Chapman Law Review

Volume 12 | Issue 3 Article 5

2009

The Fed's Backroom Bailout Policy

Robert D. Auerbach

The Fed's Backroom Bailout Policy:

Reportedly more than $2 trillion in loans and guarantees without a timely public record, expanding its regulatory powers despite a history of malfeasance and, since October 2008, rewarding banks for holding their surging reserves rather than lending.

*Robert D. Auerbach**

Since the Federal Reserve (the Fed) started its loan policies in 2007, it has loaned and guaranteed perhaps $2 trillion or more.[1] That estimate does not count the 96 percent increase in the monetary base of the money supply in the four months since October 2008 which the Fed has created; an increase of $795 billion.[2] At this rate the base of the money supply was closing in on $1 trillion.[3] A huge surge in the monetary base is necessary to keep the Fed's target short term interest rate near zero.

Where is all that money? Most is being held by the nation's banks.[4] Since October 2008, the Fed has paid interest to the banks if they held the money.[5] As I will explain, that policy intensifies the financial crisis.

Complete timely records of the Fed's bailout actions and deliberations, if they exist, would establish responsibility for its unelected officials. Bloomberg news was turned down by the Fed

---

* Professor of Public Affairs, Lyndon B. Johnson School of Public Affairs, University of Texas, Austin.

1 Mark Pittman et al., *Fed Defies Transparency Aim in Refusal to Disclose (update2)*, BLOOMBERG.COM, Nov. 10, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aOngFPgq7r3M. The monetary base calculated by the St Louis Federal Reserve would expand to over $1.7 trillion by May 29, 2009. http://research.stlouisfed.com/fred2/data/WSBASE.txt.

2 FED. RESERVE. AGGREGATE RESERVES OF DEPOSITORY INSTITUTIONS AND THE MONETARY BASE (2009), *available at* http://www.federalreserve.gov/releases/h3/current/h3.pdf.

3 *Id.*

4 *Id.*

5 Reserve Requirements of Depository Institutions, 73 Fed. Reg. 59,482 (Oct. 9, 2008) (to be codified at 12 C.F.R. pt. 204). *See also* Press Release, Federal Reserve Board (Oct. 6, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm (announcing that the Fed "will begin to pay interest on depository institutions' required and excess reserve balances.").

in its Freedom of Information Act (FOIA) request for details and has taken the matter to court.[6]

Evidently, the Fed intends to continue its record of blocking transparency as it did for seventeen years when it denied possessing transcripts of its monetary policy committee meetings.[7] Nevertheless, they were forced to show them during a Congressional investigation.[8] They were around the corner from Alan Greenspan's office. Beginning in 1994, the Greenspan Fed began to destroy the source records of those transcripts, which had been sent to the National Archives.[9]

The Fed is the major regulator of the nation's financial firms with regulatory jurisdiction over financial holding companies—that includes the large trillion dollar banks—and foreign banks.[10] It is now assuming, and Congress is suggesting, legislation for more Fed regulatory power,[11] even though the Fed's regulatory function is fundamentally flawed and remains a catalyst for more crises.[12]

The primary conflict of interest at the Fed is its outdated organization that gives bankers inside the Fed bureaucracy substantial authority to regulate the banks.[13] The banks in each of their district elect six of the nine members of the boards of directors at each of the twelve Federal Reserve district banks.[14]

---

6 Mark Pittman and Bob Ivry, *U.S. Taxpayers Risk $9.7 Trillion on Bailout Programs (Update1)*, BLOOMBERG.COM, Feb. 9, 2009, http://www.bloomberg.com/apps/news?pid=washingtonstory&sid=aGq2B3XeGKok ("Bloomberg requested details of Fed lending under the Freedom of Information Act and filed a federal lawsuit against the central bank Nov. 7 seeking to force disclosure of borrower banks and their collateral.").

7 *See* ROBERT D. AUERBACH, DECEPTION AND ABUSE AT THE FED; HENRY B. GONZALEZ BATTLES ALAN GREENSPAN'S BANK 87 (2008).

8 *Id.* at 108.

9 *Id.* at 103.

