VIII. Revisions to the Federal Reserve's Emergency Lending Rules

A. Introduction

In 1932, Section 13(3) of the Federal Reserve Act authorized the Federal Reserve to extend emergency credit to "any individual, partnership, or corporation" in "unusual or exigent" circumstances.[1] During the 2008 financial crisis, the Federal Reserve utilized this emergency lending power and established facilities for providing liquidity to financial companies and primary dealers, as well as for supplying emergency loans to purchase assets from failing broker-dealers and holding companies.[2] While the actions of the Federal Reserve appear to have minimized the effects of the financial crisis, many have criticized the Federal Reserve's emergency lending powers. Critics argued the Federal Reserve lacked transparency,[3]

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[1] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78,959 (Dec. 18, 2015) (to be codified at 12 C.F.R. pt. 201).

[2] Section 13(3) powers, which do not require congressional approval, are distinct from the TARP program, which Congress authorized in the Emergency Economic Stabilization Act. *See* Chad Emerson, *The Illegal Actions of the Federal Reserve: An Analysis of How the Nation's Central Bank Has Acted Outside the Law in Responding to the Current Financial Crisis*, 1 WM. & MARY BUS. L. REV. 109, 121 (2010) ("The [Emergency Economic Stabilization] Act allowed the federal government to purchase and insure certain types of troubled assets for the purpose of providing stability and preventing disruption to the country's economic growth. It authorized the Secretary of the Treasury to establish the Troubled Assets Relief Program (TARP) in order to purchase troubled assets from any financial institution."); Ernie Patrikis, *The Potential Impact Of Limiting Fed Emergency Lending*, LAW 360 (May 13, 2015), http://www.law360.com /articles/736000/the-potential-impact-of-limiting-fed-emergency-lending [https://perma.cc/R7PS-ZUZ5].

[3] *See* Daniel Wilson, *House Approves Bill To Overhaul Federal Reserve Processes,* LAW 360 (November 19, 2015, 12:41 PM), http://www.law360. com/articles/729173/house-approves-bill-to-overhaul-federal-reserve-processes [https://perma.cc/AP2F-FXHV] (covering the proposed Federal Oversight Reform and Modernization Act) ("House Financial Services Committee Chairman Jeb Hensarling, R-Texas, had argued that the policy decisions of the Fed need to be more transparent and that it needs to be more accountable to lawmakers and the public.").

encouraged risk-taking[4], and provided unlimited financing without clear timelines.[5] Congress reacted to the 2008 financial crisis with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[6] which, in relevant part, amended section 13(3) to reduce emergency lending powers and Federal Reserve discretion.[7] Notably, the new emergency lending rule goes even further than Dodd-Frank required, yielding to criticisms from Congress that have prompted further legislation.[8]

The amendments to section 13(3) of the Federal Reserve Act implement sections 1101 and 1103 of Dodd-Frank, with the goal of

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[4] *See* Jessica Corso, *Sens. Vitter, Warren Team Up Against Future Bank Bailouts*, LAW 360 (May 13, 2015), http://www.law360.com/articles/655440 [https://perma.cc/KN33-5TKC] (covering the proposed Bailout Prevention Act and statements of Senator Elizabeth Warren: "If big financial institutions know they can get cheap cash from the Fed in a crisis, they have less incentive to manage their risks carefully . . . .").

[5] *See* Scott Fullwiler, *Loans, Asset Purchases, and Exit Strategies—Why the WSJ Doesn't Understand the Fed's Operations*, NEW ECON. PERSPS. (July 9, 2009), http://neweconomicperspectives.org/2009/07/loans-asset-purch ases-and-exit.html [https://perma.cc/F4RX-CNSG] ("[O]ne of the main reasons why he and others . . . are so worried about the Fed's purchases of assets is the Fed, unlike the ECB, lacks a clear 'exit strategy.'").

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

[7] *See* Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances*: *The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 265-66 (2010) ("The first point concerns the newly stated purpose of the legislation. As amended, § 13(3) now states that future emergency lending will occur under a set of policies and procedures (to be established by regulation) designed to ensure that 'any emergency lending program or facility is for the purpose of providing liquidity to the financial system.'").

[8] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,960 ("The final rule adopts all of the limitations and revisions required by the Dodd-Frank Act. In addition, in response to the comments, the Board has revised the final rule in a number of significant ways."); MARC LABONTE, CONG. RESEARCH SERV., R44185, FEDERAL RESERVE: EMERGENCY LENDING 22-23 (2016) (covering H.R. 3189, S. 1320, and H.R. 2625) ("As discussed above, the Dodd-Frank Act compromised between stability and oversight concerns by requiring borrowers' identities to be publicly released with a lag. Some Members of Congress have expressed an interest in revisiting this issue.").

reducing moral hazard[9] and ending bailouts to entities "too big to fail."[10] The new rules attempt to accomplish these goals primarily through three fundamental changes.[11] First, the new rules replace the Federal Reserve's general authority to lend to an individual, partnership, or corporation with a limited authority to extend credit to broad-based eligibility programs with at least five eligible members.[12] Second, the revised emergency lending powers cannot be used, directly or indirectly, to provide credit to insolvent borrowers.[13] Third, the revised emergency lending powers now have additional congressional and executive checks on their use.[14] While these

[9] *See* Frank Ahrens, *'Moral Hazard': Why Risk Is Good*, WASH. POST (Mar. 19, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/03/18/AR2008031802873.html [https://perma.cc/9LPV-A5BP] ("Moral hazard describes a situation in which a party is insulated from the consequences of its actions. Thus protected, it has no incentive to behave differently.").

