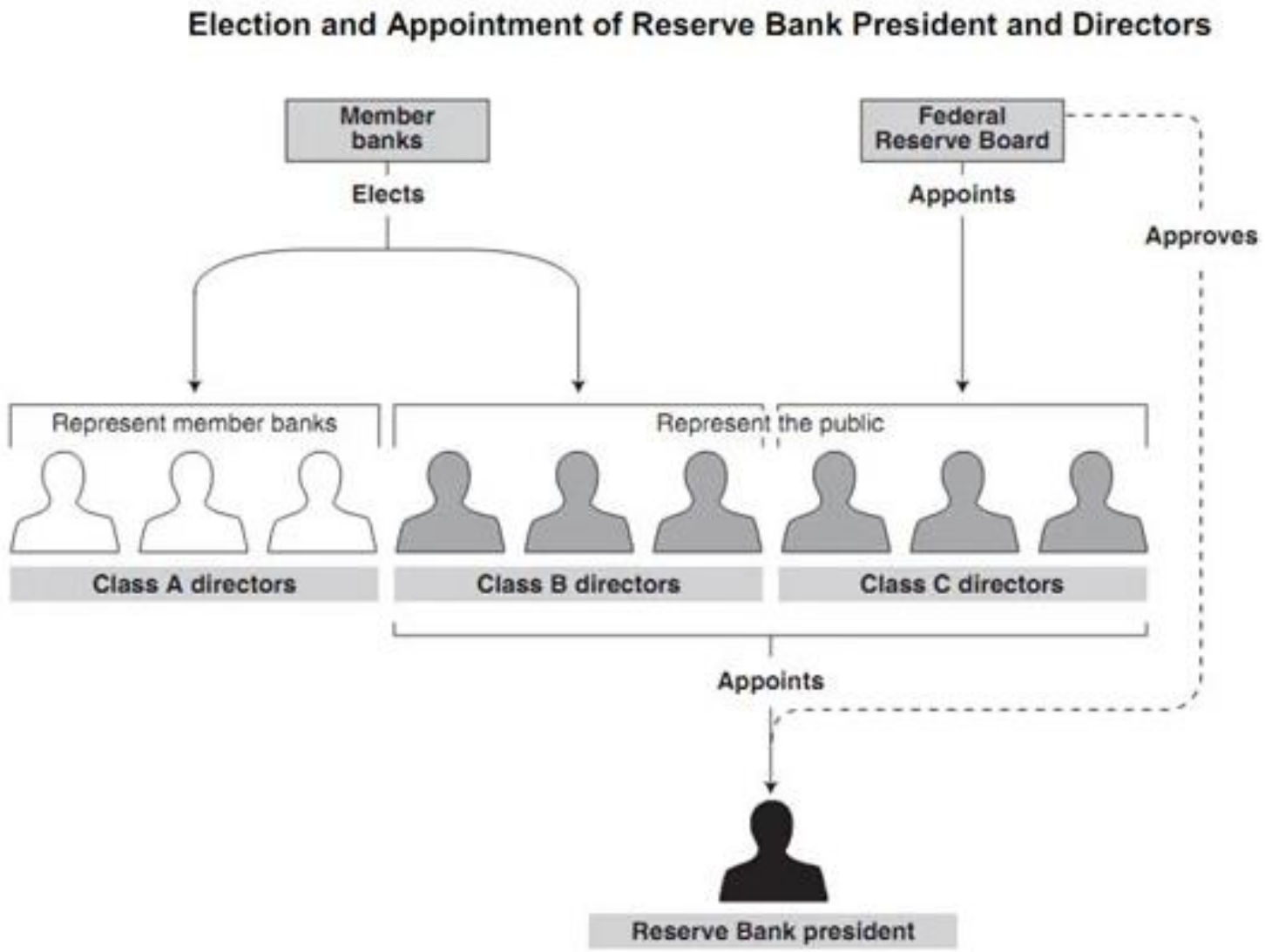
Federal Reserve Credit Policy Evolution

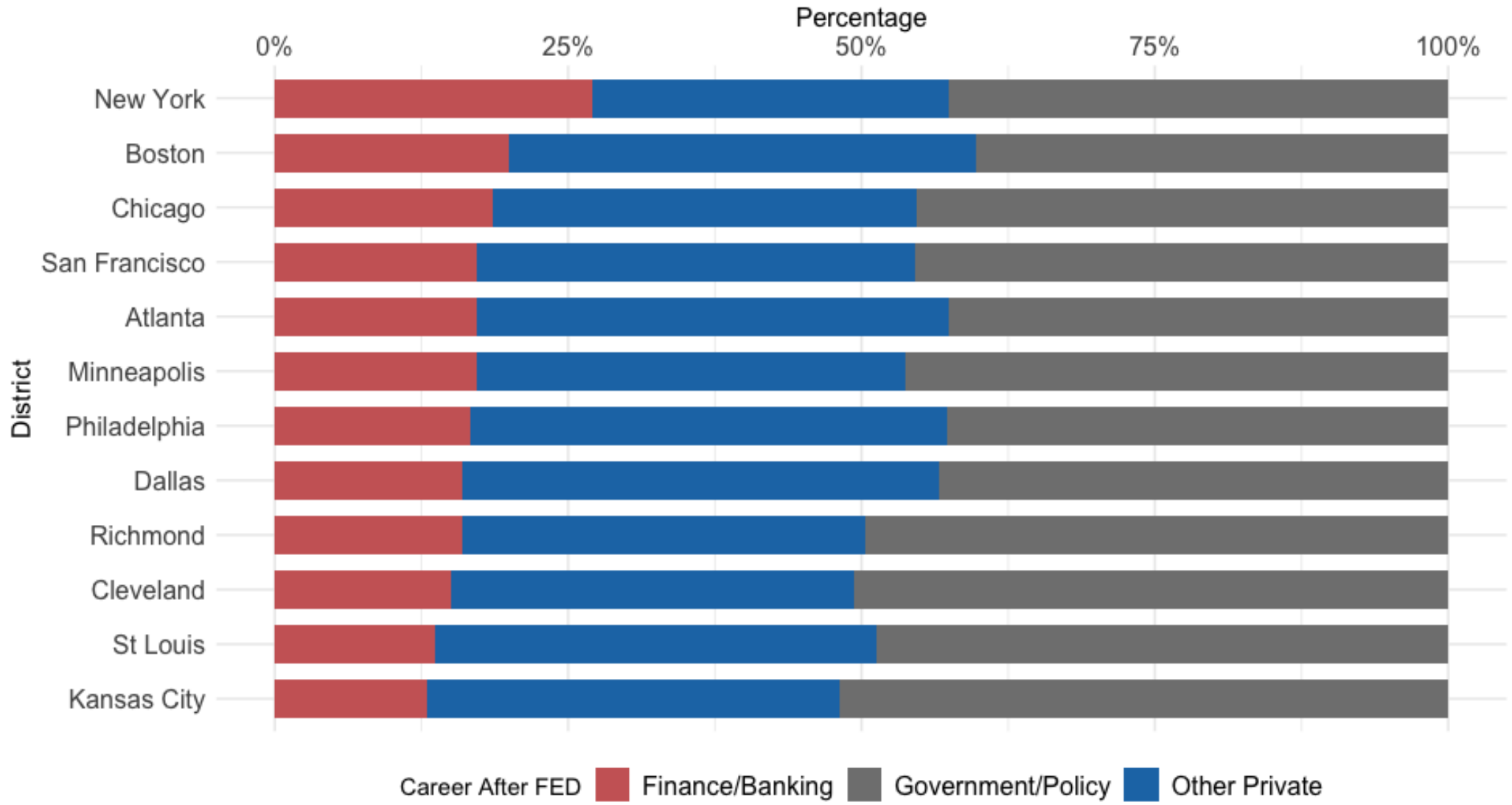
1. Lender of Last Resort (LOLR)
2. Real Bills Doctrine
3. Warburg's Mercantilism
4. Too Big to Fail (TBTF)

“As a rule, regulation is acquired by the industry and is designed and operated primarily for its benefit”

---Stigler “The Theory of Economic Regulation”



The GAO (in 2011) found that "directors of all three classes can have ties to the financial sector."



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Governance 101

Credibility on Independence

- Commitment: “Rules rather than Discretion”
- Reputation: “Will to Take Tough Decisions”
- Transparency

