EMERGENCY TOOLS TO CONTAIN A FINANCIAL CRISIS

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Abstract

In the extreme heat of the latest financial crisis, the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) took necessary and sufficient actions to address the crisis and prevent the collapse of the financial system. This article analyzes these actions and concludes that the curtailment by the Dodd-Frank Wall Street Reform and Consumer Protection Act of the powers utilized by these governmental financial authorities to take these actions has left the financial system much more vulnerable than it was before the latest financial crisis.

When capital and liquidity requirements prove not to be sufficient to prevent a financial crisis, the latest financial crisis has shown that there are two powers in the "toolboxes" of the governmental financial authorities that are necessary to contain a rapidly spreading "wildfire" that could cause financial system conflagration. First, the Federal Reserve, as the central bank, should have clear statutory authority, subject to appropriate conditions, to extend emergency credit in "unusual and exigent circumstances" to any legal entity or individual to provide liquidity in situations of severe financial distress that could likely result in widespread financial system instability. Second, in such circumstances the government should have clear statutory authority to guarantee the liabilities of financial institutions. In the latest financial crisis, the Federal Reserve provided such credit and the FDIC provided such guarantees.

<u>Emergency Credit</u>. *Two of the most important actions taken by the governmental financial authorities in 2008 that prevented the*

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crash of the financial system were the Federal Reserve's support for the acquisition of Bear Stearns by JPMorgan Chase and its support provided to AIG. Each of these actions were taken under the provisions of the then section 13(3) of the Federal Reserve Act, which prior to enactment of the Dodd-Frank Act provided that in "unusual and exigent circumstances" a Federal Reserve Bank may extend credit to any individual, partnership, or corporation, subject to certain conditions, to provide liquidity in times of financial distress.

The Dodd-Frank Act curtailed this section 13(3) authority. The Dodd-Frank Act amended section 13(3) to remove the Federal Reserve's emergency lending authority to lend to a single individual, partnership, or corporation, and to limit its emergency lending authority to extending credit to participants in a program or facility with broad-based eligibility. Further, the Federal Reserve may not establish any program or facility under the amended section 13(3) without the prior approval of the Secretary of the Treasury.

As a result of these amendments, the Federal Reserve no longer has authority to provide the type of support that it provided in the Bear Stearns and AIG cases. This article concludes that, subject to certain conditions, so long as the solvency, good collateral and penalty rate principles set out by Walter Bagehot in 1873 for lender-of-last-resort lending are satisfied, then such lending by the Federal Reserve should continue to be available in "unusual and exigent circumstances" to a single troubled entity, as well as in broad-based programs or facilities.

Over the past year or so, a number of commentators have concluded, along with this commentator, that the amendments made by the Dodd-Frank Act to section 13(3) were a serious mistake.

Liability Guarantees. In October 2008, the FDIC, invoking the "systemic risk exception" of the Federal Deposit Insurance Act to the least cost resolution requirement, established the Temporary Liquidity Guarantee Program, which (i) guaranteed new, senior unsecured debt issued by any depository institution or depository institution holding company and (ii) guaranteed all non-interest bearing deposit transaction accounts of all depository institutions.
The Dodd-Frank Act amended the Federal Deposit Insurance Act to provide that this systemic risk exception applies only for the purpose of winding up a failed depository institution for which the FDIC has been appointed receiver. The Dodd-Frank Act provides new authority for the FDIC to establish a widely available program to guarantee obligations of solvent depository institutions or solvent

depository institution holding companies (including their affiliates) during times of severe economic distress, upon a liquidity event finding. To exercise this authority, the Secretary of the Treasury, in consultation with the President of the United States, must determine the maximum amount of debt that the FDIC can guarantee, and passage of a joint resolution of Congress is required before the FDIC may issue guarantees under this authority.

As a result of these amendments, the FDIC does not have authority to provide the broad guarantees of liabilities of depository institutions and depository institution holding companies that it provided during the latest financial crisis. This article concludes that, subject to certain conditions, the FDIC should have clear statutory authority during times of severe economic distress, upon a liquidity event finding, to guarantee new, senior unsecured debt issued by any depository organization and to guarantee all non-interest bearing deposit transaction accounts of all depository institutions, and that a joint resolution of Congress should not be required before the FDIC may provide such guarantees.

In summary, after the Dodd-Frank Act, in the next financial crisis, the Federal Reserve could not provide the type of support that it provided in connection with the acquisition of Bear Stearns by JPMorgan Chase and that it provided to AIG, and the FDIC could not provide the type of guarantees of the liabilities of depository institutions and depository institution holding companies that it provided to such depository organizations during the latest financial crisis, and any guarantee program in the future would require Congressional approval. If Bear Stearns or AIG had failed and if the FDIC had not provided such guarantees, the U.S. financial system, and with it the global financial system, would have gone over the brink and crashed, taking down the U.S. and global economies. The very actions that kept the financial system from going over the brink are no longer available in our governmental financial authorities' toolboxes as a result of the Dodd-Frank Act.

Addressing these issues is a most important and pressing challenge. Otherwise, in the next financial crisis the governmental financial authorities will not have the tools they need in their crisis response toolboxes. This article examines these issues and makes recommendations for addressing them.

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I. Introduction

This article focuses on (i) certain actions taken during the latest financial crisis by the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC), (ii) limitations imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) on the power of these governmental authorities to take such actions in the future, (iii) some lessons learned from this financial crisis and (iv) the tools that are needed in the "crisis response toolboxes" of the governmental financial authorities to contain the adverse economic and human consequences of a future financial crisis.

In the wake of the 2008 global financial crisis, a number of books by America's most visible financial regulators and commentators were published that address the crisis, the governmental actions taken during the crisis, and the necessary tools to contain a financial crisis, including Henry M. Paulson, Jr.'s *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, Sheila Bair's *Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself*, Timothy F. Geithner's *Stress Test: Reflections on Financial Crises*, Ben S. Bernanke's *The Courage to Act: A Memoir of a Crisis and Its Aftermath*, and Alan S. Blinder's *After the Music Stopped: The Financial Crisis, the Response, and the Work Ahead*.[1] Not surprisingly, the financial regulators have some different perspectives and "takeaways" regarding the financial crisis after their roles

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[1] *See generally* SHEILA BAIR, BULL BY THE HORNS: FIGHTING TO SAVE MAIN STREET FROM WALL STREET AND WALL STREET FROM ITSELF (2012); TIMOTHY F. GEITHNER, STRESS TEST: REFLECTIONS ON FINANCIAL CRISES (2014); BEN S. BERNANKE, THE COURAGE TO ACT: A MEMOIR OF A CRISIS AND ITS AFTERMATH (2015); ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD (2014); HENRY M. PAULSON JR., ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM (2010). The books by Henry Paulson, the Secretary of the Treasury during the Bush administration, Sheila Bair, the Chairwoman of the FDIC during the Bush and Obama administrations, Timothy Geithner, the President of the Federal Reserve Bank of New York during the Bush administration and the Secretary of the Treasury during the Obama administration, and Ben Bernanke, the Chairman of the Federal Reserve Board during the Bush and Obama administrations, recount the views of each of these principal participants in the U.S. government's responses to the latest financial crisis.

directing governmental actions during the crisis.[2] The titles of these books reflect the severity of the latest financial crisis. In the years leading up to the financial crisis, this commentator expressed the concern that the financial system was moving at too fast a "Mach speed," and that if our "fighter jet" financial system flying at a superfast speed developed a problem and began to spin out of control, we would not be able to fix the problem before the system crashed.

In August 2007, a "problem" in the financial system manifested itself.[3] Soon thereafter, *the music stopped*, and the financial system was indeed spinning out of control.[4] The system was *on the brink*, and actions taken by governmental financial authorities, which had *the courage to act*, were implemented that took the *bull by the horns*, forcing *Wall Street* and *Main Street* through a severe *stress test*.[5] Fortunately for all of us—on *Main Street* and *Wall Street*—the system did not crash.[6]

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[2] For example, Secretary Geithner concludes that "the biggest problem with Dodd-Frank is not enough emergency bailout authority" and that "Congress should give the president and the financial first responders the powers necessary to protect the country from the devastation of financial crises." GEITHNER, *supra* note1, at 432. In *Bull by the Horns*, former FDIC Chairwoman Bair expresses "a lot of strong objections and concerns about some of the 'financial stabilization measures' (aka bailouts) [undertaken] to deal with the financial crisis." BAIR, *supra* note 1, at 355. Regarding the Dodd-Frank Act's restrictions on the Federal Reserve's section 13(3) authority, she writes, "Indeed, if anything, the rules on the Fed should be tightened." *Id.* at 327.

[3] *See* Christopher Rude, *The World Economic Crisis and the Federal Reserve's Response to It: August 2007—December 2008*, 85 STUD. POL. ECON. 125, 126 (2010) ("[T]oday's global economic crisis has a financial origin and an origin in the United States at least in the sense that the US banking and financial crisis that surfaced in August 2007 and came to a head in September 2008 was so severe the only direction the world economy could go afterwards was down.").

[4] *Id.* at 125 ("[I]n September 2008, the entire US banking and financial system collapsed as a social financial system in a period of acute turmoil as violent and decisive as that of the 1931 banking crisis.").

[5] *See generally* PAULSON, *supra* note 1; BAIR, *supra* note 1; GEITHNER, *supra* note 1; BERNANKE, *supra* note 1; BLINDER, *supra* note 1.

[6] Alan S. Blinder, *What Did We Learn from the Financial Crisis, the Great Recession, and the Pathetic Recovery?*, 46 J. ECON. EDUC. 135, 136 (2015) ("There was no Great Depression 2.0; we did not have to nationalize the banks; once the dust settled, the government turned a sizable profit on its rescue operations.").

The Federal Reserve System and the U.S. Treasury Department have been criticized for failing to recognize the fundamental changes within the U.S. financial system in the decade leading up to the financial crisis.[7] U.S. financial institution regulators, most importantly the Federal Reserve, failed to recognize and appreciate the interconnectivity of the players within the financial system.[8] It is difficult to comprehend why the regulators did not have a better understanding of the counterparty exposure levels in our interconnected financial system leading up to and at the outbreak of the financial crisis. However, while the Federal Reserve, the U.S. Treasury, and the FDIC fell far short leading up to the financial crisis, in the extreme heat of the crisis they took necessary and sufficient actions to address the crisis and prevent the collapse of the financial system.[9]

Based on lessons learned from the latest financial crisis, this article addresses the question: What are the most important tools in the "crisis response toolboxes" of the principal governmental financial authorities *to contain* the adverse economic and human consequences of a future financial crisis? Part II of this article discusses these crisis response tools. Part III analyzes the use of these tools by the principal governmental financial authorities to contain

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[7] *See, e.g.*, Neil Fligstein et al., *Why the Federal Reserve Failed to See the Financial Crisis of 2008: The Role of "Macroeconomics" as a Sense Making and Cultural Frame* 3-4 (Berkeley Inst. for Res. on Lab. & Emp., Working Paper No. 111-14, 2014), http://irle.berkeley.edu/workingpapers/111-14.pdf [https://perma.cc/N86G-QUME] (discussing the Federal Reserve's failure to recognize and anticipate the looming financial crisis).

[8] *See, e.g.*, GEITHNER, *supra* note 1, at 150-151 ("The closer Fed officials looked at Bear's connections with the broader financial system, the more they feared its sudden failure would unleash utter chaos . . . . [O]ur fear was that Bear was 'too interconnected to fail' without causing catastrophic damage. And it was impossible to guess the magnitude of that damage.").

[9] *See, e.g.*, Rude, *supra* note 3, at 127 ("The response of the US state, of the Federal Reserve in particular, was decidedly 'interventionist.'"); Robert J. Samuelson, *Dodd-Frank's Achilles' Heel*, WASH. POST (July 27, 2014), https://www.washingtonpost.com/opinions/robert-samuelson-dodd-franks-achilles-heel/2014/07/27/4721024c-1418-11e4-9285-4243a40ddc97_story.html [https://perma.cc/W3UY-AVGA] ("[Emergency credit powers] enabled the Fed to serve as a true 'lender of last resort.' Many economists believe that this may have prevented a second Great Depression."). *See generally* PAULSON, *supra* note 1; GEITHNER, *supra* note 1, at 494 ("[T]he U.S. economy escaped its death spiral.").

the latest financial crisis. Part IV addresses the limitations imposed by the Dodd-Frank Act on the power of these governmental authorities to use such tools in the future, the foundation and principles for lender-of-last-resort facilities, and such emergency credit facilities in practice. Finally, in Part V this article makes recommendations for needed legislative amendments with respect to emergency credit and liability guarantees.

II. Crisis Response Tools

The most important regulatory tools to *prevent* a financial crisis are robust capital and liquidity requirements, especially for the largest systemically important financial institutions (SIFIs).[10] While capital and liquidity requirements will never be perfectly aligned with the risks in the financial system and alone will not be able to protect the financial system from all possible risks, such requirements, recalibrated over time to be better aligned with such risks, are the front lines of preserving a stable financial system.[11]

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[10] SIFIs are "nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure", are subject to the supervision of the Federal Reserve and enhanced regulatory requirements, and are designated as such by the Financial Stability Oversight Council. Dodd-Frank Act § 112(a)(2)(H), 12 U.S.C. § 5322(a)(2)(H) (2012); *see* Emily Liner, *Understanding SIFIs: What Makes an Institution Systemically Important?*, THIRDWAY (Nov. 6, 2015), http://www.thirdway.org/report/understanding-sifis-what-makes-an-institution-systemically-important [https://perma.cc/V5S4-7TLH] (explaining that the purpose of the enhanced capital and liquidity requirements for SIFIs is to reduce the probability of their failure as well as to prevent systemic risk to the economy if a SIFI's failure is unavoidable); *see also* THOMAS EISENBACH ET AL., SUPERVISING LARGE, COMPLEX FINANCIAL INSTITUTIONS: WHAT DO SUPERVISORS DO? 5 (2015), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr729.pdf [https://perma.cc/DT7F-V9Y7] ("[T]he Federal Reserve's supervisory strategy combines a focus on the supervised firm's internal processes and governance with an independent supervisory assessment of its financial strength, especially capital and liquidity.").

[11] *See, e.g.*, Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Lessons of the Financial Crisis for Banking Supervision, Address at the Federal Reserve Bank of Chicago Conference on Bank Structure and Competition (May 7, 2009), https://www.federalreserve.gov/newsevents/speech/bernanke20090507a.htm [https://perma.cc/M9PR-CAAT].

The most important regulatory and supervisory efforts should be focused on capital and liquidity.[12] Counterparty exposure between and among major financial firms needs to be quantified and understood, and the necessary capital and liquidity support for such exposure needs to be prescribed and maintained.[13] The front line in assuring that a SIFI does not fail is effective supervision and regulation, based on a clear understanding of the interconnectedness of financial institutions,[14] accompanied by robust capital and

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[12] *See, e.g.*, *2013 Banking and Consumer Regulatory Policy*, BD. OF GOVERNORS OF THE FED. RES. SYS. (July 2, 2013), http://www.federalreserve.gov/newsevents/press/bcreg/20130702a.htm [https://perma.cc/CD38-EYWX] (discussing a final rule concerning capital requirements for banking organizations); *2013 Banking and Consumer Regulatory Policy*, BD. OF GOVERNORS OF THE FED. RES. SYS. (Oct. 24, 2013), http://www.federalreserve.gov/newsevents/press/bcreg/20131024a.htm [https://perma.cc/AZ2S-4CDJ] (discussing a proposed rule concerning the liquidity positions of banking organizations).

[13] *See, e.g.*, *2016 Banking and Consumer Regulatory Policy*, BOARD GOVERNORS FED. RES. SYS. (Mar. 4, 2016), http://www.federalreserve.gov/newsevents/press/bcreg/20160304b.htm [https://perma.cc/EGU5-TM6T] ("As demonstrated during the financial crisis, large credit exposures, particularly between financial institutions, can spread financial distress and undermine financial stability."); BD. OF GOVERNORS OF THE FED. RESERVE SYS. ET AL., INTERAGENCY SUPERVISORY GUIDANCE ON COUNTERPARTY CREDIT RISK MANAGEMENT 2 (2011), http://www.federalreserve.gov/bankinforeg/srletters/bcreg20110705a1.pdf [https://perma.cc/HJN3-Z99Z] ("[T]he financial crisis of 2007-2009 revealed weaknesses in [counterparty credit risk] management at many banking organizations, such as shortcomings in the timeliness and accuracy of exposure aggregation capabilities and inadequate measurement of correlation risks. The crisis also highlighted deficiencies in the ability of banking organizations to monitor and manage counterparty exposure limits and concentration risks, ranging from poor selection of [counterparty credit risk] metrics to inadequate system infrastructure.").

[14] *See, e.g.*, Janet L. Yellen, Vice Chairwoman, Bd. of Governors of the Fed. Reserve Sys., Interconnectedness and Systemic Risk: Lessons from the Financial Crisis and Policy Implications (Jan. 4, 2013), http://www.federalreserve.gov/newsevents/speech/yellen20130104a.htm [https://perma.cc/ZX9C-VV62] ("The difficult task . . . is to find ways to preserve the benefits of interconnectedness in financial markets while managing the potentially harmful side effects. Indeed, new regulations required by the [Dodd-Frank Act] and changes in supervisory practices by the Federal Reserve and other financial regulators are intended to do just that.").

liquidity requirements. Significant progress has been made in these respects following the latest financial crisis. Stress tests have become a key component of supervisory focus,[15] and, most importantly, capital and liquidity rules have been implemented that will go a long way to assuring the solvency of SIFIs.[16]

However, when capital and liquidity requirements prove to be insufficient to *prevent* a financial crisis, the latest financial crisis has shown that two powers in the "toolboxes" of the governmental financial authorities are necessary to *contain* a rapidly spreading "wildfire" that could cause financial system conflagration. First, the Federal Reserve, as the central bank, should have clear statutory authority to extend credit in "unusual and exigent circumstances" to any legal entity or individual to provide liquidity in situations of severe financial distress that could likely result in widespread financial system instability.[17] Second, in such circumstances the government should be authorized to guarantee the liabilities of financial institutions.[18] In the latest financial crisis, the Federal Reserve provided such credit and the FDIC provided such guarantees.[19]

III. Emergency Toolbox

A. Emergency Credit

Two of the most important actions taken by the U.S. governmental financial authorities in 2008 that prevented the crash of the financial system were the Federal Reserve's support for the acquisition of The Bear Stearns Companies, Inc. (Bear Stearns) by JPMorgan Chase & Co. (JPMorgan Chase) and the support the

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[15] *See, e.g.*, *Stress Test and Capital Planning*, BD. OF GOVERNORS OF THE FED. RES. SYS., http://www.federalreserve.gov/bankinforeg/stress-tests-capital-planning.htm [https://perma.cc/TQ3E-XYZZ] (discussing Comprehensive Capital Analysis and Review employed to assess "whether the largest bank holding companies operating in the United States have sufficient capital to continue operations throughout times of economic and financial stress and that they have robust, forward-looking capital-planning processes that account for their unique risks").
[16] *See, e.g.*, *supra* note 12.
[17] *See infra* Part V.A.
[18] *See infra* Part V.B.
[19] *See infra* Part III.A and III.B.

government provided to American International Group (AIG).[20] The Federal Reserve took both actions under the provisions of the then section 13(3) of the Federal Reserve Act.[21] Prior to enactment of the Dodd-Frank Act, this section authorized a Federal Reserve Bank in "unusual and exigent circumstances", in order to provide liquidity in times of financial distress, to extend credit to any individual, partnership, or corporation, subject to certain conditions.[22]

If Bear Stearns had failed in March 2008 or if AIG had failed in September 2008, then the financial system, and the global economy, would have gone over the brink and crashed.