[10] *See* President Barack Obama, Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, (July 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act [https://perma.cc/94ZR-F89B] ("If a large financial institution should ever fail, this reform gives us the ability to wind it down without endangering the broader economy. And there will be new rules to make clear that no firm is somehow protected because it is 'too big to fail,' so we don't have another AIG.").

[11] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,959.

[12] *See id.* at 78,960.

[13] *Id.* at 78,961 ("Importantly, the final rule would not authorize a program or facility that sought to evade these limitations by grouping multiple failing or insolvent firms in a single program or facility.").

[14] *See id.* at 78,960, 78,963 ("[T]o further Congressional oversight of emergency lending facilities, the Board's final rule establishes a process by which the Board will promptly provide written notice to Congress of any emergency program or facility established under section 13(3) of the FRA . . . [and the] Secretary of the Treasury [must approve] the renewal."); 12 U.S.C. 343(3)(B)(iv) (2012) ("The Board may not establish any program or facility under this paragraph without the prior approval of the Secretary of the Treasury."); 12 U.S.C. 343(3)(C)(i-ii) (2012) ("The Board shall provide to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives--(i) not later than 7 days after the Board authorizes any loan or other financial assistance under this paragraph, a report that includes--(I) the justification for the exercise of authority to provide such assistance; (II) the identity of the recipients of such assistance; (III) the date and amount of the assistance, and

restrictions to the Federal Reserve's emergency lending capacities may reduce moral hazard, there is still significant power for emergency lending.[15]

B. Federal Reserve Emergency Lending Powers: 1907-2010

1. The Birth and Evolution of the Federal Reserve

The history of the Federal Reserve began during the Panic of 1907, a relatively small-scale financial crisis that triggered bankruptcies and high rates of unemployment. Through coordinated efforts, private individuals and banks were only just barely able to overcome that crisis.[16] Congress investigated the source of the 1907 crisis with the National Monetary Commission and determined that US banks were highly susceptible to runs and unable to accommodate sudden change in demands for funds from depositors.[17] Recognizing the fragility of the financial markets, legislators established the Federal Reserve as a new central bank charged with establishing monetary policy, including providing rediscounting services.[18] The preamble to

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form in which the assistance was provided; and (IV) the material terms of the assistance . . . and (ii) once every 30 days, with respect to any outstanding loan or other financial assistance under this paragraph, written updates on--(I) the value of collateral; (II) the amount of interest, fees, and other revenue or items of value received in exchange for the assistance; and (III) the expected or final cost to the taxpayers of such assistance.").

[15] *See* Evan Weinberger, *Federal Reserve Rule Limits Emergency Lending Powers*, LAW 360 (Nov. 30, 2015), http://www.law360.com/articles/732064 [https://perma.cc/HNW9-M3YK] ("[T]he Fed came under pressure from key lawmakers, including Sen. Elizabeth Warren, D-Ma., and Sen. David Vitter, R-La., to make the rules more stringent in order to reduce moral hazard.").

[16] *See* Peter Conti-Brown, *The Institutions of Federal Reserve Independence*, 32 YALE J. ON REG. 257, 276 (2015) ("[T]he Panic of 1907 made bankers and politicians wary of continued reliance on the private bailout model. The Federal Reserve System was the political response to their concerns.").

[17] *Born of a Panic: Forming the Fed System*, FED. RESERVE BANK OF MINNEAPOLIS (Aug. 1988), https://minneapolisfed.org/publications/the-region/born-of-a-panic-forming-the-fed-system [https://perma.cc/X569-QNYD].

[18] *See id.*; Conti-Brown, *supra* note 16, at 277-78 ("The key consequence of this political transformation was what might be called the Compromise of 1913. The two major results of that Compromise were the creations of the leanly staffed, mostly supervisory Federal Reserve Board, based in

the 1913 Federal Reserve Act specified that these monetary policies pertained solely to member banks and not the public.[19]

The Federal Reserve's dramatic increase in powers through the Emergency Relief and Construction Act of 1932[20] included section 13(3) emergency lending powers, albeit in a form substantially more exacting than those utilized during the 2008 financial crisis.[21] In 1935, the Banking Act of 1935 relaxed the Federal Reserve Bank's requirements for discounting financial instruments from a system that requires both an endorsement and a security to a system that only requires one or the other.[22] From 1932 to 1936, the Federal Reserve

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Washington, DC, and of the twelve quasi-autonomous 'Reserve Banks,' which several active participants in the Act's drafting considered essentially private institutions.").

[19] *See* David H. Small & James A. Clouse, *The Limits the Federal Reserve Act Places on the Monetary Policy Actions of the Federal Reserve*, 19 ANN. REV. BANKING L. 553, 558 (2000) (citing Section 1-001, Federal Reserve Act of 1913, ch. 6, 38 Stat. 251 (1913) (codified as amended in scattered sections of 12 U.S.C.)) ("The Federal Reserve Act states that it is establishing the Federal Reserve System 'to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes' . . . the term 'rediscounting' presumes that the Federal Reserve would be dealing with member banks but not directly with the public.").

[20] *See* Emergency Relief and Construction Act of 1932, ch. 520, § 210, 47 Stat. 7715 (1932) (codified as amended at 12 U.S.C. §13(3) (2012)). For a list of important events and legislative changes for the Federal Reserve, see David Fettig, *The History of a Powerful Paragraph*, FED. RESERVE BANK OF MINNEAPOLIS, (June 2008), https://www.minneapolisfed.org/publications/the-region/the-history-of-a-powerful-paragraph [https://perma.cc/96QV-5MJK] ("Here are key legislative dates and related events: 1932 Emergency Relief and Construction Act: Added paragraph 3 to Section 13 of the Federal Reserve Act, opening the discount window to nonbanks 'in unusual and exigent circumstances.' 123 loans were made over four years by all 12 Federal Reserve banks, totaling about $1.5 million.").