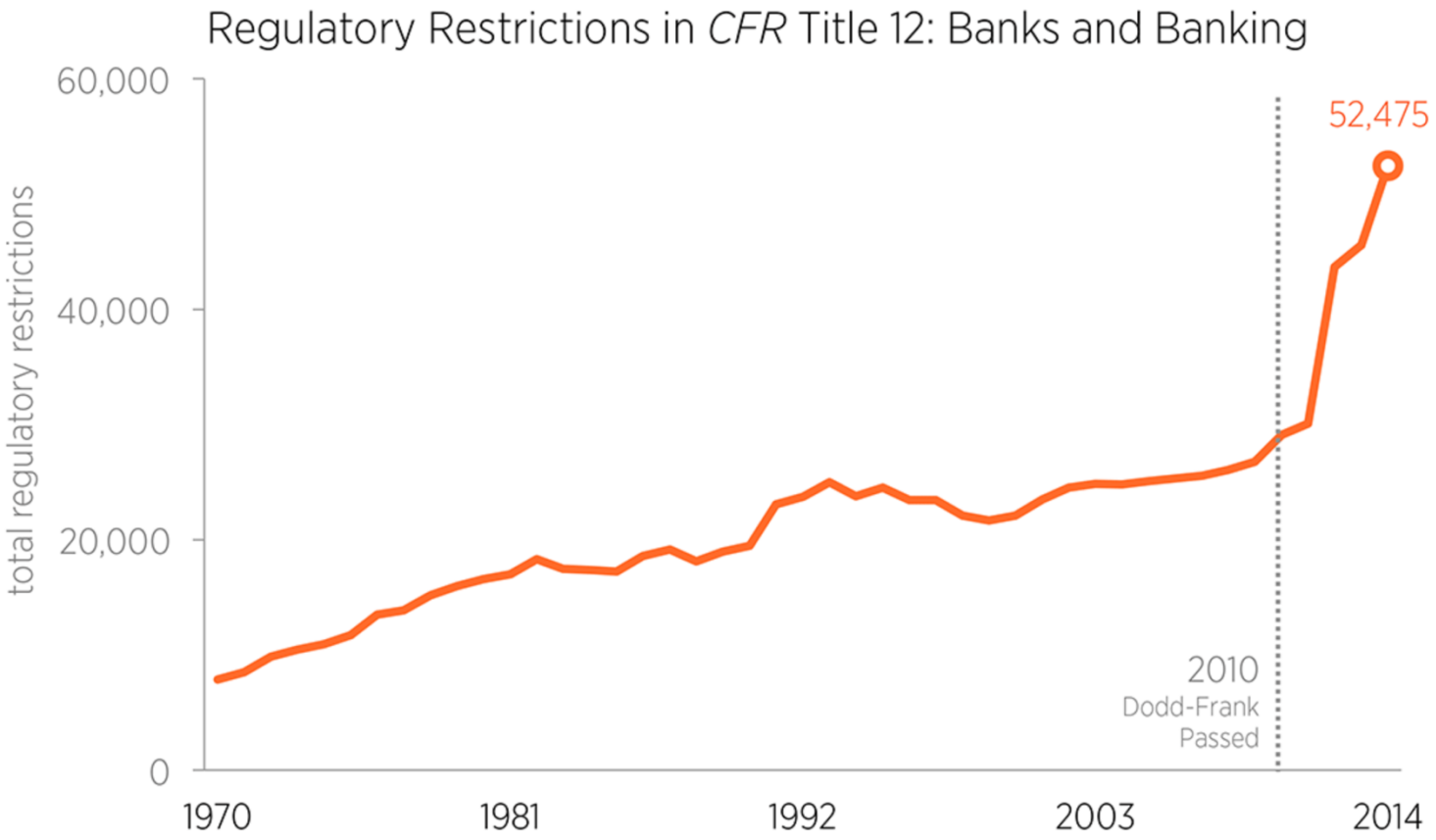
Discussion

Credibility on Independence Dented

- Lack of Commitment: “Too much Discretion?”
- Lost Reputation: “Will to Take Tough Decisions?”

Rules rather than Discretion

Too much Discretion?



Rules rather than Discretion

Too much Discretion?

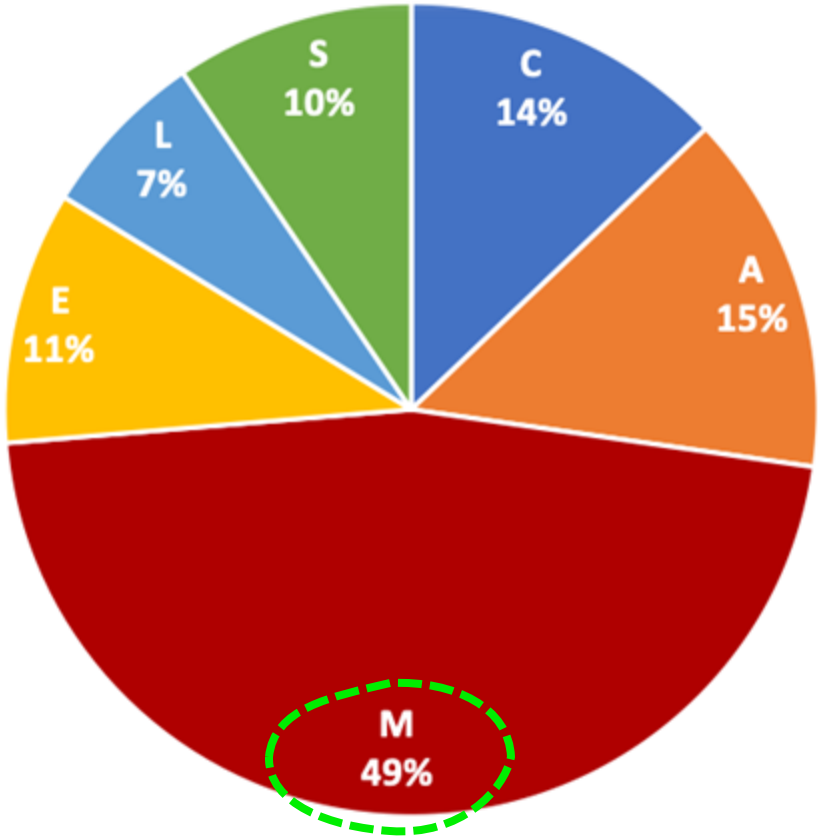
C: Capital Adequacy (1-5)
A: Asset Quality (1-5)
M: Management Quality (1-5)
E: Earnings Quality (1-5)
L: Liquidity (1-5)
S: Sensitivity to Risk (1-5)

Source: Agarwal, Morais, Seru and Shue (2024): “Noisy Experts…”

Rules rather than Discretion

Too much Discretion?

Composite CAMELS Score: (1-5)



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Rules rather than Discretion

