

## The AIG Bailout: Constraining the Fed's Discretion

### I. INTRODUCTION

The Federal Reserve System (the Fed) was established in 1913, emerging from the ashes of the banking panic of 1907.<sup>1</sup> Though the Fed's powers were relatively weak at its inception,<sup>2</sup> periods of economic crisis have resulted in an expansion of power through legislative reform leading to the strong central bank we know today.<sup>3</sup> The bailout of insurance giant American International Group (AIG) provides a recent example of the Fed's ability to flex the regulatory muscle developed over the past ninety-six years.<sup>4</sup>

This Note will analyze the development of the Fed's power during the recent financial crisis, with a particular focus on its decision to bailout AIG using its emergency powers and the implications of these actions. Though the powers the Fed relied upon are statutorily permissible and desirable in many cases, the lack of accountability and transparency in exercising those powers due to their discretionary nature is troubling.<sup>5</sup> Part II will give a brief history of the controversial development of the central bank.<sup>6</sup> Part III will detail the Fed's structure and the emergency powers used to implement the AIG bailout.<sup>7</sup> Part IV will analyze some of the reasons the financial industry, and AIG in particular, suffered such a devastating collapse and the actions taken by the Fed to mitigate the damage.<sup>8</sup> Part V will describe the potential

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1. Steven R. Blau, *The Federal Reserve and European Central Bank as Lenders-of-Last Resort: Different Needles in Their Compasses*, 21 N.Y. INT'L L. REV. 39, 46 (2008).

2. See David Fetting, *Lender of More Than Last Resort*, 2002 REGION 15, 15-16, available at <http://www.minneapolisfed.org/pubs/region/02-12/lender.pdf>; Thomas O. Porter, II, Comment, *The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers*, 13 N.C. BANKING INST. 483, 484-85 (2009).

3. See Blau, *supra* note 1, at 46-48; Porter, *supra* note 2, at 485.

4. See *infra* pp. 337-47.

5. See *infra* pp. 347-58.

6. See *infra* Part II, pp. 336-37.

7. See *infra* Part III, pp. 337-41.

8. See *infra* Part IV, pp. 341-47.

consequences of the actions taken by the Fed.<sup>9</sup> Finally, Part VI will analyze the implications of having a strong central bank that is able to act quickly and discretely, but with little oversight or transparency and discuss recent proposals to modify the Fed's power.<sup>10</sup>

## II. A BRIEF HISTORY OF THE CENTRAL BANK

The idea of a central bank, though now largely accepted, was extremely controversial during its early stages of development.<sup>11</sup> This controversy is best demonstrated by the battle between Thomas Jefferson, who strongly opposed the idea of a central bank, fearing “concentrated economic power[,]” and Alexander Hamilton, who strongly supported a central bank modeled after the Bank of England to facilitate efficient commerce.<sup>12</sup> Hamilton initially won the battle with the establishment of the first Bank of the United States (BUS) in 1792.<sup>13</sup> Though the central bank's twenty-year charter was not renewed during Jefferson's term as President,<sup>14</sup> Congress chartered the second BUS in 1816,<sup>15</sup> which functioned as a clearinghouse and exercised limited regulatory powers over the banking industry.<sup>16</sup> The second BUS met its demise in 1836 during the Jackson administration because he feared that a private banking institution was subject to corruption and could not be controlled.<sup>17</sup>

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9. See *infra* Part V, pp. 347-50.

10. See *infra* Part VI, pp. 350-58.

11. See generally, John Steele Gordon, *A Short Banking History of the United States*, WALL ST. J., Oct. 10, 2008, at A17, available at <http://online.wsj.com/article/SB122360636585322023.html> (describing the early history and establishment of central banking in the United States).

12. *Id.*

13. *Id.*

14. See *id.*; The Federal Reserve Bank of Minneapolis, *A History of Central Banking in the United States*, [http://www.minneapolisfed.org/community\\_education/student/centralbankhistory/bank.cfm](http://www.minneapolisfed.org/community_education/student/centralbankhistory/bank.cfm) [hereinafter *History of Central Banking*] (Last visited Feb. 6, 2010).

15. Gordon, *supra* note 11.

16. *History of Central Banking*, *supra* note 14.

17. *Id.*

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The Federal Reserve Act of 1913 created the Fed in response to the banking panic of 1907, when an individual person, J.P. Morgan, served as a lender of last resort.<sup>18</sup> Congress created the Fed in an effort to develop an organization to regulate the economy and act as a lender of last resort to faltering banks.<sup>19</sup> Though its goals have remained constant, the Fed has experienced a number of reforms since its inception.<sup>20</sup>

### III. THE STRUCTURE AND POWERS OF THE FEDERAL RESERVE

#### A.     *Basic Structure of the Federal Reserve*

Congress designed the Fed “to give it a broad perspective on the economy and on economic activity in all parts of the nation.”<sup>21</sup> To inform the exercise of this authority, the Fed has four primary goals that have remained substantially the same: (1) conducting monetary policy to maintain desirable employment levels and to prevent inflation; (2) supervising and regulating banking institutions; (3) ensuring financial market stability posed by systematic risk; and (4) providing depository institutions and the US government with financial services.<sup>22</sup>

The Board of Governors enjoys broad powers to supervise member banks, fashion monetary policy, implement consumer protection regulations, and oversee bank holding companies and their non-banking subsidiaries.<sup>23</sup> It is required to make an annual report to the Speaker of the House of Representatives,<sup>24</sup> but

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18. See MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867-1960*, at 156-168 (Princeton Univ. Press 1993) (1971).

19. Murray N. Rothbard, *The Origins of the Federal Reserve*, Q. J. AUSTRIAN ECON., Fall 1999, at 39 (1999).

20. See BD. OF GOVERNORS OF THE FED. RESERVE SYS., *THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 1-2* (9th ed. 2005), available at [http://www.federalreserve.gov/pf/pdf/pf\\_complete.pdf](http://www.federalreserve.gov/pf/pdf/pf_complete.pdf) [hereinafter *PURPOSES & FUNCTIONS*] (listing major legislative changes that occurred in 1935, 1946, 1956, 1970, 1977, 1978, 1980, 1989, 1991, and 1999).

21. *Id.* at 3.

22. *See id.* at 1.

23. 12 U.S.C. § 248 (2006); *see also* *PURPOSES & FUNCTIONS*, *supra* note 20, at 4 (summarizing these regulatory powers).