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[20] *See, e.g.*, Alan H. Meltzer, *Policy Principles*, *in* THE ROAD AHEAD FOR THE FED 22-23 (John D. Ciorciari & John B. Taylor eds., 2009) (discussing major actions by the U.S. authorities purported to save the financial system); Blinder, *supra* note 6, at 136 ("[I]t would have been much worse had Congress, the U.S. Treasury, and the Federal Reserve not taken a series of extraordinary actions."); William C. Dudley, President, Fed. Reserve Bank of N.Y., Remarks at the Annual Meeting of the Virginia Association of Economists: The Role of the Federal Reserve—Lessons from Financial Crises (Mar. 31, 2016), https://www.newyorkfed.org/newsevents/speeches/2016/dud160331 [https://perma.cc/R4LU-VGHQ] ("[T]hese interventions were necessary to prevent a systemic collapse of the global financial system. If such a collapse had occurred, I am convinced that the consequences would have been a global depression.").

[21] At the time of the latest financial crisis, section 13(3) of the Federal Reserve Act, which was first enacted as a part of the Emergency Relief and Construction Act of 1932, authorized a Federal Reserve Bank "to extend credit to any individual, partnership, or corporation [provided that] . . . (1) credit be extended only in unusual and exigent circumstances; (2) credit be extended only if the [Federal Reserve] Board authorizes the lending by . . . at least five of its members; (3) the lending Federal Reserve Bank obtains evidence . . . that the borrower is unable to secure adequate accommodations from other banking institutions; and (4) the extension of credit be indorsed . . . to the satisfaction of the Federal Reserve Bank." *See* Extensions of Credit by Federal Reserve System, 80 Fed. Reg. 78,959, 78,959 (Dec. 18, 2015) (codified at 12 C.F.R. pt. 201).

[22] *Id*. On the history of the Federal Reserve's emergency credit authority, see Binyamin Appelbaum & Neil Irwin, *Congress's Afterthought, Wall Street's Trillion Dollars*, WASH. POST (May 30, 2009), http://www.washingtonpost.com/wp-dyn/content/article/2009/05/29/AR2009052903403.html [https://perma.cc/QWD5-2BW9].

1. Bear Stearns

In March 2008, under the authority of section 13(3) of the Federal Reserve Act, the Federal Reserve Bank of New York (FRBNY) lent $29 billion (and JPMorgan Chase lent $1 billion) to a limited liability company that, in connection with JPMorgan Chase's acquisition of Bear Stearns, purchased $30 billion of mortgage-backed securities of Bear Stearns.[23] The FRBNY's recourse on the loan was to the mortgage-backed securities, and JPMorgan Chase's loan was subordinated to the FRBNY's loan for repayment purposes.[24] Prior to this action, the Federal Reserve had only utilized its section 13(3) authority to lend a total of $1.5 *million* during the Great Depression.[25]

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[23] *See Bear Stearns, JPMorgan Chase, and Maiden Lane LLC*, BD. GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/newsevents/reform_bearstearns.htm [https://perma.cc/334H-TJ3Q].

[24] *See* Robin Sidel et al., *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis*, WALL ST. J. (Mar. 17, 2008, 11:59 PM), http://www.wsj.com/articles/SB120569598608739825 [https://perma.cc/YFF5-24WQ] ("To help facilitate the deal, the Federal Reserve is taking the extraordinary step of providing as much as $30 billion in financing for Bear Stearns's less-liquid assets, such as mortgage securities that the firm has been unable to sell, in what is believed to be the largest Fed advance on record to a single company."); *see also Bear Stearns, JPMorgan Chase, and Maiden Lane LLC*, *supra* note 23 ("To facilitate a prompt acquisition of Bear Stearns by JPMC, the FRBNY created a limited liability company, Maiden Lane LLC, to acquire that set of assets of Bear Stearns. . . . JPMC also lent roughly $1 billion to Maiden Lane in a loan that is subordinated to the loan from the FRBNY for repayment purposes.").

[25] *See* HOWARD H. HACKLEY, BD. OF GOVERNORS OF THE FED. RESERVE SYS., LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY 130 (1973) ("[T]he Reserve Banks, over a period of 4 years, made loans to only 123 business enterprises aggregating only about $1.5 million. The largest single loan was for $300,000."). Prior to 2008, the last loan made under the authority of section 13(3) was in 1936; most such loans were made in 1932 and 1933, including "a loan of $300,000 to Smith-Corona Company, a manufacturer of typewriters; . . . a loan of $250,000 to Miller Cummings Company, a vegetable grower; and . . . a loan of $25,000 to L.N. Renault and Sons, Inc., secured by 5,000 shares of common stock of a brewing company and certificates representing ten barrels of brandy and 89 barrels of rum." THOMAS C. BAXTER, JR., THE LEGAL POSITION OF THE CENTRAL BANK: THE CASE OF THE FEDERAL RESERVE BANK OF NEW YORK 5 (2009),

Although the Bear Stearns transaction triggered discussions concerning the scope of the Federal Reserve's powers under section 13(3)[26] as well as the related moral hazards of such bailouts,[27] the

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http://www.lse.ac.uk/fmg/documents/events/conferences/2009/regulatoryResponse/1160_Baxter.pdf [https://perma.cc/U9G5-Q9C9]. For a detailed description of the history and use of section 13(3), *see generally* Christian A. Johnson, *Exigent and Unusual Circumstances: The Federal Reserve and the US Financial Crisis*, *in* LAW REFORM & FINANCIAL MARKETS 269 (Kern Alexander & Niamh Moloney eds., 2011); David Fettig, *The History of a Powerful Paragraph*, REGION, June 1, 2008, at 34, https://minneapolisfed.org/~/media/files/pubs/region/08-06/section13.pdf [https://perma.cc/994L-8B49]; David Fettig, *Lender of More Than Last Resort*, REGION, Dec. 1, 2002, at 15, https://minneapolisfed.org/publications/the-region/lender-of-more-than-last-resort [https://perma.cc/8ZWQ-U6YY]; Thomas O. Porter, II, *The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers*, 13 N.C. BANKING INST. 483 (2009); Appelbaum & Irwin, *supra* note 22.

[26] Some commentators argue that a loan to a limited liability company that purchased securities from an entity, which securities served as collateral for the loan, did not satisfy the provisions of section 13(3) because section 13(3) authorized only loans and not asset purchases, and the loan would not be made to the party that needs assistance. *See* Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 236 (2010); *see also* Lawrence H. White, *The Federal Reserve and the Rule of Law*, CATO INST. (Sept. 12, 2013), http://www.cato.org/publications/testimony/federal-reserve-rule-law [https://perma.cc/2KGQ-2LAW] ("There was no precedent, and no apparent legal authority in the Federal Reserve Act, for such special-purpose funding operations. The Fed abandoned the rule of law. . . ."). The General Counsel and Executive Vice President of the FRBNY concluded otherwise, stating "with proper Section 13(3) authorization from the Board of Governors, the Federal Reserve can create a limited liability company and then lend to it, in order to add liquidity or effect some other policy objective." *See* BAXTER, *supra* note 25, at 12-13.

[27] In particular, former Federal Reserve Board Chairman Paul Volcker opined that "the Federal Reserve judged it necessary to take actions that extend to the very edge of its lawful and implied powers. . . . The extension of lending directly to non-banking financial institutions . . . will surely be interpreted as an implied promise of similar action in times of future turmoil." Paul A. Volcker, Remarks at the 395th Meeting of the Economic Club of New York 2 (Apr. 8, 2008), http://blogs.denverpost.com/lewis/files/2008/04/volckernyeconclubspeech04-08-2008.pdf [https://perma.cc/59CQ-2VEB]; *see also* Frank Ahrens, *"Moral Hazard":*

transaction did not result in any loss to taxpayers. The FRBNY was paid in full with interest from its crisis intervention related to Bear Stearns as of June 14, 2012.[28] As of January 28, 2015, the net realized gain to the FRBNY on this facility was $765 million and the fair value of the remaining assets held by Maiden Lane LLC, the limited liability company involved in this case, was $1.686 billion.[29]

2. AIG

In September 2008, relying on the section 13(3) authority, the FRBNY extended a line of credit of up to $85 billion to AIG, an insurance company "that had written over $400 billion dollars of credit default swaps, which . . . left it facing enormous payments."[30] As consideration and collateral for the loan, the FRBNY took assets of the parent company and certain of its subsidiaries, and "[a]s additional compensation to the government, AIG issued preferred

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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/EL66-PFEA] ("In the case of Bear Stearns . . . such highflying investment houses will continue to engage in risky activities with investors' money, knowing that if they blow it, the federal government . . . will bail them out."). Moreover, Paul Volcker doubted whether the Bear Stearns transaction, "[w]hat appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve", complied with "the time honored central bank mantra in times of crisis—'lend freely at high rates against good collateral' . . . ." Volcker, at 2.

[28] *Markets & Policy Implementation, Maiden Lane Transactions*, FED. RES. BANK N.Y., http://www.ny.frb.org/markets/maidenlane.html [https://perma.cc/96KT-RTHF].

[29] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE (2015), http://www.federalreserve.gov/releases/h41/20150129/h41.pdf [https://perma.cc/NL39-YS3X] (providing statistical data of all Federal Reserve transactions); *Markets & Policy Implementation*, *supra* note 28 (summarizing a timeline of all Maiden Lane transactions).

[30] Frederick S. Mishkin & Eugene N. White, *Unprecedented Actions: The Federal Reserve's Response to the Global Financial Crisis in Historical Perspective* 9-10 (Fed. Reserve Bank of Dallas, Working Paper No. 209, 2014), https://www.dallasfed.org/assets/documents/institute/wpapers/2014/0209.pdf [https://perma.cc/2EZB-H282]; *see also Regulatory Reform, American International Group (AIG), Maiden Lane II and III*, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/newsevents/reform_aig.htm [https://perma.cc/2KE4-65JU].

stock in trust for the Treasury[,]" which was "convertible into 79.9% of AIG's common stock."[31] As a result of subsequent restructurings of the arrangement, the total loan commitment ultimately reached $142.5 billion.[32] The total interest and fees earned by, and the net realized gain to, the FRBNY from its actions and involvement with AIG were $9.549 billion.[33]

B. Liability Guarantees

During the latest financial crisis, the FDIC relied on the "systemic risk exception" under the Federal Deposit Insurance Act to issue emergency assistance in the form of liability guarantees. This exception authorized the FDIC to implement emergency measures "if the [Treasury], in consultation with the President and upon written recommendation of FDIC and the [Federal Reserve], determines that compliance with certain cost limitations would result in serious adverse effects on economic conditions or financial stability and that

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[31] Mehra, *supra* note 26, at 246-47; *see* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 431 (2015), *appeal docketed*, No. 15-5133 (Fed. Cir. Aug. 14, 2015) ("[T]he Board of Governors imposed a draconian requirement to take 79.9 percent equity ownership in AIG as a condition of the loan. . . . [T]he Government would retain its ownership interest in AIG even after AIG had repaid the loan."). In *Starr*, the United States Court of Federal Claims ruled that the FRBNY did not have authority to take stock as consideration for a loan under section 13(3) and "that FRBNY's taking of 79.9 percent equity ownership and voting control of AIG constituted an illegal exaction under the Fifth Amendment." *Id.* at 434, 466. The court, however, did not award any damages to the plaintiff, reasoning that if not for the government's intervention, AIG would have filed for bankruptcy, and in a bankruptcy proceeding the value of the stock of AIG's shareholders would have been zero. *Id.* at 474.

[32] U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-74, TROUBLED ASSET RELIEF PROGRAM: STATUS OF PROGRAMS AND IMPLEMENTATION OF GAO RECOMMENDATIONS 2 (2011), http://www.gao.gov/new.items/d1174.pdf [https://perma.cc/4NU9-J32L] [hereinafter GAO-11-74] ("As of September 30, 2010, [the Office of Financial Stability] reported $179.9 billion in gross outstanding direct loans and equity investments with a subsidy cost allowance of $36.7 billion resulting in a net balance of $142.5 billion."); *see also* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 963-75 (2009) (discussing the AIG loan and loan restructuring).

[33] *See Markets & Policy Implementation*, *supra* note28; *Actions Related to AIG*, FED. RES. BANK N.Y., http://www.ny.frb.org/aboutthefed/aig/index.html [https://perma.cc/NNL4-9GY7].

such assistance could mitigate these systemic effects."[34] The systemic risk determination allowed the FDIC to avoid the Federal Deposit Insurance Act's "least-cost" resolution requirement pursuant to which the FDIC was required to use "the least costly method when assisting an insured institution."[35]

In October 2008, the FDIC invoked the "systemic risk exception" to establish the Temporary Liquidity Guarantee Program (TLGP) consisting of the Debt Guarantee Program (DGP) and the Transaction Account Guarantee Program (TAGP).[36] The purpose of the DGP was to restore "functioning to the inter-bank lending market" and to guarantee new, senior unsecured debt issued by *any* depository institution or depository institution holding company.[37] The second component, the TAGP, guaranteed all non-interest

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[34] U.S. GOV'T ACCOUNTABILITY OFF., GAO-10-100, FEDERAL DEPOSIT INSURANCE ACT: REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION 1 (2010), http://www.gao.gov/assets/310/303248.pdf [https://perma.cc/2FA6-MPUN] [hereinafter GAO-10-100]. Under section 13(c)(4)(G) of the Federal Deposit Insurance Act prior to its amendment by the Dodd-Frank Act, the FDIC may act under the systemic risk exception to the least cost resolution requirement of section 13(c)(4)(G) only if the FDIC Board of Directors and the Federal Reserve Board each recommend use of the exception by a vote of not less than two-thirds of their respective members and deliver their written recommendation to the Secretary of the Treasury. 12 U.S.C. § 1823(c)(4)(G) (2006) (amended in 2010). Based on a review of the FDIC and Federal Reserve Board recommendation, the Secretary of the Treasury, in consultation with the President of the United States, may make a systemic risk determination authorizing the FDIC to take other action or provide assistance under section 13(c)(4) as necessary to avoid or mitigate serious adverse effects on economic conditions or financial stability. *Id.*

[35] GAO-10-100, *supra* note 34, at 1.

[36] *See* Temporary Liquidity Guarantee Program, 73 Fed. Reg. 72,244 (Nov. 26, 2008) (rescinded and removed by Temporary Liquidity Guarantee Program; Unlimited Deposit Insurance Coverage for Noninterest-Bearing Transaction Accounts, 80 Fed. Reg. 65,919 (Oct. 28, 2015)).

[37] June Rhee & Andrew Metrick, *Guarantees and Capital Infusions in Response to Financial Crises B: U.S. Guarantees During the Global Financial Crisis* (2015), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2723479. In its final rule adopted on November 21, 2008, the FDIC amended the definition of "senior unsecured debt" to include only such debt that has a stated maturity of more than thirty days. 12 C.F.R. § 370.2 (2008).

bearing deposit transaction accounts of *all* depository institutions, and certain other accounts, and was aimed at "reassur[ing] bank customer's confidence in safe banking, particularly in smaller banks."[38]

"At its peak on May 1, 2009, the DGP . . . guaranteed nearly 5,000 debt issues totaling more than $400 billion"; more than eighty-five percent of the $400 billion of guarantees were for depository institution holding companies.[39] "Under TAGP, the FDIC guaranteed an average of $114 billion of deposits during the fourth quarter of 2010"[40] above the FDIC's general limit of $250,000.[41]

While "cumulative estimated TAGP losses . . . as of December 31, 2012, totaled $2.1 billion[,]" the overall fees collected by the FDIC from TLGP exceeded the losses from the programs by $9.3 billion.[42]

This was an extremely important step in containing the financial crisis.[43] However, it is highly questionable that the FDIC

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[38] Rhee & Metrick, *supra* note 37, at 5; *see* 12 C.F.R. §§ 370.3-370.4.

[39] *See* JOHN C. DUGAN ET AL., RESPONDING TO SYSTEMIC RISK: RESTORING THE BALANCE 29 (2014), http://cdn.bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20Responding%20to%20Systemic%20Risk.pdf [https://perma.cc/8TFC-6979] ("The largest guarantees went to major bank holding companies, with almost $250 billion going to bank holding companies and nearly $100 billion going to thrift holding companies.").

[40] *2010 Annual Report Highlights*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/about/strategic/report/2010highlight/chpt1-01.html [https://perma.cc/A5ZM-2UFY].

[41] *See* DUGAN ET AL., *supra* note 39, at 31.

[42] *Temporary Liquidity Guarantee Program*, FED. DEPOSIT INS. CORP, https://www.fdic.gov/regulations/resources/tlgp [https://perma.cc/H3LX-PQW7] ("In total, $9.3 billion in TLGP fees and surcharges were deposited into the [Deposit Insurance Fund]."); DUGAN ET AL., *supra* note 39, at 29 ("The FDIC collected more than $10 billion in fees from the DGP portion of the TLGP and paid out only $153 million in losses."); *see also 2012 Annual Report*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/about/strategic/report/2012annualreport/chpt1-01.html [https://perma.cc/P32A-5SQ6] ("The DGP guarantee on all TLGP debt that had not already matured expired on December 31, 2012. Therefore, at the end of 2012 no debt guaranteed by the DGP remained.").

