

Reforming the Federal Reserve, Part 6

Responsible Last Resort Lending

BY NORBERT MICHEL AND JAI KEDIA

One role that Congress gave to the Federal Reserve in 1913 was that of “lender of last resort” (LLR). As the name suggests, this role means that the Fed is supposed to provide credit when funds are not available from any other source. The classic LLR prescription for a central bank, developed over the century prior to the Fed’s creation, dictates that the Fed should ensure the system-wide flow of credit after an economic shock by offering loans on a widespread basis at a “high” rate of interest. According to this prescription, if the central bank responds “promptly and vigorously,” its LLR actions would be temporary and therefore not interfere with its long-run monetary policy objectives. Notably, the classic prescription does not call for bolstering financially unsound firms or acting preemptively to prevent future shocks.¹

Overall, the Fed has failed to adhere to the classic LLR prescription. Throughout its history, the Fed has repeatedly lent to financially troubled firms, thus jeopardizing the independence of its monetary policy decisions and putting taxpayers at risk. During its early years, the Fed

likely worsened the Great Depression because it failed to adequately fulfill its LLR role by ensuring the system-wide flow of liquidity. During the 2008 financial crisis, the Fed facilitated bailouts to financially weak firms by invoking its so-called emergency lending authority. During the COVID-19 pandemic, the Fed created many temporary lending facilities that followed the classic LLR prescription. However, the Fed also created at least one lending facility that could have been used to lend directly to financially troubled private businesses.²

Congress could easily avoid these problems by prohibiting the Fed from making these types of loans. Indeed, as Jeff Lacker, former president of the Richmond Fed, has explained, “history and experience suggest that the Fed’s balance sheet activities should be restricted to the conduct of monetary policy.”³ Regardless, there is no clear economic rationale for the Fed to provide direct loans to private firms. Given the sophistication of modern financial markets, there is now less reason to allow the central bank to serve as an LLR than there was in 1913.



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OVERVIEW OF THE FED'S LLR HISTORY

The Fed has used several different methods throughout its history to fulfill its LLR function.⁴ The main method has been through the normal open market operations that the Fed uses to manage the monetary base. Through these operations, the Fed has regularly provided liquidity to the entire market by purchasing Treasury securities, and these operations can be temporarily expanded in the event of a crisis.

Whether on a permanent or temporary basis, open market purchases add reserves to the banking system, thus bolstering the federal funds market (a private market where banks lend reserves to each other) with additional funds. This injection of reserves tends to lower the rate that banks charge each other to lend in this market (the federal funds rate), thus providing banks with easier access to a highly liquid source of funds. Therefore, the federal funds market provides a way for the Fed to fulfill its LLR function by adding system-wide liquidity and allowing private firms—instead of the central bank—to allocate credit to specific institutions.

In several specific crises, the Fed successfully expanded its open market purchases to carry out its LLR function. For instance, after the 1987 stock market crash, prior to the Y2K computer scare, and in the wake of the 9/11 terrorist attacks, the Fed temporarily expanded its normal open market Treasury purchases. In these cases, the Fed also made clear public announcements that it was doing so specifically to provide temporary liquidity.

At many points in history, though, the Fed has used alternative methods to fulfill its LLR function that failed to adhere to the classic LLR prescription. For starters, the Fed lends directly to banks (depository institutions) through its discount window, a method of lending that was originally envisioned as the main tool of monetary policy. Initially, each of the 12 Federal Reserve Banks had an actual window in its lobby to make these loans to member banks. 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. The Fed's discount window lending has long been the source of controversy with respect to proper LLR operations.

In its earlier years, the Fed broke with the classic LLR tradition by lending continually—often to failing banks—through the discount window rather than only on a

temporary basis.⁵ One of the first troublesome expansions of discount window lending came in 1932, when the Glass–Steagall Act added Section 13(3) to the Federal Reserve Act. This change opened the Fed's discount window to nonbanks—individuals, partnerships, and corporations—in “unusual and exigent circumstances.”⁶ Another major change was instituted when the 1934 Industrial Advances Act was approved and added to the Federal Reserve Act as Section 13(b). This section authorized the district banks to provide working capital loans directly to industrial and commercial businesses for periods of up to five years, without any limitations on the type of collateral. By 1939, the district banks had provided nearly \$200 million in working capital loans to nearly 3,000 applicants. These loans did not fit the classic LLR prescription because they provided firms with a substitute for private capital.