[21] *See* Mehra, *supra* note 7, at 231 ("By specifying the collateral eligible for discount, the legislation as enacted limited the Fed's ability to extend credit to investment banks and other similar firms under § 13(3).").

[22] *See id.* at 230 ("[T]he instrument had to be 'indorsed and otherwise secured' to the Bank's satisfaction. Even though the text appears to be both conjunctive and disjunctive ('and otherwise'), it was arguable that the collateral had to be *both* endorsed and secured. This constraint was modified by § 322 of the Banking Act of 1935, which replaced 'and' with 'or.'").

utilized its emergency lending powers to provide 123 loans worth approximately $23 million when converted to 2009 figures.[23] On several occasions between 1937 and 2007, the Fed indicated its willingness to utilize its emergency lending power, although it never actually made emergency loans.[24] In 1991, section 473 of the Federal Deposit Insurance Corporation Improvement Act removed long-standing limitations on the type of collateral that the Reserve Banks were permitted to discount, enabling discount window[25] access to investment banks.[26]

2. The Financial Crisis and Emergency Lending

In June 2007, one of Bear Stearns's two hedge funds dealing in the subprime mortgage market, the Bear Stearns High-Grade Structured Credit Fund, began to collapse after its mortgage-backed securities rapidly dropped in value, prompting Bear Stearns to bail it

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[23] *Id.* at 265-66 (citing Thomas C. Baxter, Jr., Gen. Counsel, Fed. Res. Bank of N.Y., The Legal Position of the Central Bank, The Case of the Federal Reserve Bank of New York 6 (Jan. 19, 2009), http://lse.ac.uk/fmg/documents/events/conferences/2009/regulatoryResponse/1160_ Baxter.pdf [https://perma.cc/M76F-STXV]); Fettig, *supra* note 20.

[24] *See* Alexander Mehra, *supra* note 7, at 234 ("In later years, the Fed did occasionally activate its § 13(3) authority to lend. However, it did not actually make any further loans until 2008").

[25] The discount window is a Federal Reserve program where financial institutions can receive loans, usually at an above-market rate, provided that collateral requirements are met. *See* Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795, 797 (2014) ("A core function of the Federal Reserve System (the Fed) is to promote financial stability, and a primary way that the Fed furthers this aim is by acting as the lender of last resort. Until the 2007-2009 financial crisis (the Crisis), the Fed carried out this role through its discount window (the Discount Window), a standing program that enables banks to borrow from the Fed so long as they can provide adequate collateral and meet other requirements.").

[26] *See id.* at 231 ("By specifying the collateral eligible for discount, the legislation as enacted limited the Fed's ability to extend credit to investment banks and other similar firms under § 13(3). The majority of their assets consist of investment instruments, against which no loans could then be made. This constraint was abolished by § 473 of the Federal Deposit Insurance Corporation Improvement Act.").

out for $3.2 billion.[27] Several weeks later, the fund filed for bankruptcy.[28] By March 2008, rumors and speculation about Bear Stearns's financial state triggered an exodus of lending to the firm to avoid counter-party risk.[29] Since Bear Stearns was unable to secure lending to fund daily operations, the Federal Reserve used its section 13(3) emergency lending powers to establish a program designed to remove assets from Bear Stearns's balance sheet and make it a more desirable target for acquisition. The Federal Reserve created a special purpose vehicle (SPV) [30] called Maiden Lane to which it could transfer some of Bear Stearns assets.[31] Soon thereafter, JPMorgan, collaborating with the Federal Reserve, quickly purchased the remaining portion of Bear Stearns.[32]

The Federal Reserve created two SPVs, Maiden Lane II and Maiden Lane III, to supply loans to and make asset purchases from American International Group (AIG) in the face of severe liquidity

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[27] *See* Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, NY TIMES, June 23, 2007 at A1.

[28] *See* Christine Caulfield, *Ex-Bear Stearns Execs Knew the End Was Near: Feds,* LAW 360 (June 19, 2008, 12:00 AM), http://www.law360.com/articles/59628/ex-bear-stearns-execs-knew-the-end-was-near-feds [https://perma.cc/9Y59-HFE2].

[29] *See* Thomas O. Porter, *The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers*, 13 N.C. BANKING INST. 483, 493 (2009) ("Concerns spread quickly that Bear's liquidity position was compromised. Of particular significance, Goldman Sachs and Credit Suisse sent mass internal e-mails implicating Bear's counter-party risk, hedge funds began exiting Bear's prime brokerage business, and money-market funds reversed positions with exposure to Bear's commercial paper. By Thursday, March 13, 2008, Bear could not find sufficient overnight funding via 'repo lenders' to conduct business on Friday.").

[30] Paloian v. LaSalle (*In re* Doctors Hospital of Hyde Park Inc.)*,* 507 B.R. 558, 665 (Bankr. N.D. Ill. 2013) ("Special purpose vehicles—are commonly used in asset-backed securities and structured finance transactions; they are set up specifically for the purpose of financing a specific group of assets and isolating those assets from the originator of those assets.").

[31] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961; Mehra, *supra* note 7, at 237.

[32] *See* Mehra, *supra* note 7, at 237 ("JPMorgan emerged as a potential purchaser of the company. However, it did not wish to acquire all of Bear Stearns's assets. In particular, it sought to avoid purchasing Bear Stearns's illiquid MBS.").

issues similar to Bear Stearns.[33] The Federal Reserve used its section 13(3) powers to create five programs[34] and facilities utilizing SPVs: the Commercial Paper Funding Facility (CPFF), the Money Market Investor Funding Facility (MMIFF), the Primary Dealer Credit Facility (PDCF), Term Asset-Backed Securities Loan Facility (TALF), and the Term Securities Lending Facility (TSLF).[35] These facilities provided liquidity to the financial markets through asset purchases that were subsequently resold over an extended period of time.[36] The Federal Reserve created entity-specific programs for four

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[33] *Actions Related to AIG*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/aboutthefed/aig (last visited April 7, 2016) [https://perma.cc/3GJ7-F5GZ].

