COMMITTEE ON CAPITAL MARKETS REGULATION

REVISING THE LEGAL FRAMEWORK FOR NON-BANK EMERGENCY LENDING

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Staff Report:

Revising the Legal Framework for Non-Bank Emergency Lending

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Executive Summary

This Report examines the Federal Reserve's (the "**Fed's**") role in emergency lending to non-banks in light of its response to the COVID-19 pandemic. During the pandemic, the Fed took on novel responsibilities, establishing lending facilities not only to support liquidity in the financial system but also to support the flow of credit to the real economy and to state and local governments. These facilities raise critical questions about the appropriate role of the Federal Reserve in emergency lending to non-bank financial institutions and non-financial companies as authorized by Section 13(3) of the Federal Reserve Act.

This report proposes a new framework for emergency lending to non-banks. It does not suggest reforms to the Fed's exercise of monetary policy, as the Fed's monetary policy authority does not derive from Section 13(3) of the Federal Reserve Act and does not involve credit risk as the Fed only purchases government or government guaranteed securities when exercising its monetary policy authority.

The report proceeds in four parts. Part I outlines the current framework governing emergency lending to non-banks, with a focus on the restrictions adopted in the Dodd-Frank Act following the global financial crisis. These restrictions include requiring Treasury approval of any Fed lending program or facility for non-banks; requiring that loans be collateralized in a manner that is sufficient to protect taxpayers from losses; and limiting the Fed's ability to lend to insolvent borrowers.

Part II describes the Federal Reserve's assumption of a novel role as part of its response to the COVID-19 pandemic: the credit provider, not just liquidity provider, of last resort. Because of restrictions imposed on the Fed by the Dodd-Frank Act, however, the Fed could not assume this role on its own. Instead, it needed the approval of and financial backing from Treasury due to the Dodd-Frank framework.

Part III focuses on issues with the non-bank emergency lending framework that were highlighted by the Fed's pandemic response role. First, the current framework allows the Fed to operate lending programs that are essentially fiscal programs, which should properly be the responsibility of elected authorities. This was particularly an issue during the pandemic response for Fed lending programs to non-financial companies. Second, the Fed is put in the position of picking winners and losers when determining to whom it will lend. Finally, the lack of transparency regarding the design of the joint Treasury-Fed lending programs makes it difficult to determine who is responsible for success and failure. If the Fed bears the blame for failures that are the responsibility of Treasury, it could threaten the Fed's independence and its ability to exercise its more traditional functions.

Part IV proposes a revised framework for emergency lending that would address the concerns raised in Part III. Under this framework, for all emergency loans to non-banks, the Treasury must first determine whether such lending poses significant credit risk—meaning that borrowers have a substantial likelihood of being unable to repay the loans. Lending that poses significant credit risk should be viewed as implicating fiscal policy and thus outside the Fed's purview. In our view, lending to non-financial companies, such as lending programs to main street businesses, always involves significant credit risk and thus should be the sole purview of the Treasury. The Treasury should have sole responsibility for the structure and terms of emergency lending facilities that pose significant credit risk. And these programs should be identified as Treasury and not Fed

programs. However, the Fed would still have an important role to play in advising Treasury on economic conditions and serve to operate the programs as an agent of Treasury.

If the Treasury determines that the lending facilities to non-banks would *not* pose significant credit risk, then the Fed would have sole responsibility for the structure and terms of emergency lending facilities that would be identified as Fed programs. Part IV also considers whether the revised framework should be extended, in whole or in part, to the Fed's emergency lending authority for banks and concludes that there is no compelling reason to alter the longstanding framework for emergency bank lending.

I. The Threshold for Non-Bank Emergency Lending

The Fed's authority to lend to non-banks is governed by Section 13(3) of the Federal Reserve Act, which has long provided that the Fed can lend to non-banks in "unusual and exigent circumstances."[1] This standard was not changed by the Dodd-Frank Act of 2010. Historical context would suggest that this phrase was intended to have a broad meaning. When Section 13(3) was first enacted in July 1932, Congress's primary concern was that the Fed needed direct lending authority to circumvent banks, which were not extending new credit to businesses.[2] Once President Hoover and the Fed turned to implementing Section 13(3), Hoover argued that the "unusual and exigent circumstances" existed because of the number of borrowers who reported being refused for loans by banks. He noted that "the unwillingness of eligible banks to take advantage of the facilities provided by the government"—referring to the Fed's discount window—gave rise to the kind of situation envisioned by Section 13(3).[3]

The Fed periodically authorized Section 13(3) lending to nonmember banks, which at the time were not eligible for discount window loans, between 1936 and 2008, even though no systemic collapse was anticipated. In the summer of 1966, the Fed Board authorized Reserve Banks to lend to nonmember banks because of "the possibility that during the period ahead some nonmember depositary-type institutions … might be subjected to unusual withdrawals of funds,"[4] a far cry from a systemic threat to the financial system. The Board authorized lending to nonmember banks again in December 1969, on the ground that "the sharp further advance in market yields … unusually large net savings withdrawals at depositary institutions … and preliminary reports of rather poor savings experience in some areas … had all created some concern about the possibility of substantially enlarged savings attrition at such institutions."[5] In 1980, Section 13(3) was activated again, but not actually used, to grant a loan to a Michigan nonmember bank to pay for cash letters presented to it.[6] The Fed did not authorize Section 13(3) lending again until the global financial crisis of 2007 to 2009.[7]

During the financial crisis, the Federal Reserve undertook aggressive measures to stabilize financial markets.[8] These emergency actions prevented the spread of the worst liquidity crisis since

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[1] Federal Reserve Act, § 13(3)(A). The threshold requirement of "unusual and exigent circumstances" is discussed at greater length in Part 0.

[2] Partinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, FRBNY Economic Policy Review 19–23 (Sep. 2018), *available at* https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_political-origins_sastry.pdf.

[3] *Id* at 23–24. *See also* Hal S. Scott, *Connectedness and Contagion: Protecting the Financial System from Panics* 91–92 (MIT Press 2016)

[4] Board of Governors of the Federal Reserve System, *Fifty-Third Annual Report: Covering Operations for the Year 1966* 92 (Federal Reserve 1967).

[5] Board of Governors of the Federal Reserve System, *Fifty-Sixth Annual Report: Covering Operations for the Year 1969* 92 (Federal Reserve 1970).

[6] Thomas C. Baxter, Jr., *The Legal Position of the Central Bank, The Case of the Federal Reserve Bank of New York* 6 (Jan. 19, 2009), *available at* https://web.archive.org/web/20130511222423/http://lse.ac.uk/fmg/documents/events/conferences/2009/regulatoryResponse/1160_Baxter.pdf.

[7] *Id*.