24. 12 U.S.C. § 247 (2006); *see also* 12 U.S.C. § 250 (2006) (limiting the executive branch's power to compel testimony).

otherwise the Fed enjoys relative independence because its actions do not have to be ratified by the President.<sup>25</sup>

The Board of Governors and the twelve Regional Federal Reserve Banks share responsibility for regulating and supervising the banking industry.<sup>26</sup> The Regional Reserve Banks are responsible for “operating a nationwide payments system,<sup>[27]</sup> distributing the nation’s currency and coin, supervising and regulating member banks and bank holding companies,<sup>[28]</sup> and serving as banker for the U.S. Treasury.”<sup>29</sup> Each Reserve Bank is subject to supervision by the Board of Governors and must submit its budget for an annual independent audit.<sup>30</sup> The Reserve Banks conduct the day-to-day operations of the Federal Reserve System and the functions of a central bank.<sup>31</sup>

*B. Tools of the Federal Reserve*

The Fed has four primary tools to conduct monetary policy and stabilize the financial industry. These tools include open market operations,<sup>32</sup> adjusting the reserve requirement,<sup>33</sup> requiring contractual clearing balances,<sup>34</sup> and use of the discount window<sup>35</sup> to facilitate direct lending by the Fed to other institutions.<sup>36</sup> These tools are utilized primarily to adjust the federal funds rate, the

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25. PURPOSES & FUNCTIONS, *supra* note 20, at 2-3.

26. *Id.* at 3.

27. The US government charged the Fed with the operation of a payment system, which facilitates quick and efficient check clearing through the implementation of a nationwide check-clearing system. PURPOSES & FUNCTIONS, *supra* note 20, at 6, 83.

28. Generally speaking, a bank holding company is any company that directly or indirectly controls one or more banks. See 12 U.S.C. § 1841(a) (2006).

29. PURPOSES & FUNCTIONS, *supra* note 20, at 6.

30. 12 U.S.C. § 248(a); PURPOSES & FUNCTIONS, *supra* note 20, at 10-11.

31. See PURPOSES & FUNCTIONS, *supra* note 20, at 10-11.

32. Open market operations allow the Fed to control the federal funds rate through the purchase and sale of U.S. Treasury securities. See *id.* at 37-38.

33. The reserve requirement is the percentage of deposits a bank must hold against its liabilities or maintain as a non-interest bearing account at their regional reserve bank. The Fed uses this control to increase or decrease demand for federal funds. *Id.* at 41-42.

34. Contractual clearing balances are funds that banks agree to hold in excess of the reserve requirement in order to protect against unexpected debits in relation to check clearing. *Id.* at 31.

35. *Id.* at 3.

36. *Id.* at 45.

interest rate at which member banks loan excess funds on deposit at their Reserve Bank accounts to each other, by influencing the supply and demand of available funds.<sup>37</sup> Traditionally, open market operations, conducted by the Federal Open Market Committee, have been the primary tool used by the Fed in order to conduct monetary policy.<sup>38</sup> The most important tool used during the recent financial crisis, however, was lending through the discount window which hit a record high during the crisis.<sup>39</sup>

C.        *The Discount Window*

The Fed identifies multiple purposes for the discount window. First, the discount window can be used to control the federal funds rate less drastically than with open market operations.<sup>40</sup> On a daily basis, the Fed controls the supply of funds through the discount window, thus influencing the federal funds rate.<sup>41</sup> Second, the discount window can provide liquidity for institutions that fall short of their required reserves.<sup>42</sup> This is especially important in times of economic or political crisis, when a depository institution is struggling and needs increased liquidity in order to avoid collapse.<sup>43</sup> During the recent financial crisis, discount window lending reached unprecedented levels as institutions needed increased liquidity.<sup>44</sup> Even non-depository institutions such as Bear Sterns and AIG made use of the discount window, though they are not depository institutions to which the Fed would ordinarily have the power to extend discount loans.<sup>45</sup>

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37. PURPOSES & FUNCTIONS, *supra* note 20, at 2-3.

38. Blau, *supra* note 1, at 47.

39. See Meena Thiruvengadam, *Investment Bank Borrowing at Discount Window Hits Record*, WALL ST. J., Sept. 26, 2008, <http://online.wsj.com/article/SB122237806611776365.html> (discussing the use of the discount window during the crisis); cf. Porter, *supra* note 2, at 507 (discussing discount window operations during the last century).

40. See PURPOSES & FUNCTIONS, *supra* note 20, at 45.

41. See *id.*

42. *Id.*

43. See *id.* at 45-46 (mentioning operating problems, natural disaster, and a terrorist attack).

44. Thiruvengadam, *supra* note 39.

45. See 12 U.S.C. § 343 (2006); Thiruvengadam, *supra* note 39.

The Regional Reserve Banks may extend loans to depository institutions through the discount window.<sup>46</sup> They can do this in two different ways. First, they can “discount” assets presented to the bank for up to ninety days.<sup>47</sup> This practice allows the Fed to lend funds based on the present value of a financial instrument less the discount rate and then return it to the financial institution at maturity for the full value of the instrument.<sup>48</sup> Second, the Fed can make an advance secured by a “pledge of bonds, notes, certificates of indebtedness, or Treasury bills of the United States,” as well as multiple other approved assets for up to fifteen days.<sup>49</sup> This allows the Fed to extend a loan with an interest rate equal to the discount rate using approved assets as collateral.<sup>50</sup> The primary method used to make loans in recent history has been the use of advances,<sup>51</sup> perhaps due to the Fed’s ability to extend discount loans without being required to acquire financial instruments except in the case of default.<sup>52</sup>

*D. The Emergency Powers*

Though the Fed can ordinarily only extend discount loans to depository institutions, it can, in limited circumstances, make loans to nondepository institutions.<sup>53</sup> This power is extended “in unusual and exigent circumstances,” and allows a Federal Reserve Bank to make a loan to “any individual, partnership, or corporation” as long as it is collateralized to the satisfaction of the Regional Reserve Bank.<sup>54</sup> The structure of this provision inherently grants broad power to the Fed to define “unusual and

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46. 12 U.S.C. § 343; 12 U.S.C. § 347 (2006).

47. See Blau, *supra* note 1, at 51; 12 U.S.C. § 343.

48. See Blau, *supra* note 1, at 51 n.84.

49. 12 U.S.C. § 347.

50. Blau, *supra* note 1, at 51 n.84.

51. *Id.* at 52.

52. See 12 U.S.C. § 347 (stating that the Fed may make advances based on a “pledge” of acceptable collateral).

53. 12 U.S.C. § 343.

54. *Id.*

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exigent circumstances,” which firms will and will not get loans, and what can serve as collateral.<sup>55</sup>

The emergency powers, though extensive, are not unlimited. The Federal Reserve Board must determine that “unusual and exigent circumstances exist,” that the individual or institution is “unable to secure adequate credit accommodations from other sources,” and that “action on the matter is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the financial system of the United States.”<sup>56</sup> Because these powers involve significant federal intervention into the economy, until 2008, they had not been exercised for nearly eighty years.<sup>57</sup>

#### IV. THE FINANCIAL CRISIS

##### A. *Causes of the Financial Crisis*<sup>58</sup>

The severity of the global financial meltdown necessitated the exercise of the Fed’s emergency powers.<sup>59</sup> Accordingly, it is important to have a basic understanding of the financial crisis and

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55. Before the crisis the Fed had required investment-grade debt; however, since then it has allowed securities to serve as collateral. See John Goff, *Fed Ascending a Staircase*, FIN. WK., Jan. 26, 2009, <http://www.financialweek.com/article/20090126/REG/901269976/1049/Compliance>.