[34] Technically, the Federal Reserve created six facilities; however, only five were used. *See* Labonte, *supra* note 8, at 3.

[35] *See Credit and Liquidity Programs Archive*, FED. RESERVE BANK OF N.Y., https://www.newyorkfed.org/markets/funding_archive [https://perma.cc/L3VJ-HN72] (The "(CPFF), created in October 2008, provided liquidity in short-term funding markets, thereby contributing to greater availability of credit for businesses and households… (MMIFF), created in October 2008, supported a private-sector initiative to provide liquidity to U.S. money market investors… (PDCF), created in March 2008, provided overnight funding to primary dealers in exchange for a specified range of eligible collateral… (TALF) helped market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) and improving the market conditions for ABS more generally… (TSLF), created in March 2008, provided general collateral financing to promote liquidity in Treasury and other collateral markets."); *see also* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78961 ("this approach would permit the Federal Reserve to establish programs or facilities like the Term Asset-backed Securities Loan Facility (TALF), which provided several thousand loans that provided liquidity to fund several billion dollars of student loans, car loans, small business loans and other loans in the securitization market; the Commercial Paper Funding Facility (CPFF), which was a program with broad-based eligibility designed to provide liquidity to the commercial paper market; the Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and the Money Market Investor Funding Facility (MMIFF), which were programs with broad-based eligibility designed to provide liquidity to the money market fund sector; and the Primary Dealer Credit Facility (PDCF), which provided liquidity to all primary dealers in support of trading in the U.S. Government securities market.").

[36] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961.

financial institutions: Bear Stearns, AIG, Citigroup, and Bank of America.[37]

C. Changes to Emergency Lending Powers

The Federal Reserve created facilities, particularly the entity-specific programs, prompted criticism that the Federal Reserve was rewarding large financial institutions for excessive risk-taking.[38] Some commentators argued that many of these SPV loans and asset purchases were not within the purview of section 13(3).[39] The Federal Reserve's new emergency lending rules reflect both liberal and conservative concerns that the Federal Reserve had too much discretionary power under the prior emergency lending regime.[40] Prior to Dodd-Frank, there were only four conditions required to use section 13(3) emergency lending powers: (1) "unusual and exigent circumstances;" (2) board authorization by the affirmative vote of at

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[37] *See* Labonte, *supra* note 8.

[38] *See* 156 CONG. REC. S5879 (daily ed. July 15, 2010) (statement of Sen. Reid) ("Wall Street rigged the game. They put our money on the table. When they won, they won big. The jackpots they took home were in the billions. And when they lost-and, boy, did they lose—they came crying to the taxpayers for help."); Carl Hulse, *Conservatives Viewed Bailout Plan as Last Straw*, N.Y. TIMES, Sept. 8, 2008 at A1.

[39] *See* Mehra, *supra* note 7, at 244-45, 248 ("First, the transaction did not observe the loan/asset-purchase distinction. Second, there was no loan to the party that needs assistance. Third, it seems that the requirement of endorsement or security was not met."); Emerson, *supra* note 2, at 127 ("A careful review of these emergency powers reveals that the Fed exceeded even this increased authority with its recent actions. For instance, the emergency section applies only to the discounting of notes, drafts, and bills of exchange in unusual and exigent circumstances. Nowhere does the section provide the Fed with authority to purchase private assets. As a result, under the Federal Reserve Act, the Fed cannot purchase notes or drafts that do not comport with section 14."); Labonte, *supra* note 8, at 17 ("[T]he Fed required that AIG provide it with compensation in the form of an equity stake in the company in exchange for a loan. The Fed's ability to protect taxpayers against losses could be more limited in the future based on a recent court ruling. The court found that the AIG equity stake was an illegal exaction.").

[40] Corso, *supra* note 4 ("The Fed said that the rule is meant to carry out the legislative intent that any emergency lending program be designed to provide liquidity to the financial system, not aid a failing company. But the bipartisan coalition disagreed, writing that the proposed rule will do little to prevent megabanks from being bailed out in the future.").

least five of seven members;[41] (3) evidence that the borrower is unable to secure adequate credit from other banking institutions; and (4) the extension of credit is endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank.[42]

The new rules constrain the previously robust emergency lending regime in three ways.[43] First, the Federal Reserve can no longer utilize section 13(3) to provide emergency lending to individual businesses and persons.[44] Instead, to provide emergency lending, the Federal Reserve must create a program that satisfies a "broad based eligibility" requirement.[45] Second, the Federal Reserve can no longer use its emergency lending powers to assist companies facing insolvency.[46] Third, the new rules also impose increased congressional oversight and executive control over emergency lending.[47]

1. Broad-Based Eligibility Programs

Title II of Dodd-Frank provides that lending under section 13(3) is only available to a "participant in any program or facility with broad-based eligibility."[48] Broad-based eligibility requires the