[43] GAO-10-100, *supra* note 34, at 19 ("FDIC created TLGP to complement . . . other liquidity facilities in restoring confidence in financial institutions and repairing their capacity to meet the credit needs of American households and businesses.").

had statutory authority to guarantee such obligations, particularly with respect to senior unsecured debt issued by depository institution holding companies.[44] In the view of the U.S. Treasury and the Federal Reserve, the "systemic risk exception" to the least cost resolution requirement in section 13(c)(4)(G) of the Federal Deposit Insurance Act *did* authorize these guarantee programs.[45] Under this view, a systemic risk determination waives all other restrictions on FDIC assistance and authorizes additional measures not otherwise allowed by the Federal Deposit Insurance Act, provided this would avoid or mitigate the systemic risk.[46] Notably, however, FDIC Chairwoman Bair and FDIC staff seriously questioned whether the

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[44] *See* GAO-10-100, *supra* note 34, at 43, 57 (emphasis added) ("We believe there is *some support* for the agencies' position that the systemic risk exception authorizes assistance of some type under TLGP facts, as well as for their position that the exception permits assistance to the entities covered by this program. *There are a number of questions concerning these interpretations, however.* Because application of the systemic risk exception raises novel legal and policy issues of significant public interest and importance, and because of the need for clear direction to the agencies in a time of financial crisis, we recommend that Congress consider enacting legislation clarifying the requirements and assistance authorized under the exception."); *see also* THE BROOKINGS INSTITUTION, LIQUIDITY AND THE ROLE OF THE LENDER OF LAST RESORT 17 (2014) (emphasis added), http://www.brookings.edu/~/media/events/2014/04/30-liquidity-lender-of-last-resort/20140430_liquidity_transcript.pdf [https://perma.cc/W2Q3-WRD5] [hereinafter BROOKINGS CONFERENCE] (quoting John C. Dugan, in whose opinion the FDIC's systemic risk exception power "was *stretched and massaged* in ways that proved extremely powerful during the crisis").

[45] *See* PAULSON, *supra* note 1, at 331-32, 357-58; GEITHNER, *supra* note 1, at 230-34, 432, 522; *see also* GAO-10-100, *supra* note 34, at 62, 64 (governmental financial authorities explaining that the Treasury and Federal Reserve acted within their authority under the Federal Deposit Insurance Act). *But see* PAULSON, *supra* note 1, at 324-25 ("'What you really need is for the president to get the authority to guarantee any liabilities for financial institutions,' Tim [Geithner] said. He was probably right about this bold idea, but those of us dealing with Congress knew it would be impossible to get it approved.").

[46] GAO-10-100, *supra* note 34, at 43 ("The agencies also believe a systemic risk determination waives all of the normal statutory restrictions on FDIC assistance, as well as creating new authority to provide assistance, both as to the types of aid that may be provided and the entities that may receive it.").

FDIC had such authority and only reluctantly agreed to bow to pressure from the U.S. Treasury and the Federal Reserve.[47]

IV. New Legal Framework for Emergency Tools

A. Dodd-Frank Act Amendments

1. Emergency Credit

In response to public dissatisfaction resulting from the latest financial crisis, the Dodd-Frank Act significantly changed section 13(3) of the Federal Reserve Act by *eliminating the Federal Reserve's authority to provide the type of support that it provided in the Bear Stearns and AIG cases*.[48] Among other restrictions, section 1101 of the Dodd-Frank Act eliminated the Federal Reserve's emergency lending power "to lend to an individual, partnership, or corporation" and allowed the Federal Reserve to extend emergency credit only to entities participating in "broad-based eligibility" programs.[49] Further, section 1101 provides that a lending program aimed at removing "assets from the balance sheet of a single and

[47] BAIR, *supra* note 1, at 113 (explaining that lawyers at the FDIC thought that the interpretations of lawyers at the Treasury Department and Federal Reserve of the authority to guarantee holding company debt "were a stretch but couldn't definitively determine that we were legally prohibited from doing so"). FDIC Chairwoman Bair noted that "[t]he president actually personally thanked [her] for offering the debt guarantee program; it was obvious to [her] that there had been considerable debate within the White House about the legal authority to launch the program and the scope of the FDIC's authority. After being relentlessly pressured and pushed around, I was gratified that at least the president was acknowledging the brave step the FDIC was taking." *Id.* at 116. The Dodd-Frank Act amendments relating to section 13(c)(4)(G), discussed below in Part IV.A.2, make clear that Congress did *not* agree with the agencies' position on the systemic risk exception.

[48] *See* John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 (2011) ("[R]eacting to public anger at bailouts, the Dodd-Frank Act denies regulators the ability to use public funds to rescue a systemically significant financial institution and invests heavily in preventive regulation and supervision to prevent a future crisis.").

[49] Extensions of Credit by Federal Reserve System, 80 Fed. Reg. 78,959, 78,959 (Dec. 18, 2015) (codified at 12 C.F.R. pt. 201).

specific company, or established for the purpose of assisting a single and specific company avoid bankruptcy" does not fall within the definition of a broad-based eligibility program. [50] Under this amendment, any emergency lending program or facility must serve the purpose of "providing liquidity to the financial system, and not to aid a failing financial company."[51]

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[50] *Id*. One commentator has opined that "[t]his provision . . . appears to be an effort to avoid a replay of the Maiden Lane transactions structured by the Fed and Federal Reserve Bank of New York (FRBank-NY) to facilitate the merger of the Bear Stearns Companies, Inc., and JPMorgan Chase & Co. and the restructuring of the FRBank-NY's financial support to American International Group." *See* CCH ATTORNEY-EDITOR STAFF, DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT ¶5010 (2010). However, the final regulation adopted by the Federal Reserve Board states that "[section 13(3)] authorizes the Board to determine the type of mechanism or vehicle used to extend credit, so long as the facility is broad-based. For example, liquidity facilities may extend credit directly to participants in some cases, or through a special purpose vehicle in other cases." Extensions of Credit by Federal Reserve System, 80 Fed. Reg. at 78,961.

[51] Dodd-Frank Act § 1101, 12 U.S.C. § 343(3)(B)(i) (2012); *see* Extensions of Credit by Federal Reserve System, 80 Fed. Reg. at 78,962. There were cases other than Bear Stearns and AIG during the financial crisis in which the Federal Reserve provided assistance under section 13(3) to individual institutions and not in "broad-based" programs. *See* U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-696, FEDERAL RESERVE SYSTEM: OPPORTUNITIES EXIST TO STRENGTHEN POLICIES AND PROCESSES FOR MANAGING EMERGENCY ASSISTANCE 213-18 (2011), http://www.gao.gov/assets/330/321506.pdf [https://perma.cc/7SAZ-6YQ5]. During the period of September 21, 2008 through February 1, 2010, the Federal Reserve Board invoked section 13(3) to authorize the FRBNY to extend credit to U.S.-and London-based affiliates of certain primary dealers. *Id*. Further, on November 23, 2008, the Federal Reserve Board authorized the FRBNY under section 13(3) to provide a lending commitment to Citigroup as part of a larger package of assistance intended to avoid a disorderly failure of Citigroup. *Id.* at 188. The FRBNY ultimately did not lend to Citigroup under this agreement and received a $50 million fee from Citigroup following termination of the agreement in December 2009. *Id*. Similarly, on January 15, 2009, the Federal Reserve Board authorized the Federal Reserve Bank of Richmond under section 13(3) to provide a lending commitment to Bank of America Corporation, as part of a larger package of assistance intended to avoid a disorderly failure of Bank of America Corporation. *Id.* at 185. The Reserve Bank ultimately did not finalize an agreement with Bank of America Corporation, and, as part of an

Additionally, the amendment prohibits borrowing by insolvent borrowers.[52] Under the amendment, "[a] borrower shall be considered insolvent . . . if the borrower is in bankruptcy, resolution under title II of the [Dodd-Frank Act], or any other Federal or State insolvency proceeding."[53]

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agreement to terminate the agreement-in-principle in September 2009, received a $57 million fee from Bank of America Corporation. *Id*. at 186.

[52] Extensions of Credit by Federal Reserve System, 80 Fed. Reg. at 78,961.

[53] Dodd-Frank Act § 1101(a)(6)(B)(ii), 12 U.S.C. § 343(3)(B)(ii)) (2012). The Federal Reserve must establish procedures to prevent borrowing by insolvent borrowers, which may include certification from an appropriate authorized officer of the borrower at the time of the initial borrowing that the borrower is not insolvent, with a duty to update the certification if the information in the certification materially changes. *Id.*

Whether an institution is insolvent is not always a clear-cut issue. *See* James B. Stewart, *Solvency, Lost in the Fog at the Fed*, N.Y. TIMES, Nov. 7, 2014, at B1 (quoting Hal S. Scott, Professor of International Financial Systems at Harvard Law School) ("It's difficult in the middle of a run or a panic to determine whether something is insolvent, because you don't know how to value the assets. At the end of the day, it's an art, not science."). According to Marvin Goodfriend, a professor at the Carnegie Mellon Tepper School of Business, insolvency criteria "depend[] on the behavior of the entire financial system. Solvency is only well defined when a particular firm is in trouble but the rest of the economy is O.K." *Id.* Donald Kohn, the Vice Chairman of the Federal Reserve Board during the latest financial crisis, opined that "[t]he nature of a financial crisis is that the line between liquidity problems and solvency problems is not clear—institutions that might be insolvent if their assets were sold at fire sale prices might be comfortably solvent when the panic subsides; collateral whose value has dropped sharply in the panic will recover as the panic subsides." *Examining Federal Reform Proposals: Hearing before the Subcomm. on Monetary Policy and Trade of the H. Comm. on Fin. Services*, 114th Cong. 1, 4 (2015) [hereinafter *Kohn Testimony*]; *see also* Paul Tucker, *The Lender of Last Resort and Modern Central Banking Principles and Reconstruction*, 79 BANK FOR INT'L SETTLEMENTS PAPERS 10, 22 (2014) [hereinafter *BIS Papers No. 79*] ("[A] solvency judgment is inherently probabilistic."); Brian F. Madigan, Dir., Div. of Monetary Affairs, Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium (Aug. 21, 2009), http://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm [https://perma.cc/JN8F-KA4J] [hereinafter *Bagehot's Dictum in Practice*] (explaining that a decision about solvency of financial firms entails "a significant measure of judgment—judgment both about the firm's solvency and about the possible market

Under the Dodd-Frank Act, the Federal Reserve Board may not establish any program or facility under section 13(3) without the prior approval of the Secretary of the Treasury, and is required to adopt, in consultation with the Secretary of the Treasury, a regulation establishing policies and procedures under section 13(3).[54] The Federal Reserve Board is required under the Dodd-Frank Act to provide to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives, not later than seven days after the Board authorizes any loan or other financial assistance under section 13(3), a report that includes the: (i) "justification for the exercise of authority to provide such assistance"; (ii) "identity of the recipients of such assistance"; (iii) "date and amount of the assistance, and the form in which the assistance was provided"; and (iv) "material terms of the assistance," which include duration, collateral, interest, fees, items of value exchanged, corporate requirements, and "the expected costs to the taxpayers of such assistance."[55] Additionally, the Chairman of the Board may request that the identity of the borrowers, amount to be lent, and information about collateral be kept confidential, meaning that only the Chairpersons or Ranking Members of the respective Committees will have access to the information.[56]

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effects of the failure of the firm", and that "[i]n a crisis, the solvency of firms may be . . . even dependent on central bank actions . . . .").

[54] Dodd-Frank Act § 1101(a)(6)(B)(i), 12 U.S.C. § 343(3)(B)(i) (2012). The Federal Reserve Board adopted a final regulation, effective January 1, 2016, on November 30, 2015. *See* Extensions of Credit by Federal Reserve System, 80 Fed. Reg. at 78,959; *see also infra* Part IV.C (discussing the regulation).

[55] Federal Reserve Act § 13(3)(C), 12 U.S.C. § 343(3)(C) (2012). Written updates are required every thirty days. 12 U.S.C. § 343(3)(C)(ii).

[56] 12 U.S.C. § 343(3)(D); *see also* 12 U.S.C. § 248(s)(2)(C)(1)-(2) (requiring the Federal Reserve Board to disclose publicly "(A) the names and identifying details of each borrower, participant, or counterparty in any credit facility or covered transaction; (B) the amount borrowed by or transferred by or to a specific borrower, participant, or counterparty in any credit facility or covered transaction; (C) the interest rate or discount paid by each borrower, participant, or counterparty in any credit facility or covered transaction; and (D) information identifying the types and amounts of collateral pledged or assets transferred in connection with participation in the credit facility or covered transaction . . . on the date that is 1 year after the effective date of the termination by the Board of the authorization of the

One of the most important changes introduced by the Dodd-Frank Act was the creation of the orderly liquidation authority (OLA), granting financial regulators powers to "order a failing firm into receivership, restructure or repudiate its external obligations, and wind it down" in circumstances in which an orderly bankruptcy of a SIFI might not be possible.[57] This new resolution authority replaces bankruptcy procedures for "large financial institutions whose failure could threaten the United States economy"[58] and permits putting "a failing firm into receivership without creating financial chaos."[59]

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credit facility"); 12 U.S.C. § 248(a)(5) ("A credit facility shall be deemed to have terminated as of the end of the 24-month period beginning on the date on which the credit facility ceases to make extensions of credit and loans, unless the credit facility is otherwise terminated by the Board before such date."); 31 U.S.C. § 714(f)(1)(A) (defining "credit facility" as "a program or facility, including any special purpose vehicle or other entity established by or on behalf of the Board of Governors of the Federal Reserve System or a Federal reserve bank, authorized by the Board of Governors under section 13(3) of the Federal Reserve Act (12 U.S.C. 343), that is not subject to audit under subsection (e)."). Furthermore, "the Comptroller General may conduct audits . . . of any action taken by the Board under [section 13(3)] . . . with respect to a single and specific partnership or corporation." 31 U.S.C. § 714(e). Accordingly, the information provided to Congress on a confidential basis regarding any program or facility under section 13(3), as amended by the Dodd-Frank Act, would generally become subject to public disclosure several years after being provided to Congress. *See* 12 U.S.C. § 248(s)(6).

[57] *Standing-Financial Regulation—D.C. Circuit Limits Prospects for Challenging Dodd-Frank's Orderly Liquidation Authority*, 129 HARV. L. REV. 835, 835 (2016); Ben S. Bernanke, *Warren-Vitter and The Lender of Last Resort*, BROOKINGS INST. (May 15, 2015, 11:00 AM), http://www.brookings.edu/blogs/ben-bernanke/posts/2015/05/15-warren-vitter-proposal [https://perma.cc/XE5U-YU35] [hereinafter *Bernanke's Blog*]; *see also* Martin J. Gruenberg, Chairman, Fed. Deposit Ins. Corp., The Clearing House Annual Conference (Nov. 18, 2015), https://www.fdic.gov/news/news/speeches/spnov1815.html [https://perma.cc/8MYL-444B] ("As a backstop, for circumstances in which an orderly bankruptcy [of a SIFI] might not be possible, Title II of the Dodd-Frank Act provides the Orderly Liquidation Authority.").

[58] Adam Mayle, Development Article, *Orderly Liquidation Authority*, 30 REV. BANKING & FIN. L. 3, 3 (2010); *see also* Mike Konczal, *Does Dodd-Frank Really End 'Too Big to Fail'?*, WASH. POST (Mar. 2, 2013), https://www.washingtonpost.com/news/wonk/wp/2013/03/02/does-dodd-frank-really-end-too-big-to-fail/ [https://perma.cc/6LE2-RPV9] ("This allows the government to run a bridge company to keep essential operations

The OLA begins when the FDIC and the Federal Reserve recommend putting a failing entity in receivership and the Secretary of the Treasury in consultation with the President determines that this course of action is appropriate.[60]

[The OLA] tools are intended to enable the FDIC to carry out the process of winding down and liquidating the firm, while ensuring that shareholders, creditors, and culpable management are held accountable and taxpayers do not bear losses. The [OLA] provides the FDIC several authorities . . . to establish a bridge financial company, to stay the termination of certain financial contracts, to provide temporary liquidity that may not otherwise be available, to convert debt to equity, and to coordinate with domestic and foreign authorities in advance of a resolution to better address any cross-border impediments.[61]

The Dodd-Frank Act establishes an Orderly Liquidation Fund (OLF), which is a source of liquidity to be used by the FDIC, if necessary, in the initial stage of resolution of a covered financial company until private sector funding can be obtained.[62] Under the

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running at a failed firm that needs to be liquidated, with losses put on those who deserve them, rather than putting taxpayers at risk."). Martin J. Gruenberg, Chairman of the FDIC, has described the OLA as "effectively a public-sector bankruptcy process for institutions whose resolution under the U.S. Bankruptcy Code would pose systemic concerns." Gruenberg, *supra* note 57.

[59] *Bernanke's Blog*, *supra* note 57; *see also* Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part II*, 128 BANKING L.J. 867, 868-69 (2011) ("The [OLA] is designed to permit an orderly liquidation or wind-down of a [SIFI] in a way that mitigates the collateral consequences to the financial system of the liquidation while avoiding the need for a taxpayer assisted rescue or bailout.").

The FDIC has concluded that the liquidation of Lehman Brothers under the OLA "would have been vastly superior for systemic stability and achieved better recoveries for creditors than the bankruptcy process while protecting taxpayers from any loss." *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/regulations/reform/lehman.html [https://perma.cc/HT8E-NKRN], 5 FDIC Q., no. 2, 2011, at 31, 48.

[60] *See* Gruenberg, *supra* note 57; *see also* Dodd-Frank Act § 203, 12 U.S.C. § 5383 (2012).

[61] Gruenberg, *supra* note 5757.

[62] *Id.*; *see also* Dodd-Frank Act § 204(d), 12 U.S.C. § 5384(d) (2012); Lee, *supra* note 59, at 69 (explaining that the OLA permits the FDIC to grant

Dodd-Frank Act, taxpayers cannot bear losses; instead, "losses are first borne by the failed company through its shareholders and its creditors, and, if necessary, by assessments" on the financial sector.[63] In order to fund the OLF, the FDIC, upon appointment as a receiver, is authorized to issue obligations to the Secretary of the Treasury.[64]

The OLA effectively forecloses the opportunity for the U.S. government "to target funds to threatened financial institutions, except in cases where the financial institution is to be liquidated pursuant to the FDIC's resolution authority."[65] In essence, prohibiting targeted emergency lending and the introduction of the OLA prevent the Federal Reserve from authorizing the actions that it took in the Bear Stearns and AIG cases.[66] Some commentators, however, emphasize that the Dodd-Frank Act nonetheless "preserved . . . the Fed's most essential power, namely, the authority in an emergency . . . to set up broad-based lending programs in a financial panic, and thereby serve as lender of last resort" even

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government funding to preserve the continuity of systemically important operations of a failing firm).