[8] Scott, *Connectedness and Contagion* at 76 (cited in note 3). A detailed description of these measures is available from U.S. Gov't Accountability Office, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance* (2011), https://www.gao.gov/assets/gao-11-696.pdf.

the Great Depression. However, in the aftermath of the crisis, Congress concluded that the Fed had overstepped its already-broad bounds, and it imposed new restrictions on the Fed's emergency lending authority to non-banks.[9] These limits, adopted in the Dodd-Frank Act,[10] constrain the Fed's ability to exercise its emergency lending powers independently and restricted the scope of any potential lending program or facility.

Dodd-Frank Restrictions on Emergency Lending

The Dodd-Frank Act included significant revisions to Section 13(3) of the Federal Reserve Act,[11] which governs the Fed's authority to lend to non-banks "in unusual and exigent circumstances." The most important of these revisions were that: (i) the Fed cannot establish any such program or facility for non-banks without the Treasury Secretary's approval; (ii) any emergency lending program or facility for non-banks must have broad-based eligibility; (iii) the Fed must have policies and procedures in place to ensure that the security for emergency loans is sufficient to protect taxpayers from losses; and (iv) the Fed must establish procedures to prohibit the participation of insolvent borrowers in any emergency lending program or facility.

A more detailed description of each of these new requirements follows.

1. Treasury approval

The Dodd-Frank amendments to Section 13(3) specify that the Fed may not establish any program or facility for emergency lending to non-banks without the prior approval of the Secretary of the Treasury.[12] The Fed's implementing regulations clarify that this approval is necessary both for the establishment and the renewal of any such emergency lending program or facility.[13] As a practical matter, because the Secretary can withhold approval if he or she objects to any aspect of a Fed emergency lending proposal, and because the Fed is unlikely to abandon a proposal in a crisis merely because it disagrees with the Treasury's desired terms, this requirement effectively empowers the Treasury Secretary to dictate the design, terms or duration of any such emergency lending program or facility..

2. Broad-based eligibility

The Dodd-Frank amendments to Section 13(3) provide that the Fed may only authorize a facility with broad-based eligibility.[14] They also clarify that a "program or facility that is structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid" an insolvency proceeding is not

[9] For a more detailed description of these limitations, see Scott, *Connectedness and Contagion* at 93–104 (cited in note 3). Congress also contemplated significantly curtailing the Fed's supervisory responsibilities. Senator Dodd introduced a bill in 2009 that would have removed the Fed's supervisory authority over state-member banks and limited its supervisory responsibilities to systemically important non-bank financial firms and holding companies with assets over $50 billion. *See* Walter W. Eubanks, *Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis*, Congressional Research Service Report 7-5700 (April 12, 2010).
[10] Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111–203, 124 Stat. 1376 (2010).
[11] Federal Reserve Act, § 13(3)(B)(iv).
[12] 12 C.F.R. § 201.4(d)(9)(ii).
[13] The Dodd-Frank amendments to Section 13(3) also build in congressional oversight, by requiring the Fed Board to provide to committees of the House of Representatives and the Senate a report and periodic updates regarding its emergency lending activities. Federal Reserve Act, § 13(3)(C).
[14] Federal Reserve Act, § 13(3)(A).

considered to have broad-based eligibility.[15] These revisions to Section 13(3) were aimed at loans extended by the Federal Reserve during the 2008 crisis to individual non-bank financial institutions like AIG.[16]

Under implementing regulations finalized by the Fed in 2015, a program or facility is only considered to have broad-based eligibility if it is designed "to provide liquidity to an identifiable market or sector of the financial system."[17] In addition, a program or facility is treated as not having broad-based eligibility if: (i) it is designed for the purpose of assisting one or more specific companies avoid bankruptcy, resolution or another insolvency proceeding; (ii) it is designed for the purpose of aiding one or more failing financial companies; or (iii) fewer than five persons or entities would be eligible to participate in the program or facility.[18] It is not clear, for purposes of the last condition, *when* there must be at least five eligible participants: at the time a program or facility begins to extend credit, or over the entire course of its operation. If it is the latter, then the fewer-than-five restriction could have little practical impact.

3. Collateral and Security

The revisions to Section 13(3) also include provisions to protect the Fed against credit loss. In particular, Section 13(3)(B)(i) mandates that the Fed establish policies and procedures governing emergency lending that are "designed to ensure that … the security for emergency loans is sufficient to protect taxpayers from losses."[19] These policies and procedures must require that "a Federal reserve bank assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank … in determining whether the loan is secured satisfactorily."[20] These amendments indicate that the Fed cannot make loans under Section 13(3) that are not backed by sufficient collateral or a third-party guarantee or other form of protection against loss.

4. Solvency

Another bulwark against credit loss is the requirement that only solvent borrowers may participate in an emergency lending program or facility. Under Section 13(3), a borrower is considered insolvent if it is currently subject to a bankruptcy, resolution or other insolvency proceeding.[21] Section 13(3)(B)(ii) also requires the Fed to establish procedures to "prohibit borrowing from programs and facilities by borrowers that are insolvent."[22] The statute specifies that those procedures may include a certification by the borrower that it is not insolvent. The Fed's implementing regulations incorporate the certification option, allowing borrowers to self-certify that they are solvent based on their reasonable belief.[23] However, the implementing regulations go farther than the statute when it comes to the definition of insolvency by providing that a borrower

[15] Federal Reserve Act, § 13(3)(B)(iii).
[16] Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, Wall Street Journal, Sep. 16, 2008, *available at* https://www.wsj.com/articles/SB122156561931242905. *See also* U.S. Gov't Accountability Office, *Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance* at 162–177 (cited in note 8).
[17] 12 C.F.R § 201.4(d)(4)(ii).
[18] 12 C.F.R § 201.4(d)(4)(iii).
[19] Federal Reserve Act, § 13(3)(B)(i).
[20] *Id*.
[21] Federal Reserve Act, § 13(3)(B)(ii).
[22] Federal Reserve Act, § 13(3)(B)(ii).
[23] 12 C.F.R. § 201.4(d)(5)(iv)(A).

is considered insolvent if it 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."[24]

II. Emergency Lending During the COVID-19 Pandemic

The framework described in the prior section governed the Fed's emergency lending during the COVID-19 pandemic. In response to pandemic-induced economic disruption, the Fed invoked its Section 13(3) authority to establish several emergency lending facilities for non-banks. Pursuant to the Dodd-Frank amendments to Section 13(3), all of the Fed's emergency facilities required approval by the Treasury Secretary. Some of these facilities involved the Fed's traditional liquidity provision function, such as lending to primary dealers against good collateral to provide liquidity to financial markets. Others went beyond that traditional role; the Main Street Lending Program, for example, was designed to provide credit to struggling small- and mid-size enterprises. Because of Dodd-Frank's collateral requirements and the inability of many borrowers from the COVID facilities to provide collateral, the facilities were supported by financial backing by Treasury as a substitute for borrower collateral. This section describes the initial lending facilities established by the Fed at the outset of the COVID-19 pandemic; the facilities set up after the passage of the CARES Act; and the closure of the CARES Act facilities.

a. The Original Facilities

On March 17 and 18, 2020, prior to the enactment of the Coronavirus Aid, Relief and Economic Security Act (the "**CARES Act**"), the Fed announced its first three facilities to deal with the pandemic—the Commercial Paper Funding Facility (the "**CPFF**") to buy highly-rated commercial paper, the Primary Dealer Credit Facility (the "**PDCF**") to make loans to primary dealers, and the Money Market Mutual Fund Liquidity Facility (the "**MMLF**") to make loans to banks to buy money market fund assets. Each of these facilities was approved by the Treasury Secretary[25] and they were modeled after similar facilities used in 2008.