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[41] This requirement, which still exists, does not need to be met under certain unusual situations if other requirements are met. *See* 12 U.S.C. § 248(r)(2)(A) (2012).
[42] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,959.
[43] *Id.*; *see* 12 U.S.C. 343(3)(A) (2012).
[44] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,959.
[45] *Id.*
[46] *See id.* at 78,960.
[47] *See* 12 U.S.C. § 343(3)(B)(iv) (2012); 12 U.S.C. 343(3)(C)(i-ii) (2012) ("The Board shall provide to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives--(i) not later than 7 days after the Board authorizes any loan or other financial assistance under this paragraph, a report that includes--(I) the justification for the exercise of authority to provide such assistance; (II) the identity of the recipients of such assistance; (III) the date and amount of the assistance, and form in which the assistance was provided; and (IV) the material terms of the assistance… and (ii) once every 30 days, with respect to any outstanding loan or other financial assistance under this paragraph, written updates on-- (I) the value of collateral; (II) the amount of interest, fees, and other revenue or items of value received in exchange for the assistance; and (III) the expected or final cost to the taxpayers of such assistance.").
[48] *See* 12 U.S.C. § 343(3)(A) (2012).

program or facility to be designed to provide liquidity to a specific market or sector with multiple eligible participants, rather than specific entities.[49] Following the exact language of Dodd-Frank, the proposed rule stated that "a program or facility… established for the purpose of assisting a single and specific company… shall not be considered a program or facility with broad-based eligibility."[50] Some commenters expressed concern that the Federal Reserve would be able to circumvent the requirement focusing on markets rather than entities by grouping select insolvent entities together into a program or facility.[51] While rejecting a proposal that there must be at least five entities in the program, the final rule provides that at least five entities must be *eligible to participate* in the program.[52] To curb concerns that specific entities would receive favorable treatment, the final rule also states that a "program or facility will not be considered to have broad-based eligibility for purposes of this subsection if . . . designed for the purpose of assisting one or more specific companies."[53] The final rule makes clear that facilities such as the CPFF[54] and the MMIFF[55] will

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[49] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961 (First, the program or facility must be designed for the purpose of providing liquidity to an identifiable market or sector of the financial system . . . Second the program or facility must not be designed for the purpose of assisting one or more specific companies to avoid bankruptcy or other resolution, including by removing assets from the balance sheet of the company or companies… Third, the final rule provides that a program or facility would not be considered broad-based if fewer than five persons are eligible to participate in the program or facility.").

[50] *See id*.; 12 U.S.C. § 343(3)(B)(iii) (2012).

[51] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961 ("Several commenters expressed concern that the reference in the proposed rule to 'a single and specific company' could allow the Board to circumvent the limits imposed by the Dodd-Frank Act by grouping two or more bankrupt or failing firms in a program or facility.").

[52] *See id.* at 78,965-6.

[53] *See id.*

[54] (CPFF) provided liquidity to the commercial paper market and had 120 participants during the financial crisis from October 7, 2008 to February 1, 2010. *See* Labonte, *supra* note 8, at 5.

[55] The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) provided liquidity to the money market fund market and had 11 participants from 7 bank holding companies from September 19, 2008 to February 1, 2010. *See id.*

continue to be within the Federal Reserve's section 13(3) powers, since such facilities meet the broad-based eligibility requirement.[56]

2. Insolvent Entities

The new emergency lending rule prohibits the Federal Reserve from providing liquidity through section 13(3) programs or facilities to entities that are insolvent.[57] Insolvency under Dodd-Frank is defined as "any person or entity that is in bankruptcy, resolution under Title II of Dodd-Frank, or any other Federal or State insolvency proceeding."[58] Further, the revised rule requires that the Federal Reserve Board or the lending Federal Reserve Bank obtain evidence that the entity is not insolvent prior to originating loans.[59]

Under the new emergency lending rule, it is sufficient for the CEO or another authorized officer to provide a written certification attesting that the entity is not insolvent.[60] The rule goes beyond the mandates of Dodd-Frank by requiring the certifier to attest that "the potential borrower has not failed to generally pay its undisputed debts as they become due during the 90 days preceding the date of borrowing."[61] If a borrower knowingly makes material misrepresentations[62] in the certification regarding its solvency, any

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[56] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961 ("For example, this approach would permit the Federal Reserve to establish programs or facilities like… the Commercial Paper Funding Facility . . . [and] the Money Market Investor Funding Facility.").

[57] *See id.* ("Importantly, the final rule would not authorize a program or facility that sought to evade these limitations by grouping multiple failing or insolvent firms in a single program or facility.").

[58] *Id*.

[59] *Id.* at 78,966 (imposing restrictions on the Federal Reserve by prohibiting the extension of credit to an insolvent person or entity or borrowing for the purpose of lending to another insolvent person or entity).

[60] *Id.* at 78,962 ("[T]he final rule provides that the Board and a Federal Reserve Bank may rely on a written certification from the person, the chief executive officer of the entity or another authorized officer of the entity, at the time the person or entity initially borrows under a program or facility, that the person or entity is not in bankruptcy or in a resolution or other insolvency proceeding.").

[61] *Id*. at 78,966.

[62] Assuming the securities standard of "materiality" is applied, if a financial institution seeking an emergency loan intentionally provides information that is untrue or omits information that would have assumed actual significance

emergency loans, including any interest, fees, and penalties, will become immediately due.[63] Additionally, the Federal Reserve will pursue relevant civil and criminal action.[64] The final rule also permits the Federal Reserve, at its discretion, to deem, based on "audited financial statements or other relevant documentation, that an entity is otherwise insolvent."[65] Additionally, entities that become insolvent after receiving access to emergency credit cannot receive additional credit from the program or facility.[66] Further, under the revised emergency lending rules, solvent entities cannot seek emergency loans with the intent of lending those funds to insolvent entities.[67] The final rule notice emphasizes that the broad-based eligibility requirement and the solvency requirement are both necessary conditions that must be met to establish section 13(3) programs or facilities.[68]

3. Executive Control and Congressional Oversight

The new emergency lending rule establishes that the Secretary of the Treasury must approve any Section 13(3) program or facility before it is created.[69] Since the Secretary of Treasury is a member of

in a determination as to whether that institution was solvent, then there will be a "material misrepresentation." *See id.*; *accord* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) ("What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance . . . ."). "Material misrepresentation" is not defined in either the new rule or 12 U.S.C. § 221 and there have yet to be knowing material misrepresentations regarding the solvency of a financial institution when obtaining emergency loans. The term "material" has a long history in securities litigation, which may instruct the use of the term.