[63] Gruenberg, *supra* note 5757; *see also* Mayle, *supra* note 58, at 9 ("The [OLF] will be largely supported through assessments on financial companies with more than $50 billion in total assets and nonbank financial companies supervised by the [Federal Reserve].").

[64] 12 U.S.C. § 5384(d). The FDIC's issuance of obligations in connection with the liquidation of a covered financial company generally may not exceed (i) an amount equal to ten percent of the total consolidated assets of the company and (ii) an amount that is equal to 90 percent of the fair value of the total consolidated assets of the company that are available for repayment. 12 U.S.C. § 5390(n)(6)(A)-(B). The Treasury Secretary may not purchase any obligation unless there is an agreement between the Treasury Secretary and the FDIC that provides a specific plan for repayment of such borrowing and that demonstrates that the FDIC's income from the assets of the covered financial company and assessments on eligible financial companies will be sufficient to amortize the borrowings within a specified time period. 12 U.S.C. § 5390(n)(9)(B)(ii).

[65] Coffee, *supra* note 48, at 824; *see* 12 U.S.C. § 5392(a) ("Funds for the orderly liquidation of any covered financial company under this subchapter shall only be provided as specified under this subchapter."); *see also* Konczal, *supra* note 58.

[66] *Bernanke's Blog*, *supra* note 57 ("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. . . . I was delighted to see my institution taken out of the business of bailing out failing behemoths.").

though such programs would require the approval of the Secretary of the Treasury.[67]

Former Federal Reserve Chairman Ben Bernanke supported the amendments to section 13(3) of the Federal Reserve Act depriving "the Fed . . . [of] its ability to use the 'unusual and exigent' clause . . . to rescue individual institutions such as AIG and Bear Stearns."[68] He stated that "[i]t was one authority [he] was happy to lose" opining that "the trade of liquidation authority [OLA] for reduced emergency powers" was one of the "key legislative bargains" in the Dodd-Frank Act.[69] As discussed below in Part IV.D.1, it was a serious mistake to eliminate the ability of the Federal Reserve to make loans to individual firms under section 13(3) as part of a "key legislative bargain" in exchange for creating the OLA.

Going much further, Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond, argues that the Federal Reserve's section 13(3) lending authority, whether applied to an individual troubled firm or applied in a broad-based manner, "is anachronistic and unnecessary for the Fed's core mission of providing monetary stability."[70] According to the "Richmond School" view, the section 13(3) authority perpetuates an expectation of bailouts, given the Federal Reserve's historical actions, which threatens financial stability.[71] Former FDIC Chairwoman Bair also

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[67] *Id.*; *see also* BERNANKE, *supra* note 1, at 464.

[68] BERNANKE, *supra* note 1, at 464; s*ee also* BROOKINGS CONFERENCE, *supra* note 44, at 177-78 ("I think that some of these changes [made to section 13(3) by the Dodd-Frank Act] are positive—for example, the restriction to broad-based lending programs . . . . It takes the Fed out of the business of weekend emergencies.").

[69] *Bernanke's Blog*, *supra* note 57.

[70] Renee Haltom & Jeffrey M. Lacker, *Should the Fed Have a Financial Stability Mandate? Lessons From the Fed's First 100 Years*, 101 ECON. Q. 49, 68 (2015) ("A critical lesson from the Fed's first 100 years is that an overly broad interpretation of the Fed's role in financial stability in fact undermines financial stability, contributing to a cycle of moral hazard, financial failures, and rescues. The Fed already has the tools and mandate it requires to provide monetary stability, which is its best contribution to financial stability.").

[71] *Id.*; *see also* Jeffrey M. Lacker, President, Fed. Reserve Bank of Richmond, From Country Banks to SIFIs: The 100-year Quest For Financial Stability, Address Before Louisiana State University Graduate School of Banking (May 26, 2015) ("Credible commitment to orderly unassisted resolutions thus may require eliminating the government's ability

expresses concerns regarding the bailouts that took place during the most recent financial crisis [72] and has high expectation for the resolution authorities for failed SIFIs provided in the Dodd-Frank Act because these authorities are "designed to create the certainty of financial loss if an institution's financial risk taking goes awry."[73] As discussed in Part IV.D.2 below, former FDIC Chairwoman Bair's prescriptions to assure financial system stability generally are the correct prescriptions *before* a financial crisis. It is the ability of the government to act *during* a financial Armageddon that is very worrisome after the Dodd-Frank Act.

2. Liability Guarantees

With respect to liability guarantees, the Dodd-Frank Act amended section 13(c)(4)(G)(i) of the Federal Deposit Insurance Act to provide that the systemic risk exception to the least cost resolution requirement applies only for the purpose of winding up a failed

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to provide ad hoc rescues. This would mean repealing the Federal Reserve's remaining emergency lending powers and further restraining the Fed's ability to lend to failing institutions."). In rebuttal to the Richmond School view, Paul Tucker, Deputy Governor of the Bank of England during the financial crisis, has written:

> The Richmond School view echoes the argument of the early 19th century UK Currency School, pitted against the Banking School, that it is only the monetary *liabilities* of the banking system that matter to monetary stability. That's to say, we needn't be too bothered about the credit system. Recent years have, however, provided a painful reminder that monetary contraction can be driven by a collapse of confidence in the credit system; and that injecting more base money isn't an easy cure for a contraction in broad money when the credit system is fundamentally impaired; the "money multiplier" is much weaker in a banking system that is still solvent but has inadequate capital to cope with the risks that may lie ahead. Capital matters too! In a system of fractional-reserve banking, it is hard to unbundle money and credit. *Both* matter to stability.

BIS Papers No. 79, supra note 53, at 19.

[72] BAIR, *supra* note 1, at 355. Regarding the Dodd-Frank Act's restrictions on the Federal Reserve's section 13(3) authority, she writes, "Indeed, if anything, the rules on the Fed should be tightened." *Id.* at 327.

[73] *Id.* at 323.

depository institution for which the FDIC has been appointed receiver.[74] Sections 1104 and 1105 of the Dodd-Frank Act provide new authority for the FDIC to establish "a widely available program to guarantee obligations of *solvent* depository institutions or *solvent* depository institution holding companies . . . during times of severe economic distress, upon a liquidity event finding."[75] To exercise this authority, the Secretary of the Treasury, in consultation with the President of the United States, must identify the maximum amount of debt that the FDIC can guarantee, and passage of a joint resolution of Congress is required before the FDIC may issue guarantees under this authority.[76] Special rules for Senate and House consideration of the joint resolution are prescribed in detail in the statute.[77] The Dodd-Frank Act also suspends the FDIC's authority under section 13(c)(4)(G)(i) of the Federal Deposit Insurance Act to establish any widely available debt guarantee program for which section 1105 of

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[74] Federal Deposit Insurance Act § 13, 12 U.S.C. § 1823(c)(4)(G)(i) (2012) (amendments italicized)
("(G) SYSTEMIC RISK.—

> (i) EMERGENCY DETERMINATION BY SECRETARY OF THE TREASURY.—Notwithstanding subparagraphs (A) and (E) [the least cost resolution requirement], if, upon the written recommendation of the Board of Directors (upon a vote of not less than two-thirds of the members of the Board of Directors) and the Board of Governors of the Federal Reserve System (upon a vote of not less than two-thirds of the members of such Board), the Secretary of the Treasury (in consultation with the President) determines that—
>
> (I) the Corporation's compliance with subparagraphs (A) and (E) with respect to an insured depository institution *for which the Corporation has been appointed receiver* would have serious adverse effects on economic conditions or financial stability; and
>
> (II) any action or assistance under this subparagraph would avoid or mitigate such adverse effects,
>
> the Corporation may take other action or provide assistance under this section *for the purpose of winding up the insured depository institution for which the Corporation has been appointed receiver* as necessary to avoid or mitigate such effects.").

[75] 12 U.S.C. § 5612 (emphasis added).

[76] *Id*.

[77] *Id*.

the Dodd-Frank Act would provide authority.[78] As a result of these amendments in the Dodd-Frank Act, the FDIC would not be able to provide the broad guarantees of liabilities of depository institutions and depository institution holding companies that it provided during the latest financial crisis.[79]

Secretary Geithner explains that in the legislative process leading to the enactment of the Dodd-Frank Act, "the combination of effective resolution authority [OLA] plus FDIC guarantees (as well as the Fed's general authority to support the system in 'unusual and exigent circumstances') [was thought to] . . . make one-off rescues, never appealing, less necessary."[80] He emphasizes that "curtailing the [FDIC] guarantees without restoring the Fed's ability to intervene to save a failing firm would leave the system more vulnerable than ever

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[78] 12 U.S.C. § 5613 ("(a) Suspension of parallel Federal Deposit Insurance Act authority. Effective upon July 21, 2010, the Corporation may not exercise its authority under section 1823(c)(4)(G)(i) of this title to establish any widely available debt guarantee program for which section 5612 of this title would provide authority."); *see* BERNANKE, *supra* note 1, at 464-65 ("The legislation also restricted the FDIC's authority to guarantee bank debt. . . . Now the FDIC would need congressional approval in addition to the concurrence of the Fed and the Treasury secretary—not an easy hurdle to clear, as we saw with the TARP vote. And the FDIC no longer could invoke the systemic risk exception for specific firms that had allowed it during the crisis to help stabilize Citigroup."); *see also Bernanke's Blog*, *supra* note 57 ("Dodd-Frank also cut back other emergency authorities, including those exercised by the FDIC and Treasury as well as by the Fed, while increasing disclosure and reporting requirements. I thought at the time that some of the additional restrictions on emergency powers went too far and were unwise, but I supported them as part of the deal that created the orderly liquidation authority.").

[79] BERNANKE, *supra* note 1, at 464-65.

[80] GEITHNER, *supra* note 1, at 422. Secretary Geithner's parenthetical reference to "the Fed's general authority to support the system in 'unusual and exigent circumstances'" is misplaced. Outside section 13(3) of the Federal Reserve Act, prior to the amendment of this section by the Dodd-Frank Act, the Federal Reserve did not have such "general authority." Under section 13(13) of the Federal Reserve Act, which was not amended by the Dodd-Frank Act, a Federal Reserve Bank is authorized to extend credit for "periods not exceeding 90 days" to "any individual, partnership, or corporation" if the collateral used to secure the credit consists solely of "direct obligations of the United States or by any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States." 12 U.S.C. § 347(c) (2012).

in a panic."[81] In his opinion, losing both the "Fed's ability to intervene with specific firms" and the FDIC's "broad guarantee authority" "could be disastrous."[82]

Senator Dodd had promised to "fix" the legislation and provide the FDIC guarantee authority in the conference committee on the bill.[83] However, in the conference committee, the FDIC guarantee was "off the table."[84] More than six years after enactment of the Dodd-Frank Act, this legislative "fix" has not been made.

As a result of these amendments in the Dodd-Frank Act, the FDIC does not have authority to provide the broad guarantees of liabilities of depository institutions and depository institution holding companies that it provided during the latest financial crisis.

B. Recent Legislative Initiatives

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[81] GEITHNER, *supra* note 1, at 422.
[82] *Id.* at 516.
[83] *See id.* at 422 ("Dodd told me not to worry. . . . 'We'll fix it in conference,' Dodd told me.").
[84] *Id.* at 422-23 ("Dodd's counsel . . . reported the guarantees were off the table . . . [and stated to Treasury Department counsel that] we will have to come back in a year or two and fix. [H]opefully there will not be a financial crisis in the interim."). This outcome under Senator Dodd's leadership is somewhat ironic. Senator Dodd had a number of years earlier sponsored an amendment to section 13(3) that was enacted in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which eliminated collateral restrictions on emergency borrowing; after this amendment, the only collateral test remaining under Section 13(3) was "satisfactory security." Walker F. Todd, *FDICIA's Emergency Liquidity Provisions*, 29 FED. RES. BANK CLEVELAND ECON. REV. 16, 20 (1993) (statement of Sen. Dodd). This put non-banking institutions in the same position as banks for the first time under section 13(3). *Id*. Prior to this amendment, securities firms were effectively foreclosed from obtaining emergency credit under section 13(3) because the Federal Reserve could not lend under section 13(3) against securities, which constituted the bulk of such firms' assets. *Id*. With respect to this amendment, Senator Dodd stated that "[FDICIA] also includes a provision I offered to give the Federal Reserve greater flexibility to respond in instances in which the overall financial system threatens to collapse. My provision allows the Fed more power to provide liquidity, by enabling it to make fully-secured loans to securities firms in instances similar to the 1987 stock market crash." 137 Cong. Rec. S18,619 (1991); Todd, at 20 & n.19.

In August 2014, Democratic Senator Elizabeth Warren and Republican Senator David Vitter were among fifteen bipartisan members of Congress who sent a bicameral letter to Federal Reserve Chairwoman Janet Yellen stating that the Federal Reserve Board's proposed regulation under section 13(3) "places no meaningful restrictions on its emergency powers and, in a time of crisis, invites the same sort of backdoor bailout[85] we witnessed five years ago."[86] They proposed that the Federal Reserve: (i) "[e]stablish a clear time limit for a financial institution's reliance on the Board's [section 13(3)] emergency lending and provide a concrete limit on the duration of each lending facility or program"; (ii) "adopt a broader definition of 'insolvent'—one that might examine the relative value of an institution's assets and liabilities—so that the Board could not use its emergency lending program to save an institution that is on the verge of bankruptcy"; (iii) "[e]xpand the definition of 'broad-based'"; and (iv) impose a penalty rate on lending terms.[87] On March 3, 2015, Senator Warren stated that "[i]f the Federal Reserve fails to put 'real limitations' on its emergency lending authority, then Congress should take action."[88] On May 13, 2015, Senators Warren and Vitter, concluding "that the Federal Reserve's proposed procedures on emergency lending have been completely unsatisfactory and fail to place any real limits on the Fed's ability to engage in indiscriminate bailouts in the future," introduced the Bailout Prevention Act of 2015.[89] According to Senator Vitter, the

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[85] For a discussion of the difference between secured "lender-of-last-resort facilities" and "taxpayer-funded bailouts," see *infra* notes 138-40 and the accompanying text.
[86] Letter from Elizabeth Warren, U.S. Sen. (Mass.), et al., to Janet Yellen, Chairwoman, Bd. of Governors of the Fed. Reserve Sys., 1 (Aug. 18, 2014), http://www.federalreserve.gov/SECRS/2016/January/20160113 /R-1476/R-1476_112315_130118_330099608751_1.pdf [https://perma.cc/4ZTG-55MA].
[87] *Id.* at 2-3.
[88] Kim Chipman, *Federal Reserve: Congress May Need to Act on Fed's Emergency Lending Rules, Warren Says*, DAILY REPORT FOR EXECUTIVES (BNA) No. 42, at EE-15 (Mar. 4, 2015).
[89] *Vitter, Warren Introduce Bailout Prevention Act*, DAVID VITTER (May 13, 2015), http://www.vitter.senate.gov/newsroom/press/vitter-warren-introduce-bailout-prevention-act [https://perma.cc/B3JM-ADTK] [hereinafter *Vitter Press Release*]. On June 3, 2015, a bipartisan House bill, entitled the Bailout Prevention Act of 2015 (H.R. 2625), was introduced. Press Release, Reps. Garrett, Capuano Introduce Bill to Limit Fed's Bailout Authority

Bailout Prevention Act reins in the Federal Reserve's emergency lending authority by:

> Requiring lending programs to be truly broad-based: The Fed may only create facilities or programs that allow five or more institutions to participate in a significant manner.
>
> Restricting lending to only those institutions that are not insolvent: The Fed and all other banking regulators with jurisdiction over an institution that wishes to participate in a lending program must certify—based on analysis of assets and liabilities over the preceding four-month period—that the borrower is not insolvent, and must provide a contemporaneous written explanation of their analysis.

(June 3, 2015), http://garrett.house.gov/media-center/press-releases/reps-garrett-capuano-introduce-bill-to-limit-fed-s-bailout-authority [https://perma.cc/CM89-RMJN]. This bill is similar to the Senate bill as it relates to the provisions discussed in this article. *See id.* It would also reduce the delayed release of unredacted GAO reports on a section 13(3) facility, as well as reduce the delayed public disclosure by the Federal Reserve of each borrower's name, the amount borrowed, the interest rate and the type of collateral under each section 13(3) facility, from one year after termination of the facility (which shall be deemed to have terminated 24 months after the date on which the credit facility ceases to make extensions of credit and loans, unless the credit facility is terminated by the Federal Reserve Board before such date), as provided under existing law, to 60 days after termination of the facility (which shall be deemed to have terminated 60 days after the date on which the credit facility ceases to make extensions of credit and loans, unless the credit facility is terminated by the Federal Reserve Board before such date). *See* Bailout Prevention Act of 2015, H.R. 2625, 114th Cong. § 4 (2015); Federal Reserve Act, 12 U.S.C. § 248(s)(2)-(3); *see also supra* note 56. It is not clear how this public disclosure provision of H.R. 2625 relates to the provision of the bill, discussed in the text below, that requires if the Federal Reserve Board or any other banking regulator makes a certification of solvency, then the Federal Reserve Board or banking regulator, as applicable, shall issue a contemporaneous public statement providing a detailed explanation of the certification decision.

