

# SOME SECRETS DO NOT HURT EVERYONE: THE CASE FOR ADDITIONAL DISCOUNT WINDOW REFORM IN THE UNITED STATES' FEDERAL RESERVE

Ryan W. Tanselle \*

## INTRODUCTION

The global financial crisis, which began in the summer of 2007, brought about extraordinary and increased intervention in the financial sector by various developed countries and their central banks.<sup>1</sup> These countries and associated central banks include the United States' Federal Reserve, the United Kingdom's Bank of England, and the European Union's European Central Bank.<sup>2</sup> Most increased intervention occurred through each central bank's lender of last resort facility.<sup>3</sup> According to classical central bank ideology, one of the main functions of a central bank's lender of last resort facility is to provide liquidity to illiquid institutions facing a temporary shortage of cash.<sup>4</sup> The recent global financial crisis stretched this classical ideal to its limit.<sup>5</sup>

Historically, before a central bank lent its taxpayer's money to private institutions, the central bank would determine whether the institution requesting money was illiquid or insolvent.<sup>6</sup> While illiquidity is a sign that a bank could be insolvent, it alone is not determinative of insolvency.<sup>7</sup>

---

\* Ryan W. Tanselle is a J.D. candidate for 2011 at Indiana University School of Law – Indianapolis and has a B.S. in Business from the Kelley School of Business at Indiana University along with minors in Economics and Spanish.

1. A central bank is the “[p]rincipal monetary authority of a nation, which performs several key functions, including conducting monetary policy to stabilize the economy and level of prices.” BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 1 (9th ed. 2005), [http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf) [hereinafter PURPOSES & FUNCTIONS]. See *infra* Part I.A. (discussing the definition of central banks).

2. See generally Andrew Campbell & Rosa Lastra, *Revisiting the Lender of Last Resort*, 24 BANKING & FIN. L. REV. 453 (2009) (discussing the increased role of the Federal Reserve, Bank of England, and European Central Bank during the recent global financial crisis).

3. See *infra* Part IV.B. (discussing central bank activities in response to the financial crisis).

4. Campbell & Lastra, *supra* note 2, at 465.

5. See *infra* Part IV.A. (discussing events leading to the financial crisis including a discussion of normal bank activities when facing a temporary cash squeeze).

6. See *infra* Part IV.A.

7. See *infra* Part IV.

Therefore, in order to protect illiquid banks from the stigma attached<sup>8</sup> to using the same lender of last resort facility as insolvent banks, secrecy exists regarding the disclosure of traditional lender of last resort loans made to financial institutions.<sup>9</sup>

In response to the recent global financial crisis, central banks assumed much greater lender of last resort power in an effort to stabilize the financial system.<sup>10</sup> For example, central banks began “bailing out” institutions that were facing insolvency.<sup>11</sup> Because institutions facing insolvency are riskier than institutions facing illiquidity, central banks have been under pressure to disclose their use of taxpayer funds in such transactions. Some disclosure proposals specifically focused on lifting the veil of secrecy in the United States Federal Reserve’s primary lender of last resort facility, the Discount Window.<sup>12</sup> For example, the proposed Federal Reserve Transparency Act of 2009 required an annual audit of the Federal Reserve.<sup>13</sup>

Even though steps for reform, such as the Federal Reserve Transparency Act of 2009, were never undertaken, other reform measures were implemented. The first step toward lifting the veil of Discount Window secrecy came in *Bloomberg L.P. v. Board of Governors of Federal Reserve System*.<sup>14</sup> In this case, the Federal Reserve was ordered to disclose documents related to Discount Window lending under the Freedom of Information Act.<sup>15</sup> However, a more important step toward lifting the veil of Discount Window secrecy came on July 21, 2010, when the United States Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>16</sup> The Act was a compromise among numerous proposals for financial reform<sup>17</sup> and provides, among other reform measures, that the Federal Reserve will disclose certain details about *all* Discount Window

---

8. Campbell & Lastra, *supra* note 2, at 470.

9. See *infra* Part III. (discussing central bank secrecy).

10. Campbell & Lastra, *supra* note 2, at 454.

11. See *infra* Part IV.B. (discussing central bank activities in response to the financial crisis).

12. See *infra* Part II.B. (discussing the Discount Window’s role in the Federal Reserve); see also Matthew Winkler, Editorial, *Transparency and the Fed*, WALL ST. J., Sept. 18, 2009, at A21, available at <http://online.wsj.com/article/SB10001424052970204518504574418761585852036.html>.

13. Federal Reserve Transparency Act of 2009, H.R. 1207, 111th Cong. § 2 (2009).

14. *Bloomberg L.P. v. Bd. of Governors of Fed. Reserve Sys.*, 649 F.Supp.2d 262 (S.D.N.Y. 2009), *aff’d*, 601 F.3d 143 (2d Cir. 2010), *petition for cert. filed*, 79 U.S.L.W. 3271 (U.S. Oct. 26, 2010) (No. 10-543).

15. See *infra* Part IV.C.

16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

17. See generally Alison Vekshin & Phil Mattingly, *Lawmakers Reach Compromise on Financial Regulation*, BLOOMBERG (June 26, 2010, 12:01 AM), <http://www.bloomberg.com/news/2010-06-25/lawmakers-reach-compromise-on-financial-regulation.html>.

lending within two years of each loan.<sup>18</sup> Specifically, the Federal Reserve must now disclose the “name and identifying details of the depository institution; [t]he amount borrowed by the depository institution; [t]he interest rate paid by the depository institution; and [i]nformation identifying the types and amounts of collateral pledged in connection with any discount window loan.”<sup>19</sup>

Although the disclosure requirements in the Dodd-Frank Wall Street Reform and Consumer Protection Act appear harmless, the potential implications for *any* disclosure in an intertwined and increasingly global financial market are significant, as evidenced by the disclosure of Northern Rock’s receipt of lender of last resort money from the Bank of England.<sup>20</sup> Northern Rock’s disclosure showed that news of a single bank’s financial troubles could set off a chain of events that could cripple a global economy.<sup>21</sup> Therefore, in order to lift the veil of central bank secrecy while protecting the institutions that use a central bank’s lender of last resort facilities, disclosure of the use of lender of last resort facilities should only occur for high-risk institutions.

This Note examines the increasing transparency in central banks and whether such transparency should be extended to a central bank’s lender of last resort facilities. Part I analyzes the traditional roles and legal foundations of the Federal Reserve, Bank of England, and European Central Bank. Part II discusses lender of last resort theory and its implementation in the Federal Reserve, Bank of England, and European Central Bank. Part III explores central bank secrecy. Part IV outlines the myriad of central bank responses to the financial crisis. Finally, Part V posits that the Discount Window disclosure requirements in Dodd-Frank Wall Street Reform and Consumer Protection Act are too broad. Instead of requiring the disclosure of all Discount Window facility usage, the Federal Reserve should only be required to disclose Discount Window loans made to risky institutions.

## I. THE TRADITIONAL ROLES OF THE FEDERAL RESERVE SYSTEM, BANK OF ENGLAND, AND EUROPEAN CENTRAL BANK

The Federal Reserve System, Bank of England, and European Central Bank are all central banks that function in the same broad manner.<sup>22</sup> A central bank is defined as the “[p]rincipal monetary authority of a nation,

---

18. *Frequently Asked Questions – Discount Window Lending Programs*, FED. RESERVE DISC. WINDOW, <http://www.frbdiscountwindow.org/dwfaqs.cfm?hdrID=14&dtlID=75> (last updated Aug. 10, 2010). See also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

19. *Frequently Asked Questions – Discount Window Lending Programs*, *supra* note 18.

20. See *infra* Part IV.A.

21. *Id.*

22. PURPOSES & FUNCTIONS, *supra* note 1.

which performs several key functions, including conducting monetary policy to stabilize the economy and level of prices.”<sup>23</sup> The need for a national central bank and unified monetary policy arose from the vulnerability of the nineteenth and early twentieth century United States’ banking system. In that period, the “failure of the [United States’] banking system to effectively provide funding to troubled depository institutions contributed significantly to the economy’s vulnerability to financial panics.”<sup>24</sup> The failure was caused by the unavailability of short-term credit from the government, which banks rely on when they have a series of unexpected withdrawals.<sup>25</sup>

*A. The Federal Reserve System – Central Bank of the United States of America*

The Central Bank of the United States is the Federal Reserve System,<sup>26</sup> which derives its legal authority from the Federal Reserve Act.<sup>27</sup> The Federal Reserve’s operational framework is described as being “independent within the government” because it is supervised by Congress but operated by presidentially-appointed and congressionally-approved economists.<sup>28</sup> The duties of the Federal Reserve fall into four general areas: conducting monetary policy with an eye toward “maximum employment, stable prices, and moderate long-term interest rates”; “supervising and regulating banking institutions”; ensuring the stability of the financial system and minimizing any risk in the financial markets; and “providing financial services to depository institutions” and governments.<sup>29</sup>

*B. The Bank of England – Central Bank of the United Kingdom*

The United Kingdom’s central bank is the Bank of England.<sup>30</sup> It “exists to ensure monetary stability and to contribute to financial stability.”<sup>31</sup> The Bank of England’s main monetary stability function is to

---

23. *Id.* at 109.

24. *Id.* at 1.

25. *Id.*

26. *Id.*

27. *Id.* at 2; Federal Reserve Act, 12 U.S.C. §§ 221-522 (2010); *see also Federal Reserve Act: Section 13*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., <http://www.federalreserve.gov/aboutthefed/section13.htm> (last updated Aug. 13, 2008) (Federal Reserve Act with the Federal Reserve’s non-United States Code numeration).

28. PURPOSES & FUNCTIONS, *supra* note 1, at 1.

29. *Id.*

30. BANK OF ENGLAND, <http://www.bankofengland.co.uk/index.htm> (last visited Nov. 22, 2010).

31. *Core Purposes*, BANK OF ENGLAND, <http://www.bankofengland.co.uk/about/corepurposes/index.htm> (last visited Nov. 22, 2010).

safeguard the value of its currency.<sup>32</sup> More relevant to this Note is the Bank of England's financial stability function. Specifically, the Bank of England is responsible for "ensuring the stability of the monetary system" and "overseeing financial system infrastructure."<sup>33</sup>

### C. *The European Central Bank – Central Bank of the European Union*

The European Union's central bank is the European Central Bank.<sup>34</sup> Legal authority for the European Central Bank stems from the Treaty Establishing the European Community and the Statute of the European System of Central Banks and the European Central Bank.<sup>35</sup> Like the Bank of England, the primary objective of the European Central Bank is "to maintain price stability."<sup>36</sup> The European Central Bank is also responsible for the implementation of monetary policy, smooth operation of payment systems, and financial stability and supervision.<sup>37</sup> The monetary policy task is most relevant to this Note and includes promoting price stability, fostering a high level of employment, and creating sustainable and non-inflationary growth.<sup>38</sup>

The European Central Bank is markedly different in structure than its counterparts in the United States and England due to its multinational jurisdiction.<sup>39</sup> The European Central Bank is part of the larger European System of Central Banks.<sup>40</sup> The European System of Central Banks consists of the European Central Bank and individual national central banks, regardless of whether they have adopted the euro.<sup>41</sup> The European

---

32. *Core Purposes - Monetary Stability*, BANK OF ENGLAND, [http://www.bankofengland.co.uk/about/corepurposes/monetary\\_stability.htm](http://www.bankofengland.co.uk/about/corepurposes/monetary_stability.htm) (last visited Nov. 22, 2010).