10 BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS, 1–4 (1994).

11 THE DEPARTMENT OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 9 (Mar. 2008) (suggesting "[t]he Federal Reserve should have primary oversight responsibilities for such payment and settlement systems, should have discretion to designate a payment and settlement system as systemically important, and should have a full range of authority to establish regulatory standards.").

12 Press Release, U.S. Sec. and Exch. Comm'n, Statements of Chairman Cox on IG Reports Regarding CSE Program (Sept. 26, 2008) (transcript available at http://www.sec.gov/news/press/2008/2008-231.htm).

13 The Federal Reserve Board, *The Structure of the Federal Reserve System, Board of Directors, Selection and Representation*, http://www.federalreserve.gov/pubs/frseries/frseri4.htm (last visited Feb. 26, 2009) (characterizing Class A directors of the board of directors as typically being bankers).

14 *Id.* (describing the Federal Reserve Banks' board of directors as divided into three classes, where two classes—six of the nine total members—are elected by member banks in their district).

When J. P. Morgan bought Bear Stearns in 2008, its CEO, Jamie Dimon, was also on the board of directors of the bank regulator, The New York Federal Reserve Bank.[15] Sanford Weil, the CEO of Citigroup, was elected to the same board in 2001 and his bank was later investigated by Attorney General Eliot Spitzer regarding the Citigroup-WorldCom scandal.[16]

A false argument can be advanced: "Who better knows how to regulate the banks than the banks being regulated?" I could fill a book with the answers from the eleven years I assisted the Chairmen, Ranking ~~Members~~ of the House of Representatives Committee on Financial Services who carried out investigations during the tenure of four Federal Reserve Chairmen: Arthur Burns, William Miller, Paul Volcker, and Alan Greenspan.[17]

During the 1990s I assisted Chairman/Ranking Member Henry B. Gonzalez with his Congressional investigations of the Alan Greenspan Federal Reserve.[18] As I promised Henry B., as they called Gonzalez in his district, I did write a book about those investigations that was recently published.[19]

It is especially appropriate at Chapman University School of Law to mention material included in my book by or about my dissertation chairman and friend for many years, Milton Friedman.[20] In Chapter 9, "When Five Hundred Economists Are Not Enough," Milton is quoted from a Reuters' 1993 interview on the results of an astounding Congressional investigation in which I assisted:

> The Fed's relatively enhanced standing among the public has been aided 'by the fact that the Fed has always paid a great deal of attention to soothing the people in the media and buying up its most likely critics.' Recognizing that the Fed employs 'probably half of the monetary economists in the U.S. and has visiting appointments for two-thirds of the rest,' he [Friedman] saw few among the academic community who were prepared to criticize the Fed policy.[21]

---

15 Biography of Jamie Dimon, Federal Reserve Bank of New York, http://www.newyorkfed.org/aboutthefed/orgchart/board/dimon.html (last visited Feb. 26, 2009).

16 Press Release, Federal Reserve Bank of New York, *Sandford Weill Elected to NY Fed Board of Directors* (Jan. 10, 2001), http://www.newyorkfed.org/newsevents/news_archive/aboutthefed/2001/oa010110.html; *See* Elizabeth Douglass, *N.Y. Widens Salomon Investigation*, L.A. TIMES, Aug. 24, 2002, at C1.

17 *See* AUERBACH, *supra* note 7, at 106–147.

18 *Id.*

19 *See generally id.*

20 Jerry Hicks et al., *Orange County Newswatch; Teacher's Pet*, L.A. TIMES; ORANGE COUNTY EDITION, April 21, 1992, at A1 (noting that Chapman University President James L. Doti studied economics under Milton Friedman at the University of Chicago).