> Requiring lending to be provided at a penalty rate: The Fed may only offer loans that are 500 basis points or more above the cost of borrowing for the US Treasury for a similar loan term.[90]

Under the Bailout Prevention Act bill, "[s]olvency shall be assessed by examining the last [four] months of relevant financial data and determining whether the fair value of the borrower's assets exceeds the fair value of the borrower's liabilities, with appropriate adjustment for temporary illiquidity in relevant markets."[91] If the Federal Reserve Board or any other banking regulator makes a certification of solvency, then the bill requires that the Federal Reserve Board or banking regulator shall issue a contemporaneous public statement providing a detailed explanation of the certification decision.[92]

The Bailout Prevention Act bill includes a provision that permits the Federal Reserve Board to create a program that does not satisfy the broad-based or penalty rate requirements, but, in such case, the Federal Reserve must, within three calendar days of beginning the program, submit a report to Congress explaining the reasons why the requirements are inappropriate for the program and obtain Congressional approval of such program within thirty calendar days of Congress's receipt of the report.[93] If Congress does not approve the program under the expedited procedures spelled out in the Act,[94] then the program automatically terminates thirty calendar days after the date on which Congress receives the report from the Federal Reserve, and "[a]ny loan offered through the program that is outstanding on such termination date shall be repaid in full not later than [thirty] calendar days after the date on which the program is terminated."[95]

Former Federal Reserve Chairman Bernanke has written that in practice the Bailout Prevention Act bill's requirements that (i) the Federal Reserve Board and any other banking regulator of a firm

[90] *Vitter Press Release*, *supra* note 191.
[91] Bailout Prevention Act of 2015, S. 1320, 114th Cong. § 2 (2015).
[92] *Id.*
[93] *Id.* at § 3.
[94] The bill includes very detailed provisions regarding the rules of both Houses of Congress relating to expedited Congressional approval or disapproval of such a program. *Id.*
[95] *Id.*

receiving loans "certify the firm's solvency and to make its solvency analyses public immediately" and (ii) the interest rate on any emergency loan be at least 500 basis points above the cost of borrowing for the U.S. Treasury for a similar loan term "would eliminate the Fed's ability to serve as lender of last resort in a crisis."[96] He also emphasized that the proposed legislation "would create an insuperable stigma problem" of borrowing from the central bank.[97]

> First, the requirement that solvency analyses be released immediately (or quickly) would publicly identify any potential borrowers. No borrower would allow itself to be so identified, for fear of the inferences that might be drawn about its financial health. Second, the five percentage point penalty rate requirement would remove any doubt that those borrowing from the central bank had no access to other sources of funding, further worsening the stigma problem. . . . Moreover, because borrowers would know that the program could be terminated in thirty days if Congress didn't approve, the benefit of borrowing from the central bank would be limited.[[98]] Because borrowers would not willingly participate, broad-based lending programs . . . would not work, and we would have lost a critical weapon against financial panics.[99]

On November 19, 2015, the Fed Oversight Reform and Modernization Act of 2015 (FORM Act) was passed by the House of

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[96] *Bernanke's Blog*, *supra* note 57.
[97] *Id.* Ben Bernanke also wrote of this "stigma" concern in connection with a new requirement under section 1103(b) of the Dodd-Frank Act that the Federal Reserve must publish the identities of discount window borrowers with a two-year lag. *See* BERNANKE, *supra* note 1, at 464-65 ("Lagged disclosure is a lot better than immediate disclosure, but the new disclosure requirements may still increase the stigma of borrowing from the Fed in a panic.").
[98] This concern appears to be misplaced because the program could be terminated by Congress only if the program does not satisfy the broad-based requirement or the penalty rate requirement.
[99] *Bernanke's Blog*, *supra* note 57.

Representatives by a vote of 241-185.[100] This bill would amend section 13(3), as amended by the Dodd-Frank Act, to require that: (i) any loan under section 13(3) be approved by at least nine Presidents of the Federal Reserve Banks; (ii) the assisted firm be "predominantly engaged in financial activities" as defined in section 102(a) of the Dodd-Frank Act;[101] (iii) Federal Reserve Banks may not accept equity securities issued by a recipient of any loan or other financial assistance under section 13(3); (iv) before any lending by a Federal Reserve Bank the Federal Reserve Board and all relevant federal banking regulators must certify that the borrower is not insolvent; and (v) any loan must be at a "minimum interest rate," which is defined as the sum of the average discount rate of all Federal Reserve Banks over the most recent ninety-day period and the average of the difference between a corporate bond yield index and a bond yield index of debt issued by the United States over the most recent ninety-day period.[102]

Federal Reserve Chairwoman Yellen expressed concerns about the FORM Act's "debilitating restrictions on the Federal Reserve's emergency lending authorities," arguing that in a future

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[100] *All Bill Information (Except Text) for H.R.3189—Fed Oversight Reform and Modernization Act of 2015*, CONGRESS.GOV, https://www.congress.gov/bill/114th-congress/house-bill/3189/all-info [https://perma.cc/23VF-KPLH].

[101] Under section 102(a)(6) of the Dodd-Frank Act, a company is considered to be predominantly engaged in financial activities if either (A) "the annual gross revenues derived by the company and all of its subsidiaries from activities that are financial in nature . . . and, if applicable, from the ownership or control of one or more insured depository institution, represents 85 percent or more of the consolidated annual gross revenues of the company; or (B) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature . . . and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the company." Dodd-Frank Act § 102, 12 U.S.C. § 5311 (2012). Section 102(b) of the Dodd-Frank Act requires the Federal Reserve Board to establish the requirements for determining if a company is ''predominantly engaged in financial activities.'' *Id.* The Federal Reserve Board has issued a final rule establishing such requirements. *See generally* Definitions of "Predominantly Engaged In Financial Activities" and "Significant" Nonbank Financial Company and Bank Holding Company, 78 Fed. Reg. 20,756 (Apr. 5, 2013) (to be codified at 12 C.F.R. pt. 242).

[102] Fed Oversight Reform and Modernization Act of 2015, H.R. 3189, 114th Cong. (2015).

large-scale financial crisis "the Federal Reserve [should] have the emergency lending powers necessary. . . to support the flow of credit to households and businesses and mitigate harm to the U.S. economy. The FORM Act would essentially repeal the Federal Reserve's remaining ability to act in a crisis."[103]

These legislative initiatives evidence that certain parties in Congress intend to further weaken the Federal Reserve's emergency lending power.

C. Final Federal Reserve Regulation

Effective January 1, 2016, the Federal Reserve Board, in consultation with the Secretary of the Treasury, adopted its final regulation, as required by the Dodd-Frank Act, to establish policies and procedures with respect to emergency lending under section 13(3).[104] The Federal Reserve Board's proposed regulation "largely track[ed] the provisions of the Dodd-Frank Act without extending the regulation beyond the statutory provisions."[105] According to the

[103] Letter from Janet Yellen, Chairwoman, Bd. of Governors of the Fed. Reserve Sys., to Paul Ryan, House Speaker, and Nancy Pelosi, Democratic Leader, at 3 (Nov. 16, 2015); *see also* Letter from the Comm. on Capital Mkts. Regulation (CCMR), to Paul Ryan, House Speaker, and Nancy Pelosi, Democratic Leader (Nov. 18, 2015). The CCMR writes that the FORM Act "may make 13(3) lending impossible in practice" for the following reasons: "First, it would require lender-of-last-resort determination by 'committee,' which would increase uncertainty in the marketplace and slow the Federal Reserve's ability to respond to an emerging crisis. Second, by precluding non-financial institutions from borrowing from the Federal Reserve during a crisis, it would prevent the Federal Reserve from buying the commercial paper of non-financials such as McDonalds, Caterpillar . . . Ford . . . as it did in the 2008 crisis, when private financing seized up entirely." Letter from CCMR at 2. Further, in order for the Federal Reserve to make a section 13(3) loan, the bill would require that all federal banking regulators with jurisdiction over the borrower certify its solvency. *Id.* This provision could provide, for example, the Consumer Financial Protection Bureau "with veto authority over section 13(3) lending to non-banks, including broker-dealers or bank holding companies." *Id*. at 3.

[104] Extensions of Credit by Federal Reserve System, 80 Fed. Reg. 78,959 (Dec. 18, 2015); Extensions of Credit by Federal Reserve Banks (Regulation A), 12 C.F.R. pt. 201 (2016).

[105] Letter from Comm. on Capital Mkts. Regulation to Fed. Reserve Bd. (Mar. 5, 2014), http://capmktsreg.org/wp-content/uploads/2014/03/emergency.lending.comment.ltr_.pdf [https://perma.cc/6ZCH-CKFJ].

Federal Reserve Board, "[t]he final rule adopts all of the limitations and revisions required by the Dodd-Frank Act. In addition, in response to the comments [received on the proposed regulation], the Board has revised the final rule in a number of significant ways."[106] Under the final regulation, "a program or facility has broad-based eligibility only if the program or facility is designed to provide liquidity to an identifiable market or sector of the financial system."[107] Under the final rule,

> [a] program or facility will not be considered to have broad-based eligibility . . . if: (A) The program or facility is designed for the purpose of assisting one or more specific companies avoid bankruptcy, resolution under Title II of [the Dodd-Frank Act] or any other Federal or State insolvency proceeding, including by removing assets from the balance sheet of one or more such company; (B) The program or facility is designed for the purpose of aiding one or more failing financial companies; or (C) Fewer than five persons or entities would be eligible to participate in the program or facility.[108]

The latter two of these requirements were added in the final regulation and the final requirement was drawn from the Bailout

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[106] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,960. The Federal Reserve Board received nine comment letters on the proposed regulation. *Freedom of Information Office*, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve.gov/apps/foia/ViewComments.aspx?doc_ id=R%2D1476&doc_ ver=1 [https://perma.cc/5DF9-KGWR]. One of the comment letters was from the fifteen bipartisan members of the U.S. Senate who in August 2014 sent the letter to Federal Reserve Chairwoman Janet Yellen that is discussed in the text accompanying note 86 *supra*; their comment letter on the proposed regulation largely repeated their points set out in their August 2014 letter.

[107] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,965.

[108] *Id.* at 78,965-66. The Federal Reserve Board notes that "these restrictions would not permit emergency lending to remove assets from a failing firm as was done in the case of the emergency loan to Bear Stearns, or to provide credit to prevent a firm from entering bankruptcy as was done in the case of the emergency credit facility established for AIG." *Id.* at 78,961.

Prevention Act bill proposed by Senators Warren and Vitter.[109]

Under the final regulation, "insolvent" is defined as:

> (A) The person or entity is in bankruptcy, resolution under Title II of [the Dodd-Frank Act] or any other Federal or State insolvency proceeding; (B) The person or entity is generally not paying its undisputed debts as they become due during the 90 days preceding the date of borrowing under the program or facility; or (C) The Federal Reserve Board or Federal Reserve Bank otherwise determines that the person or entity is insolvent.[110]

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[109] *See* David Harrison, *Fed Adopts Dodd-Frank Bailout Limits*, WALL ST. J. (Nov. 30, 2015), http://www.wsj.com/articles/fed-set-to-adopt-final-emergency-lending-rule-1448889633?cb=logged0.5315217801327894 [https://perma.cc/HF3J-N9D7] ("Fed officials said they copied the new requirement from legislation proposed by Sens. Elizabeth Warren (D., Mass.) and David Vitter (R., La.), two of the most vocal critics of the Fed's big bank bailouts."). In response to the final regulation, Senator Warren and Vitter stated "there [were] still loopholes that the Fed could exploit to provide another back-door bailout to giant financial institutions" and that "more needs to be done. . . ." *Warren, Vitter: Fed's New Bailout Rule is a Step in the Right Direction*, ELIZABETH WARREN (Nov. 30, 2015), http://www.warren.senate.gov/?p=press_release&id=1010 [https://perma.cc/V2MA-MW6T]). Congressman Jeb Hensarling (R., Texas), Chairman of the House Financial Services Committee, stated that "by leaving the door wide open to future taxpayer-funded bailouts, the final rule compounds the moral hazard problem that lies at the core of 'too big to fail.'" Jeb Hensarling, *Fed's Emergency Lending Rule Leaves the Door Wide Open to Future Taxpayer-Funded Bailouts*, FIN. SERV. COMMITTEE (Nov. 30, 2015), http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=399995 [https://perma.cc/87A8-RGT6]. He recommended that Congress approve the FORM Act to "provide assurances to taxpayers that they will not have their pockets picked the next time the Fed decides to bail out a financial institution it decides is 'too big to fail.'" *Id*.

[110] *See* Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. at 78,966. For purposes of meeting the solvency requirement, the Federal Reserve Board or Federal Reserve Bank may rely on

> (A) A written certification from the person or from the chief executive officer or other authorized officer of the entity, at the time the person or entity initially borrows under the program or facility, that the person or entity is

The latter two of these requirements had not been included in the proposed regulation. The Federal Reserve Board also added in the final regulation the requirement that loans may not be made to companies that are borrowing for the purpose of lending to insolvent companies.[111]

The final regulation requires that emergency loans under section 13(3) must be extended at a penalty rate,[112] which will be determined with consideration of

> the condition of affected markets and the financial system generally, the historical rate of interest for loans of comparable terms and maturity during normal times, the purpose of the program or facility, the risk of repayment, the collateral supporting the credit, the duration, terms and amount of the credit, and any other factor that the Board determines to be relevant to ensuring that the taxpayers are appropriately compensated for the risks associated

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> not in bankruptcy, resolution under Title II of [the Dodd-Frank Act] . . . or any other Federal or State insolvency proceeding, and has not failed to generally pay its undisputed debts as they become due during the 90 days preceding the date of borrowing under the program or facility; (B) Recent audited financial statements of the person or entity; or (C) Other information that the Board or the Federal Reserve Bank may determine to be relevant.

12 C.F.R. § 201.4(d)(5)(iv). "If a participant or person has provided a certification . . . that includes a knowing material misrepresentation in the certification, all extensions of credit made pursuant to [the regulation] . . . that are outstanding to the relevant participant shall become immediately due and payable. . . ." 12 C.F.R. § 201.4(5)(vii). "[The Federal Reserve] will also refer the matter to the relevant law enforcement authorities for investigation and action in accordance with applicable criminal and civil law." *Id.*

[111] 12 C.F.R. § 201.4(5)(i).

[112] A penalty rate "(A) Is a premium to the market rate in normal circumstances; (B) Affords liquidity in unusual and exigent circumstances; and (C) Encourages repayment of the credit and discourages use of the program or facility as the unusual and exigent circumstances that motivated the program or facility recede and economic conditions normalize." 12 C.F.R. § 201.4(7)(ii).

> with the credit extended under the program or facility and that the purposes of [the regulation] . . . are fulfilled.[113]

Furthermore, the Federal Reserve may impose any other "fees, penalties, charges or other consideration" on a borrower if it considers it is necessary to safeguard taxpayers' interests.[114]

The final regulation provides that the Federal Reserve Board will make public and report to Congress a description of the market or sector of the financial system to which a program or facility with broad-based eligibility is intended to provide liquidity.[115] The regulation also provides that the Federal Reserve Board will review each program or facility at least every six months.[116] Finally, each program or facility will terminate within one year from the date of its first extension of credit or its latest renewal date unless the Board determines, by a vote of at least five members of the Board and with the approval of the Secretary of the Treasury, to renew the program or facility.[117]

D. Discussion: Financial Stability and Emergency Credit

1. Lender of Last Resort: Foundation and Principles

While the mandates of the Federal Reserve System have evolved over time, it is clear today that the Federal Reserve has three broad areas of responsibility: to seek to assure monetary stability,

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113 *Id.*
114 12 C.F.R. § 201.4(d)(7)(iv).
115 12 C.F.R. § 201.4(d)(9)(iii) ("The Board shall make the disclosures required under paragraph (d)(3) of this section to the public and the relevant congressional committees no later than 7 days after renewing a program or facility under this paragraph . . . .").
116 12 C.F.R. § 201.4(9)(iv) ("[T]he Board will periodically review, no less frequently than once every 6 months, the existence of unusual and exigent circumstances, the extent of usage of the program or facility, the extent to which the continuing authorization of the program or facility facilitates restoring or sustaining confidence in the identified financial markets, the ongoing need for the liquidity support provided by such program or facility, and such other factors as the Board may deem to be appropriate.").
117 12 C.F.R. § 201.4(9)(i-ii).

macroeconomic stability, *and financial system stability*.[118] The Federal Reserve System was created in response to financial panics as a tool to preserve financial stability.[119] Moreover, the recent financial crisis highlighted the significance of the financial stability goal in central banks' mandate.[120] In this connection, Federal Reserve Chairman Bernanke emphasized that "as much as possible, central banks and other regulators should try to anticipate and defuse threats to financial stability and mitigate the effects when a crisis occurs."[121]

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[118] *See, e.g.*, BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 1 (9th ed. 2005) (positing that the Federal Reserve's responsibilities include "conducting the nation's monetary policy . . . in pursuit of maximum employment, stable prices, and moderate long-term interest rates . . . [and] maintaining the stability of the financial system and containing systemic risk that may arise in financial markets").

[119] *See id.* at 1-2; Glenn Hubbard & Hal Scott, *A Financial System Still Dangerously Vulnerable to a Panic*, WALL ST. J. (Mar. 1, 2015, 5:31 PM), http://www.wsj.com/articles/glenn-hubbard-and-hal-scott-a-financial-system-still-dangerously-vulnerable-to-a-panic-1425249064 [https://perma.cc/K3BW-52DH] ("The Fed was created in 1913 to be a lender of last resort against the background of the deep recession that followed the bank runs of 1907."); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve and the Financial Crisis: Origins and Mission of the Federal Reserve, Lecture 1 at George Washington University School of Business (Mar. 20, 2012), http://www.federalreserve.gov/mediacenter/files/chairman-bernanke-lecture1-20120320.pdf [perma.cc/ULS4-9E76] ("[F]inancial stability concerns were a major reason why Congress decided to try to create a central bank in the beginning of the 20th century."); s*ee also Kohn Testimony*, *supra* note 53, at 3 ("Supplying liquidity to financial institutions by lending against possibly illiquid collateral is a key function of central banks. . . . [I]t is an essential way for the central bank to cushion Main Street from the loss of confidence in the financial sector.").

[120] Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., The Effects of the Great Recession on Central Bank Doctrine and Practice, Speech at the Federal Reserve Bank of Boston 56th Economic Conference, Boston, Mass. (Oct. 18, 2011), https://www.federalreserve.gov /newsevents/speech/bernanke 20111018a.htm [perma.cc/3SSJ-WX2T] (noting that while central banks before the latest financial crisis often viewed financial stability policy as the "junior partner" to monetary policy, the crisis underscored that maintaining financial stability is an equally critical responsibility).

[121] Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., The Federal Reserve and the Financial Crisis: The Aftermath of the Crisis,

"[G]overnments and central banks . . . need emergency authority that can be deployed quickly on a massive scale when a financial crisis hits. . . ."[122] By providing short-term loans and taking illiquid assets of an institution as collateral, central banks can put money into the financial system, allowing depositors and short-term creditors to be paid, thus calming the situation and ending the panic.[123] This authority should be reserved for the most dangerous situations, and there should be some uncertainty about its deployment to reduce the risk of moral hazard, but it should come with discretion and force.[124] The vital tools in the toolboxes of central banks and other governmental financial authorities are the lender-of-last-resort authority to provide liquidity where it is needed in the financial system and emergency authority to broadly guarantee financial liabilities, not just deposits in depository institutions. Private sector resources typically will not be able to supply enough liquidity, even on a fully secured basis, during a financial panic.[125] Indeed,

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Lecture 4 at George Washington University School of Business (Mar. 29, 2012), http://www.federalreserve.gov/newsevents/files/bernanke-lecture-four-20120329.pdf [perma.cc/VQ4E-L53A].