33. Bank of Eng., Memorandum of Understanding between HM Treasury, the Bank of England, and the Financial Services Authority, <http://www.bankofengland.co.uk/about/legislation/mou.pdf> (last visited Nov. 22, 2010).

34. *ECB, ESCB, and the Eurosystem*, EUR. CENT. BANK, <http://www.ecb.int/ecb/orga/escb/html/index.en.html> (last visited Nov. 22, 2010).

35. *Id.* See also Consolidated Version of the Treaty Establishing the European Union, Dec. 29, 2006, 2006 O.J. (C321) 1, [http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E\\_EN.pdf](http://eur-lex.europa.eu/en/treaties/dat/12002E/pdf/12002E_EN.pdf); Protocol (No. 4) on the Statute of the European System of Central Banks and of the European Central Bank, art. 14.3, May, 9, 2008, 2008 OJ (C 115) 230, [http://www.ecb.int/ecb/legal/pdf/en\\_statute\\_from\\_c\\_11520080509en02010328.pdf](http://www.ecb.int/ecb/legal/pdf/en_statute_from_c_11520080509en02010328.pdf) (unofficial consolidated version of the Statute of the European System of Central Banks and of the European Central Bank).

36. *Tasks*, EUR. CENT. BANK, <http://www.ecb.int/ecb/orga/tasks/html/index.en.html> (last visited Nov. 22, 2010).

37. *Id.*

38. *Objective of Monetary Policy*, EUR. CENT. BANK, <http://www.ecb.europa.eu/mopo/intro/objective/html/index.en.html> (last visited Nov. 22, 2010).

39. *ECB, ESCB, and the Eurosystem*, *supra* note 34.

40. *Id.*

41. *Id.*

Central Bank is also part of the Eurosystem, a governing body for individual national banks that have adopted the euro.<sup>42</sup>

Unlike the Federal Reserve and Bank of England, the European Central Bank does not act on its own accord when it conducts monetary policy operations.<sup>43</sup> Instead, each individual national bank in the European System of Central Banks carries out its monetary policy independent of the European Central Bank's directives.<sup>44</sup> However, banks within the Eurosystem must act in accordance with the guidelines set forth by the European Central Bank.<sup>45</sup> Therefore, the European Central Bank functions on two levels. First, it directs the monetary policy actions of central banks that are within the Eurosystem.<sup>46</sup> Second, it hopes to influence the monetary policy actions of central banks that are within the European System of Central Banks but are not within the Eurosystem.<sup>47</sup>

## II. THE LENDER OF LAST RESORT

On a basic level, central banks provide liquidity instead of capital to financial institutions.<sup>48</sup> Liquidity is the "ability to convert an asset to cash quickly."<sup>49</sup> In contrast, capital is simply "financial assets."<sup>50</sup> Therefore, by synthesizing the basic role of a central bank with the definitions of liquidity and capital, it follows that a central bank should facilitate actions, such as providing liquidity, that make it *easier* for a financial institution to function.<sup>51</sup> However, a central bank should *not* take actions that *enable* a financial institution to function, such as providing capital.<sup>52</sup>

To help achieve the goal of providing liquidity to financial institutions, all three central banks serve as the lender of last resort for financial institutions under their control.<sup>53</sup> The lender of last resort facility has two features that make it different from other central bank functions.<sup>54</sup>

---

42. *Id.*

43. Protocol (No. 4) on the Statute of the European System of Central Banks and of the European Central Bank, art. 12.1, May 9, 2008, 2008 OJ (C 115) 230, [http://www.ecb.int/ecb/legal/pdf/en\\_statute\\_from\\_c\\_11520080509en02010328.pdf](http://www.ecb.int/ecb/legal/pdf/en_statute_from_c_11520080509en02010328.pdf).

44. *Id.* art. 14.4.

45. *Id.* art. 14.3.

46. *Governing Council*, EUR. CENT. BANK, <http://www.ecb.int/ecb/orga/decisions/govc/html/index.en.html> (last visited Nov. 22, 2010).

47. *Id.*

48. Campbell & Lastra, *supra* note 2, at 457.

49. Definition of Liquidity, INVESTOPEDIA, <http://www.investopedia.com/terms/l/liquidity.asp> (last visited Nov. 22, 2010).

50. Definition of Capital, INVESTOPEDIA, <http://www.investopedia.com/terms/c/capital.asp> (last visited Nov. 22, 2010).

51. Campbell & Lastra, *supra* note 2, at 470.

52. *Id.*

53. *Id.* at 458-59.

54. *Id.* at 463-64.

First, the lender of last resort facility allows liquidity to flow almost immediately from a central bank in to a financial institution in need.<sup>55</sup> Second, most central banks have an unlimited amount of funds available to its lender of last resort facilities.<sup>56</sup>

#### A. Overview of Lender of Last Resort Theory

The lender of last resort facility has four pillars that central banks have historically used as a basis for lending to financial institutions.<sup>57</sup> Before the recent global financial crisis, central banks generally adhered to these four pillars when undertaking lender of last resort lending.<sup>58</sup> However, as the financial crisis worsened, central banks strayed from the four pillars.<sup>59</sup>

The first pillar is that assistance should be given to banks that are illiquid but *not* insolvent.<sup>60</sup> However, because illiquidity is a sign of possible insolvency, the distinction between the two may be difficult to discern.<sup>61</sup> The second pillar states that assistance should be given at a high rate of interest to compensate for the risk of lending to an illiquid institution.<sup>62</sup> In other words, because the central bank is the lender of last resort, a barrier in the form of a high or penalty-like interest rate should be established in order to prevent individual financial institutions from encountering any moral hazard problems.<sup>63</sup> Moral hazard, defined as the “incentive to take unusual risks,”<sup>64</sup> can arise due to the relative ease of access to emergency funds via the lender of last resort facility.<sup>65</sup> Third, assistance should be given to banks that can provide adequate and safe collateral.<sup>66</sup> Fourth, a central bank should disperse lender of last resort funds in a discretionary manner.<sup>67</sup>

A “widespread *reluctance* to allow banks to fail, even when clearly insolvent” has led central banks to stray from the four traditional pillars of lender of last resort lending.<sup>68</sup> This reluctance to allow failure may be

---

55. *Id.* at 463.

56. *Id.* at 464.

57. *Id.* at 465.

58. *Id.* at 466.

59. *See infra* Part IV.B.

60. Campbell & Lastra, *supra* note 2, at 465.

61. *See generally id.* at 467 (discussing Northern Rock’s turn from an illiquid to insolvent institution).

62. *Id.*

63. *Id.* at 465.

64. Definition of Moral Hazard, INVESTOPEDIA, <http://www.investopedia.com/terms/m/moralhazard.asp> (last visited Nov. 22, 2010).

65. Campbell & Lastra, *supra* note 2, at 465.

66. *Id.* at 465-66.

67. *Id.* at 466.

68. *Id.* at 466-67 (emphasis added).

attributed to the fact that central banks have weighed the “risk to contagion posed by a refusal to assist an insolvent bank” more heavily than the “effect on moral hazard that a bailout would create.”<sup>69</sup> Therefore, in an effort to deter widespread panic from the failure of a financial institution, central banks have violated the traditional lender of last resort pillars.<sup>70</sup>

Central banks, in their traditional lender of last resort (LOLR) role, can lend “against good collateral at a penalty rate” to an individual bank facing temporary liquidity problems, but that is otherwise regarded as solvent. The rationale would be that the failure of such a bank would lead to serious economic damage, including to the customers of the bank. The moral hazard of an increase in risk-taking resulting from the provision of LOLR lending is reduced by making liquidity available only at a penalty rate. . . . Because they are made to individual institutions, they are flexible with respect to type of collateral and term of the facility. LOLR operations remain in the [armory] of all central banks.<sup>71</sup>

The lender of last resort facility, due to its ability to provide immediate and unlimited liquidity, is an important aspect of a central bank’s operations during times of individual, national, or international crises.<sup>72</sup> In addition, the lender of last resort facility “functions as a safety valve . . . ; in circumstances where extensions of credit can help relieve liquidity strains in the banking system, the [lender of last resort] also helps to assure the basic stability of financial markets.”<sup>73</sup>

The ability of a central bank to rapidly respond to a crisis through its lender of last resort facility is crucial.<sup>74</sup> As demonstrated by the financial turmoil that began in 2007, financial crises can have broad economic effects.<sup>75</sup> Thus, immediate access to liquidity can be “very important for containing the spread of a financial crisis that can have significant

---

69. *Id.* at 467.

70. *See id.*

71. *Liquidity Support Facility for Northern Rock PLC*, BANK OF ENGLAND, (Sept. 14, 2007), <http://www.bankofengland.co.uk/publications/news/2007/090.htm> [hereinafter *Liquidity Support*].

72. Campbell & Lastra, *supra* note 2, at 467.

73. *Discount Window*, THE FED. RESERVE BANK OF MINNEAPOLIS, <http://www.minneapolisfed.org/banking/discount/> (last visited Nov. 22, 2010).

74. Eric Hughson & Marc Weidenmier, *Financial Markets and a Lender of Last Resort: Lessons from the Founding of the Federal Reserve*, VOX EU (Nov. 28, 2008), <http://www.voxeu.org/index.php?q=node/2625>.