56. 12 U.S.C. § 248(r)(2)(A)(ii) (2006); see also 12 U.S.C. § 343 (describing Fed power during “unusual and exigent circumstances.”).

57. Blau, *supra* note 1, at 53-54.

58. This part offers a very basic analysis of the financial crisis. Other articles have offered much more detailed analyses that may be informative. See generally John C. Coffee, Jr., & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?*, 95 VA. L. REV. 707 (2009) (offering a detailed analysis of the financial crisis); Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039 (2007) (offering a detailed analysis of the financial crisis); Joseph R. Mason & Joshua Rosner, *Where Did the Risk Go? How Misapplied Bond Ratings Cause Mortgage Backed Securities and Collateralized Debt Obligation Market Disruptions* 1-85 (Hudson Inst., Working Paper, 2007) (offering a detailed analysis of the financial crisis), available at [http://www.hudson.org/files/publications/Hudson\\_Mortgage\\_Paper5\\_3\\_07.pdf](http://www.hudson.org/files/publications/Hudson_Mortgage_Paper5_3_07.pdf) (offering a detailed analysis of the financial crisis).

59. Cf. Michael J. de la Merced & Eric Dash, *Fed Seems Close to Helping A.I.G.*, N.Y. TIMES DEALBOOK (Sept. 16, 2008, 12:31 PM), <http://dealbook.blogs.nytimes.com/2008/09/16/industry-efforts-to-rescue-of-aig-said-to-falter/> (stating the severe impact AIG’s collapse would have had on the financial system, which prompted the Fed to consider creating a rescue package).

why the Fed felt action was necessary to “prevent, correct, or mitigate serious harm to the economy or the stability of the financial system.”<sup>60</sup> This section provides a basic overview of the financial crisis and the circumstances that led to the collapse of major financial institutions like AIG.

Two related factors are often blamed for causing the financial meltdown: (1) the “deregulatory measures, taken both by Congress and the SEC, which placed some categories of derivatives and some firms beyond effective regulation[;]” and (2) the related subprime mortgage collapse.<sup>61</sup>

Financial derivatives, such as mortgage backed securities and credit default swaps,<sup>62</sup> allowed lenders to pass off risk to third parties.<sup>63</sup> This was particularly prevalent in the sub-prime mortgage market where most mortgages were securitized,<sup>64</sup> leading to speculation.<sup>65</sup> Moreover, the complexity of these and related instruments meant it was often difficult to evaluate the level of risk presented, leading to inaccurate risk assessments by rating agencies and, in turn, overvaluation by the market that relied on those “misapplied” ratings.<sup>66</sup> Thus, lenders could transfer their worst loans to third parties through the process of securitization and no longer carry the full risk of default.<sup>67</sup> When the mortgage market began to decline, the initial defaults led to a chain of events that caused even more defaults, a result of further declining

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60. 12 U.S.C. § 248(r)(2)(A)(ii)(II).

61. See Coffee & Sale, *supra* note 58, at 731.

62. A credit default swap is a derivatives contract where a third party insures against the occurrence of a “credit event,” usually in the form of a default. The contract functions through periodic payments by one party to the insuring party. If a “credit event” occurs, the insuring party will “settle” by paying the outstanding value of unfulfilled contract. See Patrick D. Fleming, *Credit Derivatives Can Create a Financial Incentive For Creditors to Destroy a Chapter 11 Debtor: Section 1126(e) and Section 105(a) Provide a Solution*, 17 AM. BANKR. INST. L. REV. 189, 193-94 (2009).

63. Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 743-44 (2008).

64. Engel & McCoy, *supra* note 58, at 2040.

65. See Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 436 (2005) (discussing the possibility of speculation in the derivatives markets more generally).

66. See generally Mason & Rosner, *supra* note 58 (describing the complexity of evaluating risk levels presented by derivative instruments).

67. Engel & McCoy, *supra* note 58, at 2049.

property values, which in turn, rippled through the entire financial sector.<sup>68</sup>

*B.      AIG's Involvement*

AIG was largely implicated in the financial crisis because of its heavy involvement in the issuance of credit default swaps,<sup>69</sup> which can function as insurance against mortgage defaults.<sup>70</sup> This course of action was relatively unusual, at least in the sense that most other insurance companies were not dealing with these instruments.<sup>71</sup> But because AIG was the world's largest insurer,<sup>72</sup> it was involved in more complex financial instruments than most small insurance companies. As a result of the company's significant involvement in credit default swaps, however, AIG had lost nearly \$18 billion in the three quarters leading up to September 2008; losses for which it was able to raise money in order to cover.<sup>73</sup> Credit default swaps were only one part of AIG's business and it was still operating profitable sectors of the company, including certain sectors of its insurance business.<sup>74</sup> At the time, AIG had nearly \$1 trillion in assets and shareholder equity of roughly \$78 billion, so credit default swaps were not a significant proportion of the company's overall business.<sup>75</sup>

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68. Mason & Rosner, *supra* note 53, at 77.

69. See Andrew M. Kulpa, *Minimal Deterrence: The Market Impact, Legal Fallout, and Impending Regulation of Credit Default Swaps*, 5 J. L. ECON. & POL'Y 291, 299 (2009). Credit default swaps functioned by transferring the buyers' credit risk to third parties whom would assume the risk in the form of securities in exchange for a premium. See Kim, *supra* note 63, at 729.

70. See Mathew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1, available at <http://online.wsj.com/article/SB122156561931242905.html>.

71. *Id.*

72. Lilla Zuil, *AIG's Title as World's Largest Insurer Gone Forever*, REUTERS, Apr. 29, 2009, <http://www.insurancejournal.com/news/national/2009/04/29/100066.htm> (stating that AIG was the world's largest insurer).

73. See Karnitschnig et al., *supra* note 70.

74. *Id.*

75. See Matthew Karnitschnig, Liam Plevin, & Peter Lattman, *AIG Scrambles to Raise Cash, Talks to Fed--Insurer Looks to Sell Automotive Business, Annuities Unit; It Seeks \$10 Billion in Fresh Capital as Downgrade Threatens*, WALL ST. J., Sept. 15, 2008, at C1.