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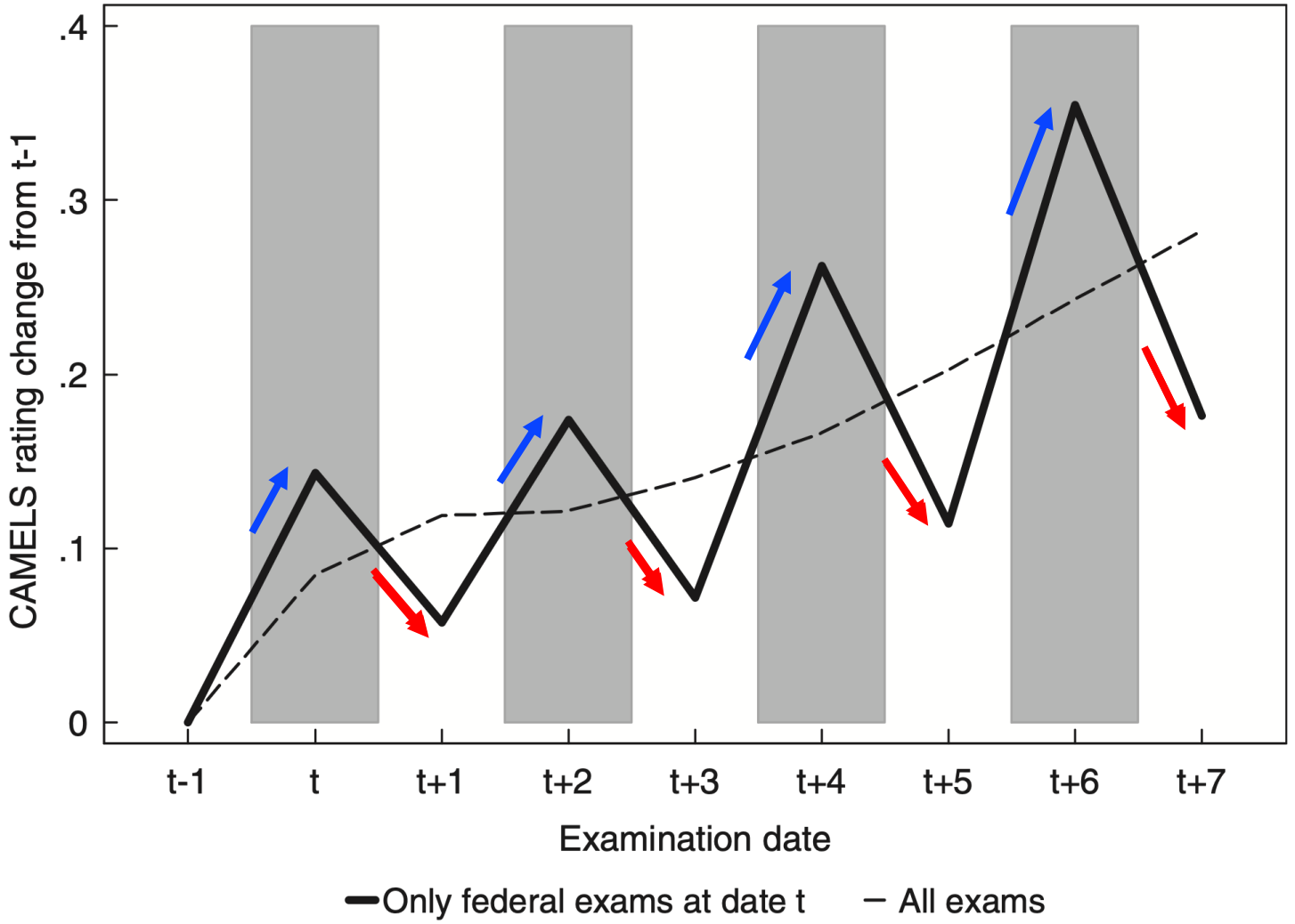
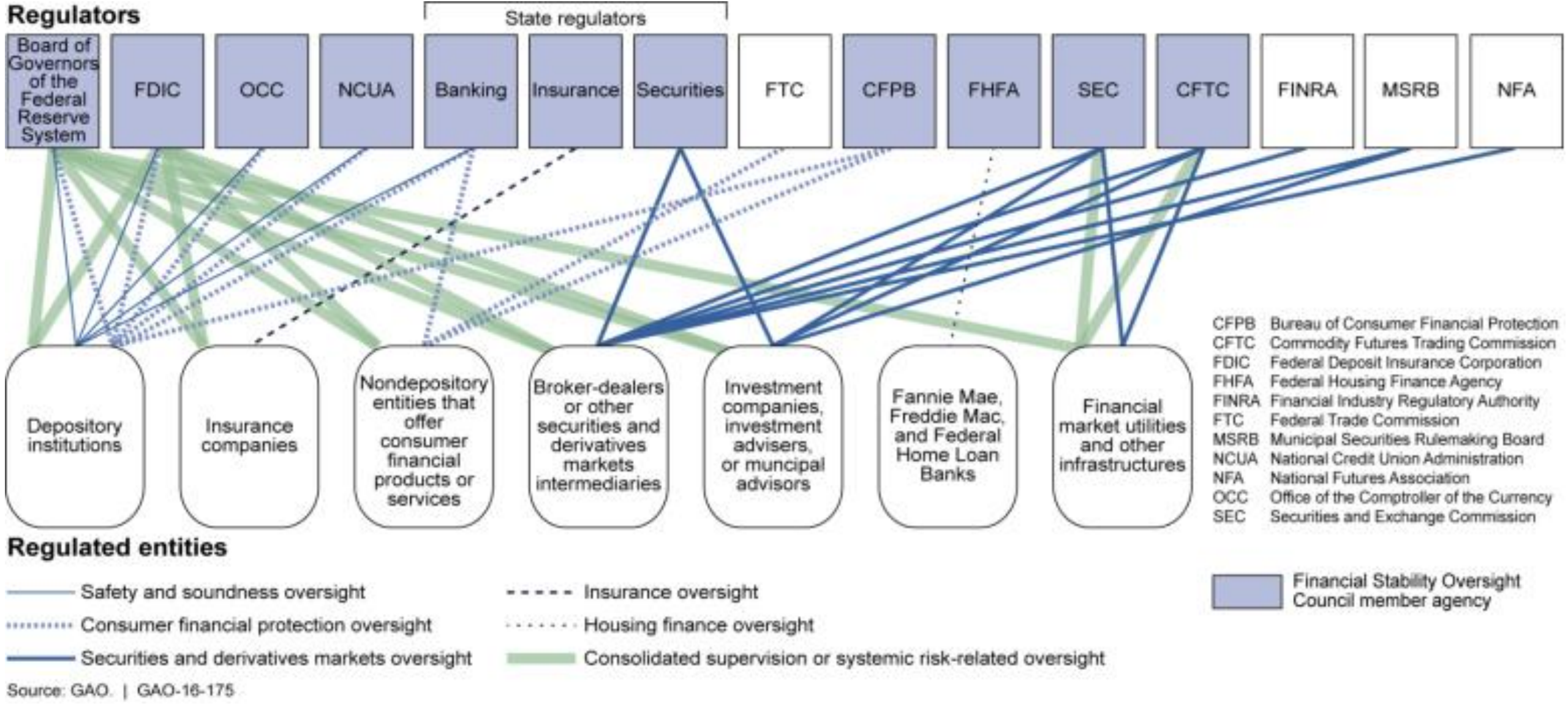