Unlike their 2008 counterparts, in 2020 both the CPFF and MMLF were backed by the Treasury's Exchange Stabilization Fund (the "**ESF**") to satisfy the Dodd-Frank collateral requirement. The CPFF was backed with a $10 billion equity contribution and the MMLF was backed with $10 billion of credit protection.[26] The legality of using the ESF in this way was not straightforward. Before it was amended by the CARES Act, the ESF's establishing statute described the purpose of the ESF as stabilizing exchange rates.[27] The statute authorizes the Treasury Secretary to deal in Treasury securities, gold, foreign exchange, "and other instruments of credit and

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[24] 12 C.F.R. § 201.4(d)(5)(iii).

[25] Federal Reserve, *Federal Reserve Board announces establishment of a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses* (Mar. 17, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317a.htm; Federal Reserve, *Federal Reserve Board announces establishment of a Primary Dealer Credit Facility (PDCF) to support the credit needs of households and businesses* (Mar. 17, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200317b.htm; Federal Reserve, *Federal Reserve Board broadens program of support for the flow of credit to households and businesses by establishing a Money Market Mutual Fund Liquidity Facility (MMLF)* (Mar. 18, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200318a.htm.

[26] Federal Reserve, *Commercial Paper Funding Facility: Program Terms and Conditions* (Nov. 30. 2020), https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-terms-and-conditions; Federal Reserve, *Money Market Mutual Fund Liquidity Facility FAQs* (March 21, 2020, amended May 26, 2020.), https://www.federalreserve.gov/monetarypolicy/files/mmlf-faqs.pdf.

[27] 31 USC 5302(a)(1).

securities the Secretary considers necessary." While this language is open-ended, in context it appears to mean that Treasury can buy or sell other securities to maintain the value of the dollar.

Treasury backing of the CPFF was necessary because the Fed purchased unsecured commercial paper. It was also necessary for the MMLF where loans to banks could be backed by unsecured commercial paper and where the Fed had no recourse back to the banks in case the paper issuers defaulted.[28]

Treasury backing was thus a substitute for the lack of collateral. If Treasury took a first-loss position in these facilities, it could be persuasively argued that the security for the loans extended through the facilities was "sufficient to protect taxpayers from losses." But, of course, that would only be true to the extent that the Fed's losses were less than the Treasury backing. Backing was not needed for the PDCF, however, because in that facility, while collateral included a range of equity securities and investment-grade debt securities, such securities were generally high quality and margin-adjusted, and there was recourse back to dealers in the case of default.[29]

None of these pre-CARES Act facilities had a fixed cap on the amount of lending they could extend or assets that they could purchase, which suggests that the Fed would have to modulate the amount of its lending itself in order to protect against the prospect of losses in excess of Treasury backing.

b. The CARES Act Facilities

The relationship between the Treasury and the Fed evolved significantly with the enactment of the CARES Act on March 27, 2020. Section 4003 of the Act appropriated at least $454 billion to the Treasury's ESF to make loans, investments or guarantees to the Fed to support Fed lending to eligible businesses, states or municipalities by purchasing obligations or making loans.[30] The bill specifically ordered the Treasury to seek Fed programs for such borrowers.[31] The legislation further stated that if there was any doubt, the provisions of Section 13(3) should apply to any Fed facilities created under the CARES Act.[32] The lending envisioned by the CARES Act went well beyond the Fed's traditional lender-of-last-resort function; instead, the CARES Act appeared to anticipate that the Fed would serve as a credit provider of last resort for broad sectors of the economy by establishing programs or facilities to purchase debt or make new loans, with Treasury backing to protect the Fed from credit risk.[33]

The authorization for the Fed to purchase existing non-bank debt, in addition to making new loans, was also novel. By statute, the Fed is only authorized to buy U.S. Treasury securities or government guaranteed debt, like mortgage-backed securities issued by government-sponsored enterprises.[34] During the global financial crisis, the Fed used its Section 13(3) authority to circumvent these restrictions on direct purchases by lending to Fed-created special purpose vehicles

[28] Federal Reserve, *Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility Terms and Conditions* (February 5, 2010): https://www.frbdiscountwindow.org/Archive/Asset-Backed-Commercial-Paper-ABCP-Money-Market-Mutual-Fund-MMMF-Liquidity-Facility-Terms-and-Conditions.
[29] Federal Reserve, *Term Sheet for Primary Dealer Credit Facility (PDCF)* (March 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200317b1.pdf
[30] Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. 116–136, § 4003 (2020).
[31] CARES Act, § 4003(a).
[32] CARES Act, § 4003(c)(3)(B).
[33] CARES Act, § 4003(b).
[34] Federal Reserve Act, § 13(2).

(SPVs) that in turn purchased assets, like commercial paper, that the Fed could not purchase directly.[35] As described in further detail below, the Fed repurposed this SPV structure for its pandemic lending facilities. This time, however, the structure was authorized by the CARES Act, which explicitly recognized that funds appropriated to the Treasury's ESF would be used to support Fed facilities that were engaged in "purchasing obligations or other interests directly from issuers of such obligations or other interests" or "purchasing obligations or other interests in secondary markets or otherwise."[36]

Over the next few months, the Fed established, with the required Treasury approval, four emergency lending facilities: (i) the Term Asset-Backed Securities Loan Facility (the "**TALF**") to purchase asset-backed securities;[37] (ii) the Primary Market and Secondary Market Corporate Credit Facilities (the "**PMCCF**" and "**SMCCF**") to purchase corporate bonds and ETFs in the primary and secondary markets, respectively;[38] (iii) the Main Street Lending Program (the "**MSLP**"), comprising five separate facilities to purchase bank loans to small- and medium-sized businesses (the Main Street New Loan Facility, Priority Loan Facility and Expanded Loan Facility) and nonprofits (the Nonprofit Organization New Loan Facility and Expanded Loan Facility);[39] and (4) the Municipal Liquidity Facility to purchase newly-issued state and municipal obligations (the "**MLF**").[40]

Each of these facilities had a similar structure: an SPV capitalized with a Treasury equity investment. For example, the two corporate credit facilities operated through the same SPV, which was capitalized with a Treasury investment of up to $75 billion (the Treasury ultimately contributed only $37.5 billion).[41] The Main Street facilities operated through a joint SPV capitalized with a Treasury investment of up to $75 billion (as with the corporate credit facilities, the Treasury ultimately only contributed $37.5 billion to this SPV).[42] Since the vast majority of borrowers targeted by Congress did not have sufficient collateral to back lending on the scale envisioned by the CARES Act, the backing by the Treasury with funds appropriated by Congress served as a substitute to protect the Fed from losses.