In 1946, the Federal Reserve Board began lobbying Congress to eliminate its own Section 13(b) authority, and Congress finally repealed Section 13(b) with the Small Business Investment Act of 1958. During the congressional debate on the 1958 bill, Fed Chairman William McChesney Martin Jr. testified to Congress that the Fed should not provide capital to institutions and that its primary objective should be “guiding monetary and credit policy.”⁷ 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 financially troubled Penn Central Railroad.⁸

That success was short-lived, though, and the Fed immediately followed that refusal with what monetary scholar Anna Schwartz called “the ‘too big to fail’ doctrine in embryo.”⁹ Ostensibly worried about fallout from Penn Central's bankruptcy and commercial paper default, the Fed announced that it would provide discount window lending to banks to assist businesses that could not issue new commercial paper. In this case, the Fed went to great lengths to prevent a potential future shock from a non-financial firm's failure. Perhaps worse, the phrase “too big to fail” came into widespread use after the Fed helped facilitate the 1984 bailout of Continental Illinois National Bank.¹⁰

During the 2008 financial crisis, the Fed allocated credit directly to several firms and created more than a dozen special lending programs by invoking its emergency authority under Section 13(3) of the Federal Reserve Act. Two of the most widely publicized examples of direct loans were the

Fed's \$13 billion loan to Bear Stearns and a \$30 billion loan to facilitate JPMorganChase's acquisition of Bear Stearns. The Government Accountability Office estimates that from December 1, 2007, through July 21, 2010, the Fed lent financial firms more than \$16 trillion (roughly equivalent to the United States' annual GDP in 2009) through its broad-based emergency lending programs, and Bloomberg Markets estimates that the Fed charged \$13 billion below market rates for its emergency loans from 2007 to 2010.¹¹

In practical terms, the Fed's LLR function must be operationalized through legislation and the provisioning of credit. In the 1930s, Congress expanded the Fed's lending authority in what may have seemed a restrictive manner, allowing it to lend only in "unusual and exigent circumstances." Of course, these terms require at least some subjective interpretation, which led, in part, to controversies surrounding the 2008 financial crisis lending programs.¹²

Perhaps less appreciated, though, is how the Fed's lending authority fits in with other operational changes the Fed has undergone. For instance, in the wake of the 2008 crisis, the Fed altered its operating system such that it depends on an abundant reserve system and the payment of interest on those reserves. This system effectively divorces the Fed's monetary policy stance from the size of its balance sheet, potentially allowing the Fed to expand its footprint and facilitate backdoor spending that usurps both the congressional appropriations process and private financial markets.¹³ Reforming the Fed's LLR function is even more important given these operational changes.

FLEXIBLE OPEN MARKET OPERATIONS AS A FIX FOR LLR

When the Fed was created in 1913, the practical implementation of LLR policy was tied to maintaining the gold standard, an international system that has not existed since the 1930s. In a modern fiat money system, however, central banks are no longer constrained by the need to protect gold reserves or to preserve the convertibility of the nation's currency to gold at a fixed exchange rate. Central banks now have one primary duty: supplying the most liquid form of the nation's money supply (cash and bank reserves) in quantities sufficient to meet certain macroeconomic targets.

As monetary scholar George Selgin has pointed out, experience suggests that the conventional dichotomy of "emergency" and "ordinary" central-bank liquidity provision has outlived its usefulness.¹⁴ Put differently, a central bank can now easily provide both emergency and ordinary liquidity provision more efficiently than in the past. In particular, the fact that central banks' main duty is to adequately and efficiently supply their economies' most liquid assets calls for assigning as large a role as possible to market prices for allocating new central-bank credits among rival applicants.

To best accomplish this goal, the Fed could implement a single auction mechanism for flexible open market operations, like the system created by the Bank of England. The idea is to provide auctions for both ordinary open market operations and predefined emergency open market operations from the same lending facility so that all eligible counterparties can compete on equal terms for central-bank liquidity. Under this arrangement, the central bank, once having set the terms of the auction, would have no other duty to perform save that of determining the aggregate amounts of credit to be auctioned. Last resort lending, instead of being a distinct central-bank duty, would become an incidental counterpart of ordinary monetary policy. It would consist of that part of auctioned credits taken up by liquidity-strapped counterparties that choose to participate in auctions only as a last resort. Thus, while there would still be last resort borrowers, there would be no last resort lending operations as such.