21 AUERBACH, *supra* note 7, at 142–43.

Unfortunately, Milton died in 2006 and could not read the finished manuscript.[22]

The devastating 1906 earthquake in San Francisco played a role in the creation of the Federal Reserve.[23] The terrible calamity shocked financial markets.[24] Still staggering in 1907, the nation's financial system was hammered when the Bank of England raised its rates causing an outflow of gold from the United States.[25] These events led to runs for deposits in private sector banks that were caught short.[26] The U.S. Treasury, which was also short of money due to expenditures on the Panama Canal, could not come to the rescue.[27] Remedies for the panic and banking collapse were worked out in a backroom deal with New York bankers who were locked in an all-night session under the piercing eyes of a Wall Street power broker, John Pierpont Morgan.[28]

Does this remind you of the following Federal Reserve negotiations in 1998?

> Working from the offices of the New York Fed Bank [in 1998], the Fed orchestrated a bailout of LTCM [Long-Term Capital Management] by private-sector banks. . . . Greenspan could not or would not tell Congress the details of the bailout, apparently because the nation's central bank produced no detailed public records of its actions. Hundreds of lawyers and many large financial firms were evidently involved in this operation. These actions put the Greenspan Fed in the same league as the tycoons of an earlier age, such as John Pierpont Morgan (1837-1913), whose enormous financial deals, which had widespread economic effects, were made out of sight of the public or its elected officials.[29]

The end of a federal government without a central bank came after Congress created the Federal Reserve in 1913.[30] The Fed has come a long way since 1913. Congress reorganized it in 1935, with its main power centered at the Washington D.C.

---

22 Jonathan Peterson, *Milton Friedman: 1912–2006; Economist changed the world*, L.A. TIMES, Nov. 17, 2006, at A1.

23 Kerry A. Odell & Marc D. Weidenmier, *Real Shock, Monetary Aftershock: The 1906 San Francisco Earthquake and the Panic of 1907*, 64 J. ECON. HIST. 1002, 1003–04, (2004).

24 *Id.*

25 *Id.*

26 *Id.*

27 A.P. Andrew, *The Treasury and the Banks Under Secretary Shaw*, 21 Q.J. ECON. 519, 542 (1907).

28 Ellis W. Tallman & Jon R. Moen, *Private Sector Responses to the Panic of 1907: A comparison of New York and Chicago*, ECON. REV., March/April 1995, at 5–8.

29 AUERBACH, *supra* note 7, at 177.

30 The History of the Federal Reserve: Federal Reserve Bank of Cleveland, http://www.clevelandfed.org/About_Us/who_we_are/about_the_system/history.cfm (last visited Feb. 27, 2009).

headquarters[31] in two committees: the seven-member Board of Governors, all of whom are nominated by the President and confirmed by the Senate, and the Federal Open Market Committee (FOMC).[32] The FOMC is composed of the Board of Governors and five of the twelve Federal district bank presidents, each of whom receives his/her appointment from the district Federal Reserve bank's boards of directors, subject to approval by the Board of Governors, without having to be publicly questioned, and have their credentials and background examined during a Senate confirmation process.[33]

The next power increase came in 1951.[34] The U.S. Treasury Department lost its authority to issue money in an agreement during the Truman Administration to end the practice of pegging interest rates at low levels in order to support the price of government bonds purchased by banks in an effort to help finance the government in World War II.[35] Its responsibilities for issuing currency and coin dwindled to running the Bureau of Printing and Engraving that prints money ordered and issued by the Federal Reserve.[36]

It is a pity that so many people in Congress think they can appropriate money, when all they can do is vote for spending bills that, when signed by the President, go to the Treasury which must then sell securities to obtain borrowed funds. Only the Federal Reserve can order the printing presses to finance the spending bills with new money.

Severe regulatory problems were uncovered during the tenure of Fed Chairman Alan Greenspan (1987–2006). A Gonzalez-led congressional investigation received information, partially confirmed by the president of the New York Fed, that Federal Reserve officers were taking gifts and socializing with the bankers they were examining.[37] Greenspan even approved of the right of Fed bank examiners to give their resumes for employment to the banks they were examining.[38]

---

31 Board of Governors of the Federal Reserve: Federal Reserve Bank of Cleveland, http://www.clevelandfed.org/About_Us/who_we_are/about_the_system/governors.cfm (last visited Feb. 28, 2009) (noting that "[t]he Board of Governors in Washington, DC,[sic] provides general oversight of the Reserve Banks.").