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[35] See Federal Reserve, *Commercial Paper Funding Facility: Frequently Asked Questions* (October 27, 2008), https://www.newyorkfed.org/markets/cpff_faq_081027.html; Eric A. Posner, *What Legal Authority Does the Fed Need During a Financial Crisis?*, 101 Minn. L. Rev. 1529, 1551-52 (2017); Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. Penn. J. Bus. L. 221, 235-36 (2011).

[36] CARES Act, § 4003(b)(4).

[37] Federal Reserve, *Federal Reserve announces extensive new measures to support the economy* (Mar. 23, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

[38] *Id.*

[39] Federal Reserve, *Main Street Lending Program*, *available at* https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm (last visited Dec. 7, 2020).

[40] Federal Reserve, *Federal Reserve takes additional actions to provide up to $2.3 trillion in loans to support the economy* (Apr. 9, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.

[41] Federal Reserve, *Primary Market Corporate Credit* Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.;Federal Reserve, *Secondary Market Corporate Credit Facility* (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf; Federal Reserve, *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release H.4.1 (Dec. 28, 2020).

[42] Federal Reserve Bank of Boston, *Main Street Lending Program For-Profit Businesses: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, *Main Street for Nonprofit Organizations Part of the Main Street Lending Program: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/- /media/Documents/special-lending-facilities/mslp/legal/frequently-asked-questions-faqs-nonprofit.pdf.; Federal Reserve, *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release H.4.1 (Dec. 28, 2020).

Each of the CARES Act facilities also featured a fixed cap on the amount it could lend or purchase. The two corporate credit facilities had a $750 billion cap on combined primary and secondary market purchases.[43] The Main Street facilities had a cap of $600 billion on aggregate loan purchases.[44] The ratio of the fixed cap to Treasury's equity investment represents the leverage of the facility: 10 times for the corporate credit facilities ($750 billion divided by $75 billion), and 8 times for the Main Street facilities ($600 billion divided by $75 billion).[45] The existence of these caps indicates an intent to limit potential losses incurred by each of the facilities—not just on the Fed's investment, but on Treasury's equity investment as well.

In addition, the CARES Act facilities had detailed requirements with respect to the qualifications and riskiness of the assets purchased or eligible borrowers. These requirements were not mandated by Congress in the CARES Act; they were determined either by the Treasury or the Fed or both.[46] The effect of these requirements, like the effect of the fixed caps on aggregate loan purchases, was to limit each facility's potential losses. Thus, for example, the corporate credit facilities specified that issuers had to have been rated at least BBB-/Baa3 as of March 22, 2020, and issuers that were subsequently downgraded had to be rated at least BB-/Ba3 as of the date of purchase.[47] Detailed requirements regarding creditworthiness were also included in the term sheets for Main Street's three for-profit business facilities.[48]

The Main Street New Loan Facility (the MSNLF), which was meant to facilitate new lending by banks to for-profit small and medium-sized businesses, can serve as a representative example of how the terms of the Main Street facilities operated to reduce credit risk. The MSNLF allowed a business borrower with up to 15,000 employees or revenue of $5 billion or less in 2019 to borrow a minimum of $100,000 ($250,000 prior to October 30, 2020) and a maximum of the lesser of: (i) $35 million or (ii) an amount that, together with the borrower's existing debt, did not exceed four times the borrower's 2019 EBITDA.[49]

The lender was specifically required to do a credit assessment of the borrower's financial condition.[50] In addition, if the borrower had an existing loan from the bank, it must have received

[43] Federal Reserve, *Primary Market Corporate Credit* Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.; Federal Reserve, *Secondary Market Corporate Credit Facility* (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

[44] Federal Reserve Bank of Boston, *Main Street Lending Program For-Profit Businesses: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, *Main Street for Nonprofit Organizations Part of the Main Street Lending Program: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/- /media/Documents/special-lending-facilities/mslp/legal/frequently-asked-questions-faqs-nonprofit.pdf.

[45]Federal Reserve, *Primary Market Corporate Credit* Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.; Federal Reserve Bank of Boston, *Main Street Lending Program For-Profit Businesses: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs;

[46] See Part c for a discussion of the problems raised by the absence of clear responsibility.

[47] Federal Reserve, *Primary Market Corporate Credit Facility*, https://www.federalreserve.gov/monetarypolicy/pmccf.htm (last visited Oct. 4, 2020); Federal Reserve, *Secondary Market Corporate Credit Facility*, https://www.federalreserve.gov/monetarypolicy/smccf.htm (last visited Oct. 4, 2020).

[48] Federal Reserve Bank of Boston, *Main Street Lending Program For-Profit Businesses: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, *Main Street for Nonprofit Organizations Part of the Main Street Lending Program: Frequently Asked Questions* (Nov. 25, 2020), https://www.bostonfed.org/- /media/Documents/special-lending-facilities/mslp/legal/frequently-asked-questions-faqs-nonprofit.pdf.

[49] Federal Reserve, *Federal Reserve Board adjusts terms of Main Street Lending Program to better target support to smaller businesses that employ millions of workers and are facing continued revenue shortfalls due to the pandemic* (Oct. 30, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/monetary20201030a.htm.

[50] Federal Reserve, *Main Street New Loan Facility* (October 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201030a1.pdf

an internal risk rating equivalent to a "pass" (the highest rating) in the supervisory rating system as of the end of 2019 (or upon origination or purchase, if the loan was originated or purchased in 2020).[51] Moreover, the borrower had to certify that it had the ability (with the loan) to meet its financial obligations and did not anticipate going into bankruptcy in the next 90 days.[52] These creditworthiness requirements precluded many needy borrowers from using the facility.

The terms of the loans issued through the MSNLF were also demanding and thus unattractive to many needier borrowers. The interest rate on loans was adjustable LIBOR plus 300 basis points, and the loans were relatively short-term with a maturity of 5 years.[53] The new loans could also include up to 200 basis points of origination and transaction fees.[54] The borrower could not use the proceeds of the new tranche of the loan to repay or reduce existing debt (but could use them to make mandatory principal and interest payments).[55]

Finally, the requirement that banks continue to hold a portion of eligible loans also reduced the uptake of the MSNLF, thus reducing the risk of potential losses that would be borne by the facility. Under the MSNLF, the shared Main Street SPV bought 95 percent of new program loans, and banks continued to hold the remaining 5 percent with no protection from the Fed for this exposure.[56] A large amount of 5 percent stakes adds up to significant exposure.