On September 15, 2008, partly in response to these losses, AIG's credit ratings were downgraded.<sup>76</sup> To bolster its rating, AIG had to post an additional \$14 billion dollars in collateral for its credit default swaps.<sup>77</sup> Additionally, AIG would have been required to post collateral to investment banks and other institutions with which it had a trading relationship.<sup>78</sup> Though AIG was able to raise the funds to cover losses from the previous three quarters, this time the company could not find the additional funds it needed.<sup>79</sup> AIG had far more than \$14 billion in assets; however, it did not have enough liquidity in order to raise the money in time.<sup>80</sup> AIG and the Fed tried to arrange a private loan from third parties in the financial sector but were unsuccessful.<sup>81</sup> As a result, the Fed had to intervene in order to avoid AIG's imminent bankruptcy.<sup>82</sup>

### C. Fed Action

To save AIG, the Fed relied on its emergency powers in order to extend a loan to the struggling insurance giant.<sup>83</sup> Pursuant to those powers, the Fed authorized the Federal Reserve Bank of New York to create an \$85 billion dollar credit line for AIG.<sup>84</sup> This loan was collateralized by assets of AIG and its subsidiaries.<sup>85</sup> The federal government also "received a 79.9 [percent] equity interest in AIG" and the right to veto dividend payments to

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76. See Mary Williams Walsh & Michael J. de la Merced, *A Race for Cash at A.I.G.*, N.Y. TIMES, Sept. 16, 2008, at C1, available at 2008 WLNR 17575045.

77. Yomarie Silva, Recent Development, *The "Too Big to Fail" Doctrine and the Credit Crisis*, 28 REV. BANKING & FIN. L. 115, 125 (2009); Karnitschnig et al., *supra* note 70.

78. Karnitschnig et al., *supra* note 70.

79. *See id.*

80. *See id.*

81. David S. Hilzenrath & Glenn Kessler, *U.S. Seizes Control of A.I.G. With \$85 Billion Emergency Loan*, WASH. POST, Sept. 17, 2008, <http://www.washingtonpost.com/wpdyn/content/article/2008/09/16/AR2008091602174.html?sid=ST2008091600045>.

82. *See* Karnitschnig et al., *supra* note 70.

83. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), <http://www.federalreserve.gov/newsevents/press/other/20080916a.htm>. §13(3) refers to the emergency powers clause.

84. *Id.*

85. Silva, *supra* note 77, at 124-25.

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shareholders.<sup>86</sup> Shortly thereafter, AIG CEO Bob Willumstad was asked to leave the company by Secretary of the Treasury Henry Paulson, and he was replaced by Edward Liddy.<sup>87</sup>

Less than a month later, the Fed was forced to invoke its emergency powers again, this time extending a \$37.8 billion dollar loan to AIG.<sup>88</sup> This loan was collateralized using fixed income securities that were previously lent to other investors but had since been returned.<sup>89</sup>

*D. Why the Fed Took Action*

While the Fed was relatively oblique with regard to why it chose to exercise its emergency powers to save AIG, it later provided some hints as to why it thought action was necessary.<sup>90</sup> First, the Fed would have been statutorily required to take the position that the circumstances were “unusual and exigent.”<sup>91</sup> The Fed had already invoked its emergency powers to save Bear Stearns earlier that year.<sup>92</sup> The AIG events also came on the heels of the Lehman Brothers collapse just two days earlier.<sup>93</sup> Chairmen Bernanke indicated that both of those events led the Fed to believe “unusual and exigent circumstances” existed and that AIG’s collapse threatened financial market stability.<sup>94</sup> Second, the Fed had shown that AIG was unable to secure funds from other,

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86. *Id.* at 125; see also Charles Gasparino et al., *AIG to Get \$85 Billion Loan, Gives Up 79.9% Stake*, CNBC.COM, Sept. 17, 2008, <http://www.cnbc.com/id/26747020/print/1/displaymode/1098/> (describing the details of the plan).

87. See Karnitschnig et al., *supra* note 70.

88. See Tami Luhby, *AIG Hits Up Fed for More Money*, CNNMONEY.COM, Oct. 8, 2008, <http://money.cnn.com/2008/10/08/news/companies/aig/index.htm>.

89. See *id.*

90. See *Testimony on AIG before the H. Comm. of Fin. Serv.*, 111th Cong. (2009) (statement of Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve), <http://www.federalreserve.gov/newsevents/testimony/bernanke20090324a.htm> [hereinafter Bernanke Testimony].

91. See 12 U.S.C. § 343.

92. See Edmund L. Andrews et al., *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1, available at 2008 WLNR 17634395.

93. See Carrick Mollencamp et al., *Lehman Files for Bankruptcy, Merrill Sold, AIG Seeks Cash*, WALL ST. J., Sept. 16, 2008, <http://online.wsj.com/article/SB122145492097035549.html>.

94. See Bernanke Testimony, *supra* note 90 (using the language “extraordinary” rather than unusual and exigent).

private institutions.<sup>95</sup> All that remained was a finding that action was “necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the financial system of the United States.”<sup>96</sup> That finding would be reasonable since the Lehman Brothers collapse led to a financial panic that nearly froze the financial markets<sup>97</sup> and actually resulted in some money-market funds “breaking the buck.”<sup>98</sup>

Chairman Bernanke, in consultation with Treasury Secretary Henry Paulson and President of the Federal Reserve Bank of New York, Timothy Geithner, came to the conclusion that Fed action was necessary to prevent AIG’s bankruptcy, which could have “disastrous repercussions” in the financial sector.<sup>99</sup> This view is justifiable for a number of reasons. First, the Fed was worried that effects of AIG’s collapse would be realized by those who had not been involved in speculative derivatives trading, such as investors involved in money-market funds.<sup>100</sup> AIG was heavily involved in money-markets, both by insuring money-market instruments and by selling investment securities in the money-markets, and the Fed feared that a collapse would have “spillover” effects.<sup>101</sup> This was especially worrisome to the Fed because money-market instruments had traditionally been considered extremely safe even though they were not FDIC insured.<sup>102</sup> In fact, the Treasury announced shortly thereafter that investments in money-market funds before September 19, 2008, would be insured.<sup>103</sup> Secondly, there was some concern about how an AIG

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95. Karnitschnig et al., *supra* note 70.

96. See 12 U.S.C. § 248(r)(2)(a)(ii)(II); *supra* pp. 340-45.

97. See David Wessel, *Lehman’s Legacy: Government’s Trial and Error Helped Stem Financial Panic*, WALL ST. J., Sept. 14, 2009, at A1.

98. Bernanke Testimony, *supra* note 90; see also Diana B. Henriques, *The Buck Broke. So How to Retool Money Funds?*, N.Y. TIMES, Oct. 11, 2009, at BU13, available at 2009 WLNR 20052901.

99. Karnitschnig et al., *supra* note 70.

100. See *id.* (discussing concerns over spillover effects into seemingly safe investments held by small investors).

101. *Id.*; see also Andrews et al., *supra* note 92 (discussing the possibility of spillover effects).

102. See Diana B. Henriques, *Money Market Funds Are a Refuge, Right?*, N.Y. TIMES, Jan. 11, 2009, at BU17, available at <http://www.nytimes.com/2009/01/11/business/mutfund/11money.html> [hereinafter *Refuge*].