32 Melcher v. Fed. Open Market Comm., 644 F. Supp. 510, 518 (1986).

33 *See id.*

34 DONALD R. WELLS, THE FEDERAL RESERVE SYSTEM: A HISTORY 93–94 (2004); *see also* AUERBACH, *supra* note 7, at 5.

35 WELLS, *supra* note 34, at 94.

36 Bureau of Engraving and Printing-About the BEP, http://www.moneyfactory.gov/section.cfm/2 (last visited Mar. 25, 2009).

37 AUERBACH, *supra* note 7, at 61.

38 *Id.* at 63–64.

The 1999 Financial Modernization Bill (Gramm-Leach Bliley Act) further destroyed bank examination of the trillion dollar banks.[39] The 1999 bill repealed the provisions in the banking laws of 1932 and 1933 (the Glass-Steagall acts) that separated banks from underwriting and other investment bank activities. Banks could now be combined with other financial businesses with the approval of the Federal Reserve. Academics who misunderstood turf wars praised the functional examination of financial conglomerates being spread to many different entities, including state insurance regulators.[40] The barrier between deposits—much of which are a liability of the taxpayers—and other activities in these conglomerates is now protected by little more than the fictional potted plant between their desks.[41]

In 1998, Secretary of the Treasury Robert Rubin warned the Senate Banking Committee about some serious concerns if the Modernization Law—which would create superbanks—was passed.[42] He said, "these large aggregations could present competitive problems in the initial stages, and then subsequently, if small banks are not able to compete, then you can have other kinds of pricing mechanisms develop once they're gone."[43] The bill to create superbanks was required to keep together the large financial conglomerate Citigroup, an institution built by its former CEO Sanford Weill.[44] Citigroup hired Rubin a month before the bill became law.[45]

During the recent bailout, the locus of policy has shifted from the FOMC to the Board of Governors.[46] The Board has the immense power to bypass the congressional appropriation process to make loans to individuals, partnerships and corporations that are "unable to secure adequate credit accommodations from other banking institutions" provided there are "unusual and exigent circumstances" and, before 2002, provided at least five of the seven Fed governors authorized the

39 *Id.* at 162.

40 *See id.* at 163.

41 *See id.* at 186 (noting that, under the Gramm-Leach-Bliley Act, bank operations that sold insurance would only be regulated by state agencies).

42 *Competition In The Finance Services Industry: Hearing on H.R. 10 Before the S. Banking, Housing and Urban Affairs Comm.*, 105th Cong. 30 (1998) (statement of Robert Rubin, Treasury Secretary of the United States).

43 *Id.*

44 #242 [of the 400 Richest Americans] – Sanford Weill, FORBES.COM, Sept. 21, 2006, http://www.forbes.com/lists/2006/54/biz_06rich400_Sanford-Weill_HRFZ.html.

45 Ken Brown & David Enrich, *Rubin Defends His Role at Citi*, WSJ.COM, Nov. 29, 2008, http://online.wsj.com/article/SB122791795940965645.html#.

46 Patrick McGee, *FOMC Preview: Fed Expected to Maintain Aggressive Policy Stance*, FOREXTV.COM, Jan. 28, 2009, http://www.forextv.com/Forex/News/ShowStory.jsp?seq=220568&category=Us+Economic+News,FED.

action.[47] In 2001, the law was amended after the 9/11/01 terrorist attacks so that, if there are less than five governors in office, this loaning power could be authorized by a "unanimous vote of all available members then in office—if at least 2 members are available."[48] Few may argue about the meaning of "available" in an explosive financial crisis; for other occasions it may not be clear.

Under the authority of its Board of Governors, the Fed stopped a run on an investment bank.[49] Reportedly, Chairman Ben Bernanke received an early morning crisis request from New York Fed Bank President, Timothy Geithner.[50] Bernanke "did a head count" authorizing J.P. Morgan Chase to bailout/takeover/rescue (depending on where you sit) Bear Stearns.[51]

The Fed's accounting rules for Bear Stearns' assets of mainly "mortgage backed securities and other mortgage-related assets," which "Bear Stearns valued at $30 billion on March 14," are suspect.[52] Morgan will "absorb the first $1 billion of any losses" and the "Fed is on the hook for the rest."[53]

What about the market value now? Testifying in his role as President of the New York Fed Bank, Geithner informed the Senate Banking Committee that he would report quarterly on the "fair value."[54] The members of the Senate and House Banking and Financial Services Committees should be continually updated on the estimated value and the complete details of the method of estimation. This information should not be kept secret from the taxpayers.