75. *Id.* *See infra* Part IV.A.



macroeconomic effects.”<sup>76</sup>

*B. The Discount Window: The Lender of Last Resort in the Federal Reserve System*

In the Federal Reserve System, the lender of last resort facility is called the Discount Window.<sup>77</sup> “The Discount Window is the long-standing program through which the twelve Federal Reserve Banks make short-term loans (often overnight) to depository institutions, and it can serve as ‘an emergency, back-up source of liquidity’ for borrowing depository institutions that lack other options.”<sup>78</sup> Specifically, the Discount Window can be used to supply temporary funding to institutions experiencing significant financial difficulties if that institution’s collapse would have an adverse effect on the financial system.<sup>79</sup> In addition, the Discount Window may be used cautiously to help facilitate the “orderly resolution of a failing institution.”<sup>80</sup> These various uses have caused the Discount Window to be described as a “sort of soup kitchen for the waifs and strays of America’s banking world. When lenders are in dire straits and no one else will heed their cries for help, there’s always Uncle Sam, in the form of the . . . Discount Window, as a final port of call.”<sup>81</sup>

The Discount Window is also important to the United States because it helps control the federal funds rate.<sup>82</sup> The federal funds rate is the “[r]ate charged by a depository institution on an overnight loan of federal funds to another depository institution; [the] rate may vary from day to day and from bank to bank.”<sup>83</sup> Controlling the federal funds rate through the Discount Window is essential to the Federal Reserve because the “Federal Reserve implements monetary policy through its control over the federal funds rate.”<sup>84</sup>

To receive credit through the Discount Window, a bank must present sufficient collateral to the Federal Reserve.<sup>85</sup> Once sufficient collateral is presented, there are three types of credit available through the Discount

---

76. Hughson & Wedenmier, *supra* note 74.

77. Campbell & Lastra, *supra* note 2, at 491.

78. *Bloomberg L.P. v. Bd. of Governors of Fed. Reserve Sys.*, 601 F.3d 143, 146 n.1 (2d Cir. 2010), *petition for cert. filed*, 79 U.S.L.W. 3271 (U.S. Oct. 26, 2010) (No. 10-543).

79. PURPOSES & FUNCTIONS, *supra* note 1, at 46.

80. *Id.*

81. *30 Second Guides: Discount Window*, THIS IS MONEY, (Aug. 21, 2007, 12:00 AM), [http://www.thisismoney.co.uk/30-second-guides/article.html?in\\_article\\_id=423570&in\\_page\\_id=53611&ct=5](http://www.thisismoney.co.uk/30-second-guides/article.html?in_article_id=423570&in_page_id=53611&ct=5).

82. PURPOSES & FUNCTIONS, *supra* note 1, at 45.

83. *Id.* at 114.

84. *Id.* at 3.

85. *Id.* at 50.

Window.<sup>86</sup> The first type of credit is primary credit.<sup>87</sup> Primary credit is generally available to financially sound financial institutions on an overnight basis.<sup>88</sup> Primary credit is a back-up source of funding for banks in occasional need of temporary liquidity.<sup>89</sup> Therefore, as a penalty for using the Discount Window, the primary credit rate is typically 100 basis points (one percent) above the target federal funds rate and is commonly called the discount rate.<sup>90</sup>

Secondary credit is available to institutions ineligible for primary credit.<sup>91</sup> These institutions are typically less financially sound than institutions that are able to take advantage of primary credit.<sup>92</sup> Therefore, the interest rate associated with secondary credit is 150 basis points above the target federal funds rate.<sup>93</sup>

Finally, the Federal Reserve also offers seasonal credit through the Discount Window.<sup>94</sup> Seasonal credit is available to small firms that experience "significant seasonal swings in their loans and deposits."<sup>95</sup> Generally speaking, banks in agricultural and tourist areas qualify for seasonal credit.<sup>96</sup> Therefore, unlike Discount Window lending using primary or secondary credit, seasonal credit is not used by institutions facing financial difficulties.<sup>97</sup>

### *C. The Sterling Monetary Framework: The Lender of Last Resort in the Bank of England*

The Bank of England recently established the Sterling Monetary Framework as its lender of last resort facility.<sup>98</sup> In 2008, the Sterling Monetary Framework replaced the Bank of England's Standing Facilities, which "allowed banks to borrow [an] unlimited amount from the Bank of England at any time."<sup>99</sup> The Bank of England developed the Sterling Monetary Framework because it believed the August 2007 Northern Rock crisis stigmatized the Standing Facilities.<sup>100</sup> The Sterling Monetary Framework consists of two parts: the Operational Standing Facility and the

---

86. *Id.* at 46.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 48.

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.* at 49.

97. *Id.*

98. Campbell & Lastra, *supra* note 2, at 484-85.

99. *Id.* at 484.

100. *Id.* See *infra* Part IV.A.

Discount Window Facility.<sup>101</sup>

The Operational Standing Facility is an overnight lending facility for firms facing a temporary shortage in cash.<sup>102</sup> The purpose of Operational Standing Facilities is to give banks a way “to manage unexpected (frictional) payment shocks.”<sup>103</sup> Operational Standing Facilities are composed of two parts: a depositing facility and a lending facility.<sup>104</sup> Important to this Note is the lending facility, which enables a bank to borrow overnight funds from the Bank of England against sufficient collateral for a penalty rate of seventy-five basis points.<sup>105</sup> Financial institutions that need longer-term help use the Discount Window Facility instead of the Operational Standing Lending Facility.<sup>106</sup>

“The purpose of the [Discount Window Facility] is to provide liquidity insurance to the banking system. The Discount Window Facility is not intended for firms facing fundamental problems of solvency or viability.”<sup>107</sup> Therefore, the Bank of England’s Discount Window Facility was not designed to be used by institutions in need of a government bailout to continue operations even though it has a longer-term lending period than the Operational Standing Facility.<sup>108</sup>

Borrowers from the Discount Window Facility are required to borrow funds for either 30 days or 364 days.<sup>109</sup> The penalty rate for Discount Window Facility lending is generally based on the type of collateral that a financial institution is able to provide.<sup>110</sup> Therefore, the penalty lending rate is lower if a bank is able to provide high quality collateral.<sup>111</sup> If high quality collateral is provided, the Discount Window Facility minimum

---

101. *Sterling Monetary Framework*, BANK OF ENGLAND, <http://www.bankofengland.co.uk/markets/money/index.htm> (last visited Nov. 22, 2010).

102. See BANK OF ENG., DOCUMENTATION FOR THE BANK OF ENGLAND’S OPERATIONS UNDER THE STERLING MONETARY FRAMEWORK (June 15, 2010), available at <http://www.bankofengland.co.uk/markets/money/documentation/100615operating.pdf> (discussing in detail the purpose and operational intricacies of the Discount Window Facility and the Operational Standing Facilities).

103. *Sterling Monetary Framework: Operational Standing Facilities*, BANK OF ENGLAND, <http://www.bankofengland.co.uk/markets/money/osf/index.htm> (last visited Nov. 22, 2010) [hereinafter *Operational Standing Facilities*].

104. *Id.*

105. *Id.*

106. See generally, *Sterling Monetary Framework: Discount Window Facility*, BANK OF ENGLAND, <http://www.bankofengland.co.uk/markets/money/dwf/index.htm> (last visited Nov. 22, 2010) [hereinafter *Discount Window Facility*].

107. *Id.*

108. See *id.*

109. *Id.*

110. See BANK OF ENGLAND, BANK OF ENGLAND CONSOLIDATED MARKET NOTICE: DISCOUNT: WINDOW FACILITY 5 (Mar. 29, 2010), available at <http://www.bankofengland.co.uk/markets/marketnotice100326dwfcon.pdf>.

111. See *id.*

penalty rate is only fifty basis points.<sup>112</sup>

*D. The Marginal Lending Facility: The Lender of Last Resort in the European Central Bank*

The European Central Bank's lender of last resort facility is the marginal lending facility.<sup>113</sup> The marginal lending facility helps financial institutions "obtain overnight liquidity from the central bank, against the presentation of sufficient eligible assets."<sup>114</sup> The marginal lending facility, like the Bank of England's Operational Standing Facilities, consists of both a depository facility and a marginal lending facility.<sup>115</sup> To receive funds through the marginal lending facility, a financial institution must present sufficient collateral.<sup>116</sup> Once the institution has presented sufficient collateral, it can receive funds at a penalty rate of 175 basis points.<sup>117</sup>

Financial institutions within the European System of Central Banks and the Eurosystem face a different set of hurdles when going to European Central Bank for lender of last resort funds. Since the European Central Bank is not a national central bank, it cannot extend long-term credit through its marginal lending facility.<sup>118</sup> However, the European Central Bank is able to provide direct temporary liquidity assistance to member banks.<sup>119</sup> Thus, it must rely on national central banks within the European System of Central Banks and Eurosystem to make long-term, but not short-term, lender of last resort decisions regarding institutions in their respective countries.<sup>120</sup>

### III. VIEWS ON CENTRAL BANK TRANSPARENCY

*A. Historical Aversion to Central Bank Transparency*

Historically, most central banks were strong advocates of central bank secrecy.<sup>121</sup> "The historical reluctance of central banks to become open and transparent is well known. Many journalists, academics, and Members of

112. *Id.*

113. *Discount Windows*, BANK IMPLODE-O-METER (Jan. 21, 2008, 09:52 AM), <http://bankimplode.com/blog/2008/01/21/european-central-bank-discount-window/>.

114. *Standing Facilities*, EUR.CENT. BANK, <http://www.ecb.int/mopo/implement/sf/html/index.en.html> (last visited Nov. 22, 2010).

115. *Id.*

116. *Id.* (click on the "Data" tab).

117. *Id.*

118. Campbell & Lastra, *supra* note 2, at 464.

119. *Id.*

120. *Id.* See also *supra* Part I.C. (discussing the European Central Bank's legal framework).

121. JOINT ECON. COMM., 106TH CONG., TRANSPARENCY AND FEDERAL RESERVE MONETARY POLICY (1999), available at <http://www.house.gov/jec/fed/fed/transpar.pdf>.

Congress have recognized that secrecy and ambiguity are part of the culture of central banks.<sup>122</sup> One of the strongest arguments for central bank secrecy was that decisions regarding monetary policy were too complex for the uneducated individual to understand.<sup>123</sup> Central bankers reasoned it was better to keep laypersons in the dark about central bank operations in order to prevent market panic.<sup>124</sup>

The Federal Reserve has been a particularly strong proponent of central bank secrecy.<sup>125</sup> The Federal Reserve “explicitly defended secrecy [and] opposed full disclosure . . . . The argument has been that fuller disclosure would promote unnecessary volatility in financial markets . . . and interfere with the execution of monetary policy.”<sup>126</sup> Even in recent years, the Federal Reserve was somewhat secretive, as evidenced by carefully guarded statements from former Federal Reserve Chairman Alan Greenspan.<sup>127</sup> “Americans had grown used to the cryptic statements of Mr. Greenspan in his day and the merest pause or grumble would be solemnly interpreted by semi-professional Greenspan-watchers for the rest of us waiting with bated breath.”<sup>128</sup>

Another argument in favor of central bank secrecy was that the central bank serves as the lender of last resort.<sup>129</sup> “Part of the responsibility of the [lender of last resort] was to maintain public confidence in the banking system while at the same time protecting the proprietary information of troubled banks. This function contributed to the culture of central bank secrecy which [arguably] continues to this day.”<sup>130</sup> This secrecy was deemed necessary due to the potential harm a financial institution may face if its proprietary data were misinterpreted by members of the public as a result of a lender of last resort usage disclosure.