[122] *See* GEITHNER, *supra* note 1, at 515.

[123] *See BIS Papers No. 79*, *supra* note 53, at 10.

[124] GEITHNER, *supra* note 1, at 516 ("These firefighting authorities do create some moral hazard. . . . In fact, once the time for prevention and preparation is over, letting the fire burn for a while is the right opening move.").

[125] *See* Letter from Richard Levin, Chair, Nat'l Bankr. Conference, to the Honorable Tom Marino, Chairman, House Subcomm. on Regulatory Reform, Commercial and Antitrust Law et al. at 7 (June 18, 2015), http://newnbc.wpengine.com/wp-content/uploads/2015/07/2015-Jun-18-NBC_Ltr_to_Cong_re_SIFI_Bills.pdf [https://perma.cc/H4BA-DXWY] [hereinafter *NBC Letter*] ("[T]o be successful, any recapitalization procedure, whether under the Bankruptcy Code or under a special resolution regime like OLA, requires a non-market backstop liquidity source as a bridge for the recapitalized firm until liquidity outflows abate and access to market liquidity returns.").

An example of when the Federal Reserve deemed private sector resources to be sufficient to avert a financial crisis is the near failure of Long-Term Capital Management (LTCM) in September 1998, when a consortium of 14 banks and brokerage firms, brought together by the Federal Reserve Bank of New York, invested $3.625 billion in LTCM to prevent the firm's collapse. *See* Michael Fleming & Weiling Liu, *Near Failure of Long-Term Capital Management*, FED. RES. BANK N.Y. (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/52 [perma.cc/H5SS-2V59] (describing the refinancing of LTCM).

recognition of this was a motivating factor in the creation of the Federal Reserve System.[126]

While emergency lending authorities do create moral hazard, it is much better to have the power to put out a financial "fire" as "the potential benefits of avoiding a depression far outweigh the potential costs of saving people who don't deserve to be saved."[127] With authority to provide emergency liquidity and liability guarantee assistance, governmental actions can start out slowly and accelerate quickly if needed.[128] The goal is to let the system start to adjust without tipping into panic and collapsing.[129] Former Treasury Secretary Geithner warns that

> [t]he inconvenient truth of financial-crisis response is that the actions that feel right are often wrong. The natural instinct is to wait as long as possible before intervening, to escalate as gradually as possible, to minimize taxpayer exposure to losses, to impose stringent conditions on assistance, to teach the arsonists a lesson, to address the root causes of the crisis. Let failing firms fail. Let the creditors who financed their binges pay the price. But that is a recipe for making a systemic crisis worse. The public will want Old Testament justice, punishment for the venal. The moral hazard fundamentalists will want to send a message that irresponsible behavior will not be rewarded. If policymakers listen, they will court disaster.[130]

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[126] *See BIS Papers No. 79*, *supra* note 53, at 10 (emphasis added) ("[T]he fragile banking system . . . called central banking into existence as a *liquidity insurer* in the first place. . . ."); *see also* BROOKINGS CONFERENCE, *supra* note 44, at 172 ("[T]he original mission of the Fed was essentially to be a lender of last resort.").

[127] GEITHNER, *supra* note 1, at 516.

[128] *Id*. at 517 ("You can afford to start slowly only if your government and central bank have the authority and the will to accelerate quickly into something approaching overwhelming force.").

[129] *Id*. ("Ideally, you want to provide just enough liquidity and other support for the system to prevent it from falling apart, but not so much that you sustain unsalvageable firms or unsustainable asset prices.").

[130] *Id*. at 518.

Geithner continues, "[i]t's easier to arrest a financial panic than to clean up after an economic disaster" and "[t]he goal is to make it irrational to run."[131]

In explaining this governmental authority to intervene in times of financial crisis, commentators traditionally rely on the principles developed by Walter Bagehot in 1873.[132] In Bagehot's view, the central bank should perform functions of the lender of last resort (LOLR) with an aim to contain a financial crisis and "prevent a liquidity crisis from creating a financial panic that froze the markets and depressed the economy."[133]

Bagehot did not envisage unconditional power of a central bank to grant emergency lending. A tenet traditionally referred to as "Bagehot's dictum" limits central bank's emergency lending authority only to situations where the loan is fully secured and the borrower is solvent but illiquid.[134] Moreover, the interest rate for such loans should exceed the market rate.[135] "[Central banks] do not provide capital to failed firms that protect shareholders or creditors against losses. Nor do they result in governments assuming risks for which they are not compensated."[136]

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[131] *Id*. Geithner emphasizes that "[t]here will be intense pressure to let major firms fail, avoid moral hazard, minimize governmental intervention. But that's a formula for a larger crisis that will ultimately require greater governmental intervention and create more moral hazard." *Id.*

[132] *See* WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 160 (1877). Bagehot believed that lender-of-last-resort facilities should not be limited only to banks; in his view, lender-of-last-resort advances should be made "on proper security to *anyone* who applies for it." *Id.* at 168 (emphasis added). "Theory suggests, and experience proves, that in a panic the holders of the ultimate Bank reserve [the central bank] . . . should lend to *all* that bring good securities quickly, freely, and readily. By that policy they allay a panic . . . ." *Id.* at 173 (emphasis added). "[I]n time of panic [the central bank] must advance freely and vigorously to the *public* out of the reserve." *Id.* at 196 (emphasis added); *see also Bagehot's Dictum in Practice*, *supra* note 53, at 1 ("Bagehot saw few limitations on the appropriate counterparties of a central bank in a financial crisis.").

[133] Coffee, *supra* note 48, at 823; *see also BIS Papers No. 79*, *supra* 53, at 15.

[134] Coffee, *supra* note 48, at 823.

[135] *See* JOHN F. BOVENZI ET AL., TOO BIG TO FAIL: THE PATH TO A SOLUTION 48 (2013), http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/TooBigToFail.pdf [perma.cc/V6EU-AA72].

[136] *Id*.

> Instead they are designed to prevent the unnecessary destruction of value that would otherwise be caused by the tragedy-of-the-commons problem that arises when the public loses confidence in certain banks or other financial institutions engaged in the maturity transformation process or the banking system as a whole. . . . Even if the institution is indisputably solvent, and every depositor or similar creditor knows it, each of them has an incentive to run if others start running to protect against the risk that the others will force the institution to sell its illiquid assets at fire-sale prices, causing it to become insolvent. If that happens, individuals who did not run will suffer losses that could have been avoided had they run in the first place when everyone else did.[137]

Bagehot's principles also illustrate the difference between a "lender-of-last-resort facility" and a "taxpayer-funded bailout."[138] The former "only provide[s] fully secured liquidity to solvent financial institutions at above-market interest rates," while the latter "provide[s] capital to insolvent or severely undercapitalized firms."[139] Lender-of-last-resort facilities that only provide fully

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[137] *Id.*; *see also* Bernanke, *supra* note 120.

[138] BOVENZI ET AL., *supra* note 135, at 3, 47.

[139] *Id.*; *see also NBC Letter*, *supra* note 125, at 7 ("A distinction should be made between a government bailout . . . by adding equity capital to an insolvent firm . . . and traditional secured lender-of-last-resort liquidity provided to a recapitalized firm. . . . In the former case, taxpayers absorb the firm's losses. In the latter case, private sector shareholders and creditors absorb the firm's losses. . . ."); s*ee also* Randall D. Guynn, Address Before the Subcommittee of Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing, and Urban Affairs, at 13 (July 29, 2015), http://www.banking.senate.gov/public/_cache/files/93762f4b-5364-47fc-b0e6-dd763f32978c/23C6AE00CC53D93492511CC744028B5E.guynntestimony72915.pdf [https://perma.cc/9379-NV6C] [hereinafter *Guynn Statement*] ("[T]raditional LOLR facilities provide only temporary fully secured liquidity at above-market interest rates to solvent firms with sufficient capital. If properly structured, such facilities expose the government to no

secured liquidity to solvent firms at above-market interest rates are *not* taxpayer-funded bailouts.

So long as the Bagehot's dictum requirements are met, then the requirement of the Dodd-Frank Act that lender-of-last-resort funding is available only to the financial system at large—and not to a single troubled, but solvent, SIFI to avoid its disorderly failure—is misguided, and could well result in serious damage to the financial system—Wall Street—and the economy at large—Main Street—in the next financial crisis.

LOLR emergency lending serves two functions. On one hand, even in light of the mere possibility of emergency lending, "banks' short-term creditors should be less inclined to run."[140] On the other hand, if such run could not be avoided, central bank LOLR lending becomes a source of liquidity for the affected institutions, thus "reduc[ing] the need for a forced sale of assets that otherwise would depress values, causing avoidable insolvencies and knocking the economy as a whole onto an inferior equilibrium growth path."[141] Commentators conclude that "the LOLR can reduce both the probability and impact of runs. It helps to preserve stability in the face of unwarranted runs and contains the spread of panic to *sound* firms in the face of warranted runs on other, fundamentally bust firms. Its purpose . . . is to contain contagion."[142]

2. Emergency Credit Facilities in Practice

In the most recent financial crisis, the Federal Reserve used its pre-Dodd-Frank Act powers to secure financial stability. In particular, Federal Reserve Chairman Bernanke emphasized that "[t]he rationale for providing credit support to particular institutions was to avert a disorderly failure of these institutions and so to limit the impact of the firms' difficulties on the functioning of financial markets and the broader economy."[143] In his view, "AIG's demise

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risk of loss and require borrowers to adequately compensate it for the small amount of liquidity risk it assumes.").

140 *BIS Papers No. 79*, *supra* note 53, at 15.

141 *Id.*

142 *Id.*

143 *See* Letter from Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., to the Financial Crisis Inquiry Commission, at 9 (Nov. 4, 2010).

would be a catastrophe"[144] because it was so interconnected.[145] Former Treasury Secretary Paulson also shared these concerns, emphasizing that AIG's collapse "would have buckled our financial system and wrought economic havoc on the lives of millions of our citizens."[146] Robert Samuelson, a columnist for *The Washington Post*, contended that the authority under section 13(3) "may have prevented a second Great Depression" in 2008.[147] He opined that the Dodd-Frank Act's restrictions on the Federal Reserve's section 13(3) authority is "the sleeper issue in judging Dodd-Frank."[148]

Moreover, the Federal Reserve's section 13(3) actions in the cases of Bear Stearns and AIG met the solvency, collateral, and penalty rate requirements set out by Bagehot.[149] Although former

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[144] *See* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 443 (2015).

[145] *Id*. ("In our estimation, the failure of AIG would have been basically the end. It was interacting with so many different firms. It was so interconnected with both the U.S. and the European financial systems and global banks.").

[146] *Id*. (quoting former Treasury Secretary Paulson) ("An AIG failure would have been devastating to the financial system and to the economy. . . . [I]t would be catastrophic if AIG filed for bankruptcy. . . . [I]f AIG went down, the country faced a real disaster.").

[147] Samuelson, *supra* note 9 ("Dodd-Frank's provisions, even if they worked as hoped, can't permanently shield us from unforeseen problems. In a crisis, we need a competent first responder. The Fed, though hardly infallible, is the best choice. A farsighted and wise Congress . . . would restore its flexibility.").

[148] *Id*.; *see also* Alan S. Blinder, *Beware of Wooly-Minded Attacks on the Fed*, WALL ST. J. (Jan. 27, 2015, 6:25 PM), http://www.wsj.com/articles/alan-s-blinder-beware-of-woolly-minded-attacks-on-the-fed-1422401124 ("[I]n writing Dodd-Frank, Congress clipped the Fed's wings.").

[149] The Federal Reserve Board determined that Bear Stearns and AIG were illiquid but solvent. For a discussion of the Bear Stearns case, see BD. OF GOVERNORS OF THE FED. RESERVE SYS., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008, LOAN TO FACILITATE THE ACQUISITION OF THE BEAR STEARNS COMPANIES, INC. BY JPMORGAN CHASE & CO. 6 (2008) (discussing factors mitigating the risk of losses being incurred by the FRBNY loan in connection with the Bear Stearns transaction). For a discussion of the AIG case, see *2008 Other Announcements*, BD. GOVERNORS FED. RES. SYS. (Sept. 16, 2008), http://www.federalreserve.gov/newsevents/press/other/20080916a.htm [https://perma.cc/BT2U-VM4L] ("The secured loan has terms and conditions designed to protect the interests of the U.S. government and

taxpayers."). Federal Reserve Chairman Bernanke also argued that AIG, unlike Lehman Brothers (discussed below in this note), was having problems with liquidity rather than facing insolvency. Bernanke, *supra* note 143, at 13 ("AIG's problems appeared at the time to be more classical liquidity needs that were quantifiable in amounts and could be covered with borrowings secured by valuable available collateral-the shares of stock of profitable insurance companies and other businesses."); Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Reflections on a Year of Crisis, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium, Jackson Hole, Wyoming (Aug. 21, 2009), http://www.federalreserve.gov/newsevents/speech/bernanke20090821a.htm [https://perma.cc/GX3H-QZ2H]) [hereinafter *Reflections on a Year of Crisis*] ("[T]he Federal Reserve judged that the company's financial and business assets were adequate to secure an $85 billion line of credit, enough to avert an imminent failure."). The $85 billion proved to be insufficient, and the U.S. Treasury added $49.1 billion under the Troubled Asset Relief Program (TARP) established under the Emergency Economic Stabilization Act of 2008, which was enacted on October 3, 2008, and the Federal Reserve's total loan commitment ultimately reached $142.5 billion. *See* GAO-11-74, *supra* note 32, at 2; *see also* Sjostrom, *supra* note at 32 963-75 (discussing the AIG loan and loan restructuring).

On the issue of Bear Stearns' and AIG's solvency, see also WILLIAM R. CLINE AND JOSEPH E. GAGNON, LEHMAN DIED, BAGEHOT LIVES: WHY DID THE FED AND TREASURY LET A MAJOR WALL STREET BANK FAIL? 5 (2013), https://www.piie.com/publications/pb/pb13-21.pdf [https://perma.cc/64GS-7ENX] ("Bear Stearns was solvent at the time of its emergency loan, but its capital had been eroded by more than 90 percent and its shareholders took a large loss."); *id.* at 10 ("AIG appears to have been solvent throughout the last five years, though it was on the verge of insolvency in late 2008 and 2009, if the value of Fed claims on AIG equity is excluded.").

Certain commentators have concluded that the Federal Reserve did not follow the Bagehot principles in the AIG case. *See, e.g.*, LEVY ECONOMICS INSTITUTE OF BARD COLLEGE, THE LENDER OF LAST RESORT: A CRITICAL ANALYSIS OF THE FEDERAL RESERVE'S UNPRECEDENTED INTERVENTION AFTER 2007 10 (2013), http://www.levyinstitute.org/pubs/rpr_4_13.pdf [https://perma.cc/L5D4-4PSK]. This Levy Economics Institute report concludes that AIG was insolvent, and that the Federal Reserve accepted questionable, hard-to-value collateral and accommodated AIG at below-market or subsidy rates since "it charged AIG rates of 8.5 to 12 percent at a time when junk bonds of the same degraded quality as AIG's assets were yielding 17% or more." *Id.* at 19, 21, 22. The solvency conclusion of the report is not analyzed or supported; the questionable collateral value conclusion is not consistent with the fact that the FRBNY

Federal Reserve Chairman Ben Bernanke argues that "the rescues of AIG and Bear Stearns were not standard Bagehot-type activities,"[150] it would be incorrect to conclude that "a Bagehot-type activity"

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realized a more than $9.4 billion gain from its actions and involvement with AIG, and the below-market or subsidy rates conclusion does not take into account AIG's financial and business assets that secured the line of credit to AIG and overall interest rates at the time. *See Actions Related to AIG*, *supra* note 33; *Reflections on a Year in Crisis*.

The issue of whether Lehman Brothers was insolvent or illiquid, which is beyond the scope of this article, remains the subject of debate. *See* FIN. CRISIS INQ. COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 340 (2011); *see also Reflections on a Year of Crisis*, at 1-2 (stating that Lehman's "available collateral fell well short of the amount needed to secure a Federal Reserve loan of sufficient size to meet its funding needs"); CLINE & GAGNON, at 10 ("[O]ur overall judgment on Lehman is that it was deeply insolvent at the time of its bankruptcy."). *But see* Neil Irwin, *Six Years Later, We're Still Litigating the Bailouts. Here's What We Know.*, N.Y. TIMES (Oct. 3, 2014), http://www.nytimes.com/2014/10/05/upshot/six-years-later-were-still-litigating-the-bailouts-heres-what-we-know.html?smprod=nytcore-ipad&smid=nytcore-ipad-share ("Inside the New York Fed there were teams who concluded that Lehman was narrowly solvent. . . ."); James B. Stewart & Peter Eavis, *Revisiting the Lehman Brothers Bailout That Never Was*, N.Y. TIMES, Sept. 30, 2014, at A1 ("[I]nterviews with current and former Fed officials show that a group inside New York Fed was leaning toward the opposite conclusion—that Lehman was narrowly solvent and therefore might qualify for a bailout. In the frenetic events of what has become known as the Lehman weekend, that preliminary analysis never reached senior officials before they decided to let Lehman fail."). The Financial Crisis Inquiry Commission noted that the Federal Reserve did not furnish to it "any written analysis to illustrate that Lehman lacked sufficient collateral to secure a loan under Section 13(3)." FIN. CRISIS INQ. COMM'N, at 341.

