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Lessons Learned: William Nelson

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Lessons Learned

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William Nelson was deputy director, Division of Monetary Affairs, at the Federal Reserve Board during the Global Financial Crisis of 2007–09 (GFC). As the nation's central bank, chief financial regulator, and lender of last resort, the Federal Reserve Board took the lead in setting monetary policy and stabilizing the financial system during the crisis.

Nelson's responsibilities at the Fed during the crisis included analysis of monetary policy and discount window policy as well as financial institution supervision, and he regularly briefed the board and the Federal Open Market Committee. He developed special expertise in designing liquidity facilities and was a member of the Large Institution Supervision Coordinating Committee (LISCC) and the steering committee of the Comprehensive Liquidity Analysis and Review (CLAR). This "Lessons Learned" is based on an interview with Mr. Nelson.

Be prepared: Focusing on financial stability issues long before the crisis unfolded led to a more agile response.

As the person responsible for overseeing discount window policy at the Federal Reserve, Nelson recognized in the late 1990s the need to focus on financial stability issues. As head of the first internal group dedicated to financial stability, he spearheaded efforts to catalog possible events that could undermine the safety and soundness of the financial system—compiling the scenarios in "crisis binders"—and developed databanks that measured the degree of strain in the system and contained possible response mechanisms as well as key information on major financial institutions.

Federal Reserve Board members could access a dedicated website on financial stability issues; they also received quarterly briefings and additional write-ups as needed. Observed Nelson,

> When we started the team, I adopted the philosophy that we weren't going to be able to predict crises, but we could do our best to measure the conditions that made them more likely. Many European central banks had already developed central bank financial stability groups. One of the first things I did was to study what others were doing.

When the 2007–09 crisis hit, Nelson easily shifted his focus from research and analysis of monetary policy to getting directly involved in crafting a response.

Invoking 13(3) authority: The bell that can't be unrung.

During the GFC, the Federal Reserve pressed emergency "lender-of-last-resort" powers into service for the first time since the Great Depression: its so-called 13(3) authority [after Section 13(3) of the Federal Reserve Act] allows the agency to lend to nonbanks. With much of the liquidity problems during the GFC centered among nonbanks, invoking the authority gave the Fed ammunition to create liquidity facilities to maintain the flow of credit that led ultimately to stabilizing the financial system.

Nelson initially was skeptical whether the Fed would use its emergency authority during the GFC because it had gone 70 years without needing to invoke it. Also, he believed the moral hazard associated with bailing out institutions that exist out of the Fed's normal purview and are more lightly regulated and supervised, would give the central bank pause. While the Fed did go down that path, it did so reluctantly. Nelson observed: "Not only did the Fed use [Section 13(3)] several times during the crisis, when it did, it did so with great misgivings and awareness of the implications of what it was doing."

Yet, he expressed concern the practice could become the rule rather than the exception. Said Nelson,

> This past March [2020], when turmoil hit and the Fed immediately reopened all the facilities that had been built in the great financial crisis, it seemed like a bell that can't be unrung. Fed Chairman Jay Powell has frequently addressed this issue and has said, "These are emergency authorities, and when we're done we're going to put them away." But I do feel at this point these sorts of actions in support of financial markets and nonbank financial institutions are going to be expected and standard now.

Driving the Fed's current willingness to use its emergency authorities is the fact that the United States is no longer bank-centric: most credit intermediation occurs in the financial markets through lightly regulated institutions, or what is known as the "shadow banking sector." If that kind of liquidity support is expected to continue, Nelson noted, then it might also make sense in the future to apply the same liquidity and capital requirements to nonbanks.

Nelson is concerned that investors and market participants may be reading too much into the Fed's willingness to purchase assets and come to expect the agency eventually to purchase equities to support the stock market, expectations that are likely to be dashed, especially as the stock market appears richly valued. Opined Nelson, "It doesn't seem like those hopes are going to be realized."

Maintaining Federal Reserve Board independence: the risks are real.

Historically, the Federal Reserve Board has operated independently from the rest of the federal government and at a remove from political influences. Nelson noted that countries in which central bank independence is the custom typically experience superior economic results.

However, one of the outcomes of the GFC has been much greater collaboration between the Federal Reserve and other government agencies, most notably Treasury, initially out of necessity and more recently by design. Said Nelson,

> You see it even more now where, by congressional design, the CARES Act and in changes to 13(3) authorization, you have to have very close collaboration between the Treasury and the Fed. That's not necessarily a good thing.

What had typically been a formal and distant relationship between the two became much collaborative during the GFC under then Treasury Secretary Timothy Geithner, partly owing to his former role as president of the Federal Reserve Bank of New York. Nelson noted that over the course of the crisis, the two agencies were working together all the time, frequently on joint projects. This was a source of alarm to some longtime Federal Reserve officials.

As Nelson observed,

> It's a direct risk to central bank independence, even if it's a friendly risk. If there is regular interaction between the Treasury and the Fed, that works in the wrong direction.

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