More fundamentally, historical central bank opposition to transparency seemingly relates to a distrust of market mechanisms stemming from the original lender-of-last-resort function of central banks . . . . The original lender-of-last-resort (LOLR) function of central banks was premised on a belief in the inability of market mechanisms to prevent contagious bank runs causing contractions of the

---

122. *Id.* at 3.

123. *See id.* at 2-3.

124. *See id.* at 3.

125. *Id.*

126. *Id.*

127. Lune, *Central Bank Transparency: Good or Bad?*, NAKED CAPITALISM (Aug. 1 2008, 9:52 PM), <http://www.nakedcapitalism.com/2008/08/central-bank-transparency-good-or-bad.html> [hereinafter *Central Bank Transparency*].

128. *Id.*

129. JOINT ECON. COMM., *supra* note 121, at 3.

130. *Id.* at 3 n.7.

money supply and economic activity. Earlier provision[s] of LOLR services involved the use of the Discount Window which necessarily involved proprietary information about individual bank loans and the individual portfolios of banks.<sup>131</sup>

Therefore, central banks were extremely unwilling to give out any kind of data about the financial institutions which used their lender of last resort facilities.<sup>132</sup>

### *B. Recent Increases in Central Bank Transparency*

The cloud of secrecy surrounding central banks began to lift recently. "In the span of fifteen years, central bank transparency . . . is now an accepted broad goal to which all central banks pay at least lip service."<sup>133</sup> Central bank secrecy has decreased, in part, because "many central banks have become remarkably more transparent by placing much greater weight on their communication."<sup>134</sup> Central bank communication increased as a response to the increased risk central banks faced as financial markets and instruments grew more complex.<sup>135</sup>

In recent years, however, the regulatory system not only failed to manage risk, it also failed to require disclosure of risk through sufficient transparency. American financial markets are profoundly dependent upon transparency. After all, the fundamental risk/reward corollary depends on the ability of market participants to have confidence in their ability to accurately judge risk.<sup>136</sup>

Increased central bank transparency reflects the efficient market hypothesis, which is the idea that market participants will make the best decision if they have all available market, or in this case, central bank

---

131. *Id.* at 3.

132. *See id.*

133. ADAM S. POSEN, INST. FOR INT'L ECON., SIX PRACTICAL VIEWS OF CENTRAL BANK TRANSPARENCY 1 (2002), available at <http://www.iie.com/publications/papers/posen0502.pdf>.

134. Alan S. Blinder et al., *What We Know and What We Would Like to Know About Central Bank Communication*, VOX EU (May 15, 2008), <http://www.voxeu.org/index.php?q=node/1143>.

135. CONG. OVERSIGHT PANEL, SPECIAL REPORT ON REGULATORY REFORM (Jan. 2009), available at <http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf>.

136. *Id.* at 3.

information.<sup>137</sup> In accordance with the efficient market hypothesis, increased transparency is generally a positive and necessary component of the market.<sup>138</sup> Moreover, secrecy is against the principles of the efficient market hypothesis and therefore should be avoided under efficient market hypothesis ideology.<sup>139</sup> “Today’s changing financial environment demands more transparent Federal Reserve monetary policy. Such transparency would help establish understandable rules and procedures, eliminate unnecessary market uncertainties and volatility, and to minimize the costs of anti-inflation monetary policy.”<sup>140</sup>

“Transparent monetary policy is characterized by openness and a lack of secrecy and ambiguity. Transparency is multi-dimensional and includes the clarification of policy goals, of policy procedures, and the timeliness in reporting policy decisions.”<sup>141</sup> There are many advantages to having a transparent monetary policy.<sup>142</sup> “It can work to (1) clarify policy objectives, (2) improve the workings of financial markets, (3) enhance central bank credibility, (4) reduce the chances of monetary policies manipulation for political purposes, (5) foster better monetary policymaking, and (6) complement congressional monetary policy oversight responsibilities.”<sup>143</sup> A simplified view of the benefits of increased central bank transparency is that “greater transparency is beneficial, improving democratic accountability by making it easier to judge whether a central bank is committed to its announced policy and improving policy effectiveness by facilitating the interpretation of policy changes.”<sup>144</sup> In addition, there is some empirical data suggesting that increased central bank transparency leads to real-world benefits.<sup>145</sup>

### C. Criticism of Increased Central Bank Transparency

The increase in central bank transparency is not without criticism. One view is that “transparency should not be seen as good for whatever ails

---

137. Definition of Efficient Market Hypotheses (EMH), INVESTOPEDIA <http://www.investopedia.com/terms/e/efficientmarkethypothesis.asp> (last visited Nov. 22, 2010).

138. See JOINT ECON. COMM., *supra* note 121, at 4-8.

139. Definition of Efficient Market Hypotheses (EMH), *supra* note 137.

140. JOINT ECON. COMM., *supra* note 121, at 1.

141. *Id.* at 9.

142. *Id.*

143. *Id.*

144. Ellen E. Meade & David Stasavage, *The Dangers of Increased Transparency in Monetary Policymaking*, VOX EU (June 26, 2008), <http://www.voxeu.org/index.php?q=node/1271>.

145. Christopher Crowe & Ellen E. Meade, *Central Bank Independence and Transparency: Not Just Cheap Talk*, VOX EU (July 31, 2008), <http://www.voxeu.org/index.php?q=node/1489> (“[G]reater transparency is associated with more accurate private sector forecasts.”).

central banks.”<sup>146</sup> Another view is that central bank transparency undermines the political independence of most major central banks.<sup>147</sup> However, most empirical evidence is in contrast with the decreased political independence criticism.<sup>148</sup> One report shows that “[t]ransparency tends to be beneficial when information asymmetries are themselves the cause of inefficiencies in the economy but can be costly in a second-best environment where the central bank is able to offset other inefficiencies by exploiting its informational advantage.”<sup>149</sup> Skepticism of increased central bank transparency also stems from the idea that increased transparency may show a lack of accountability in central banks.<sup>150</sup> An oft-cited benefit of central bank transparency is that increased transparency leads to increased accountability.<sup>151</sup> Thus, when a central bank is more transparent, it should have less room to take unpopular courses of action or go against its own word.<sup>152</sup> However, a transparent central bank can inadvertently show a lack of accountability by not following its published policy objectives.<sup>153</sup>

Finally, the increase in central bank transparency may lead to concessionary behaviors by members of a central bank’s board.<sup>154</sup> “[G]reater transparency of central bank policymaking – in which committee deliberations are made more open to the public – may prevent the full and frank discussion needed to make the best decisions.”<sup>155</sup> For example, after Congress ordered the Federal Reserve to publish verbatim transcripts of its Federal Open Market Committee (FOMC) meetings, most FOMC members were reluctant to say what they were truly thinking for fear of public repercussion.<sup>156</sup> “While before 1993, FOMC discussions were [characterized] by frequent ‘off the cuff’ remarks and interruptions, since 1993 there has been an increase in prepared statements that may result in less real deliberation.”<sup>157</sup> However, current Federal Reserve Chairman Ben Bernanke prefers that members of the Federal Reserve Board of Governors voice their disagreements through published meeting notes.<sup>158</sup>

---

146. POSEN, *supra* note 133, at 19.

147. *Id.* at 3.

148. *Id.* at 22.

149. Crowe & Meade, *supra* note 145.

150. POSEN, *supra* note 133, at 20-21.

151. *Id.* at 3.

152. *Id.* at 20-21.

153. *Id.*

154. Meade & Stasavage, *supra* note 144.

155. *Id.* Generally, this concern is nothing new; James Madison believed the secrecy surrounding the Constitutional Convention of 1787 was one of the major reasons for its success. *Id.*

156. *Id.*

157. *Id.*

158. *Central Bank Transparency*, *supra* note 127.



#### D. Increased Transparency and the Lender of Last Resort

Most historical increases in central bank transparency dealt with macroeconomic monetary policy, not with the lender of last resort function.<sup>159</sup> However, increased transparency regarding the lender of last resort is prevalent within the Bank of England.<sup>160</sup> Sir Edward George, former Governor of the Bank of England, wrote that the disclosure of lender of last resort usage should be kept secret until the risk of market volatility passes.<sup>161</sup> To this end, the Bank of England has statutorily mandated the disclosure of the aggregate usage of the Operational Lending Facility only after an appropriate time period has passed.<sup>162</sup> However, this disclosure does not require Discount Window Facility disclosure and does not require disclosure of the names and financial details of individual institutions receiving funds through either facility.<sup>163</sup>

The Dodd-Frank Wall Street Reform and Consumer Protection Act has done the most to increase central bank transparency in the United States' Federal Reserve System.<sup>164</sup> It provides, among other reform measures, that the Federal Reserve will disclose certain details about *all* Discount Window lending with a maximum of a two year lag.<sup>165</sup> However, this increase in central bank transparency may be too great of an increase and could cause harm to financial institutions in the United States.<sup>166</sup>

#### IV. LENDER OF LAST RESORT AND THE RECENT FINANCIAL CRISIS

The recent global financial crisis has been characterized by some economists as the worst financial crisis since the Great Depression of the 1930s.<sup>167</sup> Federal Reserve Chairman Ben Bernanke said that the "current crisis has been one of the most difficult financial and economic episodes in modern history."<sup>168</sup> While the financial crisis has affected virtually all

---

159. Blinder et al., *supra* note 134.

160. Campbell & Lastra, *supra* note 2, at 487.

161. *Id.*

162. *Id.* at 484-85.

163. *Id.*

164. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

165. *Id.*

166. *See infra* Part V.

167. Cambridge Energy Research Assocs. & IHS Global Insight, Press Release, *Three Top Economists Agree 2009 Worst Financial Crisis Since Great Depression; Risks Increase If Right Steps Are Not Taken*, REUTERS, (Feb. 27, 2009, 10:22 AM), <http://www.reuters.com/article/pressRelease/idUS193520+27-Feb-2009+BW20090227>.

168. Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys., Address at Morehouse College, Atlanta, Georgia: Four Questions About the Financial Crisis (Apr. 14, 2009), in *2009 Speeches*, BD. GOVERNORS FED. RES. SYS., <http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm> (last updated Apr. 14, 2009).

global economies, most analysts who studied the economic crisis agree that it began with the subprime mortgage crisis in the United States, which began showing its severity in 2007.<sup>169</sup>

#### A. Events Contributing to the Financial Crisis

The subprime mortgage crisis was a “financial crisis that arose in the mortgage market after a sharp increase in mortgage foreclosures, mainly subprime, collapsed numerous mortgage lenders and hedge funds.”<sup>170</sup> A subprime mortgage is a “type of mortgage that is normally made out to borrowers with lower credit ratings.”<sup>171</sup> In turn, banks typically charge a higher rate of interest to subprime borrowers in order to compensate for their increased risk of default.<sup>172</sup> In the early twenty-first century, lending to subprime borrowers presented few problems because interest rates were kept very low by the Federal Reserve in an effort to resuscitate the United States economy after both the September 11, 2001, tragedy and the burst of the technology bubble.<sup>173</sup> Interest rates remained low through 2004, hovering around one percent.<sup>174</sup> However, as interest rates jumped from 1% in 2004 to 5.35% in 2006, many subprime borrowers could not afford the higher interest payments and defaulted on their mortgages.<sup>175</sup> Between February and March 2007, twenty-five subprime lenders declared bankruptcy.<sup>176</sup>

The effect of the subprime mortgage defaults went beyond the subprime lenders.<sup>177</sup> Many subprime lenders sold their subprime mortgages to banks and other investors in bundles called Collateralized Debt Obligations (CDOs).<sup>178</sup> Because subprime borrowers were defaulting on

---

169. See MAURO F. GUILLÉN, THE GLOBAL ECONOMIC & FINANCIAL CRISIS: A TIMELINE 1, available at <http://lauder.wharton.upenn.edu/pdf/Chronology%20Economic%20%20Financial%20Crisis.pdf> (last visited Nov. 22, 2010); INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK: CRISIS AND RECOVERY 2 (Apr. 2009), available at <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/text.pdf>; *Timeline: Credit Crunch to Downturn*, BBC NEWS, (Aug. 7, 2009, 9:54 AM), <http://news.bbc.co.uk/2/hi/7521250.stm> [hereinafter *Credit Crunch to Downturn*]; *Timeline: Global Economy in Crisis*, COUNCIL ON FOREIGN RELATIONS, <http://www.cfr.org/publication/18709/> (last visited Nov. 22, 2010) (click on Meltdown (2007-Present) tab, navigate to February 2007 slide using previous and/or next buttons) [hereinafter *Global Economy in Crisis*].

170. Definition of Subprime Meltdown, INVESTOPEDIA, <http://www.investopedia.com/terms/s/subprime-meltdown.asp> (last visited Nov. 22, 2010).

171. Definition of Subprime Mortgage, INVESTOPEDIA, [http://www.investopedia.com/terms/s/subprime\\_mortgage.asp](http://www.investopedia.com/terms/s/subprime_mortgage.asp) (last visited Nov. 22, 2010).

172. *Id.*

173. Definition of Subprime Meltdown, *supra* note 170.

174. *Credit Crunch to Downturn*, *supra* note 169.

175. *Id.*

176. *Global Economy in Crisis*, *supra* note 169.

177. *Credit Crunch to Downturn*, *supra* note 169, at interactive slide 1 of 10.

178. *Id.*

their mortgages, the subprime mortgages that comprised the CDOs stopped receiving payments from borrowers.<sup>179</sup> When payments were not being made by the borrowers, CDO investors also stopped receiving payment.<sup>180</sup> The severity of the crisis became clear in July and August 2007 when investment banks Bear Stearns and BNP Paribas informed investors they would receive little, if any, money from their CDO-backed investment funds.<sup>181</sup>

Additionally, banks are required to keep a minimum amount of capital on hand and will normally loan capital amounts in excess of the minimum to banks in need of capital via the interbank loan market.<sup>182</sup> As worries began to surface about the amount of subprime investments banks held and the potential for losses from such investments, the interbank loan markets in both New York and London began to dry up.<sup>183</sup> For example, in September 2007, the London Interbank Offered Rate (LIBOR) went higher than the penalty rate the Bank of England charged to a bank wishing to use its lender of last resort facility.<sup>184</sup>

The equivalent of LIBOR in the United States is the Federal Funds Rate.<sup>185</sup> Even though the New York-based Federal Open Market Committee sets *targets* for the Federal Funds Rate, the rate, like LIBOR, is ultimately decided by the market.<sup>186</sup> In late 2007, both LIBOR and the Federal Funds Rate were very high, indicating that “banks [were] reluctant to lend money to each other.”<sup>187</sup> This reluctance arose because “banks [did] not want to lend out their spare liquidity because there [was] uncertainty - both about whether the bank will need the cash itself in coming months, and about the financial health of the borrowing bank.”<sup>188</sup>

One of the most dramatic examples of the liquidity freeze in the interbank loan market was the collapse of Northern Rock Bank.<sup>189</sup> Northern Rock was the United Kingdom’s fifth largest mortgage lender in 2006 following a period of rapid expansion.<sup>190</sup> This expansion was largely the result of Northern Rock’s decision to abandon the traditional method of

---

179. *Id.*

180. *Id.*

181. GUILLÉN, *supra* note 169, at 1.

182. Definition of Interbank Rate, INVESTOPEDIA, <http://www.investopedia.com/terms/i/interbankrate.asp> (last visited Nov. 22, 2010).

183. Campbell & Lastra, *supra* note 2, at 461.

184. *Credit Woes Hit Bank Lending Rate*, BBC NEWS, (Sept. 4, 2007, 12:13 PM), <http://news.bbc.co.uk/2/hi/business/6977798.stm>.

185. Definition of Federal Funds Rate, INVESTOPEDIA, <http://www.investopedia.com/terms/f/federalfundrate.asp> (last visited Nov. 22, 2010).

186. *Id.*

187. *Credit Woes Hit Bank Lending Rate*, *supra* note 184.

188. *Id.*

189. Campbell & Lastra, *supra* note 2, at 473-74.

190. *Id.* at 474.

mortgage funding of using depositors' funds for mortgage lending while keeping enough money in reserve to withstand any withdrawals.<sup>191</sup> Only twenty-five percent of Northern Rock's mortgage funding came from its deposits.<sup>192</sup> Instead, Northern Rock elected to raise money for lending directly from the money markets through the securitization of its loan portfolio.<sup>193</sup> Securitization is the "process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors."<sup>194</sup> However, when the credit markets lost their liquidity, Northern Rock encountered major funding issues.<sup>195</sup> On August 10, 2007, Northern Rock realized that it needed three billion dollars in immediate funding; however, the bank was unable to get such funds in the regular interbank markets.<sup>196</sup> Ultimately, the Bank of England decided that it would lend to Northern Rock through a special liquidity support facility.<sup>197</sup>

Despite the Bank of England's efforts to keep news of its lending to Northern Rock secret, the information leaked and caused a bank run,<sup>198</sup> which further chilled the credit markets.<sup>199</sup> "The fact that Northern Rock was receiving financial support sparked public" panic and began a "dramatic" bank run.<sup>200</sup> Live news coverage of the "lengthy lines at some Northern Rock branches" took over all of the United Kingdom's television channels and was shown in the United States as well.<sup>201</sup> What resulted was the biggest run on a British bank in more than a century as customers withdrew money until the government intervened and guaranteed depositors' savings.<sup>202</sup>

Despite the turmoil in 2007, the "global economy bent but did not buckle."<sup>203</sup> However, in early 2008, financial market troubles continued with the decline of United States investment banking firm Bear Stearns.<sup>204</sup> Bear Stearns faced severe liquidity problems in March 2008, a time at which it was Wall Street's fifth-largest investment bank.<sup>205</sup> Bear Stearns was so intertwined in the financial markets that investors feared the collapse

---

191. *Id.*

192. *Id.*

193. *Id.*

194. Definition of Securitization, INVESTOPEDIA, <http://www.investopedia.com/terms/s/securitization.asp> (last visited Nov. 22, 2010).

195. Campbell & Lastra, *supra* note 2, at 475.

196. *Id.*

197. *Liquidity Support*, *supra* note 71.

198. Campbell & Lastra, *supra* note 2, at 476-77.

199. *Id.* at 477.

200. *Id.* at 476.

201. *Id.*

202. GUILLÉN, *supra* note 169, at 2.

203. INT'L MONETARY FUND, *supra* note 169, at 2.

204. *Credit Woes Hit Bank Lending Rate*, *supra* note 184.

205. *Id.*

of Bear Stearns would “spark a collapse of the financial sector.”<sup>206</sup> Bear Stearns, whose stock traded for \$172 per share in late 2007 and early 2008, was ultimately bought by JPMorgan Chase for \$10 per share in a sale backed by the United States government through the Discount Window.<sup>207</sup> “The collapse and sale of one of the most iconic institutions on Wall Street spark[ed] broad fears about the future of the financial sector.”<sup>208</sup> Ultimately, the collapse of Bear Stearns was just the first in a series of financial institution failures. For example, in July 2008, Fannie Mae and Freddie Mac, the United States’ two largest lenders, were given assistance, but not a bailout, by the United States government over fears that they were no longer liquid.<sup>209</sup>

However, in September 2008, the financial crisis began to show its true severity.<sup>210</sup> “The [financial] situation deteriorated rapidly after the dramatic blowout of the financial crisis in September 2008.”<sup>211</sup> The severity of the situation was especially noticeable in the largest economies. “In the advanced economies, fears about growing losses on U.S.-related assets at major European banks caused wholesale markets to freeze in September 2008, with a number of failing banks requiring state intervention.”<sup>212</sup> Alan Greenspan, Ben Bernanke’s predecessor as Chairman of the Board of Governors of the Federal Reserve System, said the entire situation was “probably a once in a century type of event.”<sup>213</sup>

In September 2008, Fannie Mae and Freddie Mac, two institutions that received earlier government assistance, were completely bailed out by the United States government.<sup>214</sup> Additionally, Lehman Brothers, another Wall Street investment bank, filed for Chapter 11 bankruptcy protection in September 2008, becoming the first major United States investment bank to do so.<sup>215</sup> Furthermore, American International Group (AIG), the largest insurer in the United States, received a large bailout from the United States government in September 2008.<sup>216</sup> Finally, federal regulators closed Washington Mutual, a commercial bank, in September 2008 in what was the largest bank failure in United States history.<sup>217</sup>

The financial contagion was not limited to the United States.<sup>218</sup> For

---

206. *Global Economy in Crisis*, *supra* note 169.