[150] BROOKINGS CONFERENCE, *supra* note 44, at 176 (stating that the rescues of AIG and Bear Stearns "were ad hoc responses to a particular problem, which was that the United States . . . did not have . . . a mechanism for unwinding a large financial firm in a way that was safe for the broader financial system"). Mr. Bernanke thus concluded that "as a result, the Fed used various lending authorities to try to prevent the failure of firms." *Id.* But in his opinion this was not "a Bagehot activity" but "an ad hoc response to a lack of necessary authority, one that's being addressed." *Id.* Mr. Bernanke further stated that "the use of the lending authority to try to prevent disorderly collapses of firms was not genuine LOLR in [his] opinion—lender of last resort—and [he was] glad to see that those two authorities [were] broken apart." *Id.* at 178.

involves LOLR funding only to the financial system at large and not to a single troubled, but solvent, institution. Walter Bagehot's book *Lombard Street* published in 1873—"the bible of central banking"[151]—states that the lender of last resort must lend to "anyone" and "all," whenever the security is good.[152] Bagehot does not state or imply that the lender of last resort should only lend in a broad-based program—as Ben Bernanke himself has noted, Bagehot "had a dictum that during a panic central banks should lend freely to *whoever* comes to their door; as long as they have collateral, give them money."[153]

Although the Federal Reserve successfully averted a catastrophic financial disaster in the latest financial crisis by implementing emergency measures with respect to single institutions,[154] the Dodd-Frank Act makes such actions impossible in the future.[155] It is counterintuitive that section 13(3), which was first enacted by Congress to address the emergency economic conditions of the Great Depression,[156] would be circumscribed by Congress following its very effective utilization by the Federal Reserve during the latest financial crisis—the so-called "Great Recession"—to prevent the financial system from going over the brink. The Federal

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[151] GEITHNER, *supra* note 1, at 118.
[152] *See* BAGEHOT, *supra* note 132.
[153] *See* Bernanke, *supra* note 119 (emphasis added).
[154] *See supra* Part III.A (discussing emergency measures implemented by the Federal Reserve in the latest financial crisis).
[155] Donald Kohn, former Vice Chairman of the Bd. of Governors of the Fed. Reserve Sys., Liquidity and the Role of the Lender of Last Resort (Apr. 30, 2014), http://www.brookings.edu/~/media/events/2014/04/30-liquidity-lender-of-last-resort/20140430_liquidity_transcript.pdf [https://perma.cc/AT2X-RYDF] (opining that the Dodd-Frank amendments on the emergency lending authority "limit more than is wise"). John Dugan, the Comptroller of the Currency during the financial crisis, and Darrell Duffie, Professor of Finance at Stanford University, expressed similar concerns. *See id.* at 18, 19. For a discussion of the Dodd-Frank Act amendments, see *supra* Part IV.A.1.
[156] Tim Sablik, *Fed Credit Policy during the Great Depression* 2, FED. RESERVE BANK OF RICHMOND, https://www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_brief/2013/pdf/eb_13-03.pdf [https://perma.cc/4BZB-QYHR] (stating that Congress passed a new bill to add section 13, paragraph 3, which expanded the Federal Reserve's ability to extend credit to individuals and businesses during the Great Depression).

Reserve has been an excellent steward of its section 13(3) authority. The Federal Reserve did not use its section 13(3) authority for roughly 76 years notwithstanding pressure to do so over the years.[157] The fact that the Federal Reserve has profited more than $30 billion dollars from its section 13(3) lending during the latest financial crisis is evidence of this successful prudential stewardship.[158]

The OLA and other macroprudential regulatory requirements imposed by the Dodd-Frank Act and regulations issued thereunder, such as capital and liquidity requirements, may limit the future need for emergency lending by the Federal Reserve during a financial crisis.[159] But the OLA resolution provisions are untested, and macroprudential regulation does not always work as expected.[160] In this connection, Ben Bernanke explained that

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[157] Specifically, in 1975, "[t]he financial difficulties faced by the city of New York raised questions about whether the Federal Reserve might serve as a source of emergency credit." *See* Fettig, *supra* note 25. Additionally, "[i]n the days following the terrorist attacks of Sept. 11, 2001, some observers suggested that—based on the 1991 amendment—the U.S. airline industry could receive emergency loans." *Id.* For a discussion of the 1991 amendment, see *supra* note 84.

[158] MARC LABONTE, CONG. RESEARCH SERV., R44185, FEDERAL RESERVE: EMERGENCY LENDING 2 (2016) ("Contrary to popular belief, the Fed did not suffer any losses on transactions taken under Section 13(3) and earned profits of more than $30 billion (more than half of which is AIG related)."); *see also* Dudley, *supra* note 20 ("Despite the degree of dislocation in the financial system at the time and the severity of the Great Recession, there were no losses for any of the Fed's programs.").

[159] *Bernanke's Blog*, *supra* note 57 (stating that the creation of orderly liquidation authority eliminated the Federal Reserve's need to make loans to individual troubled firms); Daniel K. Tarullo, Member of the Bd. of Governors of the Fed. Reserve Sys., Yale Law School Conference on Challenges in Global Financial Services (Sept. 20, 2013), http://www.federalreserve.gov/newsevents/speech/tarullo20130920a.pdf [https://perma.cc/TC72-VWKZ] ("[A]n appropriately refocused set of macroprudential capital requirements can help make the financial system better able to withstand shocks from unanticipated, as well as familiar, sources.").

[160] *See* BROOKINGS CONFERENCE, *supra* note 44, at 20 (comments of Darrell Duffie, Professor of Finance at Stanford University) (explaining that the argument frequently invoked "against providing emergency liquidity" that "macroprudential regulation will take care of this problem" did not show good results in the latest financial crisis); *see also* William C. Dudley, *Is the Active Use of Macroprudential Tools Institutionally Realistic*?, FED. RES.

> liquidity risk management at the level of the firm, no matter how carefully done, can never fully protect against systemic events. In a sufficiently severe panic, funding problems will almost certainly arise and are likely to spread in unexpected ways. Only central banks are well positioned to offset the ensuing sharp decline in liquidity and credit provision by the private sector. They must be prepared to do so.[161]

Financial crises cannot be outlawed or regulated out of existence, and the central bank needs the requisite authority "to offset sharp declines in liquidity and credit provision by the private sector in a severe financial panic."[162]

The purpose of the orderly wind down and liquidation of an institution under the OLA is to prevent loss to the taxpayers.[163] Shareholders and management lost out "big time" under the Federal Reserve's actions in the Bear Stearns and AIG cases, but there was no ultimate cost to taxpayers; indeed, there was a gain of $12 billion to taxpayers as a result of the Federal Reserve's actions under section 13(3) in connection with the Bear Stearns and AIG cases.[164] The operations of Bear Stearns and AIG were less disrupted, and the impact on their employees was less severe, under the Federal Reserve's section 13(3) actions than would have been the case under the OLA.

Use of the "living will" process under Title I of the Dodd-Frank Act to facilitate an orderly resolution under the Bankruptcy Code, or, as a backstop to bankruptcy, use of the powers available under the OLA to manage the orderly failure and liquidation of a

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BANK N.Y. (Oct. 3, 2015), https://www.newyorkfed.org/newsevents/speeches/2015/dud151003 [https://perma.cc/EGK2-B487] ("[While] the use of macroprudential tools holds promise, we are a long way from being able to successfully use such tools in the United States.").

161 *Reflections on a Year of Crisis*, *supra* note 149.

162 *Id.*; Coffee, *supra* note 48, at 815 ("[The] claim that systemic failures will periodically recur . . . is simply a distillation of what financial historians have long reported. . . . [H]uman beings have bounded rationality and will predictably be blindsided by a new crisis.").

163 *See supra* note 61 and the accompanying text.

164 *See supra* Part III.A.

firm, may prove to be effective tools in a financial crisis.[165] However, living wills and the OLA are untested, while the Federal Reserve's section 13(3) authority has been tested in the latest financial crisis and worked very effectively, with no loss to the taxpayers (and indeed with a sizeable gain).[166]

Progress has been made in addressing "cross-border uncertainty and contagion risks" associated with both the OLA and Bankruptcy Code regimes,[167] but uncertainty in these regards remains.

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[165] Bankruptcy is the statutory first option under the Dodd-Frank Act's framework for resolving SIFIs. The largest bank holding companies and designated non-bank financial companies are required to prepare resolution plans, also referred to as "living wills," under Title I of the Dodd-Frank Act. 12 U.S.C. §§ 5325(d), 5365(d) (2012); Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22,648, 22,648 (Apr. 22, 2011) (codified at 12 C.F.R. pt. 252 (Federal Reserve) and 12 C.F.R. pt. 381 (FDIC)) ("[A] nonbank financial company supervised by the Board and each bank holding company with total consolidated assets of $50 billion or more [are required] to periodically submit . . . a plan for such company's rapid and orderly resolution in the event of material financial distress or failure . . . ."); *see also* James R. Wigand, Dir., Off. of Complex Fin. Inst. & Richard J. Osterman, Jr., Acting General Counsel, Fed. Deposit Ins. Corp., *Who is Too Big to Fail? Examining the Application of Title I of the Dodd-Frank Act before the Subcomm. on Oversight and Investigations, Comm. on Financial Services, U.S. House of Representatives* (Apr. 16, 2013), https://www.fdic.gov/news/news/speeches/archives/2013/spapr1613.html [https://perma.cc/NA5Q-ZAHE] ("Title I of the Dodd-Frank Act requires that all large, systemic financial companies prepare resolution plans, or 'living wills', to demonstrate how the company would be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company's material financial distress or failure."). These living wills must demonstrate that the firm could be resolved under the Bankruptcy Code without severe adverse consequences for the financial system or the U.S. economy. Title II of the Dodd-Frank Act provides the OLA as a backstop for circumstances in which an orderly bankruptcy might not be possible. *Id.*

[166] *See supra* notes 26-29, 33 and the accompanying text.

[167] *See, e.g.*, Gruenberg, *supra* note 57 ("[E]fforts [by the FDIC, the Federal Reserve, the International Swaps and Derivatives Association, and other parties with respect to 'qualified financial contracts' (including derivative contracts)] improve resolution under both the Orderly Liquidation Authority and bankruptcy by helping to address some of the cross-border uncertainty and contagion risks in both regimes.").

This continues to be an area of concern under the OLA and Bankruptcy Code processes.[168]

Commentators note that "success [of the OLA] will be determined by how manageable large and complex firms are under bankruptcy and whether under any circumstance they can be resolved without major disruption to the economy."[169] There are two impediments to organizing an orderly bankruptcy or liquidation of such failing systemic firms:

> First, it is not possible for the private sector to provide the necessary liquidity through "debtor in possession" financing due to the size and complexity of the institutions and due to the speed at which crises occur. There simply would be too little confidence in bank assets and the lender's ability to be repaid, and too little time to unwind these firms in an orderly fashion in a bankruptcy. Under the current system, it would have to be the government that provides the needed liquidity, it is argued, even in bankruptcy to avoid a broader financial meltdown.
>
> Second, when a mega banking firm goes into bankruptcy, capital markets and cross-border flows of money and capital most likely would seize up, intensifying the crisis, as happened following the failure of Lehman Brothers, for example.[170]

It is unclear at this point how often this authority will be used effectively—"an overarching question is whether the [Federal Reserve] or the FDIC will have the political courage to place a significant financial institution into receivership before it has clearly failed. Politically, it may be safer and easier to delay and hope for the best."[171]

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[168] *Id.*

[169] Thomas M. Hoenig, Vice Chairman, Fed. Deposit Ins. Corp., Presentation to the National Association for Business Economics 30th Annual Economic Policy Conference (Feb. 24, 2014), https://www.fdic.gov/news/news/speeches/spfeb2414.html [https://perma.cc/7SE8-XTK3].

[170] *Id.*

[171] Coffee, *supra* note 48, at 825.

While the OLA may prove to be an important tool in the crisis response toolboxes of the governmental financial authorities for containing a financial crisis, the section 13(3) authority of the Federal Reserve to lend to an individual institution, a tool with proven effectiveness, should not have been used as a bargaining chip as part of a "key legislative bargain" to create the OLA.[172]

Moreover, requiring that the Federal Reserve wait until an entire, broader class of firms is at risk is likely to delay lending until market conditions are worse, perhaps until it is too late for the lending to do much good.[173] "The speed at which the government can act during a financial crisis is a critical element for success," and the importance of rapid action will continue to increase as technology and global interconnectedness of markets increase further.[174]

A particular concern is a cyber-attack on a SIFI, or a non-financial institution as well, that could warrant section 13(3) lending to a single institution.[175] The Financial Stability Oversight Council,

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172 *Bernanke's Blog*, *supra* note 57.

173 *See* DUGAN ET AL., *supra* note 39, at 42 ("If in 2008 the Federal Reserve had been forced to wait until the entire insurance industry was at risk before extending credit to AIG, the giant insurer would have collapsed, causing huge collateral damage to the rest of the financial system."). This paper, published by the Bipartisan Policy Center, recommends that Congress restore the authority of the Federal Reserve to make emergency loans to an individual non-depository institution. *Id.*; *see also* Coffee, *supra* note 48, at 817 ("Another dimension of the systemic risk problem involves the speed with which regulatory interventions must be effected to work. Because of the dependence of banks on short-term financing, the end comes quickly for a financial institution that loses credibility with the market. Time is therefore of the essence in any effort to structure either a bailout or a merger to prevent a panic-inducing insolvency."). Commentators emphasize that "[w]hen Bear Steams began to collapse on Friday, March 14, 2008, the Federal Reserve had only a weekend to negotiate a merger between Bear Stearns and JPMorgan Chase." *Id.*

174 DUGAN ET AL., *supra* note 39, at 41; Gregory J. Hudson, *Balancing Central Bank Accountability and Independence: The Case of the Federal Reserve's Emergency Powers After Dodd-Frank*, 132 BANKING L.J. 161, 184-85 (2015) (emphasizing the need for the Federal Reserve to "have all the tools it needs to act quickly and decisively to combat future panics that threaten the stability of the financial system.").

175 *See* Robert Sales, *Cybersecurity and Regulatory Issues in Forefront at GARP 2015 Convention*, GLOBAL ASSOCIATION OF RISK PROFESSIONALS (Mar. 20, 2015), http://www.garp.org/#!/risk-intelligence/detail /a1Z40000002vUesEAE [https://perma.cc/Z67F-6FS2] ("Cyber risks can

in its *2015 Annual Report*, highlighted concerns about the potential for a cyber-attack incident "that could impair financial sector operations."[176]

The International Monetary Fund has opined that "introducing too much rigidity in rules hinders future crisis management", emphasizing that "[t]o 'tie the hands' of some authorities in such a way to prevent moral hazard issues from arising may at the end of the day cause more panic than it prevents when financial stress arises."[177]

Glenn Hubbard, Dean of Columbia Business School and former Chairman of the Council of Economic Advisors under George W. Bush, and Hal Scott, Professor of International Financial Systems at Harvard Law School, opine that the Dodd-Frank Act curtailment of the Federal Reserve's LOLR powers "pose a threat to U.S. and global financial stability."[178]

> Some claim there is nothing to worry about because of new regulations to prevent another crisis: enhanced capital requirements, new liquidity requirements and new resolution procedures. This

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take many forms—including unauthorized stock trading, market manipulation, account takeovers (e.g., theft of funds), denial-of-service attacks (e.g., making a website indefinitely or temporarily unavailable), third-party breaches (e.g., attacks on partners and vendors) and theft of intellectual property or data."). Cybersecurity has become more and more relevant for the financial services industry. *Id.*; *see also* Press Release, U.S. Dep't of the Treasury, Remarks by Deputy Secretary of the Treasury Sarah Bloom Raskin at The Center For Strategic And International Studies Strategic Technologies Program (Sept. 10, 2015), http://www.treasury.gov/press-center/press-releases/Pages/jl0158.aspx [https://perma.cc/QU32-6HMC] (emphasizing the vulnerability of "major economic and social sectors and institutions [including such entities as JPMorgan Chase] . . . to hacking and cyber-sabotage").

176 FIN. STABILITY OVERSIGHT COUNCIL, 2015 ANNUAL REPORT 105 (2015), http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2015%20FSOC%20Annual%20Report.pdf [https://perma.cc/6PSY-KCFV].

177 DUGAN ET AL., *supra* note 39, at 40-41 (quoting STIJN CLAESSENS & LAURA KODRES, THE REGULATORY RESPONSES TO THE GLOBAL FINANCIAL CRISIS: SOME UNCOMFORTABLE QUESTIONS 15 (2014)).

178 Hubbard & Scott, *supra* note 119.

> approach calls to mind a strategy of two wings and a prayer.[179]

They emphasize the significance of emergency lending to "solvent institutions . . . that are panic victims, not undue risk takers" in containing the "spreading contagion of a run."[180]

The National Bankruptcy Conference, "a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners[,]" has commented on two bills that were introduced in 2013 and 2014 to amend the Bankruptcy Code to add special procedures for the resolution of SIFIs,[181] stating "that any procedure contemplating use of bankruptcy proceedings to recapitalize a SIFI" should include provisions that provide assurance that some form of lender-of-last-resort liquidity will be available, "on a fully secured basis, to all members of the SIFI group, including the bank and broker-dealer operations of the recapitalized firm."[182] The National Bankruptcy

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[179] *Id.* at 120. Moreover, some commentators have explained that "[w]hile moral hazard is a legitimate risk, limiting the Fed's ability to enhance systemic safety is . . . like shutting down the fire department to encourage fire safety." Stephen A. Schwarzman, *How the Next Financial Crisis Will Happen*, WALL ST. J. (June 9, 2015, 7:15 PM), http://www.wsj.com/articles/how-the-next-financial-crisis-will-happen-1433891718 [http://perma.cc/BFU5-TZ5W]; *see also* Coffee, *supra* note 48, at 799 ("[A]lthough the Dodd-Frank Act properly recognizes that the 'too big to fail' phenomenon generates a 'moral hazard' problem, one cannot respond to that problem in the manner of King Canute and simply order that there be no more failures.").

[180] Hubbard & Scott, *supra* note 119 ("Concerns about moral hazard should not bar the Fed from being the lender of last resort . . . .").

[181] *NBC Letter*, *supra* note 125 (addressing the Conference's concerns about the inadequacy of both bills). These bills are the Taxpayer Protection and Responsible Resolution Act, S. 1861 (TPRRA), which would have added a new Chapter 14 to the Bankruptcy Code, and the Financial Institution Bankruptcy Act of 2014, H.R. 5421 (FIBA), which would have added a new subchapter V to Chapter 11 of the Bankruptcy Code. TPRRA would prohibit a Federal Reserve Bank from making advances for the purpose of providing debtor-in-possession financing to either (i) a bridge financial company or (ii) a covered financial company that is a debtor in a pending case under a new Chapter 14. The Senate did not take any action on TPRRA. FIBA was passed by the House on December 1, 2014, just before adjournment of the 113th Congress. *Id.*

[182] *Id.* at 3.