To maximize the effectiveness of this type of system, the Fed should expand its counterparties. That is, rather than maintaining its outdated primary dealer system of just 25 financial institutions, the Fed should allow all commercial banks eligible for discount window loans to participate in its routine credit auctions. By updating the primary dealer system in this manner, flexible open market operations would serve as a reliable source of liquidity both in ordinary times and during times of extreme financial distress. There would no longer be a need for discount windows or an assortment of narrowly designated lending facilities. Instead, the provision of last resort credit to liquidity-stricken institutions would be a by-product of the Fed's ordinary monetary policy. In the sense that monetary policy itself consists of providing system-wide liquidity, this type of flexible system would also enhance the effectiveness of the Fed's routine open market operations.

To ensure that the Fed would no longer use other lending facilities, Congress should restrict the Fed to these types of temporary expansions of open market operations. At a minimum, Congress should amend the Federal Reserve Act so that it eliminates the discount window and revokes the type of emergency lending possible through Section 13(3) of the act.

CONCLUSION

Historically, the Fed has sometimes effectively fulfilled its LLR function by providing liquidity to the entire market rather than allocating credit to specific firms. However, many of the Fed's LLR actions have been counter to the very principles that defined the classical LLR concept. Fortunately, the conditions

NOTES

1. Thomas M. Humphrey, "The Classical Concept of the Lender of Last Resort," Federal Reserve Bank of Richmond *Economic Review* (January/February 1975).

2. In March 2020, the Fed created the Primary Market Corporate Credit Facility for the purpose of buying corporate bonds directly from US companies and extending loans to those same companies. See Norbert Michel, "The Federal Reserve Should Not Help Congress Duck Its Responsibilities: Part 2," *Forbes*, April 27, 2020.

3. Renee Haltom and Jeffrey M. Lacker, "Should the Fed Do Emergency Lending?," Federal Reserve Bank of Richmond Economic Brief no. 14-07, July 2014.

4. Prior to the creation of the Fed, private clearinghouses played a key role in stemming banking panics by providing short-term loans to member banks. Though this arrangement worked to provide a LLR function, it was not sufficient to overcome the many problems of the 19th-century banking system, problems that ultimately led to popular support for a central bank. See Ellis W. Tallman and Jon Moen, "Liquidity Creation Without a Lender of Last Resort: Clearing House Loan Certificates in the Banking Panic of 1907," Federal Reserve Bank of Cleveland Working Paper no. 10-10, July 2010; Richard H. Timberlake Jr., "The Central Banking Role of Clearinghouse Associations," *Journal of Money, Credit and Banking* 16, no. 1 (1984); J. G. Cannon, "Clearing House Methods and Practices," in *Clearing Houses and Credit Instruments*, vol. 6, Publications of National Monetary Commission (Government Printing Office, 1911);

that existed in 1913 necessitating a separate LLR function for central banks no longer exist. Given the sophistication of financial markets, the Fed can now create a single flexible open market operation facility that would render last resort lending an incidental counterpart of ordinary monetary policy.

By allowing a broad set of potential applicants, perhaps using a wide range of eligible collateral, to compete for available funds, flexible open market operations would help *minimize* the Fed's credit footprint. This type of system would help prevent the Fed from taking part in either deliberate or inadvertent credit-allocation exercises for which fiscal rather than monetary authorities ought to be responsible. Put differently, this type of system would focus the Fed on adequately and efficiently supplying the most liquid form of the nation's money supply.

and George Selgin, "The Case for Free Banking: Then and Now," Cato Institute Policy Analysis no. 60, October 21, 1985.

5. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 58.

6. For a more detailed historical overview, see Norbert Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder no. 2943, August 20, 2014.

7. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 61.

8. President Richard Nixon also tried to secure a bailout of Penn Central through the Defense Production Act, but Congress refused. See Christopher Lydon, "Patman Releases Report on Pennsy," *New York Times*, July 23, 1970.

9. Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review* 74, no. 5 (September/October 1992): 62.

10. "Continental Illinois: A Bank That Was Too Big to Fail," Federal Reserve History, May 15, 2023.

11. Norbert Michel, "The Fed's Failure as a Lender of Last Resort: What to Do About It," Heritage Foundation Backgrounder no. 2943, August 20, 2014.

12. Lawrence H. White, *Ending the Federal Reserve System's Overreach into Credit Allocation*, Testimony Before the Subcommittee on Monetary Policy and Trade of the House Committee on Financial Services, 113th Cong., 2nd sess., March 12, 2014.

13. Norbert Michel and Jai Kedia, "Reforming the Federal

Reserve, Part 4: Restoring Sensible Asset Purchases," Cato Institute, June 26, 2025.

14. George Selgin, "Reforming Last-Resort Lending: The Flexible Open-Market Alternative," in *Prosperity Unleashed: Smarter Financial Regulation*, ed. Norbert Michel (Heritage Foundation, 2017): 201–12.



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