The Fed then expanded its loan faculties to investment banks;[55] a move that may have saved Bear Stearns had the Fed

---

47 *See* 12 U.S.C. § 343 (2006).

48 *See* 12 U.S.C. § 248(r)(2)(A) (2006).

49 *See* Greg Ip, *Crisis management: Fed's Fireman on Wall Street Feels Some Heat; Debate Over Bear Stearns Rescue Puts Geithner in Spotlight; Bernanke's War Room*, WALL ST. J. (Eastern Addition), May 30, 2008, at A1.

50 *Id.*

51 *Id.*

52 Jonathan Weil, *Fed's Bear Stearns books Look Prime for Cooking*, BLOOMBERG.COM, June 18, 2008, http://www.bloomberg.com/apps/news?pid=20601039&sid=a70JZmfcakF0&refer=home#.

53 *Id.*

54 *Turmoil in the U.S. Credit Markets: Examining the Recent Actions of the Federal Financial Regulators Before the S. Banking, Housing and Urban Affairs Comm.*, 110th Cong. 57 (2008) (statement of Timothy Geithner, President, Federal Reserve Bank of New York).

55 *See* Edmund L. Andrews, *Fed Loosens Standards on Emergency Loans*, N.Y. TIMES, Sept. 15, 2008, at A1, *available at* http://www.nytimes.com/2008/09/15/business/15fed.html.

taken action several weeks earlier. They could have saved Lehman Brothers had they used Section 13-3 of the Federal Reserve Act or they could have made it a bank holding company with access to the Federal Reserve's loan window as they did in the same month for Goldman Sacks and Morgan Stanley.[56] But, very mysteriously, several officials in the backroom of the New York Federal Reserve claimed they lacked the power at that time to bailout Lehman Brothers.[57]

Like the promised quarterly reports,[58] Congressional banking and financial services committees should also receive a complete transcript of the Board of Governors' meetings. While the Fed's Freedom of Information Office offers a $6 CD recording of the Fed's "open meetings," the informational content is minimal due to the many statutory exceptions contained in the inaptly named Government in the Sunshine Act.[59]

The New York Federal Reserve Bank should provide Congress with a complete record of its backroom negotiations as well as full minutes of its board of directors' meetings. Two former chairmen of the House Banking committee—Henry Reuss (1975–80) and Henry B. Gonzalez (1989–94, Ranking Member until 1999)—managed to obtain the minutes of the board of directors' meetings at the twelve Fed Banks.[60] They were deliberately vacuumed, as emphasized by one Fed Bank president who told his board of directors in 1976:

> I would think that if this involves a lot of work, which it will . . . that someone on Mr. Reuss' Committee, a friendly individual should know what we're being called upon to do. Because I think this can be used against Reuss if we react intelligently and as I see it in the St. Louis case, it's appalling how skimpy or meaningless our minutes are, I'm sure we did this with great wisdom knowing that a man named Reuss would ask for them. The minutes are really terribly shallow. Tell nothing.[61]

---

56 12 U.S.C. § 343 (2006). Lehman Brothers filed for bankruptcy on September 15, 2008. Seven days later the New York Times reported this latter action was taken for two hold investment banks. Andrew Ross Sorkin and Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of An Era*, NYTIMES.COM, September 22, 2008.

57 Joe Nocera & Edmund L. Andrews, *Struggling to Keep Up as the Crisis Raced On*, N.Y. TIMES, Oct. 23, 2008, at A1, *available at* http://www.nytimes.com/2008/10/23/business/economy/23paulson.html?scp=1&sq=Struggling%20to%20keep%20up%20as%20the%20crisis%20raced%20on&st=Search.