103. *Id.*

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bankruptcy would affect insurance policy holders.<sup>104</sup> Nonetheless, this fear was likely overblown, as AIG CEO Edward Liddy assured the public that “[AIG’s] insurance businesses...[were] strong and well capitalized.”<sup>105</sup> In fact, based on AIG’s subsidiary business structure, it was unlikely that any private insurance policies would have been affected.<sup>106</sup> Thirdly, Chairman Bernanke subsequently indicated that the Fed considered the exposure of other large financial institutions to AIG products, such as commercial paper, and worried about a further contraction of the financial markets that might follow if AIG failed.<sup>107</sup> Finally, state and local governments had lent billions of dollars to AIG, much of which might have been lost if AIG had filed for bankruptcy.<sup>108</sup>

The view that AIG’s collapse likely would have caused major economic harm is justifiable because of the “spillover” effects into various market sectors and because its collapse could have induced financial panic.<sup>109</sup> Thus, it is reasonable to assume that the Fed determined that AIG’s failure would cause significant problems in the financial markets and bailing out AIG would prevent that harm. Presumptively, the Fed’s decision to exercise its emergency powers in favor of AIG was based upon its finding that all the statutory elements were met.<sup>110</sup>

## V. POTENTIAL CONSEQUENCES OF FED ACTION

### A. *Too Big to Fail*

The Fed’s decision to rescue AIG, as well as other major financial firms, supports the “too big to fail doctrine.”<sup>111</sup> This action was the result of the Fed’s concern over the lasting, and possibly permanent, damage that could be caused by the collapse

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104. Andrews et al., *supra* note 92.

105. Luhby, *supra* note 88.

106. See Karnitschnig et al., *supra* note 70; Andrews et al., *supra* note 92.

107. Bernanke Testimony, *supra* note 85.

108. *Id.*

109. Wessel, *supra* note 92.

110. *See id.*

111. See Bill Saporito, *How AIG Became Too Big to Fail*, TIME, Mar. 19, 2009, <http://www.time.com/time/business/article/0,8599,1886275,00.html>; Silva, *supra* note 77.

of a major, systemically significant firm like AIG through “spillover” effects.<sup>112</sup> The premise behind the doctrine is that a firm can grow to be “so large or so complex” that government intervention becomes necessary in order to avert economic disaster when the firm begins to falter<sup>113</sup> or that the government cannot afford to let the institution crumble due to the effects its failure will have on the market as a whole.<sup>114</sup>

In advance of a collapse, however, there is currently no clear criteria to determine which institutions’ failure would result in such a systemic risk.<sup>115</sup> Whether an institution is actually “too big to fail” would be impossible to ascertain until it collapses and the effects have been realized.<sup>116</sup>

In the absence of a set standard for what constitutes a company that is too big to fail,<sup>117</sup> many interpretations exist as to which companies will be saved and which ones will be allowed to fail. This lack of clarity may explain why the decision to allow Lehman Brothers to fail has been so heavily criticized.<sup>118</sup> Arguably, Lehman Brothers was in a similar situation to AIG, but it did not receive emergency aid from the federal government and was forced to file for bankruptcy.<sup>119</sup> Since that time however, it seems that the federal government has declared that multiple firms in many different industries are “too big to fail,” including General Motors, Chrysler, Citigroup, and Bank of America.<sup>120</sup>

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112. Karnitschnig et al., *supra* note 70; *see supra* pp. 345-47; *infra* pp. 348-50.

113. *See* Saporito, *supra* note 111; Silva, *supra* note 77.

114. Peter J. Wallison, Op-Ed., *Not Everything Can Be Too Big to Fail*, WALL ST. J., Nov. 22, 2008, at A15, available at <http://online.wsj.com/article/SB122731217473649399.html>.

115. *Id.*

116. *Id.*

117. Silva, *supra* note 77.

118. John Cassidy, *Anatomy of a Meltdown: Ben Bernanke and the Financial Crisis*, NEW YORKER, Dec. 1, 2008, available at [http://www.newyorker.com/reporting/2008/12/01/081201fa\\_fact\\_cassidy](http://www.newyorker.com/reporting/2008/12/01/081201fa_fact_cassidy); *see also* Joe Nocera, *Lehman Had to Die So Global Finance Could Live*, N.Y. TIMES, Sept. 12, 2009, at A1, available at <http://www.nytimes.com/2009/09/12/business/12nocera.html> (detailing the criticisms of the failure to rescue Lehman, before ultimately concluding it was a beneficial decision).

119. *See* Susanne Craig, Deborah Solomon, Carrick Mollenkamp, & Matthew Karnitschnig, *Lehman Races Clock; Crisis Spreads*, WALL ST. J., Sept. 13, 2008, available at <http://www.gata.org/node/6591>; Silva, *supra* note 77.

120. Edmund L. Andrews & David E. Sanger, *U.S. Is Finding Its Role in Business Hard to Unwind*, N.Y. TIMES, Sept. 14, 2009, at A1, available at <http://www.ny>

*B.        Expectations of Financial Actors*

A second consequence of actions taken by the Fed, and related to the “too big to fail doctrine,” is the alteration of future expectations by financial actors. Because the government has no set standards as to how it decides when a company is “too big to fail,”<sup>121</sup> expectations, or a lack of clear expectations, may contribute to market instability and moral hazard by incentivizing financial institutions to take excessive risk with the expectation that they will be saved by the government.<sup>122</sup>

The power of expectations could be seen as Congress sought to pass the Troubled Asset Relief Program (TARP); the stock market swayed up and down with every development, as investors gambled on whether financial actors would be rescued.<sup>123</sup> The power of expectations could also be seen as a financial panic erupted following the Lehman Brothers collapse.<sup>124</sup> While not bailing out Lehman Brothers may provide a lesson to those companies who are thinking about taking excessive risk,<sup>125</sup> it may not have been worth the financial panic that ensued following its collapse.<sup>126</sup> There is also no definite way to determine whether these companies will look to the Lehman Brothers model or the AIG model when gauging future behavior. It is possible that major financial institutions will look at federal action in particular, and decide that taking high levels of risk is the rational choice because they will be rescued by the Fed if the risk does not pay off,

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times.com/2009/09/14/business/14big.html [hereinafter Andrews & Sanger]; see also Silva, *supra* note 77 (discussing the too big to fail problem).

121. See Silva, *supra* note 77.

122. See Robert Robb, Op-Ed., *The Lehman Debacle and Lessons Learned*, ARIZ. REPUBLIC, Sept. 18, 2009, at B5, 2009 WLNR 18491482; see also Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, 106 COLUM. L. REV. 1698, 1698 (2006) (introducing the idea of moral hazard relating to the “too big to fail” doctrine in the accounting industry).

123. See Robb, *supra* note 122; Jim Zarroli & Steve Inskeep, *U.S. Markets Wait Anxiously For Rescue Plan*, NPR, Oct. 1, 2008 available at <http://www.npr.org/templates/story/story.php?storyId=95236423&ps=rs>.