Critics attacked the design of the CARES Act facilities—the Main Street facilities in particular—for prioritizing loss minimization at the expense of getting funds to needy but risky borrowers.[57] Specifically, they noted that the terms of the Main Street facilities—too onerous for borrowers and insufficiently attractive to lenders—would hamper their ability to channel credit to needy small and mid-size businesses.[58] Treasury Secretary Mnuchin appeared to confirm this prioritization when he told reporters in late April that "[i]f Congress wanted me to lose all the money, that money would have been designed as subsidies and grants as opposed to credit support," and affirmed that "[w]e're looking at it in a base case scenario that we recover our money." [59]

When the CARES Act facilities stopped purchasing assets on January 8, 2021, Treasury had only invested $102.5 billion of the CARES Act appropriation (although it had committed more than this, $195 billion), together with its investment of $11.5 billion from the Exchange Stabilization Fund before passage of the CARES Act.[60] Moreover, lending or purchases under the CARES Act facilities fell far short of the scale provided by Congress: when they were shut down, the

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[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *See*, *e.g.*, Glenn Hubbard & Hal Scott, *Main Street Needs More Fed Help*, Wall Street Journal (Apr. 16, 2020), *available at* https://www.wsj.com/articles/main-street-needs-more-fed-help-11587055459; Editorial Board, *The Main Street Fakeout*, Wall Street Journal (Apr. 30, 2020), *available at* https://www.wsj.com/articles/the-main-street-fakeout-11588288799; Glenn Hubbard & Hal Scott, *Who's Looking Out for Main Street?*, Wall Street Journal (May 17, 2020), *available at* https://www.wsj.com/articles/whos-looking-out-for-main-street-11589741411.
[58] *See*, *e.g.*, Glenn Hubbard & Hal Scott, *'Main Street' Program Is Too Stingy to Banks and Borrowers*, Wall Street Journal (July 20, 2020), available at https://www.wsj.com/articles/main-street-program-is-too-stingy-to-banks-and-borrowers-11595284266.
[59] Kate Davidson & Richard Rubin, *Steven Mnuchin Says U.S. Aims to Get Back Its Money From Fed Programs*, Wall Street Journal, Apr. 29, 2020, *available at* https://www.wsj.com/articles/mnuchin-says-u-s-not-aiming-to-lose-money-on-fed-lending-facilities-11588178749.
[60] Federal Reserve, *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release H.4.1 (Jan. 14, 2021).

facilities had only purchased $40.5 billion worth of loans (the maximum amount outstanding over time) approximately 2 percent of the $2 trillion cap on aggregate lending through all of the facilities.[61]

Despite their lack of uptake, several of the facilities do appear to have stabilized financial markets, allowing private sector lending to resume and preventing a full-blown financial crisis. The existence of these facilities, rather than the amount of credit that they extended, stabilized the market.[62] By contrast, the minimal uptake on the Main Street facilities—aggregate purchases of $16.5 billion, supporting just over $17 billion in loans, compared to a total cap of $600 billion—occurred against the backdrop of deteriorating credit conditions for small and medium-sized businesses throughout the pandemic.[63] The market-based facilities, like the corporate credit facilities, could backstop specific markets by ensuring access to credit for borrowers, thus reducing rollover risk and risk spreads in those markets without issuers actually accessing the facilities. Because small and medium-sized businesses do not borrow in capital markets, the Main Street facilities could not aid them without actually extending credit.[64] And such credit did not otherwise come from banks. The Federal Reserve reports that, leaving out $525 billion in forgivable loans extended as part of the Small Business Administration's Paycheck Protection Program, commercial and industrial loans extended by banks declined in 2020.[65]

c. Closing the CARES Act Facilities

On November 19, Secretary Mnuchin sent a letter to the Chairman of the Federal Reserve ordering the Fed to close, at the end of the year, all the facilities that had received Treasury backing with funds appropriated under the CARES Act.[66] As noted above, under the Dodd-Frank amendments to Section 13(3), the approval of the Treasury Secretary is necessary for any Fed non-bank lending facilities or programs, and the CARES Act explicitly reinforced this authority.[67] Moreover, the CARES Act facilities were due to expire at year end; under Fed regulations the Treasury Secretary's approval would have been necessary to renew the facilities.[68] As the power to approve includes the power to disapprove, Secretary Mnuchin was effectively authorized to terminate any and all of the CARES Act facilities. However, the fact that he undertook unilateral action through a letter, ordering the Fed to comply, was an extraordinary and historic economic confrontation, given repeated statements by Fed officials that the facilities should remain in place past the end of

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[61] *Id*.
[62] Committee on Capital Markets Regulation, *Treasury and Fed Lending Programs: An Assessment and Call for Continued Support for SMEs* 11–19 (Dec. 30, 2020), https://www.capmktsreg.org/2020/12/30/treasury-and-fed-lending-programs-an-assessment-and-call-for-continued-support-for-smes/ (discussing TALF and the corporate credit facilities); Nicholas Fritsch, John Bagley & Shawn Nee, *Municipal Markets and the Municipal Liquidity Facility*, Working Paper 21-07 (March 22, 2021), https://www.clevelandfed.org/en/newsroom-and-events/publications/working-papers/2021-working-papers/wp-2107-municipal-markets-and-the-municipal-liquidity-facility.aspx (discussing the Municipal Liquidity Facility).
[63] Committee on Capital Markets Regulation, *Treasury and Fed Lending Programs* at 23–27 (cited in note 62).
[64] William B. English & J. Nellie Liang, *Designing the Main Street Lending Program: Challenges and Options*, Hutchins Center Working Paper #64 (June 2020), https://www.brookings.edu/wp-content/uploads/2020/06/WP64_Liang-English_FINAL.pdf.
[65] Federal Reserve, *Supervision and Regulation Report* 8-9 (April 2021), https://www.federalreserve.gov/publications/files/202104-supervision-and-regulation-report.pdf.
[66] *Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized under Section 13(3) of the Federal Reserve Act* (Nov. 19, 2020), *available at* https://home.treasury.gov/system/files/136/letter11192020.pdf.
[67] Federal Reserve Act, § 13(3)(B)(iv).
[68] 12 C.F.R. § 201.4(d)(9)(ii).

the year.[69] Although the Fed immediately objected to the closure of the facilities,[70] without the Treasury Secretary's approval to extend the facilities it could not unilaterally continue their operation and was thus forced to comply.