58 *See supra* note 54 and accompanying text.

59 Government in the Sunshine Act, 5 U.S.C 552(b) (2006); *see also* FRB: FOIA Exceptions, http://www.federalreserve.gov/generalinfo/foia/exemptions.cfm (last visited Apr. 2, 2009).

60 *See* AUERBACH, *supra* note 7, at 19, 159.

61 *Id.* at 19.

Despite this apparent deliberate destruction of the record, there was some valuable information such as the discovery of the Fed's role in the Watergate scandal cover-up.[62] Reuss's investigation led to the 1977 Federal Reserve Reform Act that brought Fed bank directors under the scope of federal conflict-of-interest laws.[63] Now the Board of Governors and the New York Fed Bank should present the congressional oversight committees—the Senate and House Banking and Financial Services Committees—with the complete records of the negotiations and their meetings with their new multi-trillion dollar loan policies.

I wish to close with an example of poor policy being used by the Fed to discourage banks to lend.

Bank reserves supplied by the Fed have risen from $44 billion in September 2008 to an astounding $901 billion in January 2009.[64] Consider what the Fed initiated in October 2008 as the financial crisis deepened: It began to pay interest on these reserves.[65] It said this policy helped it control reserves.[66] That questionable rationale now means the Fed is paying banks to hold record reserves rather than lending money; a policy that intensifies the crisis.

I testified before a Financial Services Subcommittee in 2003 against the payment of interest on reserves because that policy would lead to a number of problems including parallel actions and asymmetrical information as has existed in the commercial bank lending markets where competition has been impeded.[67]

62 *Id.* at 20–28 (discussing how Fed Chairman Burns "doesn't want the system to get involved" in the Watergate affair even though the Fed was the source of some of the money used to pay the Watergate burglars).

63 *Id.* at 19.

64 Jim McTague, *Where's the Stimulus?*, Barron's at 27, Feb. 2, 2009, http://online.barrons.com/articles/SBI123335947137335199.html.

65 *See infra* Figure 1; *see also* Press Release, Board of Governors of the Federal Reserve System, 2008 Monetary Policy Releases (Oct. 6, 2008), *available at* http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm.

66 *See* Board of Governors of the Federal Reserve System, *Monetary Policy Report to the Congress,* July 15, 2008, at 30:

> The authority to pay interest on reserves could be helpful to the Federal Reserve in limiting the volatility in the federal funds rate. The ability to pay interest on reserves would also allow the Federal Reserve to manage its balance sheet more efficiently in circumstances in which promoting financial stability required the provision of substantial amounts of discount window credit to the financial sector. In light of these considerations, the Federal Reserve has asked the Congress to accelerate the effective date of statutory authority to pay interest on reserve balances, which is currently October 2011.

67 *Business Checking Freedom Act of 2003: Hearing Before the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Financial* Services, 108th Cong. 28(1st Sess. 2003) (testimony of Robert Auerbach).

Without adequate competition, the interest payments on reserves would, in large part, pass through to bank stock holders not the deposit holders, as some academics have theorized.[68] There was little doubt that the banks had successfully lobbied so that both sides of the aisle would favor paying interest on the reserves. I estimated, at the time, the present value of the future stream of interest payments would be $16.7 billion.[69]

I worked on legislation that was passed in 1980 that gave the Fed the right to pay interest on deposits in special cases in which they had to raise reserve requirements to control the money supply.[70] I discussed these "supplemental reserve requirements," worked out with former Fed Chairman Paul Volcker, when I testified in 2003.[71] No one was interested, not even the Fed, when they testified about the need for paying interest on deposits.

The effect of paying interest on reserves held at the Fed—now at the rate of ¼ of 1 percent—is to reduce the banks' incentive to lend.[72] As the Fed's target interest rate is raised—which it must do in the future to prevent substantial inflation or a rise in interest rates from financing of dollars of federal government deficit—the interest on reserves will likewise be raised.[73] If the spread between the risk-free rates of return on alternative income-earning assets increases, there will be a greater incentive for banks to hold reserves and decrease lending.[74] Lending has taken a hit, as shown in Figure 2, for percentage changes in commercial loans from banks.[75] The correct policy at this time should not be to penalize bank lending with a risk-free rate of return from the Fed to reward banks for holding the huge amount of reserves the Fed has supplied.