124. Wessel, *supra* note 97.

125. Cf. Robb, *supra* note 122 (citing Lehman’s bankruptcy proceedings because they were not rescued).

126. See *id.*

thus embodying the phenomenon known as moral hazard.<sup>127</sup> President Obama has since tried to undo the damage caused by these expectations, telling financial institutions not to return to reckless behavior and warning them that taxpayers will not be there to save them next time.<sup>128</sup> But can rhetoric alone really be effective? Furthermore, how likely is it that we can afford to take a hard-line and allow companies to fail in the future? Is it more likely that the government will make the same decisions again if potential collapse poses a high degree of systemic risk?<sup>129</sup>

#### VI. THE SYSTEMIC RISK REFORM AGENDA

This Part will discuss the positive and negative aspects of the Fed wielding the incredible power of emergency intervention and will summarize and supplement current proposals on how to achieve a better balance between independence, transparency, and accountability without resorting to the current ad hoc system that leads to inherent uncertainty.

The Fed was designed as an independent central bank, isolated from outside political pressure.<sup>130</sup> Accordingly, the Fed implements its emergency powers with a relatively low level of external restriction or control, even though these actions have far-reaching effects.<sup>131</sup> With independence and high levels of discretion come various strengths and weaknesses that should be considered when making policy decisions.

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127. Editorial, *Few Changes Follow Year of Recovery*, N.Z. HERALD, Sept. 19, 2009, at A018, 2009 WLNR 18383060 [*hereinafter Few Changes*]; see also Cunningham, *supra* note 122, at 1698 (discussing moral hazard).

128. *Few Changes*, *supra* note 127.

129. See Wallison, *supra* note 114.

130. See Michael Wade Strong, *Rethinking the Federal Reserve System: A Monetarist Plan for a More Constitutional System of Central Banking*, 34 IND. L. REV. 371, 371 (2001).

131. See generally David Small & James Clouse, *The Limits the Federal Reserve Act Places on the Monetary Policy Actions of the Federal Reserve*, 19 ANN. REV. BANKING L. 553 (2000) (discussing the broad powers of the Fed).

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A.        *Who Should Decide Too Big to Fail?*

The question of who should decide which companies are “too big to fail” presents conflicting goals of independence, transparency, accountability, and efficiency. In the present crisis, multiple agencies including the Treasury Department, the Fed, and the Federal Deposit Insurance Corporation (FDIC), have all played a role in rescuing various institutions.<sup>132</sup> Policy makers must determine whether it is best to have an existing agency be the exclusive entity to make this determination, whether to create a new agency for this purpose, or whether to continue with the *ad hoc* system currently in place.

Recently, there has been criticism of the Fed’s negotiations with AIG over the bailout, alleging weakness and ineffectiveness.<sup>133</sup> Concurrently, proposals have emerged that recommend stripping powers from the Fed.<sup>134</sup> These proposals range from a requirement that the Fed get Treasury approval for the exercise of its emergency powers<sup>135</sup> to only allowing the Fed to authorize lending to healthy firms through broad-based lending program using its emergency powers.<sup>136</sup> The second proposal would only allow the FDIC to lend to individual firms with the purpose of facilitating an orderly dissolution of the company, not performing a rescue.<sup>137</sup> The FDIC process for identifying systemic risk and solutions already involves a system of approval by the Treasury Department and the Fed.<sup>138</sup> The second solution would

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132. Andrews & Sanger, *supra* note 120.

133. See Mary Williams Walsh, *Audit Faults New York Fed in A.I.G. Bailout*, N.Y. TIMES, Nov. 17 2009 at B1, available at 2009 WLNR 23127399 [hereinafter *Audit Faults*].

134. See Discussion Draft, Davis Polk, Summary of The Restoring American Financial Stability Act of 2009, Introduced by Senator Christopher Dodd (D-CT) November 10, 2009 (Nov. 13, 2009), at 8, available at [http://www.davispolk.com/files/Publication/64ce87e4-9e7a-4d10-ba6c27a55ad72f09/Presentation/PublicationAttachment/31830e60-c328-4f73-887d27c5bd2d5d6b/111309\\_dodd\\_legislative\\_summary.pdf](http://www.davispolk.com/files/Publication/64ce87e4-9e7a-4d10-ba6c27a55ad72f09/Presentation/PublicationAttachment/31830e60-c328-4f73-887d27c5bd2d5d6b/111309_dodd_legislative_summary.pdf) [hereinafter Davis Polk]; see also DEP’T. OF THE TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 8 (2009), available at [http://www.financialstability.gov/docs/regs/FinalReport\\_web.pdf](http://www.financialstability.gov/docs/regs/FinalReport_web.pdf) [hereinafter FINANCIAL REGULATORY REFORM].

135. See FINANCIAL REGULATORY REFORM, *supra* note 134, at 8.

136. See Davis Polk, *supra* note 134, at 12.

137. See *id.*

138. See 12 U.S.C. § 1823(c)(4)(G) (2006).

essentially eliminate the too big to fail problem because individual, struggling companies would not survive.<sup>139</sup> Proposals that require the creation of new agencies or councils would likely have the same result, though it may provide for more coordination across regulators.<sup>140</sup> These proposals show some promise of increasing transparency and accountability by putting the exercise of the most contentious decision in the hands of more politically accountable agencies, while retaining the Fed's role as the conductor of monetary policy.

*B. Transparency*

The recent financial crisis has stirred criticism over the transparency of Fed action.<sup>141</sup> In fact, the Fed has been able to make over \$2 trillion in emergency loans without revealing the names of the institutions receiving the money.<sup>142</sup> The Fed argues that this lack of transparency is necessary in order to protect banks from any stigma that may attach due to borrowing from the discount window, and thus, further weaken the financial markets.<sup>143</sup> The idea that transparency will discourage banks from borrowing at the discount window is a valid concern,<sup>144</sup> but there is no reason that the details of these loans should not at least be disclosed to

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139. See Davis Polk, *supra* note 134, at 4 (also proposing direct regulation on systemically important institutions before they are subject to collapse through increased capital, leverage, and liquidity requirements based on size and interconnectedness). A similar solution has been passed in the House of Representatives, modifying the power of the Fed and requiring a dissolution fund for failed systemically significant institutions to be determined by the President. See Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

140. See FINANCIAL REGULATORY REFORM, *supra* note 134, at 8.

141. See Steve Matthews & Craig Torres, *Bernanke Says Federal Reserve Won't Reveal Details on Loans*, BLOOMBERG.COM, Nov. 18, 2008, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aS1eWoJj0sKc>.

142. *Id.*

143. *See id.*

144. Dan Wilchins, *Top International Banks Tap Fed Discount Window*, REUTERS, Aug. 22, 2007, <http://www.reuters.com/article/businessNews/idUSN2243173420070823> (discussing the stigma traditionally attached with borrowing from the discount window).