[63] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,966.

[64] *Id.* at 78,962.

[65] *Id.*

[66] *Id.*

[67] *Id.* at 78,966 ("A Federal Reserve Bank may not extend credit . . . to any person or entity that is borrowing for the purpose of lending the proceeds of the loan to a person or entity that is insolvent.").

[68] *Id.* at 78,961 n.11 ("While the final rule requires that at least five persons be eligible to participate in a program or facility, that requirement is in addition to the restriction on establishing a program or facility for the purpose of providing credit to prevent the failure or resolution of any number of specific failing or insolvent persons, and would not allow a program or facility designed for the purpose of preventing the resolution or failure of more than five persons.").

[69] *Id.* at 78,960.

the President's Cabinet, the requirement places a strong executive check on the use of emergency lending powers.[70] The new rule also requires that the Board of Governors of the Federal Reserve must either terminate or formally extend section 13(3) programs or facilities within one year.[71] Formal extension requires the approval of the Secretary of the Treasury, notice to Congress, and an affirmative vote of five of seven Board members.[72]

When the proposed emergency lending rule was released, one commenter suggested that facilities and programs should have to be approved by a joint resolution of Congress.[73] In rejecting this proposal, the Board of Governors of the Federal Reserve highlighted that Dodd-Frank imposed that approval requirement for emergency actions by the Federal Deposit Insurance Corporation (FDIC), but did not impose such restriction on the Federal Reserve.[74] If this limitation was in place, the Federal Reserve would effectively return the congressionally delegated emergency lending powers to Congress.[75] However, the final rule does require that the Federal Reserve provide Congress with written notice of emergency programs or facilities within seven days after their creation, including the identity of

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[70] Anita S. Krishnakumar, *In Defense of the Debt Limit Statute*, 42 HARV. J. ON LEGIS. 135, 170 (2005) ("For without the debt limit, all control over debt issuance would shift to the Treasury Secretary, a member of the President's Cabinet, leaving the President effectively in command of government borrowing.").

[71] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,966.

[72] *Id.* at 78,966-7 ("A program or facility may be renewed upon the vote of not less than five members of the Board that unusual and exigent circumstances continue to exist and the program or facility continues to appropriately provide liquidity to the financial system, and the approval of the Secretary of the Treasury.").

[73] *Id.* at 78,960 ("One commenter suggested that, in addition to this approval, the Board should seek a joint resolution of Congress in connection with the establishment of a program or facility.").

[74] *See id.*

[75] See Timothy A. Canova, *The Transformation of U.S. Banking and Finance: From Regulated Competition to Free-market Receivership*, 60 BROOK. L. REV. 1295, 1345 (1995) ("While the Constitution gives Congress the exclusive right to coin money, that power is effectively farmed out to the private bankers which dominate the Fed. Such broad legislative delegations of power effectively permit bureaucratic agencies such as the Fed to 'pick winners and losers' while shielding agency deliberations from the scrutiny of open public debate.").

participants, the type of assistance, and the terms of that assistance.[76] Every thirty days after an emergency program or facility has been created, the Federal Reserve must also report to Congress the value of the collateral pledged by the participant, interest, fees, revenue, and the expected cost to taxpayers from the program.[77]

D. Implications and Trends

The implications of reining in Federal Reserve emergency lending discretion are uncertain and depend on one's stance on the Federal Reserve's emergency loans during the recent financial crisis. The sections of Dodd-Frank pertinent to the Federal Reserve's emergency lending powers are aimed to reduce moral hazard and prevent tailored bailouts to specific entities "too big to fail" while leaving the Federal Reserve with some ability to respond to market fluctuations.[78] To some, the new emergency lending rules will allay fears of a future bailout of entities positioned similarly to Bear Stearns and AIG in 2007 and 2008.[79] After all, the final rule explicitly states that the Federal Reserve can neither lend to individual entities nor insolvent entities.[80] If it were to make emergency loans to individual or insolvent entities in the face of its recent explicit disclaimer of authority, it would face severe congressional backlash.[81] Since these

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[76] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,965 (regarding the disclosure of justification and terms, the notice must also state which markets or sectors' liquidity is intended to be provided through the program or facility).

[77] *See id.*

[78] *See* Obama, *supra* note 10; Labonte, *supra* note 8, at 10 ("Generally, the intention of the provision in the Dodd-Frank Act was to prevent the Fed from bailing out failing firms while preserving enough of its discretion that it could still create broadly based facilities to address unpredictable market-access problems during a crisis.").

[79] *See* Labonte, *supra* note 8, at 11 (citing Ben Bernanke, *Warren-Vitter and the Lender of Last Resort*, BROOKINGS INST. (May 15, 2015), http://www.brookings.edu/blogs/ben-bernanke/posts/2015/05/15-warren-vitter-proposal [https://perma.cc/FP9S-SQ7X]) ("With the creation of the liquidation authority, the ability of the Fed to make loans to individual troubled firms like Bear and AIG was no longer needed and, appropriately, was eliminated.").

[80] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,961.