Conference reasoned that "meeting the liquidity needs of a distressed SIFI is essential to successfully resolving the firm without creating undue systemic risk." If the recapitalized firm

> is forced to sell assets to meet a run, market prices will be further depressed, imposing additional losses on the firm and creating losses at other firms that mark their balance sheets to market. The only way to prevent this type of transmission of balance sheet losses and the resulting contagion is for the recapitalized firm to borrow against its unencumbered assets as necessary to meet the outflows, instead of dumping its assets on the market.[183]

The National Bankruptcy Conference concluded that "to be successful, any recapitalization procedure, whether under the Bankruptcy Code or under a special resolution regime like OLA, requires a non-market backstop liquidity source as a bridge for the recapitalized firm until liquidity outflows abate and access to market liquidity returns."[184] While the FDIC has the power to provide such liquidity from the Orderly Liquidation Fund in a resolution under the OLA,[185] there is no governmental source of such liquidity in a resolution under the Bankruptcy Code,[186] which is the statutory first option under the Dodd-Frank Act's framework for resolving SIFIs.[187] The provision of such liquidity to a recapitalized firm under the Bankruptcy Code could have been provided by the Federal Reserve under section 13(3) prior to enactment of the Dodd-Frank Act, but

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183 *Id.*

184 *Id.* at 7; *see also Guynn Statement*, *supra* note 139, at 10-14, 20-22 ("[T]he business transferred to the bridge [financial holding company (FHC)] must have access to a sufficient amount of liquidity in a Title II or bankruptcy proceeding for the business to be stabilized after it has been transferred to the largely debt-free bridge FHC. If the business does not have sufficient liquidity, it may be forced to sell illiquid assets at fire-sale prices, which can cause an otherwise solvent bridge FHC to become insolvent.").

185 *See* Dodd-Frank Act § 210(n), 12 U.S.C. § 5310(n) (2012).

186 *See Guynn Statement*, *supra* note 139, at 11.

187 *See supra* note 165.

can no longer be provided in such a case as a result of the Act's amendments to section 13(3).

To repeat, overall "the biggest problem with Dodd-Frank is not enough emergency bailout authority" and "Congress should give the president and the financial first responders the powers necessary to protect the country from the devastation of financial crises."[188]

V. Recommendations

A. Emergency Credit

After the latest financial crisis, the debate and examination on the use of emergency credit powers by the Federal Reserve should focus on whether the Federal Reserve during that crisis followed the Bagehot principles—in a financial panic, to provide liquidity only on good collateral to firms that are solvent, and at an interest rate that is above the prevailing market rate.[189] The severe curtailment of the Federal Reserve's section 13(3) authority by the Dodd-Frank Act to prohibit lending to a single, but solvent, firm to avoid "a catastrophe," a failure that "would have been basically the end," and a collapse that "would have buckled our financial system and wrought economic havoc on the lives of millions of our citizens,"[190] represents a mistaken, populist driven, overreaction to Federal Reserve actions that prevented the financial system from going over the brink. Congress should amend section 13(3) to again permit the Federal Reserve to exercise its lending authority with respect to a single institution and not only as part of a broad-based program. It is significant in this regard that the actions of the Federal Reserve in the

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[188] GEITHNER, *supra* note 1, at 432. It is noted again that emergency LOLR authority should not be categorized as "bailout authority." *See supra* notes 138-40 and the accompanying text.

[189] *See supra* notes 133-36 and the accompanying text; *see also* BLINDER, *supra* note 1, at 103-04 ("A firm is *illiquid* when it is *short on cash*, even if its balance sheet displays a healthy net worth. In such cases, the firm needs short-term credit, not euthanasia. Insolvency is a fatal disease; illiquidity is a bad cold, perhaps a *very* bad cold. It was exactly this distinction that Walter Bagehot had in mind in 1873 when he counseled central banks to lend free (to relieve illiquidity problems) against good collateral (because only solvent institutions can post enough collateral).").

[190] *See* Starr Int'l Co. v. United States, 121 Fed. Cl. 428, 431 (2015), *appeal docketed*, No. 15-5133 (Fed. Cir. Aug. 14, 2015) (testimony of Federal Reserve Chairman Ben Bernanke and Treasury Secretary Henry Paulson).

Bear Stearns and AIG cases resulted in a gain to the taxpayers of $12 billion.

Following Walter Bagehot's dictum, section 13(3) facilities should be available only for *solvent* firms.[191] However, as noted previously, the determination of whether an institution is solvent or insolvent is not always a clear-cut issue.[192] Accordingly, the Federal Reserve Board should develop a framework for how it would assess whether or not an institution is solvent that goes beyond what it set out in its Regulation A.[193] This framework should address how the Federal Reserve would assess asset values, including the probabilities it would take into account and the effect of the Federal Reserve's own actions in the broader financial system. The Federal Reserve should carefully consider the approach envisioned in the Bailout Prevention Act bill of analyzing the fair value of the assets and liabilities of an institution over the preceding four-month period, with appropriate adjustment for temporary illiquidity in the relevant market.[194]

In developing these standards, the Federal Reserve might rely on the definition of solvency for LOLR credit developed by the Peterson Institute for International Economics: An institution is solvent if it "is expected to have substantially positive net income over the medium term, assuming that it can roll over its short-term liabilities at a normal market rate of return,"[195] recognizing that

> future cash flows from assets should be discounted at a rate that is closer to historic norms than what may be implied by market prices of assets during a

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[191] *Bagehot's Dictum in Practice*, *supra* note 53, at 186 ("[A]s Bagehot recommended, we should look to the restrictions of lending only to solvent firms, only against good collateral, and only at high rates to limit distortionary effects on markets . . . while allowing central bank credit to prevent financial panics from having excessively adverse effects on economic activity and employment.").
[192] *See supra* note 53.
[193] *Id.*; *see* Extensions of Credit by Federal Reserve Banks (Regulation A), 12 C.F.R. pt. 201 (2016); *see also BIS Papers No. 79*, *supra* note 53, at 15 (recommending that lenders of last resort should "[p]ublish a framework for how soundness/solvency will be assessed, probabilistically and conditioned on reasonable assumptions about the effect of the liquidity operation on the path of the economy and default rates").
[194] *See supra* note 90 and the accompanying text.
[195] CLINE & GAGNON, *supra* note 149, at 3-4.

> panic. . . . [A]n institution is solvent if its assets exceed its liabilities when evaluated at medium-term values, rather than at fire-sale prices in the midst of the crisis.
>
> Our definition of solvency requires a forecast of future revenues and expenses, which in turn depend on many factors, including the state of the economy. . . .
>
> An alternative way of measuring solvency under our definition is whether the firm is able to repay the emergency loans in a reasonable period and at a rate of return that is higher than the government's cost of funds.[196]

Setting out a framework for solvency determinations will not be easy, and a "scientific" approach will not be possible. Such a framework should not bootstrap the Federal Reserve into a particular analytical approach, but it should set out the principles that the Federal Reserve would apply in making such an analysis and determination. This is a difficult, but most important, task that the Federal Reserve should undertake, and it might well address concerns evidenced by Congress' enactment of the limitations in the Dodd-Frank Act on the Federal Reserve's section 13(3) authority and by more recent legislative proposals.[197] [This paragraph is right margin justified.]

Following Bagehot's dictum[198] further, section 13(3) facilities should be available only at a penalty rate. That rate should be left to the discretion of the Federal Reserve Board and not mandated by statute as would be required by the Bailout Prevention Act[199] and the FORM Act.[200] It should be "a rate that is higher than

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[196] *Id.*

[197] *See supra* notes 92-93 and the accompanying text.

[198] CLINE & GAGNON, *supra* note 149, at 1 ("To avert panic, central banks should lend early and freely (i.e., without limit), to solvent firms, against good collateral, and at 'high rates.'").

[199] *See Bernanke's Blog*, *supra* note 57 ("[T]he five percentage point penalty rate requirement [in the Bailout Prevention Act] would remove any doubt that those borrowing from the central bank had no access to other sources of funding, worsening the stigma problem.").

normal but may be lower than the fear rate that we're seeing [in the market]." [201] The valuation of collateral is also relevant to the determination of a penalty rate; loan collateral should not be valued at "fire sale" prices.[202] The Federal Reserve Board's final regulation on its section 13(3) emergency lending authority pursuant to the Dodd-Frank Act sets out a reasonable approach for the determination of a penalty rate in the view of this commentator.[203]

Congress should remove the requirement that the Federal Reserve Board may not establish any program or facility under section 13(3) without the prior approval of the Secretary of the Treasury. This requirement introduces unhelpful uncertainty with respect to the Federal Reserve's lender-of-last-resort capacity and is inconsistent with, and an erosion of, the independence, *de jure* and *de facto*, of the Federal Reserve System, which is accountable to the

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[200] *See* H.R. 3189, *supra* note 128 ("[A]ny loan must be at a 'minimum interest rate,' which is defined as the sum of the average discount rate . . . and the average of the difference between a corporate bond yield index and a bond yield index of debt issued by the United States . . . .").

[201] *See* BROOKINGS CONFERENCE, *supra* note 44, at 173.

[202] *Id.* at 172 ("[Y]ou can't lend strictly on fire sale prices either—the very lowest prices—because if you do you're not really helping anything, because they can always get the fire sale prices in the market. So, there's a sense in which the Bagehot principle says that you should lend at a price that may be something closer to what a normal market would produce for that asset."); *see also id.* at 11 ("Bagehot says that the central bank should not chase collateral values down. The central bank should value the collateral as it would be valued in a normal time, otherwise you just keep adding to the problems."). This is supported by Bagehot's prescription for the lender of last resort: "If it is known that the Bank of England is freely advancing on what *in ordinary times* is reckoned a good security—on what is then commonly pledged and easily convertible—the alarm of the solvent merchants and bankers will be stayed." BAGEHOT, *supra* note 132, at 198 (emphasis added).

[203] *See* 12 C.F.R. § 201.4(d)(7)(iv) ("In determining the rate, the Federal Reserve Board will consider the condition of affected markets and the financial generally, the historical rate of interest for loans of comparable terms and maturity during normal times, the purpose of the program or facility, the risk of repayment, the collateral supporting the credit, the duration, terms and amount of the credit, and any other factor that the Federal Reserve Board determines to be relevant to ensuring that the taxpayers are appropriately compensated for the risks associated with the credit extended under the program or facility and that the purposes of the regulation are fulfilled.").

legislative branch and not the executive branch of the U.S. government. While consultation between the Federal Reserve and the U.S. Treasury is entirely appropriate, requiring the prior approval of the Secretary of the Treasury in such emergency circumstances introduces the potential for political influence in the decision-making process that could affect or override the Federal Reserve's decision of what action to take.[204]

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[204] *But see* BERNANKE, *supra* note 1, at 464 (emphasis added) ("We would still be able to use 13(3) to create emergency lending programs with broad eligibility . . . *although we'd have to obtain the Treasury secretary's permission first*. I didn't consider that much of a concession, since I couldn't imagine a major financial crisis in which the Fed and the Treasury would not work closely.").

Republican Senator David Vitter underscored concerns related to the independence of the Federal Reserve arguing that if Federal Reserve has to seek Treasury's approval before implementing emergency programs, "the Fed is acting more like a department of the government than an independent bank." *The Administration's Proposal to Modernize the Financial Regulatory System: Hearing Before the Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 21 (2009). Democratic Senator Mark Warner "also share[s] some concerns that putting restrictions on the 13(3) powers of the Fed could potentially further politicize." *Id.* at 23.

In defense of the requirement that the Federal Reserve Board must receive the prior approval of the Secretary of the Treasury before establishing a program or facility under section 13(3), Secretary Geithner stated at this hearing:

> You were right that . . . to require that action require the approval of the Secretary of the Treasury is an important change. But we believe, and I believe the Chairman of the Federal Reserve believes that is an appropriate, justifiable change, in part because of the concerns expressed by many of your colleagues, understandably, about the Fed being pulled into doing things that go well beyond the classic responsibilities of the lender of last resort . . . .
>
> [B]ecause the taxpayer would ultimately bear the losses that might come with any of those basic judgments [in the context of the Bear Stearns and AIG cases], the Fed required the concurrence in writing of the Secretary of the Treasury before it took those actions. I think that was an appropriate step then, because ultimately this was the taxpayers' money at risk, and ultimately it is the taxpayers' burden if the government fails to get this balance of moral hazard and safeguards right.

There is a significant and increasing amount of credit provision outside the regulated banking system in the United States,[205] and section 13(3) facilities and programs should remain available to non-bank financial firms, including primary dealers, non-bank affiliated broker-dealers, money market funds, asset-backed securities facilities, commercial paper facilities, and "shadow banking" entities. Further, in an era of cyber-attacks and terrorist acts, it only seems sensible that section 13(3) facilities and programs should not be limited only to financial institutions.

Further consideration should also be given to the "stigma" concern addressed by former Federal Reserve Chairman Bernanke.[206] The new public disclosure requirements enacted in the Dodd-Frank Act with respect to each borrower's name, the amount borrowed, the interest rate and type of collateral, even if disclosed on a lagged basis, and those proposed in the Bailout Prevention Act and the FORM Act bills, including with respect to making the regulator's certification of each borrower's solvency available to the public immediately, may severely impact the effectiveness of the Federal Reserve's emergency lending powers. There needs to be a careful balance of public

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Id. at 22. He further opined that "where the Fed . . . used 13(3) in particular cases with individual institutions, it did ask for the explicit concurrence of the Secretary of the Treasury in recognition again of the potential losses to the taxpayer that were inherent in those judgments, and . . . that was appropriate for the Fed to do. . . . [T]hat would [not] constrain the Fed's ability in the future." *Id.* at 38.

Bernanke argued that "13(3) loans . . . must be 'secured to the satisfaction' of the lending Reserve Bank. In other words, the borrower's collateral had to be sound enough that the Federal Reserve could reasonably expect full payment. This last requirement protected taxpayers, as any losses on 13(3) loans would reduce the profits the Fed paid each year to the Treasury and thus add to the budget deficit." BERNANKE, *supra* note 1, at 205. This rebuts the need for "the explicit concurrence" of the Secretary of the Treasury in recognition of the potential losses to the taxpayers that were inherent in section 13(3) lending judgments by the Federal Reserve.

[205] *See* BROOKINGS CONFERENCE, *supra* note 45, at 10 (comments of Donald Kohn) ("So, I start with the premise that nonbank financial intermediation has become and will . . . continue to be an important source of intermediation in the US economy. . . . It's been of growing importance over the 20th century and into the 21st century, and as we restrict bank intermediation, make it more expensive, there's more as likely to flow out to the nonbank sector.").

[206] *See* BERNANKE, *supra* note 1, at 464; *see also supra* notes 97-99 and the accompanying text (addressing the issue of stigma).

accountability for the Federal Reserve's emergency lending with practical considerations that could effectively eliminate the Federal Reserve's ability to serve as a lender of last resort.

F. Liability Guarantees

With respect to depository organization liability guarantees, the FDIC should be given clear statutory authority during times of severe economic distress, upon a liquidity event finding, to guarantee new, senior unsecured debt issued by *any* depository institution or depository institution holding company (including their affiliates) and to guarantee all non-interest bearing deposit transaction accounts of *all* depository institutions and certain other accounts.[207] The Dodd-Frank Act requirement that a depository institution and depository institution holding company (including their affiliates) must be solvent should be removed. The fact that the FDIC has profited in the many billions of dollars from its liability guarantee programs during the latest financial crisis is evidence of its ability to exercise such authority prudently.

The Dodd-Frank Act requirement that a joint resolution of Congress must be passed before the FDIC may issue guarantees during times of severe economic distress, upon a liquidity event finding, should be removed.[208] Prior to the enactment of the Dodd-Frank Act, the FDIC could exercise its "systemic risk" authority only if the FDIC Board of Directors and the Federal Reserve Board each recommend use of the authority by a vote of not less than two-thirds of their respective members and deliver their written recommendation to the Secretary of the Treasury, who, based on a review of the FDIC and Federal Reserve Board recommendation, in consultation with the President of the United States, makes a systemic risk determination authorizing the FDIC to provide such guarantees.[209] This procedure is appropriate and should be applied to

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[207] *See* DUGAN ET AL., *supra* note 39, at 30 ("It is important that the financial system can count on the government's ability to implement a program involving such guarantees in an expeditious manner to help stabilize firms by relieving the need to borrow only on a short-term basis, while at the same time facilitating the flow of credit to the real economy.").

[208] *Id.* at 42 ("Congress should eliminate the Dodd-Frank requirement for the FDIC to gain prior congressional approval to provide emergency guarantees to debt issued by depository institutions or their affiliates.").

[209] 12 U.S.C. § 1823 (2012).

FDIC guarantees issued during times of severe economic distress, upon a liquidity event finding. This procedure worked very effectively in the latest financial crisis. The requirement in the Dodd-Frank Act of obtaining a joint resolution of Congress would only add uncertainty and delay to the process and should be removed.

VI. Conclusion

In the next financial crisis, the Federal Reserve will be incapable of providing the type of support that it provided in connection with the acquisition of Bear Stearns by JP Morgan Chase and that it provided to AIG. Likewise, the FDIC will be incapable of guaranteeing the liabilities of depository institutions and depository institution holding companies as it did during the latest financial crisis, and any guarantee program in the future would require Congressional approval.

If Bear Stearns or AIG had failed and if the FDIC had not provided such guarantees, the U.S. financial system, and with it the global financial system, would have gone over the brink and crashed, taking down the U.S. and global economies.[210] As a result of the Dodd-Frank Act, however, the very actions that kept the financial system from going over the brink are no longer available in our governmental financial authorities' toolboxes.

So long as the solvency, good collateral, and penalty rate principles set out by Walter Bagehot in 1873 for lender-of-last-resort lending are satisfied, then such lending by the Federal Reserve should, subject to the conditions discussed in this article, continue to be available in "unusual and exigent circumstances" to a *single* troubled institution, as well as in broad-based programs or facilities. The FDIC should, subject to the conditions discussed in this article, have clear statutory authority during times of severe economic distress, upon a liquidity event finding, to guarantee new, senior unsecured debt issued by any depository organization and to guarantee all non-interest bearing deposit transaction accounts of all depository institutions, and a joint resolution of Congress should not be required before the FDIC may provide such guarantees.

Addressing these issues is a most important and pressing challenge. Otherwise, in the next financial crisis the governmental

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[210] *See* Dudley, *supra* note 20; *see also* Blinder, *supra* note 6, at 136 ("[I]t would have been much worse had Congress, the U.S. Treasury, and the Federal Reserve not taken a series of extraordinary actions.").

financial authorities will not have the tools they need in their crisis response toolboxes.