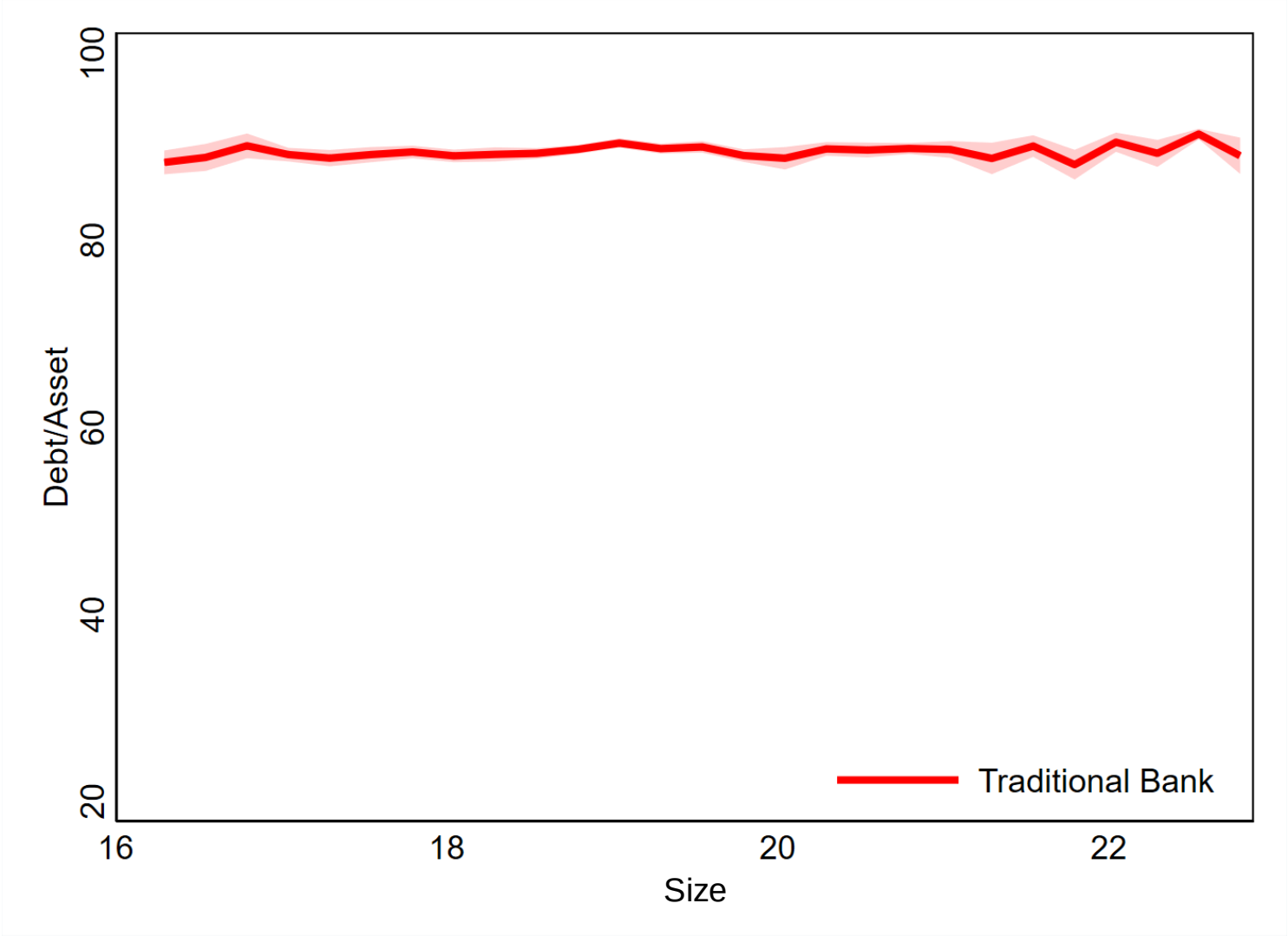
Source: Agarwal, Lucca, Seru and Trebbi (2014): "Inconsistent Regulators..."



Rules rather than Discretion | Too Much Discretion?

Will to Act Tough?