[81] *See id.* ("Thus, the revisions in the final rule would not permit the Federal Reserve to extend emergency credit in a case like the Bear Stearns or AIG

entities cannot rely upon the Federal Reserve to tailor individual loans to fit an emergency situation, entities will arguably internalize the heightened consequences of insolvency by engaging in reduced risk-taking.[82]

Those who view the Federal Reserve's actions in 2008 as illegal will remain skeptical; should another large financial institution face insolvency, the Federal Reserve could act illegally again.[83] Furthermore, the "broad-based eligibility" hurdle to creating a program or facility is not particularly imposing; only five entities need to be *eligible* to participate, rather than actually engaged, in the program[84] and every facility created during the financial crisis had over five participants.[85] It is worth noting, however, that broad-based eligibility may curtail loan terms that unduly favor specific entities, since loans cannot be tailored to individual entities.[86]

Others view the new rules as a step in the right direction, but believe that they inadequately rein in the Federal Reserve's discretion.[87] The Federal Reserve has steadfastly resisted calls for rules that set specified penalty rates on section 13(3) loans.[88] It has

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situation simply by establishing a single program or facility for the purpose of providing credit to both Bear Stearns and AIG, or any other number of specific failing or insolvent firms.").

[82] *See* Mehra, *supra* note 7, at 263.

[83] *See* Emerson, *supra* note 2, at 133 ("Though the Fed's illegal equity purchase activities are evident in a macro sense, the precise details of this malfeasance is difficult to expose, especially because Congress currently does not possess the power to comprehensively audit the Fed."); *see also* Porter, *supra* note 29, at 512-3 (2009) ("[S]ubsequent actions raise questions about whether the Fed continued to meet the 'unusual' standard required under § 13(3)").

[84] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,960.

[85] *See* Labonte, *supra* note 8, at 5.

[86] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,960.

[87] *See* Wilson, *supra* note 3.

[88] *See* Weinberger, *supra* note 12 ("Critics of the Dodd-Frank provision limiting the Fed's emergency powers have said that it takes away the central bank's flexibility in responding to a crisis."); Harriet Torry & Josh Zumbrun, *Yellen Reiterates Opposition to Taylor Rule in Letter to Ryan, Pelosi*, WALL ST. J. (Nov. 17, 2015), http://www.wsj.com/articles/yellen-reiterates-opposition-to-taylor-rule-in-letter-to-ryan-pelosi-1447778723?mg=id-wsj [https://perma.cc/6L27-NJSM] ("A statement from Mrs. Pelosi's office said she 'strongly opposes Republican efforts to compromise the Fed's independence by politicizing its monetary policy decision making.'"); *see also* Bailout Prevention Act of 2015, H.R. 2625, S. 1320, 114th Cong. (2015).

also resisted calls for restricting collateral requirements.[89] The revised emergency lending rules now require that the Federal Reserve "assign lendable value to all collateral for the program or facility, consistent with sound risk management practices . . . ensuring protection for the taxpayer."[90] The Federal Reserve noted that in the final rule, however, it followed this requirement prior to enacting the rules.[91] The Federal Reserve emphasized that it will continue to discount collateral for emergency lending purposes in accordance with the Federal Reserve Discount Window and Payment System Risk Collateral Margins Table and the Federal Reserve Collateral Guidelines.[92] In light of the collateral previously accepted by the Federal Reserve's emergency programs during the 2008 financial crisis, as well as the heightened risk associated with emergency lending generally, the sufficiency of the current discount window collateral requirements is debatable in an emergency lending situation.[93]

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[89] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,962 ("Some commenters argued that the Board should limit the types of collateral the Federal Reserve Banks may accept in support of an emergency credit.").
[90] *See id.* at 78,966.
[91] *See id.* (describing the final rule's emphasis on protecting taxpayers in the Federal Reserve's issuing of emergency loans and the safeguards in place to promote risk management in general).
[92] *See id.* at 78,962 ("In all cases, the Reserve Bank applies appropriate discounts or 'haircuts' to the value of the collateral. The haircuts applied to collateral are described in the Federal Reserve Discount Window & Payment System Risk Collateral Margins Table and the Federal Reserve Collateral Guidelines."); Discount Window and Payment System Risk Collateral Margins Table (Aug. 3, 2015), https://www.frbdiscountwindow.org/Home/Pages/Collateral/Discount-Window%20and%20Payment-System-Risk-Collateral-Margins-Table [https://perma.cc/HC9V-DSD8] (discount margins effective beginning August 3, 2015).
[93] *Compare* Small & Clouse, *supra* note 19, at 562 ("[T]he credit risk of the underlying collateral again stays with the depository institution, and the only risk the Federal Reserve takes on is the risk that the depository will default."), *with* Mehra, *supra* note 7, at 269 ("What about transactions in which the Fed made § 13(3) loans against collateral of low quality? These would appear to have been acceptable under the terms of the statute at the time the Fed used it. In such cases, by definition, there is a substantial likelihood that the loan will not be repaid in full. Consequently, the Fed is likely to incur losses. These are ultimately borne by the taxpayer, because the Fed remits the profits it makes to the Treasury.").

Finally, a third stance views the new emergency lending rules as excessively restricting the Federal Reserve from acting in emergency situations. While it is difficult to imagine the counterfactual economic effects had the Federal Reserve not acted in 2008, many argue the consequences would have been dire.[94] Under the new rules, once an entity has crossed the threshold into insolvency, the Federal Reserve cannot provide that entity access to emergency credit.[95] Similarly, even if an entity seeking an emergency loan is solvent, the Federal Reserve will be unable to provide access to emergency lending if the entity does not fit into a broad-based eligibility program.[96] This may result in entities sinking into insolvency like AIG and Bear Stearns in 2008 despite the fact that some of these entities would be able to recover with the help of such emergency loans.[97] Ironically, the new emergency lending rule may have flipped the "lender of last resort" model on its head by restricting access to emergency loans.[98] The Federal Reserve may soon find itself

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[94] *See* Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 93 (2011) ("Paired with additional requirements for the central clearing of CDSs, such limitation on the Federal Reserve's ability to lend to CCPs would have threatened to exacerbate potential future crises. The final version of Dodd-Frank, fortunately, recognizes the systemic importance of clearinghouses and explicitly permits the Federal Reserve to extend credit to CCPs, even if only in emergency circumstances.").