The Treasury Secretary's letter went further than just terminating new lending or purchases under the CARES Act facilities. It also requested that the Fed return any "unused" Treasury funds.[71] On the next day, November 20, 2020, the Fed acceded to the Treasury's requests, noting that the Fed would work with Treasury to return the unused portion of the CARES Act funds in connection with the facilities' year-end termination.[72] The Fed's agreement was not a foregone conclusion, since the authority of the Treasury Secretary under the CARES Act to order the return of Treasury's equity investments was unclear.[73] The CARES Act provided that "remaining funds" appropriated to back Fed lending could not be used for new loans or investments after December 31, 2020, but that restriction was best read to refer to funds made available to but not used by the Treasury. Funds that had already been invested in Fed lending facilities were already used and therefore would most likely not have qualified as "remaining funds."[74]

While the Treasury Secretary closed the CARES Act facilities, the CARES Act left open the possibility that a new Treasury Secretary could restart them, albeit without the funds that had already been returned by the Fed.[75] Coronavirus relief legislation passed in late December as part of the omnibus Consolidated Appropriations Act of 2021, however, forbade the CARES Act facilities from making any new loans or purchasing new assets after December 31, 2020 (except for the Main Street facilities, which were allowed to continue to purchase certain loan participations until January 8, 2021).[76]

The legislation also prohibited the use of funds from the Treasury's ESF to back any new Fed program or facility, except for the TALF, "that is the same as any such program or facility in which the [Treasury] Secretary made an investment pursuant to" the CARES Act.[77] Although that provision forbids Treasury from using the ESF to back a facility that is the "same" as one of the CARES Act facilities, it leaves open the possibility that Treasury could in the future use the ESF's remaining "core funds"—which stood at approximately $95 billion as of December 31, 2020—to

[69] *See, e.g.,* Colby Smith & James Politi, *Political divisions put Fed's pandemic emergency measures in doubt*, Financial Times (Nov. 19, 2020) (citing Fed Chair Powell's statement that "[w]hen the right time comes, and I don't think that time is yet or very soon, we will put those tools away").

[70] James Politi & Colby Smith, *US Treasury refuses to extend some of Fed's crisis-fighting tools*, Financial Times (Nov. 19, 2020), https://www.ft.com/content/e4b3a063-db44-4e6c-b998-74a29d70b136 ("The Federal Reserve would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy.").

[71] *Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized under Section 13(3) of the Federal Reserve Act* (cited in note 66).

[72] *Letter from Chair Powell to Secretary Mnuchin regarding emergency lending facilities* (Nov. 20, 2020), https://www.federalreserve.gov/foia/files/mnuchin-letter-20201120.pdf.

[73] Jay B. Sykes, *Section 4029 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Extension of the Federal Reserve's Emergency-Lending Programs* 6–7 (Dec. 17, 2020), *available at* https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov /files/Memo%20re%20CARES%20Act%20Section%204029.pdf.

[74] *Id*.

[75] *Id*.

[76] *Consolidated Appropriations Act, 2021*, H.R. 133, 116th Cong., Division N, § 1005 (December 27, 2020), *available at* https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-116HR133SA-RCP-116-68.pdf.

[77] *Id*, § 1005.

back Fed emergency lending facilities that were similar but not the "same" as the CARES Act facilities.[78]

III. The Problems with the Section 13(3) Framework

The experience of the CARES Act facilities illustrates three problems with the current Section 13(3) framework for emergency lending to non-banks. The first is that it allows the Fed to operate lending programs that, like the Main Street Lending Program, are essentially fiscal programs, which arguably should properly be the responsibility of elected authorities, not independent agencies. Second, the current framework vests the Fed with considerable discretion to pick winners and losers. Finally, shared Treasury-Fed responsibility for emergency lending and a lack of transparency makes it difficult to determine who should be held responsible for success or failure.

a. The Fed's Exercise of Fiscal Authority

The CARES Act facilities—especially the Main Street facilities—gave the Fed a central role in supporting the flow of credit to certain non-financial firms. Although actual lending on the scale anticipated by Congress did not materialize, risky extensions of credit could have exposed the Fed to potential losses if losses had exceeded Treasury backing. Of course, credit loss would not bankrupt the Fed since it can create money. Nonetheless, Fed losses would impact the taxpayer by reducing the amount of profit the Fed annually remits to the Treasury.[79] Moreover, if the losses were severe enough, they might tarnish the Fed's credibility and reputation.[80] Congress and the Treasury would likely feel compelled to recapitalize the Fed, so the losses would be passed on to the American taxpayer.

The more fundamental concern raised by the Fed's potential assumption of significant credit risk, however, is that by engaging in risky lending the Fed would wrongly cross the line into making fiscal decisions which, in a democracy, rightly belong to elected government officials—the Congress and the Administration—not an independent agency like the Fed. In a democracy, fiscal authority should lie with actors that are directly accountable to voters.[81] The exercise of fiscal policy by the Fed clearly raises concerns about political accountability.

At the same time, there is widespread recognition that the Fed can, and should, act independently as the lender of last resort to prevent financial crises. So then what is the line between the Fed's legitimate role as lender of last resort and the exercise of fiscal authority? Basically, the line is between *liquidity* provision and high-risk *credit* provision. If firms with strong balance sheets need to borrow from the Fed simply because the financial system has withdrawn private liquidity, even from solvent borrowers, then that is a liquidity problem that the Fed can and should

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[78] *See* Hal Scott, *Here's how the Fed can do more to support US small business*, Financial Times (Jan. 11, 2021), *available at* https://www.ft.com/content/0d0b0f48-df3c-4b2f-97b8-d2da0415d8d6.

[79] At their high in 2015, remittances constituted $117 billion, including a one-time capital surplus transfer of more than $19 billion, 3.6% of U.S. general revenue. Internal Revenue Service, *Gross collections, by type of tax and state, fiscal year 2015* (2016), *available at* https://www.irs.gov/pub/irs-soi/15db05co.xls.

[80] *See* Martin Hellwig, *Financial Stability and Monetary Policy*, MPI Collective Goods Preprint, No. 2015/10, 12-13 (Aug. 2015), *available at* http://ssrn.com/abstract=2639532.

[81] For an elaboration of a similar view, *see* Paul M.W. Tucker, *Solvency as a Fundamental Constraint on LOLR Policy for Independent Central Banks: Principles, History, Law*, 2 J Fin. Cris. 1, 9-11 (2020).

address independently. However, if firms are substantially likely to become insolvent absent some intervention, then that is a credit problem.[82]

Concern over the Fed's assumption of fiscal authority, and exposure to potential financial losses, in its capacity as a lender of last resort is not self-evident. After all, there is a broad consensus that the Fed's independence from the executive branch, and politics more generally, is important for sound monetary policy, and monetary policy has a profound influence on fiscal policy.[83] It is also the case that the Fed's exercise of monetary policy could, in theory, incur significant risk of loss, in the form of interest rate risk through its holdings of government obligations, principally Treasury securities.[84]

There are, however, significant differences between the Fed's exercise of credit policy and its exercise of monetary policy. For one, there is a broad and longstanding consensus of Fed independence when it comes to monetary policy. Further, there is an important distinction between interest rate risk and credit risk. Credit risk deals with the risk of borrower default, of which there is virtually none with respect to the Fed's traditional portfolio—holding U.S. government and government-backed obligations. Also, the Fed is protected against the full impact of interest rate risk since it does not mark-to-market its portfolio and only incurs gains or losses when its sells portfolio holdings.[85]