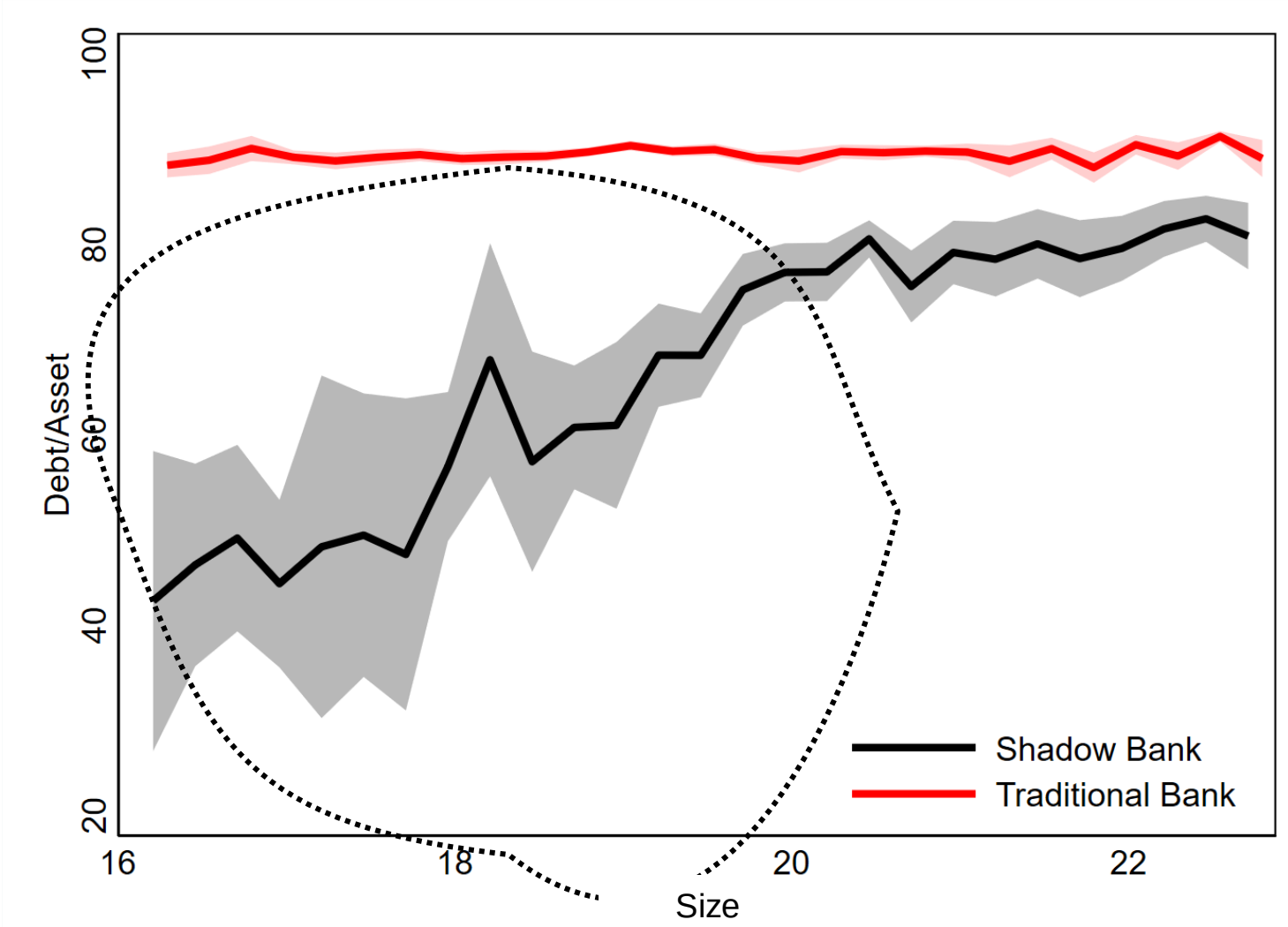
Too much Discretion?



Source: Jiang, Matvos, Piskorski, Seru (2020): "Banking without Deposits"...

Will to Act Tough?

Too much Discretion?



Source: Jiang, Matvos, Piskorski, Seru (2020): "Banking without Deposits"…

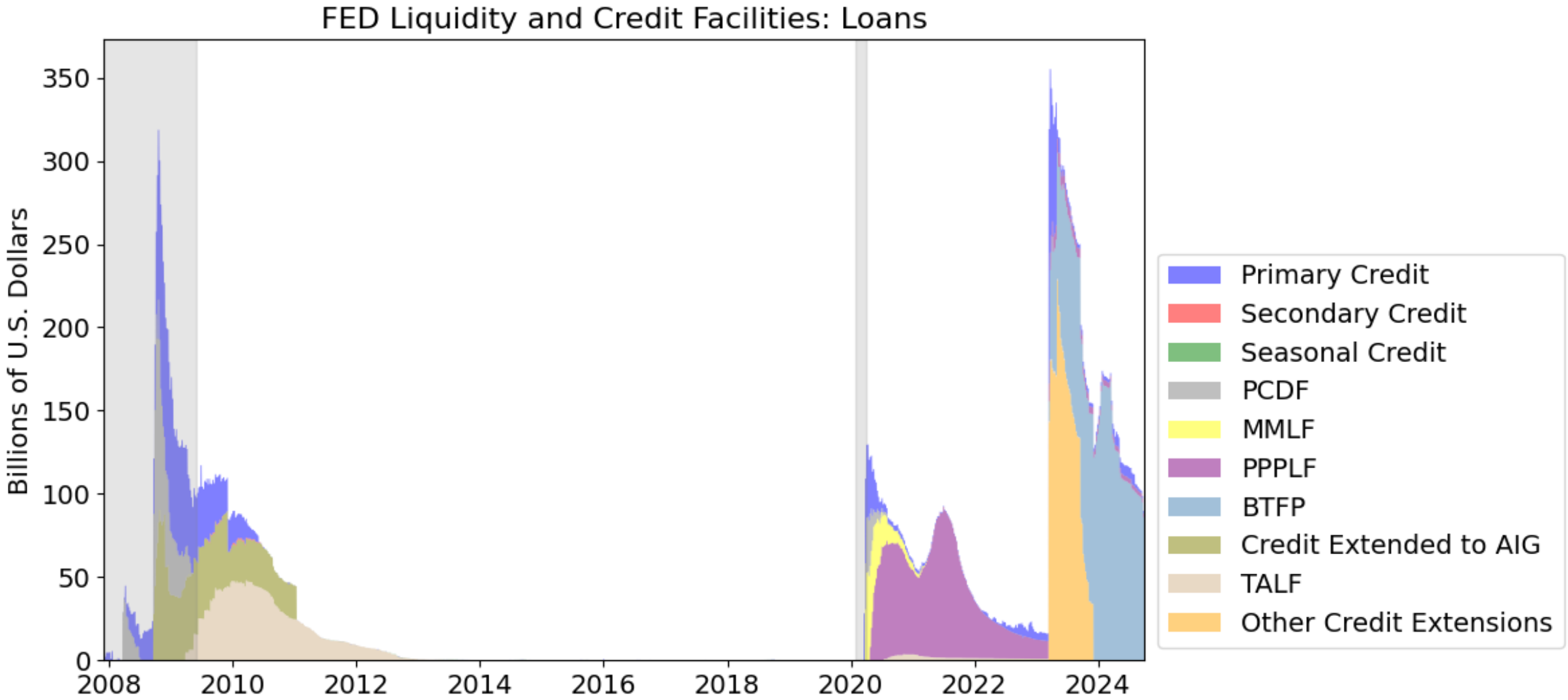
Will to Act Tough?