Congress, to which the Fed is accountable.<sup>145</sup> Limited disclosure would allow some monitoring of Fed action without exposing the names of borrowers directly to the public. Conversely, this may allow the development of a public political battle if Congress is particularly unhappy with a decision.<sup>146</sup>

As a result of the growing concern with the Fed's lack of transparency, Congress has taken multiple steps to find a suitable solution.<sup>147</sup> First, the Senate passed a non-binding resolution demanding the Fed to reveal the names of the institutions to which it is lending.<sup>148</sup> Second, and perhaps more significantly, Congressman Ron Paul proposed the Federal Reserve Transparency Act of 2009.<sup>149</sup> This legislation would amend 31 U.S.C. § 714 to allow and mandate an audit of the Fed and would make the results available to Congress.<sup>150</sup> More recent proposals have also suggested requiring GAO audits of any use of emergency powers, publication of any use of Fed emergency powers, and periodic reports to Congress.<sup>151</sup>

These measures in Congress have had some persuasive effect on Fed actions.<sup>152</sup> Recently, the Fed has been much more forthcoming about the details of its lending program.<sup>153</sup> The Fed is still hesitant to release the names of ordinary borrowers and may, at any time, cease its policy of voluntary disclosure of the names of

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145. See Sudeep Reddy, *Fed Weighs Naming Borrowers*, WALL ST. J., Sept. 26, 2009, at A2, available at <http://online.wsj.com/article/SB125389264645141251.html> (discussing the Congressional demand for more disclosure).

146. See, e.g., *History of Central Banking*, *supra* note 14, at 6 (citing previous power struggles between the Fed and the other branches of government).

147. RANDALL D. GUYNN, ANNETTE L. NAZARETH & MARGARET E. TAHYAR, DAVIS POLK FINANCIAL CRISIS MANUAL: CHAPTER 1: FEDERAL RESERVE EMERGENCY INTERVENTION AUTHORITY: OLD TOOLS USED IN NEW WAYS 36-37 (Davis, Polk, & Wardwell Sept. 2009).

148. *Id.*

149. Federal Reserve Transparency Act, H.R. 1207, 111th Cong. (2009). Language from this proposed bill was adopted in a more comprehensive financial reform bill passed by the House. See Wall Street Reform & Consumer Protection Act, 111 H.R. 4173, 111th Cong. (2009).

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

151. See Davis Polk, *supra* note 134, at 51.

152. See Guynn, Nazareth, & Tahyar, *supra* note 147, at 37.

153. *Id.* at 37; see also *Federal Reserve Transparency Before the H. Com. on Fin. Serv.*, 111th Cong. (2009) (testimony of Scott G. Alvarez, Gen. Counsel, Federal Reserve Board), <http://www.federalreserve.gov/newsevents/testimony/alvarez20090925a.htm> [hereinafter Alvarez Testimony].

large financial institutions borrowing as a result of the exercise of its emergency powers.<sup>154</sup>

Despite increased voluntary transparency, the Fed adamantly opposes passage of the Federal Reserve Transparency Act,<sup>155</sup> stressing the fact that it is already subject to an annual audit, testimony before Congress, and voluntarily publishes details of its decisions regarding open market operations.<sup>156</sup> The Fed argues that subjecting monetary policy to GAO audit, or the threat of an audit, would allow Congress to influence monetary policy and could even lead to less productive discussions of what action should be taken.<sup>157</sup> It argues further that subjecting discount window operations to audit would decrease its effectiveness by increasing the stigma associated with borrowing and decreasing investor confidence.<sup>158</sup>

Lack of transparency at the Fed raises many questions. There are concerns over the legitimacy of decisions made by the Fed when those decisions cannot be checked by the body to which it is accountable, especially when those decisions are extraordinary. Arguably, the funds from TARP, administered by the Treasury Department, perform a similar task, but the Treasury Department has vowed to meet demands for transparency through disclosure and procedural safeguards.<sup>159</sup> If the Treasury Department can perform the same job as the Fed and is transparent and more directly accountable, why should the Fed be involved? What is certain, is that without some transparency, at least to Congress or certain congressional committees, there is no

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154. Guynn, Nazareth, & Tahyar, *supra* note 147, at 37; *see also* Alvarez Testimony, *supra* note 153 (discussing the Fed's disclosure policy).

155. Alvarez Testimony, *supra* note 153.

156. *Id.*

157. *Id.*

158. *Id.*

159. Matthews & Torres, *supra* note 141; *see also* Letter from Timothy F. Geithner, Sec'y. of Treas., Dep't. of Treas., to Nancy Pelosi, Speaker of the House, U.S. House of Representatives (Apr. 15, 2009), *available at* <http://www.financialstability.gov/docs/TransparencyLetters1.pdf> [hereinafter Geithner Letter].

way to hold the Fed accountable for mistakes it has made or to prevent mistakes that it may be making.<sup>160</sup>

Policymakers must also ask whether transparency is desirable and in what situations. At least some have argued that increased transparency may, in some circumstances, lead to more efficient markets.<sup>161</sup> Nonetheless, policymakers must also be aware of the stigma associated with full transparency and the resulting economic harm that may result.<sup>162</sup> As the Fed argues, it has taken important steps to increase its transparency during the recent financial crisis.<sup>163</sup> Nonetheless, it has refused to be transparent with regard to most discount window operations because it believes it will reduce effectiveness.<sup>164</sup> Policymakers in Congress must find the proper balance between transparency and independence to maximize legitimacy, clarify expectations, and simultaneously retain the independence necessary to operate successful monetary policy.

### C. *Accountability*

Another major concern with the Fed's broad emergency powers is its lack of political accountability.<sup>165</sup> Congress intended to design an independent agency that would be isolated from political influence in making decisions for the best interest of the nation's economy.<sup>166</sup> Recently, however, there is growing concern in Congress and in the public that voters have no means to hold the Fed responsible for its actions despite the broad influence it exercises over the economy.<sup>167</sup> Currently, the method for ensuring

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160. Editorial Copy, *Focus on the Fed*, WASH. POST, at A20, July 24, 2009, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/07/23/AR2009072303004.html> [hereinafter *Focus on the Fed*].

161. See Eric T. Swanson, *Federal Reserve Transparency and Financial Market Forecasts of Short-Term Interest Rates*, Bd. of Gov. of the Fed. Reserve, at 4, (2004), <http://www.federalreserve.gov/pubs/feds/2004/200406/200406pap.pdf> (stating that Fed transparency has had some positive impact on predictions of short-term interest rates).

162. Matthews & Torres, *supra* note 141.

163. Alvarez Testimony, *supra* note 153.

164. *Id.*

165. See Strong, *supra* note 130, at 387-88.

166. *Id.*

167. Guynn, Nazareth, & Tahyar, *supra* note 147, at 38.

accountability is to require the Fed to report to Congress and congressional committees at various stages throughout the year.<sup>168</sup> Presently, Congress has three options as pressure mounts to make the Fed more accountable. Congress can completely eliminate the Fed, maintain the current status of the Fed, or find an intermediate position.