In fact, the interest rate risk on monetary policy is rather small. A 2011 note published by the Federal Reserve Bank of San Francisco concludes that the short-term interest rate would need to be around 7% for the Fed's interest expenses to surpass its interest income.[86] And the Fed's balance sheet has substantially increased since then. Treasury, agency and government-backed securities as of August 25, 2021, were $7.787 trillion, and bank reserves were $4.2 trillion.[87] Continuing to assume, as did the Fed note, that the average coupon yield on the bundle of assets is 4 percent, this would generate $311 billion in interest income. The short-term interest rate would then need to be above 7.4% for the Fed's interest expenses to surpass its interest income. According to this calculation, the Fed has even lower interest rate risk in 2021 than in 2011. However, the current Fed balance sheet also includes significant reverse repo liabilities, approximately $1.4 trillion, while the 2011 balance sheet only included less than $60 billion of reverse repos.[88] Adding the potential interest rate expense associated with the reverse repo liabilities, the short-term interest right would need to rise above 5.5% for the Fed's total interest expense to surpass its interest income. But since the reverse repo rate has historically been below the Fed Funds rate, the short-term rate that would equate interest expense with interest income likely falls somewhere between 5.5% and 7.4%. Therefore, under this alternative calculation that includes reverse repos, the interest rate risk is still relatively low, although not necessarily lower than in 2011.

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[82] *See* Tucker, *Solvency as a Fundamental Constraint on LOLR Policy* at 13-15 (cited in note 81) (noting that distinguishing between liquidity problems and solvency problems involves inherently forward-looking, probabilistic judgments).

[83] Christopher J. Waller, *Independence + Accountability: Why the Fed Is a Well-Designed Central Bank*. Federal Reserve Bank of St. Louis Review, 292-301 (September/October 2011), https://doi.org/10.20955/r.93.293-302.

[84] Frederic S. Mishkin, *Don't Monetize the Debt*. Wall St. J., (September 9, 2010), https://www.wsj.com/articles/SB10001424052748704358904575477580959771188#U3012412216331wH.

[85] Board of Governors of the Federal Reserve System (Federal Reserve), *Financial Accounting Manual for Federal Reserve Banks* 104 (January 2020).

[86] Glenn D. Rudebusch, *The Fed's Interest Rate Risk*, FRBSF Economic Letter 2011-11 (April 11, 2011).

[87] Federal Reserve, *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release H.4.1 (August 26, 2021).

[88] Id.

If the Federal Reserve shrinks its holdings of Treasury, agency and government-backed assets and bank reserve liabilities in the same proportion, then the short-term interest rate needed for interest expenses to surpass interest income would remain unchanged. Otherwise, if the Federal Reserve only sells off longer-term assets and bank reserve liabilities remain the same, the short-term interest rate needed for interest expenses to surpass interest income will decrease. But in any event, interest rate risk is minimal compared with credit risk.

The current Section 13(3) framework allowed the Fed to take a central role in credit provision. In the case of the CARES Act facilities for non-bank financial institutions, the Fed took steps to limit its role to liquidity provision without significant credit risk by lending to mostly investment grade or near-investment grade borrowers and keeping the duration of most of its lending relatively short-term.[89] However, the Main Street facilities (for non-financial companies) were examples of credit facilities—designed to support firms struggling with weak balance sheets—rather than liquidity facilities. And emergency lending that involves significant credit risk should be the exclusive domain of elected authorities that are accountable to the public—not an independent agency like the Fed. Admittedly, the Fed's exposure to excessive Main Street losses was mitigated by Treasury backing of the facilities. The facilities, however, were still nominally Fed facilities, and thus the Fed rather than the Treasury would still be deemed responsible for their success or failure.

We note the separate argument that, when the Fed exercises fiscal authority, this could raise constitutional concerns. The Constitution provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."[90] By assigning the "power of the purse" to Congress, the Constitution forbids any federal agency or official, including the Fed, from engaging in public spending without legislative authorization.[91] Of course, Congress has explicitly authorized the Federal Reserve to act as a lender of last resort, including by lending to non-banks in specified circumstances. So the argument would be that the Constitution limits Congress's ability to delegate its fiscal authority to another federal agency, including the Fed.[92] That said, although there is no case law on point, courts have applied the nondelegation doctrine sparingly and, in particular, appear to have rejected the notion that Congress's appropriations power is categorically nondelegable.[93] So the issue of whether the Treasury or the Fed should take on credit risk is ultimately a matter of policy rather than constitutional concern.

b. Picking Winners and Losers

A related problem with the current Section 13(3) framework arises in connection with programs that vest the Fed with significant discretion to choose which specific borrowers or assets,

[89] Jerome H. Powell, *Statement before the Committee on Banking, Housing and Urban Affairs, U.S. Senate* (Dec. 1, 2020), https://www.federalreserve.gov/newsevents/testimony/files/powell20201201a.pdf ("The SMCCF supports market liquidity by purchasing, in the secondary market, corporate bonds issued by investment-grade U.S. companies, by U.S. companies that were investment grade before the onset of the pandemic and remain near investment grade."). For a concise description of each facility's terms, *see* Andrew P. Scott, Rachel Y. Tang, Marc Labonte & Ben Wilhelm, *Treasury and Federal Reserve Financial Assistance in Title IV of the CARES Act*, CRS Report R46329 9-11 (Jan. 6, 2021). https://crsreports.congress.gov/product/pdf/R/R46329.
[90] U.S. Constitution, art. I, § 9, cl. 7.
[91] *See* Kate Stith, *Congress' Power of the Purse*, 97 Yale L.J. 1343, 1356–60 (1988).
[92] *Id.* at 1381–86.
[93] *See, e.g.*, Synar v. United States, 626 F. Supp. 1374, 1385–86 (D.D.C. 1986) (noting in obiter dicta that "[t]he appropriations power is not functionally distinguishable from other powers successfully delegated by Congress."). *See generally* Eric A. Posner & Adrian Vermeule, *Interring the Nondelegation Doctrine*, 69 U. Chi. L. Rev. 1721 (2002) (critiquing the nondelegation doctrine).

or categories of borrowers or assets, are eligible for participation: the risk of picking winners and losers. Although the Fed will always exercise some discretion when determining program eligibility, the more it does so, the greater the concern that it has favored some prospective borrowers over others.