207. *Id.*

208. *Id.*

209. *Credit Crunch to Downturn*, *supra* note 169.

210. INT’L MONETARY FUND, *supra* note 169, at 75.

211. *Id.* at 2.

212. *Id.*

213. *Credit Crunch to Downturn*, *supra* note 169.

214. *Id.*

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

example, in the United Kingdom, Lloyds TSB, a commercial bank, took over HBOS, Britain's then-largest lender.<sup>219</sup> In addition, European insurance and banking giant Fortis was nationalized to ensure that it could continue its operations.<sup>220</sup>

Finally, the large increase in the extension of credit by commercial banks to less than creditworthy individuals and entities also contributed to the financial crisis.<sup>221</sup> "Aspects of this broader credit boom included widespread declines in underwriting standards, breakdowns in lending oversight by investors and rating agencies, increased reliance on complex and opaque credit instruments that proved fragile under stress, and unusually low compensation for risk-taking."<sup>222</sup> "These events prompted a huge increase in perceived counterparty risk as banks faced large write-downs, the solvency of many of the most established financial names came into question, the demand for liquidity jumped to new heights, and market volatility surged once more."<sup>223</sup>

### *B. Central Bank Response to the Financial Crisis*

The financial crisis showed that banks were unwilling to lend, even to other banks, no matter how much of their own money was available.<sup>224</sup> For example, the European Central Bank's deposit facility saw increased usage during the financial crisis as banks "saved up" their liquidity instead of lending to other banks.<sup>225</sup> Therefore, to combat the liquidity freeze, most central banks expanded their traditional lender of last resort roles.<sup>226</sup> Lender of last resort expansion was accomplished by conducting financial operations that were larger than usual or different from their regular schedule.<sup>227</sup> For example, central banks tried to keep markets liquid by ensuring there was adequate overnight funding through their short-term

---

219. *Id.*

220. *Id.*

221. Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys., Address at the Stamp Lecture, London School of Economics, London, England: The Crisis and the Policy Response (January 13, 2009), in *Speeches 2009*, BD. OF GOVERNORS FED. RES. SYS., <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm> (last updated Jan. 13, 2009) [hereinafter Bernanke, *Crisis and Response*].

222. *Id.*

223. INT'L MONETARY FUND, *supra* note 169, at 2.

224. Emese Bartha, *ECB Deposit Facility Use Heavy, Rising*, DOW JONES NEWS WIRES, (Oct. 16, 2008, 7:54 AM), <http://www.fxstreet.com/news/forex-news/article.aspx?StoryId=7a610916-a198-4175-9d99-fa9cf7a5977b>.

225. *Id.*

226. COMM. ON THE GLOBAL FIN. SYSTEM, BANK FOR INT'L SETTLEMENTS, CGFS PAPERS NO. 31, CENTRAL BANK OPERATIONS IN RESPONSE TO THE FINANCIAL TURMOIL 5 (2008), available at <http://www.bis.org/publ/cgfs31.pdf> [hereinafter CGFS PAPERS NO. 31].

227. *Id.*

lender of last resort facilities.<sup>228</sup>

Specifically, the Federal Reserve undertook significant actions to combat the financial crisis.<sup>229</sup> When the crisis first began, the Federal Reserve cut the discount rate, the rate the Federal Reserve uses to lend to depository institutions at the Discount Window.<sup>230</sup> The Federal Reserve also cut the Federal Funds Rate,<sup>231</sup> which is the “[r]ate charged by a depository institution on an overnight loan of federal funds to another depository institution.”<sup>232</sup> Federal Reserve Chairman Ben Bernanke stated that in “historical comparison, this policy response stands out as exceptionally rapid and proactive.”<sup>233</sup> The Federal Reserve’s actions during the financial crisis were classified as actions to ease United States’ monetary policy.<sup>234</sup> By easing the monetary policy, the Federal Reserve made it more attractive, in theory, for borrowers to get money by pushing the interbank interest rate lower.<sup>235</sup>

The Federal Reserve also took steps to restore the credit markets to functionality and provide liquidity to the private sector.<sup>236</sup> In doing so, the Federal Reserve “deployed a number of additional policy tools, some of which were previously in [their] toolkit and some of which ha[d] been created as the need arose.”<sup>237</sup> One tool that the Federal Reserve used, like all central banks, was increased communication with the markets about its expectations of market conditions during the financial crisis.<sup>238</sup> In addition to traditional policy tools, the Federal Reserve began using an “extraordinary” set of tools.<sup>239</sup>

Over the course of the crisis, the [Federal Reserve] has taken a number of extraordinary actions to ensure that financial institutions have adequate access to short-term credit. These actions include creating new facilities for auctioning credit and making primary securities dealers, as well as banks, eligible to borrow at the [Federal Reserve's]

---

228. *Id.* at 6.

229. See Campbell & Lastra, *supra* note 2, at 490.

230. Bernanke, *Crisis and Response*, *supra* note 221.

231. *Id.*

232. PURPOSES & FUNCTIONS, *supra* note 1, at 114.

233. Bernanke, *Crisis and Response*, *supra* note 221.

234. *Id.*

235. Definition of Loose Credit, INVESTOPEDIA, [http://www.investopedia.com/terms/l/loose\\_credit.asp](http://www.investopedia.com/terms/l/loose_credit.asp) (last visited Nov. 22, 2010).

236. Bernanke, *Crisis and Response*, *supra* note 221.

237. *Id.*

238. *Id.* See *supra* Part III.B. (discussing the increased use of communication to help ease central bank secrecy); see also CGFS PAPERS NO. 31, *supra* note 226, at 22-40 (providing an in-depth analysis of specific actions each central bank took from August 2007-June 2008).

239. Bernanke, *Crisis and Response*, *supra* note 221.

Discount Window. [The Federal Reserve] lowered the spread between the discount rate and the federal funds rate target . . . ; increased the term of Discount Window loans from overnight to 90 days; created the Term Auction Facility, which auctions credit to depository institutions for terms up to three months; put into place the Term Securities Lending Facility, which allows primary dealers to borrow Treasury securities from the [Federal Reserve] against less-liquid collateral; and initiated the Primary Dealer Credit Facility as a source of liquidity for those firms, among other actions.<sup>240</sup>

In explaining the risk involved with these extraordinary actions, Federal Reserve officials stated that the “the provision of credit to financial institutions exposes the Federal Reserve to only minimal credit risk; the loans that we make to banks and primary dealers through our various facilities are generally overcollateralized and made with recourse to the borrowing firm.”<sup>241</sup> An overcollateralized loan is a loan where more collateral than what would normally be necessary is given to the bank in order to fund the loan.<sup>242</sup> A loan made with recourse simply means that the lender, in this case the Federal Reserve, has the right to collect on the collateral.<sup>243</sup> Therefore, the “Federal Reserve has never suffered any losses in the course of its normal lending to banks.”<sup>244</sup>

The Federal Reserve also created new lending programs that were designed to serve another classic central bank purpose as “liquidity provider of last resort.”<sup>245</sup> These actions included providing liquidity for both the commercial paper and money market mutual funds markets.<sup>246</sup> The Federal Reserve purchased, and thus removed from the market, longer-term securities in exchange for more liquid, shorter-term assets that went to the market in order to help keep money in the financial market flowing.<sup>247</sup> Additionally, the Federal Reserve created various special purpose vehicles called Maiden Lane I, II, and III.<sup>248</sup> These Maiden Lane transactions created limited liability companies that the Federal Reserve used to

---

240. *Id.*

241. *Id.*

242. Definition of Overcollateralization – OC, INVESTOPEDIA, <http://www.investopedia.com/terms/o/overcollateralization.asp> (last visited Nov. 22, 2010).

243. Definition of Recourse, INVESTOPEDIA, <http://www.investopedia.com/terms/r/recourse.asp> (last visited Nov. 22, 2010).

244. Bernanke, *Crisis and Response*, *supra* note 221.

245. *Id.*

246. *Id.*

247. *Id.*

248. *Maiden Lane Transactions*, FED. RES. BANK OF N.Y., <http://www.newyorkfed.org/markets/maidenlane.html> (last visited Nov. 22 2010).



facilitate the buyout of Bear Stearns and the bailout of AIG.<sup>249</sup> No matter which new lending program was used, the Federal Reserve ended up lending or purchasing securities.<sup>250</sup>

While the sheer volume of the Federal Reserve's actions made them unusual, if not extraordinary, the fact that the Federal Reserve began lending to non-depository institutions was perhaps even more extraordinary.<sup>251</sup> Until early 2008, the Federal Reserve was restricted to lending to depository institutions.<sup>252</sup> In order to give assistance to non-depository institutions, the Federal Reserve invoked Section 13.3 of the Federal Reserve Act.<sup>253</sup> Section 13.3 provides the following:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System . . . may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.<sup>254</sup>

The financial crisis was the “first time since the 1930s that the [Federal Reserve] used this provision.”<sup>255</sup> Section 13.3 of the Federal Reserve Act enabled the Federal Reserve to undertake extraordinary and unusual central bank actions such as bailing out AIG, Bear Stearns, and others.<sup>256</sup>

The Bank of England also took many steps to ensure liquidity and to act as a lender of last resort.<sup>257</sup> One of the first steps it took was lending

---

249. *Id.*

250. Bernanke, *Crisis and Response*, *supra* note 221.

251. Campbell & Lastra, *supra* note 2, at 491.

252. *Id.* at 492.

253. *Id.* See also Federal Reserve Act, 12 U.S.C. § 343 (2010).

254. 12 U.S.C. § 343 (2010).

255. Campbell & Lastra, *supra* note 2, at 492.

256. *Id.* at 492-94.

257. *Id.*

emergency liquidity assistance funds to Northern Rock.<sup>258</sup> While this eventually helped end the bank run on Northern Rock,<sup>259</sup> it likely led to the stigmatization of the Bank of England's lender of last resort facilities, which in turn led to the creation of the Sterling Monetary Framework in October 2008.<sup>260</sup> The Bank of England took other steps to help ease the financial crisis, including lowering interest rates, allowing banks to swap risky mortgages for safer government bonds, and injecting money into the markets.<sup>261</sup>

The European Central Bank also took steps to ensure that its marginal lending facility was widely available for use in order to help facilitate the flow of liquidity.<sup>262</sup> Such actions included changing the interest rate of its overnight loans and fine-tuning overnight loan operations in order to ease money flow, refinancing longer-term loans, performing various reserve management operations, and participating with foreign central banks in coordinated liquidity-easing ventures.<sup>263</sup>

### C. Current State of Reform and Increased Transparency

Opposition to increased activity by the United States' Federal Reserve was used to push for proposals to limit the power of the Federal Reserve.<sup>264</sup> One such proposal, which was never passed, was the Federal Reserve Transparency Act of 2009.<sup>265</sup> Other pushes for global financial reform came at worldwide conferences, such as the 2009 G-20 summit in Pittsburgh, Pennsylvania and the 2010 World Economic Forum in Davos, Switzerland.<sup>266</sup>

In the United States, the passage of the Dodd-Frank Wall Street

---

258. *Id.* at 476-77.