Some scholars have gone so far as to argue that the idea of the Fed as an independent organization is unconstitutional.<sup>169</sup> They argue that the power to conduct monetary policy, including the emergency powers, should be given to Congress, creating more accountability to the general public.<sup>170</sup> Furthermore, this plan would require Congress to assign monetary policy to a committee and would then allow ratification of Congressional action by the President.<sup>171</sup> Nonetheless, the Fed has become a major player in the United States and it is doubtful that its role would be simply handed over to Congress and the President.<sup>172</sup> This plan would also politicize monetary policy decision-making and could lead to negative economic consequences.<sup>173</sup>

Other solutions exist that may increase the Fed's accountability without vastly reshaping the central bank. These solutions are especially relevant since most economists support the idea of retaining a fairly independent actor to conduct monetary policy.<sup>174</sup> One solution would be to transfer the emergency powers to the Treasury Department or another entity.<sup>175</sup> Proposals in Congress take this approach, advocating a new agency or council that would continuously supervise systemic risk determinations by

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168. Federal Reserve System: Frequently Asked Questions, Federal Reserve Board, available at <http://www.federalreserve.gov/generalinfo/faq/faqfrs.htm#8>.

169. See generally Strong, *supra* note 130 (arguing that the Fed is unconstitutional).

170. *Id.* at 388.

171. *Id.* at 390.

172. See Alvarez Testimony, *supra* note 153 (demonstrating the Fed's opposition to attempts to assert Congressional control).

173. See generally Thomas Havrilesky, *The Politicization of Monetary Policy: The Vice Chairman As the Administrations Point Man*, 13 CATO J. 137 (1993) (arguing that inflation performance is more successful in countries that have an independent central bank conducting monetary policy).

174. See Guynn, Nazareth, & Tahyar, *supra* note 147, at 37.

175. *Id.* at 38.

the Fed.<sup>176</sup> The emergency powers have little to do with conducting everyday monetary policy and more to do with stabilizing the market during times of crisis.<sup>177</sup> This solution would leave the Fed to conduct everyday monetary policy isolated from political interference, but would also allow the Treasury Department, which is more accountable to the people through the President, to make the most controversial decisions, such as creating rescue packages to save AIG or allowing Lehman Brothers to fail. A variant of this proposal would be to require the Secretary of the Treasury to approve emergency action taken by the Fed.<sup>178</sup> This solution would allow the Fed to retain all of its discretionary power, but would only subject the more political, emergency decisions to Treasury approval. Nonetheless, the process could be politicized if a public power struggle were to ensue between the two bodies.<sup>179</sup>

Because it is highly unlikely that the Fed will cease to exist and because it is undesirable to allow monetary policy to become politicized<sup>180</sup> the most viable option is to design legislation to increase accountability, especially with regard to discretionary, controversial decisions like the exercise of emergency powers, while retaining the relative independence of everyday monetary policy. Either of the ideas proposed would accomplish this task and would give large institutions pause before they take excessive

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176. See FINANCIAL REGULATORY REFORM, *supra* note 134, at 4, (proposing a Financial Services Oversight Council composed of the heads of financial services agencies and Treasury approval of emergency powers decisions); CHAIRMAN CHRIS DODD S. COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, 111TH CONG., RESTORING AMERICAN FINANCIAL STABILITY 3 (Comm. Print 2009) (2009), available at [http://banking.senate.gov/public/\\_files/FinancialReformSummaryFC11189.pdf](http://banking.senate.gov/public/_files/FinancialReformSummaryFC11189.pdf) (proposing the creation of a new Agency for Financial Stability composed of the heads of financial services agencies).

177. See Andrew Ross Sorkin, *How the Fed Reached Out to Lehman*, N.Y. TIMES, Dec. 16, 2008, at B1, available at 2008 WLNR 24053612.

178. Guynn, Nazareth, & Tahyar, *supra* note 147, at 39; see also FINANCIAL REGULATORY REFORM, *supra* note 134, at 4. A variant of this solution was considered and passed by the House, requiring Treasury and Presidential approval. See H.R. 4173, 111th Cong. (2009).

179. See, e.g., *History of Central Banking*, *supra* note 14 (citing previous power struggles between the Fed and the other branches of government).

180. Guynn, Nazareth, & Tahyar, *supra* note 147, at 37.

risk.<sup>181</sup> They would know that any attempt to create a rescue package would meet strong opposition from Congress, which may result in an increased congressional assertion of power over the process.<sup>182</sup> Congress must decide how accountable the Fed should and will be to the public and to the three political branches.

*D. Speed of Action*

One positive aspect of the Fed's power to act in emergency situations is speed and flexibility. The Fed acted almost immediately to rescue AIG.<sup>183</sup> On the other hand, Congress took more than two weeks to pass the TARP legislation,<sup>184</sup> so it may prove unwise to rely on congressional action during each crisis. It seems that Congress lacks the ability to make quick, expensive decisions that the Fed has demonstrated its ability to make. This is likely due to the independence of the Fed and its lack of accountability to the public, a virtue in some circumstances. The Fed's efficiency provides one reason not to completely delegate monetary policy to Congress, the President or other agencies, but instead, to create a new process or agency to manage systemic risk in the future.<sup>185</sup> Nonetheless, it is also possible that Congress could redesign the Fed to increase accountability and transparency while maintaining the Fed's ability to act quickly. These are issues that must be discussed going forward.

## VII. CONCLUSION

The actions the Fed took during the recent financial crisis to rescue firms like AIG have provoked much discussion. It is

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181. Cf. Brian Naylor, *Senate Tries Its Hand at Passing Bailout Plan*, NPR, Oct. 1, 2008, available at <http://www.npr.org/templates/story/story.php?storyId=95236420&ps=rs> (demonstrating the strong opposition from both political parties in Congress in passing a bailout plan).

182. *See id.*

183. *See* Karnitschnig et al., *supra* note 70.

184. The Fed. Res. Bank of St. Louis, *The Financial Crisis: A Timeline of Events and Policy Actions*, <http://timeline.stlouisfed.org/index.cfm?p=timeline> (last visited Jan. 21, 2010).

185. *See contra*, Strong, *supra* note 130, at 388 (arguing that we should turn over monetary policy decisions to Congress and the President).

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important to continue this discussion as Congress analyzes the role of the Fed in our national financial system. While the history of the central bank has not always been smooth,<sup>186</sup> the United States has come a long way in designing an institution that is relatively independent and isolated from direct political influence.<sup>187</sup> The Fed has proven its ability to act quickly and decisively.<sup>188</sup> Nonetheless, it is also possible that the Fed will make mistakes, especially when making highly politicized decisions about systemic risk.<sup>189</sup> It is important for congressional policymakers to design a central bank that strikes the correct balance between enhancing accountability and transparency, while maintaining the positive aspects of an independent, nonpolitical institution.

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186. See generally Gordon, *supra* note 11 (discussing the history of U.S. central banking).

187. *Focus on the Fed*, *supra* note 160.

188. See Sorkin, *supra* note 177.

189. See Wessel, *supra* note 97 (arguing Lehman Brothers' collapse led to financial panic).