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Lending Blind: Shadow Banking and Federal Reserve Governance in the Global Financial Crisis

MATTHEW BERG

The 2008 Federal Open Market Committee (FOMC) transcripts[1] provide a rare portrait of how policymakers responded to the unfolding of the world's largest financial crisis since the Great Depression. The transcripts reveal an FOMC that lacked a satisfactory understanding of a shadow banking system that had grown to enormous proportions—an FOMC that neither comprehended the extent to which the fate of regulated member banks had become intertwined and interlinked with the shadow banking system, nor had considered in advance the implications of a serious crisis. As a consequence, the Fed had to make policy on the fly as it tried to prevent a complete collapse of the financial system.

The shadow banking system constituted nothing short of a gaping hole in the Federal Reserve's information set. William Dudley, who had recently joined the staff of the New York Fed from Goldman Sachs, emerged as a key architect of the Fed's crisis response, in part due to his relative familiarity with the shadow banking world. Dudley noted as early as January that the Federal Reserve had no real idea about what assets the monoline insurers (and presumably also AIG) held, or about whom they had sold insurance to: "There's quite a bit of cloudiness about what their true condition is" (Transcript, January 29–30, 2008, 18).

Similarly, even three months after the Bear Stearns debacle, New York Fed bank supervisor Arthur Angulo revealed that the Federal Reserve did not have hard numbers about what the run on Bear actually consisted of (June 24–25, 2008, 148). Likewise, FOMC member Charles Plosser asked "what kind of collateral Lehman posted" to special facilities such as the Primary Dealer Credit Facility. But it turned out that the Federal Reserve only found out what collateral it was making loans against *after* having already made the loans.

These informational deficiencies meant that the Federal Reserve had no real way of assessing the solvency of the institutions to which it was lending. As a consequence, the Fed was effectively "lending blind" to much of the global financial system. As Committee member Richard Fisher put it, "I can see the criticism of almost lending blind, taking substandard collateral" (March 10, 2008, 18).

As the crisis spread through the system, a number of FOMC members drastically underestimated the severity of the situation. Most remarkably, James Bullard argued in August 2008, just one month prior to the bankruptcy of Lehman Brothers, that "the level of systemic risk has dropped dramatically and possibly to zero," and that "the FOMC should begin to de-emphasize systemic risk worries" (August 5, 2008, 50–51). Although some Committee members such as Janet Yellen and Frederic Mishkin begged to differ, Bullard's sentiment was by no means unique: both Plosser and Jeffrey Lacker went out of their way to volunteer their strong agreement (August 5, 2008, 61; 70-71).

The Federal Reserve was caught off guard by the global financial crisis, and responded with a series of ad hoc measures devised to address ongoing events. Each one of these measures, individually, could be justified as merely an incremental step. But the series of incremental steps eventually added up to a response that was greater than the sum of its parts. By September, Chairman Ben Bernanke lamented:

> The ideal way to deal with moral hazard is to have in place before the crisis begins a well-developed structure that gives clear indications in what circumstances and on what terms the government will intervene with respect to a systemically important institution. We have found ourselves, though, in this episode in a situation in which events are happening quickly, and we don't have those things in place. . . . So in each event, in each instance, even though there is this sort of unavoidable ad hoc character to it, we are trying to make a judgment. . . . Frankly, I am decidedly confused and very muddled about this. (September 16, 2008, 74–75)

Finally, the 2008 FOMC transcripts raise a number of important governance issues. For instance, Lacker bemoaned the Committee's lack of involvement in the creation of a number of the Federal Reserve's special programs, such as the Term Asset-Backed Securities Loan Facility (TALF): "We were basically informed about the TALF rather than consulted in any meaningful sense" (December 15–16, 2008, 176).

One consequence of the implementation of many of these special programs by the Board of Governors is that since the Board does not release transcripts, information about the discussions that led to many momentous Federal Reserve policy decisions is unavailable. Therefore, it would not be unreasonable to reconsider whether merely releasing FOMC transcripts—but not other information such as transcripts of Board of Governors meetings—provides the degree of transparency, openness, and democratic accountability to Congress and to the American people befitting the nation's central bank.

A more detailed discussion of the issues can be found at www.levyinstitute.org/publications/reforming-the-feds-policy-response-in-the-era-of-shadow-banking.

MATTHEW BERG is a Ph.D. student at the University of Missouri–Kansas City and is working on a Ford Foundation grant directed by Levy Institute Senior Scholar L. Randall Wray: "A Research and Policy Dialogue Project on Improving Governance of the Government Safety Net in Financial Crisis."

[1] Available at www.federalreserve.gov/monetarypolicy/fomchistorical2008.htm.