259. *Id.* at 477.

260. *Id.* at 484.

261. *Credit Crunch to Downturn*, *supra* note 169.

262. See CGFS PAPERS NO. 31, *supra* note 226, at 22-40 (providing an in-depth analysis of specific actions each central bank took from August 2007 to June 2008).

263. *Id.*

264. Sudeep Reddy, *Bernanke Foes Seek to Curtail Fed*, WALL ST. J., Dec. 16, 2009, at A4, available at [http://online.wsj.com/article/SB126091294891892399.html?mod=WSJ\\_hpp\\_MIDDLENexttoWhatsNewsTop#articleTabs%3Darticle](http://online.wsj.com/article/SB126091294891892399.html?mod=WSJ_hpp_MIDDLENexttoWhatsNewsTop#articleTabs%3Darticle).

265. Federal Reserve Transparency Act of 2009, H.R. 1207, 111th Cong. (2009).

266. See Bob Davis & Stephen Fidler, *Nations Ready Big Changes to Global Economic Policy*, WALL ST. J., Sept. 22, 2009, at A1, available at <http://online.wsj.com/article/SB125348959155226421.html> (stating that financial sector overhaul was a key issue at the 2009 Group of Twenty (G-20) meeting in Pittsburgh, Pennsylvania); Marcus Walker & Emma Moody, *At Davos, Bankers Are on the Run*, WALL ST. J., Jan. 29, 2010, available at <http://online.wsj.com/article/SB10001424052748704343104575033373335750804.html> (stating that financial reform was broadly discussed at the early 2010 World Economic Forum).

Reform and Consumer Protection Act initiated financial sector reform.<sup>267</sup> As previously stated, the Act, with regard to Discount Window lending disclosure, requires the Federal Reserve to disclose the “name and identifying details of the depository institution; [t]he amount borrowed by the depository institution; [t]he interest rate paid by the depository institution; and [i]nformation identifying the types and amounts of collateral pledged in connection with any [D]iscount [W]indow loan.”<sup>268</sup> This mandatory disclosure must occur within two years of the initial Discount Window lending date for the primary, secondary, and seasonal lending programs.<sup>269</sup> Early disclosure is permissible if certain criteria are met.<sup>270</sup>

In addition, a United States District Court ordered the Federal Reserve to disclose records related to the use of various government lending facilities, including its lender of last resort facility.<sup>271</sup> This case, *Bloomberg L.P. v. Bd. of Governors of Fed. Reserve Sys.*, arose from a Freedom of Information Act request by Bloomberg.<sup>272</sup> Bloomberg “sought (in relevant part) detail[s] about loans that the twelve Federal Reserve Banks made to private banks in April and May 2008 at the Discount Window and pursuant to ad hoc emergency lending programs.”<sup>273</sup> The details Bloomberg specifically wanted, “loan by loan, [were] the name of the borrowing bank, the amount of the loan, the origination and maturity dates, and the collateral given.”<sup>274</sup> The document request was filed under the Freedom of Information Act, which “obliges federal agencies to make government documents available to the public, subject to various exemptions.”<sup>275</sup>

The Federal Reserve fought against disclosure of such information.<sup>276</sup> “Lawyers for the Federal Reserve Board argued . . . that the [Federal Reserve] wasn’t required to make public information about individual banks borrowing from its Discount Window and other last-resort lending programs.”<sup>277</sup> Specifically, the Federal Reserve’s lawyers argued that

---

267. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

268. *Frequently Asked Questions - Discount Window Lending Programs*, *supra* note 18. See also Dodd-Frank Wall Street Reform and Consumer Protection Act, 124 Stat. 1376.

269. *Frequently Asked Questions- Discount Window Lending Programs*, *supra* note 18.

270. *Id.*

271. *Bloomberg L.P. v. Bd. of Governors of Fed. Reserve Sys.*, 649 F.Supp.2d 262 (S.D.N.Y. 2009), *aff’d*, 601 F.3d 143 (2d Cir. 2010), *petition for cert. filed*, 79 U.S.L.W. 3271 (U.S. Oct. 26, 2010) (No. 10-543).

272. *Bloomberg*, 601 F.3d at 145.

273. *Id.* (parenthesis in original).

274. *Id.* at 145-46.

275. Jonathan Stempel, *Federal Reserve Loses Suit Demanding Transparency*, REUTERS, (Aug. 24, 2009, 8:39 PM), <http://www.reuters.com/article/businessNews/idUSTRE57003P20090825>.

276. Chad Bray, *Fed Resists Identifying Loan Users*, WALL ST. J., Jan. 12, 2010, available at <http://online.wsj.com/article/SB126325700903725517.html>.

277. *Id.*

“banks would be less likely to use the Discount Window, which provides short-term loans to banks, or other last-resort lending programs if they knew their usage would be made public. Accessing the window carries a negative connotation, even when a healthy bank suffering a short-term liquidity issue does it.”<sup>278</sup> However, because this case dealt with a Freedom of Information Act request, the district court found that Federal Reserve board had not shown that competitive harm was imminent by disclosing such records and ordered such records disclosed.<sup>279</sup>

The Second Circuit’s decision to affirm the district court’s opinion in *Bloomberg* drew sharp criticism from economists, with one stating that the “Federal Reserve might be facing the irrelevancy of one of its key emergency lending tools.”<sup>280</sup> Even though the Court based its decision on the statutory mandate of the Freedom of Information Act,<sup>281</sup> “many economists agree with the [Federal Reserve’s] view” that “the Discount Window would simply go untapped” if disclosure of its users was required.<sup>282</sup>

## V. RECOMMENDATIONS

The proliferation of central bank activity, particularly in the Federal Reserve’s expanded scope of operations under Section 13.3, has not been without criticism. This criticism has been shown through opposition to Ben Bernanke’s eventual reconfirmation as Chairman of the Board of Governors of the Federal Reserve.<sup>283</sup> In addition, some observers opined that “[i]f we are going to have a [Federal Reserve] and a political class as reckless as we have, then we need a more comprehensive answer to financial risk.”<sup>284</sup> Similarly, former United States President George W. Bush warned that increased government intervention, such as increased Federal Reserve actions in financial markets, will lead the economy away from free-market principles.<sup>285</sup>

---

278. *Id.*

279. *Bloomberg L.P v. Bd. of Governors of Fed. Reserve Sys.*, 649 F.Supp.2d 262, 280 (S.D.N.Y. 2009), *aff’d*, 601 F.3d 143 (2d Cir. 2010), *petition for cert. filed*, 79 U.S.L.W. 3271 (U.S. Oct. 26, 2010) (No. 10-543).

280. Michael S. Derby, *Discount-Window Future Darkens After Court Move*, WALL ST. J. REAL TIME ECON. BLOG (Mar. 19, 2010, 3:45 PM), <http://blogs.wsj.com/economics/2010/03/19/discount-window-future-darkens-after-court-move/>.

281. *Bloomberg*, 601 F.3d at 151.

282. Derby, *supra* note 280.

283. Op-Ed., *The Bernanke Record*, WALL ST. J., Dec. 4, 2009, at 10, available at <http://online.wsj.com/article/SB10001424052748704107104574572160340353006.html>.

284. Op-Ed., *Obama v. Wall Street*, WALL ST. J., Jan. 22, 2010, at A18, available at <http://online.wsj.com/article/SB10001424052748703699204575017341468635052.html>.

285. *Bush Warns of 'Temptation' to Abandon Free-Market System in Wake of Recession*, FOXNEWS.COM, (Nov. 13, 2009), <http://www.foxnews.com/politics/2009/11/12/bush-warns-temptation-abandon-free-market-wake-recession/?test=economy>.

However, Federal Reserve Chairman Ben Bernanke has vigorously defended the Federal Reserve against such criticism:

In its making of monetary policy, the [Federal Reserve] is highly transparent, providing detailed minutes of policy meetings and regular testimony before Congress, among other information. Our financial statements are public and audited by an outside accounting firm; we publish our balance sheet weekly; and we provide monthly reports with extensive information on all the temporary lending facilities developed during the crisis. Congress, through the Government Accountability Office, can and does audit all parts of our operations except for the monetary policy deliberations and actions covered by the 1978 exemption. The general repeal of that exemption would serve only to increase the perceived influence of Congress on monetary policy decisions, which would undermine the confidence the public and the markets have in the [Federal Reserve] to act in the long-term economic interest of the nation.<sup>286</sup>

At first glance, the Federal Reserve appears to be in a contradictory position. The Federal Reserve believes transparency is a vital part of the modern economy.<sup>287</sup> However, the Federal Reserve advocates for secrecy when it feels that it is in the best interest of the market to do so.<sup>288</sup> Central bank transparency, in general, has helped the financial markets become more efficient by helping market participants make more informed decisions.<sup>289</sup> However, as the Northern Rock disclosure shows, there is the possibility that the market can receive too much information, or at least too much information at an improper time, causing market panic.<sup>290</sup>

According to the Bank of International Settlements, a “standing lending facility is a widely adopted central bank instrument for providing liquidity insurance against frictional problems in payment systems and overnight money markets. However, in the United States . . . the effectiveness of this instrument has been limited by banks’ unwillingness to use it.”<sup>291</sup> The Bank of International Settlements stated that this unwillingness to use the lender of last resort facility is because of the stigma

---

286. Ben Bernanke, Op-Ed., *The Right Reform for the Fed*, WASH. POST, Nov. 29, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/11/27/AR2009112702322.html>.

287. *Id.*

288. *See id.*

289. *See supra* Part III.B. (discussing increased central bank transparency).

290. *See supra* Part IV.A. (discussing how an accidental disclosure created a bank run and slowed liquidity in credit markets).

