Michelle W Bowman: Design issues for central bank facilities in the future

Remarks by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the Chicago Booth Initiative on Global Markets Workshop on Market Dysfunction, Panel "Design issues for central bank facilities in the future", Chicago, Illinois, 3 March 2023.

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Thanks, Anil. It's a pleasure to be with you today and to be part of this discussion on how central banks can support the effective functioning of financial markets.[1]

Financial stability is essential for a well-functioning economy. A financial system is considered stable when its markets and institutions are resilient and able to function even following a severe shock. The Federal Reserve monitors risks to financial stability and uses its supervisory and regulatory tools to mitigate the risks and consequences of financial instability. During periods of financial system stress, the Federal Reserve can use additional tools, such as lending facilities and open market operations, to directly support the effective functioning of key financial markets and the flow of credit throughout the economy.

The onset of the global pandemic in the spring of 2020 was a severe shock both to financial markets and to the U.S. economy, and the Federal Reserve responded forcefully to support market functioning and the flow of credit. To address the liquidity strains in Treasury and repo markets, the Fed directly purchased large amounts of Treasury securities and conducted term and overnight repo operations using the FOMC's open market operations authority. To address strains in other markets, with the backing of the U.S. Treasury, the Fed used its 13(3) emergency lending authority to establish a number of facilities to support the flow of credit to households, businesses, and communities.[2] The Federal Reserve also took a number of other actions, including easing terms on discount window lending and supervisory and regulatory actions, to encourage banks to lend and act as market intermediaries.[3]

The Fed's actions were effective in restoring financial market functioning, but the channels through which they operated varied. Significant asset purchases and take-up of the Fed's repo operations were required to restore smooth functioning in Treasury markets because of the liquidity needs of a wide swath of investors. By comparison, many of the 13(3) lending facilities saw relatively limited take-up, but they helped support market functioning and the supply of credit in the targeted markets by offering a backstop and bolstering investor confidence.[4]

The pandemic lending programs that experienced more usage saw a decline in use as market functioning was restored, which is a key benefit of lending programs compared with asset purchases. Moreover, shorter-term loans under these programs were relatively quick to roll off the Fed's balance sheet. In fact, most of the lending programs expired by late 2020. And some of the emergency securities purchase programs, such as the Secondary Market Corporate Credit Facility, sold the securities they had purchased during their wind-down phases.

The pandemic experience demonstrated the effectiveness of lending programs designed to serve as backstops to support market functioning and the flow of credit in times of stress. The temporary nature of loans from lending facilities activated only under financial market stress adds to the attractiveness of these tools. Lending programs are most effective as backstops when loans are offered at a penalty rate and are of short duration. When appropriately calibrated, lending programs can help promote market functioning but limit the Federal Reserve's overall footprint in financial markets in the longer term.

The pandemic experience illustrated that liquidity strains can sometimes be so severe that targeted purchases of the affected assets may be the most effective tool to quickly support market functioning, as was the case in Treasury markets in the spring of 2020. In taking this step, a key issue for central banks to consider is how to clearly distinguish asset purchases from the central bank's monetary policy actions.[5] This would be especially important during a period of monetary policy tightening, as we are currently experiencing. A related issue is how to minimize the Fed's footprint and amount of asset purchases needed to restore market functioning. A further consideration is how to construct and communicate an exit strategy to reduce the enlarged balance sheet over time.

Finally, while it is important to consider the design of central bank tools to address future episodes of severe financial market dysfunction, it is also important for central banks and other agencies to ensure that regulations and market oversight foster prudent financial institution behavior and resiliency in core financial markets. Doing so can increase the ability of private markets and institutions to function during times of stress and reduce the likelihood of future market interventions by the central bank. In this regard, it is important for the Federal Reserve to engage along with the other agencies in a thoughtful consideration of possible regulatory adjustments and structural reforms to increase the resiliency of the Treasury markets and reduce the likelihood of future market dysfunction.[6]

Thank you, again, for the opportunity to chair this panel. I look forward to our discussion.

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[1] These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

[2] The Fed also used its open market operations authority to purchase agency residential and commercial mortgage-backed securities and conducted repo operations with an expanded set of global counterparties. Some of the 13(3) facilities were versions of those that had been used during the 2008 financial crisis and others were new, such as corporate credit facilities, which directly purchased corporate bonds to support the flow of credit to the economy. All 13(3) lending facilities require the approval of the Secretary of the Treasury. For further details, see Board of Governors of the Federal Reserve System (2021), "Funding, Credit, Liquidity, and Loan Facilities," webpage.

[3] For a further description of these actions, see Board of Governors of the Federal Reserve System (2021), "Supervisory and Regulatory Actions in Response to COVID-19," webpage.

[4] For a discussion of the 13(3) lending facilities and their usage, see Board of Governors of the Federal Reserve System (2020), *Financial Stability Report* (PDF) (Washington: Board of Governors, November).

[5] This issue is most relevant when the assets purchases are those that the Fed can purchase using its open market operations authority, including Treasury and agency debt and agency-backed mortgage-backed securities. Programs to purchase other types of debt would need the approval of the Secretary of the Treasury under section 13 (3) of the Federal Reserve Act.

[6] For a discussion of potential reforms, see Inter-Agency Working Group on Treasury Market Surveillance (2021), *Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report* (PDF) (Washington: U.S. Department of the Treasury, November); and Inter-Agency Working Group on Treasury Market Surveillance (2022), *Enhancing the Resilience of the U.S. Treasury Market: 2022 Staff Progress Report* (PDF) (Washington: U.S. Department of the Treasury, November).