68 *Id.* at 29.

69 *Id.*

70 *Id.*

71 *Id.* at 36–37.

72 *See id.* at 33–34.

73 Federal Funds - Fedpoints, Federal Reserve Bank of New York, http://www.newyorkfed.org/aboutthefed/fedpoints.html (last visited Apr. 4, 2009).

74 *Business Checking Freedom Act of 2003-H.R. 758 and H.R. 859 Before the Subcomm. On Financial Inst. and Consumer Credit of the H. Comm. on Financial Services*, 108th Congress 6 (2003) (statement of Donald Kohn, Governor, Federal Reserve Board of Governors).

75 *See infra* Figure 2, available at http://www.economagic.com/em-cgi/charter.exe/fedstl/busloans+1990+2009+2+0+0+290+545++0 (last visited Apr. 4, 2009).

Figure 1: H.3 Aggregate Reserves of Depository Institutions

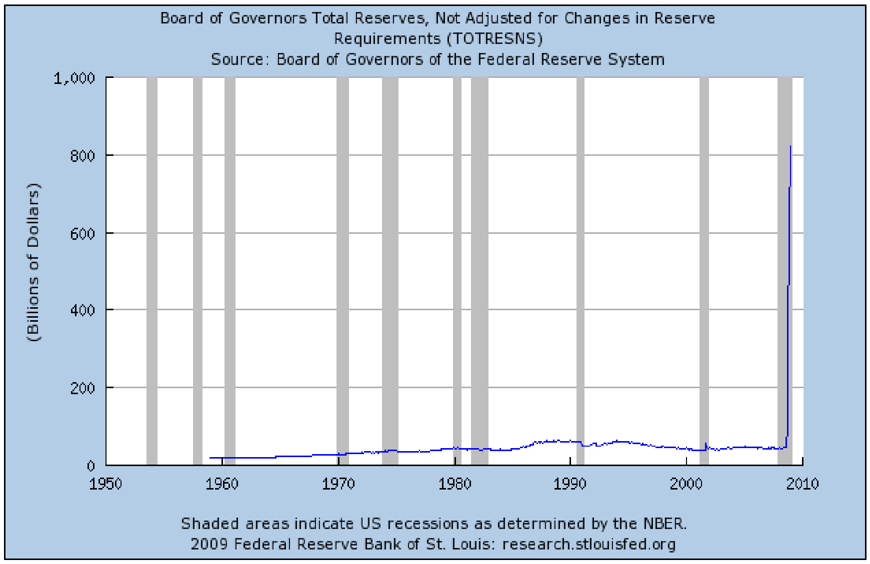

Figure 2: Commercial and Industrial Loans at All Commercial Banks, Percentage monthly changes at annual rates

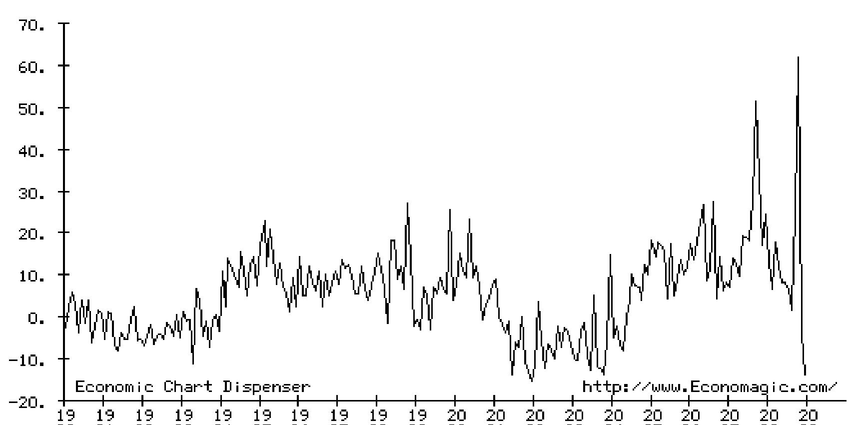

Figure 3: Federal Reserve Board of Governors: Press Release[76]
Release Date: October 6, 2008

Interest on Reserves

The Financial Services Regulatory Relief Act of 2006 originally authorized the Federal Reserve to begin paying interest on balances held by or on behalf of depository institutions beginning October 1, 2011. The recently enacted Emergency Economic Stabilization Act of 2008 accelerated the effective date to October 1, 2008.