291. CGFS PAPERS NO. 31, *supra* note 226, at 20.

associated with using the lender of last resort facility.<sup>292</sup> “While stigma is most often associated with lending related to emergency liquidity assistance, it can also affect lending for more benign purposes . . . particularly when financial turmoil [generally] raises doubts about the soundness of financial institutions.”<sup>293</sup>

Currently, the Federal Reserve’s lending occurs through the Discount Window.<sup>294</sup> Therefore, a bank going to the Federal Reserve for overnight funds, or primary credit, receives money from the same facility as a bank needing serious financial assistance, or secondary credit.<sup>295</sup> Without knowing the details of each transaction, there is no way for an outside observer to know which type of credit a bank is receiving. The identification of all Discount Window borrowers, as currently required by the Dodd-Frank Wall Street Reform and Consumer Protection Act,<sup>296</sup> would likely create unwillingness by financial institutions needing primary credit to use the Federal Reserve’s Discount Window since it is used for both primary and secondary credit lending.<sup>297</sup>

In order to increase the usage of the Federal Reserve’s Discount Window and conform to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the structure of the Discount Window should be altered so that there are two separate lending programs which are similar to the Bank of England’s Operational Standing Facility and Discount Window Facility.<sup>298</sup> One of the two proposed lending programs would involve the use of the Federal Reserve as a backstop to the interbank lending market.<sup>299</sup> The Bank of England’s Operational Standing Facility provides a model as a backstop to the interbank lending market because its main purpose is to help banks in times of unexpected payment shock.<sup>300</sup> This would be a benign or safe lending program since it would involve banks with a financially sound balance sheet. This lending program would ensure that commercial banks have immediate access to liquidity, even when there was “unexpected friction” in the market.<sup>301</sup>

In order to keep stigma away from this program, disclosure of financial institutions using the benign program would not be allowed. Non-

---

292. *Id.*

293. *Id.*

294. *See supra* Part II.B.

295. *Id.*

296. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

297. Bray, *supra* note 276.

298. *See supra* Part II.C. (detailing the Bank of England’s current lender of last resort structure).

299. *See supra* Part II.C. (discussing the Bank of England’s current lender of last resort facilities).

300. *See supra* Part II.C.

301. *Operational Standing Facilities, supra* note 103.

disclosure for overnight lending should increase the willingness of financial institutions to use this new facility and thus, reduce any possibility for stigma to exist.<sup>302</sup> Instead of full disclosure, as currently mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Federal Reserve should only report aggregate statistics of usage, interest income generated, and losses. Disclosure of the names or financial details of users of this program should never be disclosed. Since institutions using this facility would be financially sound, there should be no worry from taxpayers or government officials that funds were being used unwisely. “If anonymity is not well preserved . . . then there is a greater risk that borrowing from standing facilities would be regarded as a sign of borrower weakness. When this occurs, the effectiveness of these facilities as a liquidity backstop is severely impaired.”<sup>303</sup>

The second lending program, much like the Bank of England’s Discount Window Facility, would be established to help banks acquire liquidity, but not capital, if they were in dire financial straits.<sup>304</sup> Due to the increased risk of this secondary lending program, the Federal Reserve should require prospective borrowers to post more collateral than necessary in order to protect the taxpayers from unnecessary loss. Additionally, like the Discount Window Facility, this program should require loan terms of 30 or 364 days in order to ensure that these riskier institutions do not rush loan repayment and end up with the same sort of risk that forced the institution to initially seek government assistance. Since these transactions are likely to be smaller in number but greater in scope than the transactions of the benign program, secrecy should be maintained, but only for as long as necessary. Disclosure should occur after the Federal Reserve determines that the market and the institution receiving funds could adequately handle disclosure without subsequent panic, or after two years, whichever occurs first.<sup>305</sup> This disclosure requirement falls in line with the current requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.<sup>306</sup>

In times of financial crisis, this long-term lending program for risky institutions could be used in combination with Section 13.3 of the Federal Reserve Act to create innovative financial solutions to combat any future crises. The creative aspect of Section 13.3 was used in the current financial crisis with great success:

Mr. Bernanke's [Federal Reserve] found new ways to pump

---

302. CGFS PAPERS NO. 31, *supra* note 226, at 20.

303. *Id.*

304. *See supra* Part II.C. (discussing the Bank of England’s Discount Window Facility).

305. *See supra* Part II.C.

306. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

liquidity into the credit markets that were on the verge of a total freeze-up. This could only have happened because of the [Federal Reserve's] independence, experience in and understanding of the financial world, and its wide-ranging authority. No one could respond better than the [Federal Reserve] if the next crisis is anywhere near as severe as the last one.<sup>307</sup>

Therefore, this long-term lending program, in conjunction with the broad power of Section 13.3, would help the Federal Reserve act in an aggressive manner to control any subsequent financial crisis. For example, the Maiden Lane special purpose vehicles would receive their funding through the secondary lending program.

Provided that central banks make smart loans, even in a lender of last resort situation, increased central bank lending and activity in the market can be beneficial both to the market and to the central bank. The Federal Reserve saw "record profits in 2009 as its holdings of Treasury [bonds], mortgage-backed securities[,] and agency debt grew."<sup>308</sup> In 2009, profits at the Federal Reserve increased forty-seven percent from 2008.<sup>309</sup> "The windfall came as the [Federal Reserve's] balance sheet ballooned to more than \$2.2 trillion and the [Federal Reserve] acquired billions of dollars in securities through unusual asset-purchase programs aimed at spurring economic growth."<sup>310</sup> Finally, "[o]f the 2009 earnings, \$46.1 billion was generated through open-market operations and \$5.5 billion was generated by [the Maiden Lane vehicles] it created as part of the Bear Stearns, AIG and other rescue operations."<sup>311</sup> If the Federal Reserve continues to make such loans to stressed corporations, it could end up making money that can be deposited in the United States Treasury, and as a result, save taxpayer money.

The Bank of England's lender of last resort facilities provide a real-life model for the Federal Reserve, and other similarly situated central banks, to follow in order to protect both taxpayers, through increased disclosure, and lender of last resort users, through non-disclosure of safe lending programs. In addition, the Bank of England's Sterling Monetary Framework proves that stigma can be eliminated in lender of last resort

---

307. Mortimer Zuckerman, Op-Ed., *Finding the Right Fix for 'Too Big to Fail'*, WALL ST. J., Nov. 25, 2009, available at <http://online.wsj.com/article/SB10001424052748704888404574550570805868530.html>.

308. Meena Thiruvengadam, *Fed Profits Set Record Last Year*, WALL ST. J., Jan. 14, 2010, at A7, available at [http://online.wsj.com/article/SB126333721463026795.html?mod=WSJ\\_WSJ\\_US\\_News\\_5](http://online.wsj.com/article/SB126333721463026795.html?mod=WSJ_WSJ_US_News_5).

309. *Id.*

310. *Id.*

311. *Id.*



facilities.<sup>312</sup> In November 2009, the Bank of England disclosed emergency liquidity assistance it provided to Royal Bank of Scotland (RBS) and HBOS, two United Kingdom banks.<sup>313</sup> While there has been some backlash and controversy surrounding the terms of the assistance given to the banks, there was not any apparent negative connotation associated with the banks for receiving the liquidity assistance or a run on either bank.<sup>314</sup> The lack of market reaction to this disclosure proves that the Bank of England's model has eliminated some stigma associated with the use a central bank's lender of last resort facilities. Therefore, the United States' Federal Reserve should follow the same model.

### CONCLUSION

When used properly, secrecy can be beneficial for a central bank in its lender of last resort operations. Individual institutions that experience financial friction value secrecy more than institutions that experience financial turmoil.<sup>315</sup> In this context, secrecy enables a central bank to ensure that financially sound banking institutions will not encounter unnecessary stress or negative publicity for using a central bank's lender of last resort facility.<sup>316</sup> This lack of negative publicity, in turn, keeps liquidity flowing through the interbank loan market, which is an important aspect to stability in the financial markets as a whole.<sup>317</sup>

A central bank should be able to provide long-term support as needed to banks, and at appropriate times, non-banks.<sup>318</sup> Such lending, however, is risky and akin to the Federal Reserve's secondary credit program or the Bank of England's Discount Window Facility.<sup>319</sup> Therefore, in order to help paint a more accurate picture of a central bank's balance sheet and risks, a central bank should disclose the names of risky firms to which it gives liquidity assistance only after a reasonable amount of time has passed, such as the timeframe required by the Dodd-Frank Wall Street Reform and

---

312. BANK OF ENG., ADDITIONAL INFORMATION PROVIDED TO THE TREASURY COMMITTEE BY THE BANK OF ENGLAND 1 (Nov. 24, 2009), available at <http://www.bankofengland.co.uk/publications/other/treasurycommittee/financialstability/ela091124.pdf>.

313. *Id.*

314. Louise Armitstead, *PAC Slams Treasury Over Bank Rescues During Financial Crisis*, TELEGRAPH, Feb. 9, 2010, available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/7191148/PAC-slams-Treasury-over-bank-rescues-during-financial-crisis.html>.

315. Bray, *supra* note 276.

316. *Id.*

317. *See supra* Part IV.A. (discussing events leading to the recent financial crisis including the freezing of liquidity in the interbank loan market).

318. *See supra* Part IV.B. (discussing central bank activities during the recent financial crisis including extending loans to various insurance companies).

319. *See supra* Part II.B-C. (discussing the Federal Reserve's and Bank of England's lender of last resort facilities).

Consumer Protection Act.<sup>320</sup> Using the Dodd-Frank standard enables a central bank to balance the needs of secrecy in the financial markets with the need for transparency and openness of central bank operations.<sup>321</sup> The Bank of England's current lender of last resort facilities provide an example for the Federal Reserve and other similarly situated central banks to follow.

Therefore, the Federal Reserve should follow the Bank of England's lender of last resort model and create two lender of last resort facilities: one for relatively safe overnight loans and one for institutions in need of long-term assistance. Additionally, the new overnight program should deviate from the current disclosure requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Disclosure should not occur for the overnight facility but should occur for the long-term facility after the risk of market panic has passed. Having two lender of last resort programs would help strike a balance between transparency and secrecy and help eliminate the stigma associated with the Federal Reserve's lender of last resort operations.

The creation of two lender of last resort programs with different disclosure requirements fits within Federal Reserve Chairman Ben Bernanke's desire to "ensure that any disclosure of emergency borrowing, via the Discount Window or through another program, isn't interpreted to reflect poorly on the current state of the bank that drew the credit."<sup>322</sup> A long-term lender of last resort facility with mandatory disclosure provides financial market participants and taxpayers with an accurate assessment of the risky financial institutions using such government facilities. Perhaps more importantly, the elimination of stigma through the non-disclosure of financial institutions using a newly-created overnight lender of last resort facility should keep liquidity flowing in the credit markets and prevent a financial crisis similar to the recent, and crippling, financial crisis.

---

320. See *supra* Part III.B. (discussing the benefits of increased central bank transparency); see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

321. See *supra* Part II.B.

322. Derby, *supra* note 280.