Too much Discretion?

- Tough (Rules based)
  - Identifying insolvent bank
  - Restructuring/Raising Equity

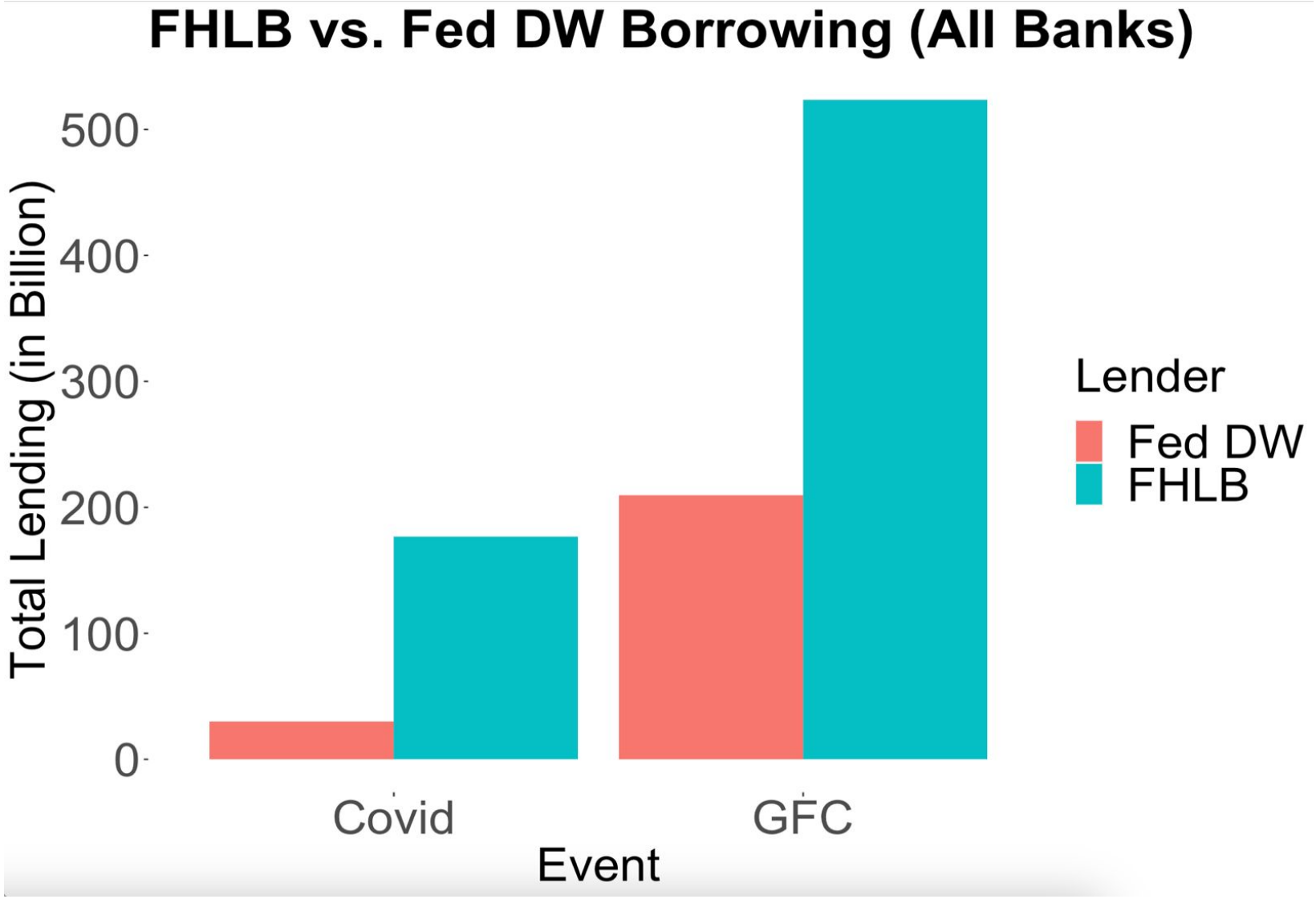
- Easy (Discretion based)
  - Reinterpret “solvency” as “liquidity”
  - Heisenberg’s Paradox
    → Neither defined Nor measured
    → Slow…Fast…Sudden…

Liquidity → LOLR → Subsidies



Source: *Federal Reserve Balance Sheet: Factors Affecting Reserve Balances - H.4.1*

Will to act Tough? | Too Much Discretion?