[95] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,966 ("Before extending credit through a program or facility established under this paragraph (d) to any person or entity, the Federal Reserve Bank must obtain evidence that the person or entity is not insolvent . . . .").

[96] *See id.* at 78,960 (describing the provision for Section 201.4(d)(1) of the final rule which allows for the Board, upon affirmative vote of at least 5 members, to extend credit in "unusual and exigent circumstances").

[97] *See* Labonte, *supra* note 8, at 7 ("While some have described this assistance as a bail out of failing firms, in all four cases, there was not clear evidence that the firms were insolvent in the classic sense. In the case of Bear Stearns, JP Morgan Chase was willing to pay more to acquire it than the value of the Fed's assistance, but later reported losses related to the transaction. The other three firms all eventually returned to profitability once the crisis had ended, which means they may or may not have been solvent at the time of the intervention.").

[98] *See* John Carney, *How the Fed Protected Its Bailout Powers*, WALL ST. J. (Nov. 30, 2015), http://www.wsj.com/articles/how-the-fed-protected-its-bailout-powers-1448916675?mg=id-wsj [https://perma.cc/M472-VAYA]

in a strange predicament where borrowers seek out emergency loans before emergency situations actually arise out of fear that those loans will be unobtainable at a later time.[99]

A dire situation may occur if an entity properly seeks emergency loans prior to insolvency (which it could only do through a broad based eligibility program), but the act of seeking emergency loans triggers a downgrade in that entity's credit rating.[100] This downgrade would further limit access to market liquidity and incentivize other entities to reduce counter-party risk, which could quickly result in insolvency.[101] Under the new emergency lending rules, the now insolvent entity's outstanding emergency loans would become immediately due and the Federal Reserve would be prohibited from making any additional loans to the previously serviced entity.[102] This would effectively ensure that the entity would remain insolvent.

("In reality, the rule might incentivize regulators charged with preserving financial stability to set up lending facilities earlier than they might otherwise. These would also likely be broader. So rather than curtail emergency lending, the rule might expand it.").

[99] *See id*. ("The Fed won't be allowed to lend to a firm that generally isn't paying its debts as they become due, or already determined insolvent. But in either case, such a firm is likely already dead on arrival—and undergoing resolution. So this won't significantly curtail the Fed's options . . . [this] will likely mean future emergency funds will come with steep price tags. And banks will have to bear that cost.").

[100] Financial markets would quickly be aware of which entity was receiving emergency loans and the terms of those loans due to new reporting requirements for emergency loans. *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,965 (requiring the disclosure of justification and terms, the notice must also state which markets or sectors' liquidity is intended to be provided through the program or facility).

[101] This happened to both Bear Stearns and AIG in 2008. *See* Porter, *supra* note 29, at 493 ("Concerns spread quickly that Bear's liquidity position was compromised. Of particular significance, Goldman Sachs and Credit Suisse sent mass internal e-mails implicating Bear's counter-party risk, hedge funds began exiting Bear's prime brokerage business, and money-market funds reversed positions with exposure to Bear's commercial paper. By Thursday, March 13, 2008, Bear could not find sufficient overnight funding via 'repo lenders' to conduct business on Friday.").

[102] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,962 ("Section 201.4(d)(5)(vi) of the final rule also provides that a participant that is or has become insolvent would be prohibited from receiving any new extension of credit under the program or facility.").

E. Conclusion

The Federal Reserve's emergency lending powers have been the subject of fierce debate since 2008.[103] While those powers have provided a valuable control over access to credit in times of need, those same powers may likewise increase moral hazard to the detriment of financial markets generally.[104] The new rules seek to reduce moral hazard and prevent another Bear Stearns or AIG-type bailout by prohibiting lending to singular entities or insolvent entities and by increasing congressional and executive involvement in emergency lending situations.[105] The new emergency lending rules limit the Federal Reserve's emergency lending powers, shrink the safety net below the financial markets, and encourage orderly resolution under Title II of Dodd-Frank.[106] Whether this will cause financial entities to walk the tightrope of high-risk lending more carefully, or will simply lead to a severe fall, remains to be seen.

Evan A. Johnson[107]

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[103] *See generally* Corso, *supra* note 4; Fullwiler, supra note 5; Wilson, *supra* note 3. For debate existing prior to 2008, see Canova, *supra* note 75.

[104] *See generally* Creswell & Bajaj, *supra* note 27 (documenting constraints on capital Bear Stearns faced); Labonte, *supra* note 8, at 17 (discussing moral hazard concerns relating to Section 13(3) raised by House Financial Services Committee Chairman, Jeb Hensarling); Mehra, *supra* note 7, at 263.

[105] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,960, 78,963 ("[T]o further Congressional oversight of emergency lending facilities, the Board's final rule establishes a process by which the Board will promptly provide written notice to Congress of any emergency program or facility established under section 13(3) of the FRA . . . [and to renew a program of facility, the] "Secretary of the Treasury [must approve] the renewal.").

[106] *See* Labonte, *supra* note 8, at 11 ("[P]roponents of the Dodd-Frank Act argue that eliminating the Fed's ability to prevent firms from failing under Section 13(3) will not result in financial instability now that firms can undergo an orderly resolution under Title II.").

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