Employing the accelerated authority, the Board has approved a rule to amend its Regulation D (Reserve Requirements of Depository Institutions) to direct the Federal Reserve Banks to pay interest on required reserve balances (that is, balances held to satisfy depository institutions' reserve requirements) and on excess balances (balances held in excess of required reserve balances and clearing balances).

The interest rate paid on required reserve balances will be the average targeted federal funds rate established by the Federal Open Market Committee over each reserve maintenance period less 10 basis points. Paying interest on required reserve balances should essentially eliminate the opportunity cost of holding required reserves, promoting efficiency in the banking sector.

The rate paid on excess balances will be set initially as the lowest targeted federal funds rate for each reserve maintenance period less 75 basis points. Paying interest on excess balances should help to establish a lower bound on the federal funds rate. The formula for the interest rate on excess balances may be adjusted subsequently in light of experience and evolving market conditions. The payment of interest on excess reserves will permit the Federal Reserve to expand its balance sheet as necessary to provide the liquidity necessary to support financial stability while implementing the monetary policy that is appropriate in light of the System's macroeconomic objectives of maximum employment and price stability.

76 A full copy of this press release can be found at http://www.federalreserve.gov/newsevents/press/monetary/20081006a.htm. *See also* Reserve Requirements of Depository Institutions, 70 C.F.R. 59482, 59482–83 (Oct. 9, 2008) (to be codified at 12 C.F.R. pt. 204).

ADDENDUM

Jim McTague, the Washington editor of Barron's, highlighted a part of the author's speech at the January 30, 2009 Chapman University School of Law symposium:

> University of Texas Professor Robert Auerbach, an economist who studied under the late Milton Friedman, thinks he has the makings of a malpractice suit against Federal Reserve Chairman Ben Bernanke, as the Fed is holding a record number of reserves: $901 billion in January as opposed to $44 billion in September [beginning in October], when the Fed began paying interest on money commercial banks parked at the central bank. The banks prefer the sure rate of return they get by sitting in cash, not making loans. Fed, stop paying, he says.[77]

Two weeks later, Federal Reserve Chairman Ben Bernanke told the National Press Club audience:

> Importantly, the management of the Federal Reserve's balance sheet and the conduct of monetary policy in the future will be made easier by the recent congressional action to give the Fed the authority to pay interest on bank reserves. Because banks should be unwilling to lend reserves at a rate lower than they can receive from the Fed, the interest rate the Fed pays on bank reserves should help to set a floor on the overnight interest rate.[78]

That was an admission that the Fed's payment of interest on reserves did impair bank lending, a counterproductive policy in the 2008–09 financial crisis. Also, William T. Gavin, a Federal Reserve economist, wrote "[f]irst, for the individual bank, the risk-free rate of ¼ percent must be the bank's perception of its best investment opportunity."[79]

Also, Bernanke's rationale for preventing banks from lending at lower interest rates was illogical at the time when the Fed's target interest rate for federal funds was zero to a quarter of one percent. The banks would be unlikely to lend at negative rates of interest even without the Fed paying them to hold reserves.

---

77 Jim McTague, *Where's the Stimulus?*, BARRON'S, at 27, Feb. 2, 2009, http://online.barrons.com/articles/SBI123335947137335199.html.

78 Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve System, Speech at the National Press Club Luncheon (Feb. 18, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090218a.htm.

79 William T. Gavin, *More Money; Understanding Recent Changes in the Monetary Base,* FED. RES. BANK OF ST. LOUIS REV. 57 (Mar./Apr. 2009), *available at* http://research.stlouisfed.org/publications/review/09/03/Gavin.pdf.