Source: *Bank Call Reports*

Will to act Tough? | Too Much Discretion?

Credibility?

- SVB, First Republic,….Republic First
  - Liquidity (Fed: 300+ in the report)
  - Liquidity (FDIC)
  - Liquidity (Basel Committee)

- Lots of “liquidity” infusion…
  - …yet banks kept failing
  - Reality: SVB/ others insolvent → capital issue

Credibility?

- Basel III: End Game
  - Raise Capital: See SVB turmoil
  - …

“Some industry representatives claim that inadequate capital had nothing to do with those bank failures,” the Federal Reserve’s vice-chair for supervision said

How Wall Street won ‘capitulation’ from the Federal Reserve on new bank rules

Fed vice-chair says he learnt ‘lesson of humility’ when he had to revise capital requirements plan

Credibility?

- Innovation in Financial Sector
  - Fintech, payments, crypto, private credit…
  - …
  - Slow

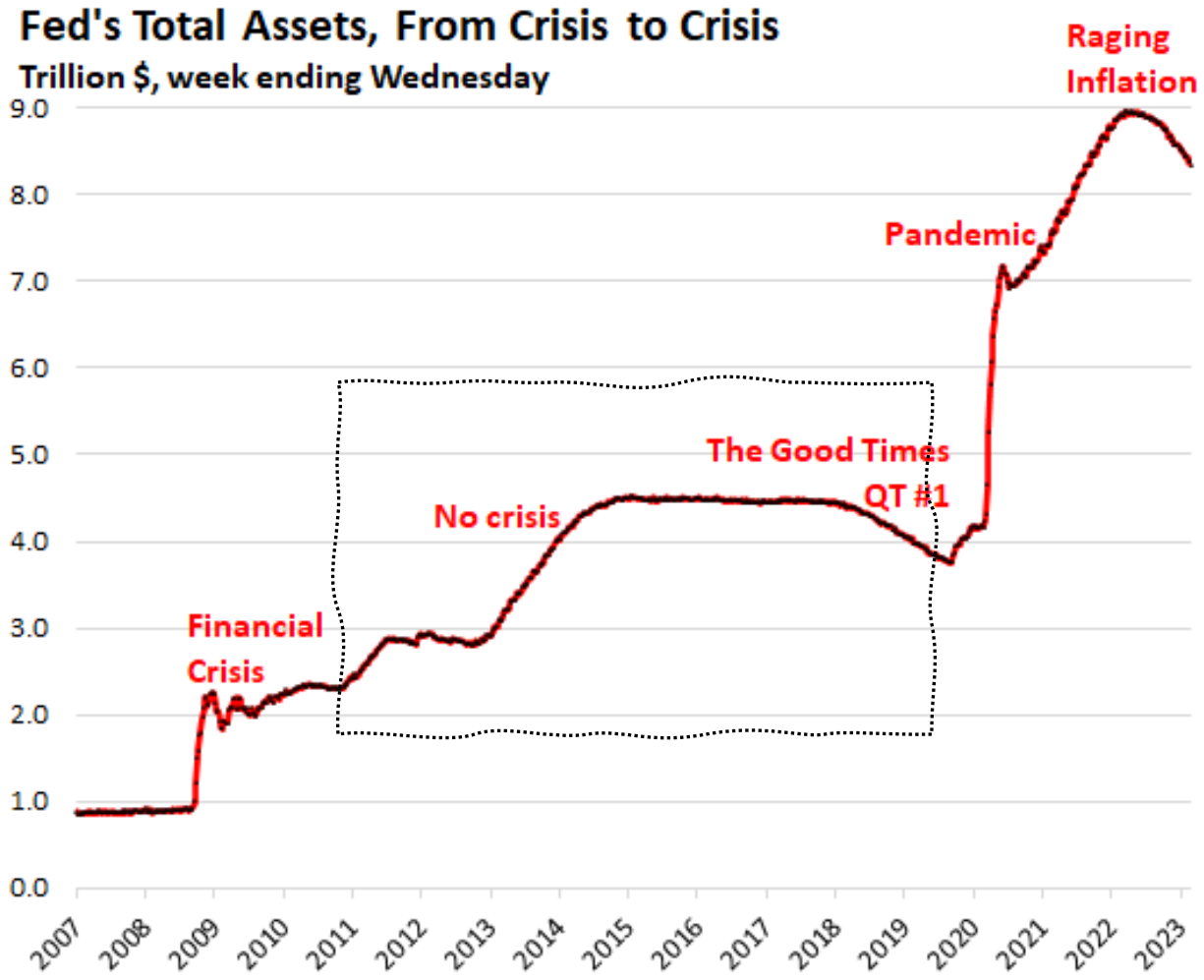
Banks push back against CBDC

The nation's biggest bank and bank trade groups stressed the risks of creating a central bank digital currency in comments to the Fed.

Powell says Fed not "remotely close" to a central bank digital currency

Credibility?

- Unwinding what has been wound up
  - Fed Balance Sheet
  - …



Conclusion

"Net interest income used to be the bellwether of whether [a] bank is doing well or not," said Kim Forrest, chief investment officer at Bokeh Capital Partners. "Investors have comprehended that they'll make money in good times and bad."

Great Paper…

- Too much discretion → Blunts will to act tough → Reinterpret events → LOLR/Subsidy infestation
- Heads I win: Saved system from sudden shocks…
  Tails I win too: If turmoil see Heads (& ignore costs)

Credibility Dented → Re-org/Reset