This problem was, to some extent, a problem with all of the pandemic lending facilities. Most of those facilities involved the Fed setting generally applicable terms for all willing borrowers. Thus, each of the PDCF, MMLF and TALF involved the Fed (or SPVs controlled by the Fed) lending to private entities—banks, primary dealers, and other financial institutions—that used the proceeds of those loans to purchase eligible assets.[94] In the case of the CPFF, PMCCF and MMLF, eligible issuers could only sell commercial paper or newly issued corporate or municipal debt to the Fed on general terms set by the Fed, rather than based on the Fed's exercise of discretion.[95] Whenever the Fed sets generally applicable terms, it must decide which borrowers or assets are eligible for participation and which are not. Wherever the Fed decides to draw the line, it can create the perception that the Fed is helping or penalizing certain sectors or industries.[96]

Another potential issue of picking winners and losers arose in connection with the operation of the Fed's Secondary Market Corporate Credit Facility (the SMCCF), since the Fed exercised its discretion to determine which ETFs and bonds the SMCCF would buy and at what price.[97] The Fed attempted to minimize this problem by initially only purchasing highly diversified ETFs, but it still had to decide which ones to buy. And when it later bought bonds directly, it did so by constructing its own broad bond index composed of all secondary market issues that met the SMCCF's eligibility criteria.[98] A similar winners-and-losers concern would have arisen if demand for any of the CARES Act facilities would have exceeded capped supply, and the Fed were forced to choose between different eligible participants. Because of the limited take-up of the pandemic facilities, this particular concern did not actually arise.

The "winners and losers" problem is an inherent issue with any Fed lending program and can pose a political threat to the independence of the Fed, particularly if the Fed is picking "winners and losers" among borrowers that pose significant credit risk rather than the Fed's more appropriate role of providing liquidity to solvent borrowers during a market-wide liquidity crisis.

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[94] TALF also limited this problem by excluding single-asset, single-borrower commercial mortgage-backed securities as eligible collateral. *See* Board of Governors of the Federal Reserve System, *Term Sheet for Term Asset-Backed Securities Loan Facility* (July 28, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a6.pdf.

[95] Federal Reserve, *Commercial Paper Funding Facility: Program Terms and Conditions* (Nov. 30. 2020), https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-terms-and-conditions; Federal Reserve, *Term Sheet for Primary Dealer Credit Facility (PDCF)* (March 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200317b1.pdf; Federal Reserve, *Money Market Mutual Fund Liquidity Facility* (Nov. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201130a2.pdf.

[96] *See, e.g.,* Victoria Guida & Zack Colman, *Fed's expansion of lending program sparks oil bailout worries*, Politico (April 30, 2020), https://www.politico.com/news/2020/04/30/feds-expansion-of-lending-program-sparks-oil-bailout-worries-227545 (Fed's relaxation of Main Street terms raises concerns about lobbying by oil-and-gas companies); Robert Schmidt, Jesse Hamilton, & Sally Bakewell, *Private Equity to Get Squeezed Out of Another Stimulus Program*, Bloomberg News (April 23, 2020) (private equity owned companies concerned that they would not qualify for Main Street facilities), https://www.bloomberg.com/news/articles/2020-04-23/private-equity-to-get-squeezed-out-of-another-stimulus-program?sref=2lCQoM0A.

[97] Federal Reserve, *Secondary Market Corporate Credit Facility* (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

[98] *Id.*

c. The Problem of Joint Responsibility

The current Section 13(3) framework gives Treasury the final say on any non-bank emergency lending by the Fed. But this arrangement makes it unclear where the responsibility for the design of any such facility actually lies, as between the Treasury and the Fed. Did the Treasury dictate the terms, or did it merely accede to terms proposed by the Fed? The current framework blurs the lines of political accountability, rendering it impossible to determine who should be responsible for the success and failure of lending programs. If the Fed shoulders the blame for failures that are properly the responsibility of Treasury, it could threaten the Fed's longstanding independence and its ability to exercise its traditional functions.

Treasury's role in the design of the emergency lending facilities was particularly evident in the case of the CARES Act facilities. A major driving force behind their structure and terms appears to have been Treasury's desire to minimize losses on its investments in the facilities. As noted above, Secretary Mnuchin emphasized that he did not expect Treasury to incur losses in connection with the CARES Act facilities.[99] Each of the CARES Act facilities featured a fixed cap on lending, with a leverage ratio set based on the perceived riskiness of the facility's loans. Specific terms governing participation in the CARES Act facilities also appear to have been designed to protect against credit risk. For example, as noted above, the Main Street facilities directed banks to make creditworthiness judgements about potential borrowers and required that eligible borrowers have a "pass" rating requirement for existing loans.[100] Perhaps the most direct evidence of Treasury's concern with incurring losses in connection with the CARES Act facilities was Treasury's reluctance to use the entire $454 billion Congress appropriated in the CARES Act. When the facilities were closed, $351.5 billion of that CARES Act funding had never been put at risk.[101]

Despite Treasury's apparent role in setting the terms of the pandemic emergency lending facilities, responsibility for the success and failure of the facilities remains murky. On the one hand, the Fed may have agreed with the program design, or even suggested it, being unwilling to step into fiscal territory. Vice-Chair Quarles testified before the Senate Banking Committee:

> We are required by law that we structure these facilities so that they are loans to entities that we <u>expect</u> to be repaid and that the various measures and metrics that we have included in the Main Street facility are designed to try to balance as broad a reach as we can while maintaining fidelity to the statutory requirements.[102]

In addition, the Congressional Budget Office (the CBO) estimated, "[b]ased in part on information from the [Fed] Board of Governors," that the budgetary impact of the appropriation to Treasury under the CARES Act would be zero, since income from the facilities would basically

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[99] Kate Davidson & Richard Rubin, *Steven Mnuchin Says U.S. Aims to Get Back Its Money From Fed Programs*, Wall Street Journal, Apr. 29, 2020, *available at* https://www.wsj.com/articles/mnuchin-says-u-s-not-aiming-to-lose-money-on-fed-lending-facilities-11588178749.

[100] Federal Reserve, *Term Sheet for Main Street New Loan Facility* (Apr. 9, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a7.pdf; Federal Reserve, *Term Sheet for Main Street Expanded Loan Facility* (Apr. 9, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a4.pdf.

[101] Federal Reserve, *Factors Affecting Reserve Balances*, Federal Reserve Statistical Release H.4.1 (Jan. 14, 2021).

[102] United States Committee on Banking, Housing, and Urban Affairs, *Oversight of Financial Regulators* (May 12, 2020), https://www.banking.senate.gov/hearings/05/12/2020/oversight-of-financial-regulators

offset any losses.[103] On the other hand, reports indicate that the Fed sought to soften the terms of the Main Street facilities and take more credit risk.[104] While some of the terms were, in fact, relaxed in subsequent revisions of the facilities' terms, they were not softened enough to make them attractive to borrowers.

Further challenges of joint responsibility were raised in connection with the closing of the CARES Act facilities. The Treasury ordered the Fed to close the facilities and return the Treasury's investments. Although the Fed was reluctant to do so, it ultimately did not resist. Under the existing Section 13(3) framework, both the Fed and Treasury are needed to approve any emergency lending facility at the outset and its continued operation. Thus, one of them—Treasury in this case—can shut it down unilaterally by refusing to extend it.

The question of responsibility is more acute when one considers what would have happened if the emergency lending facilities had failed entirely and the U.S. had been plunged into a depression. Who would have been held responsible, the Fed or Treasury? And who will be held responsible for future programs (or future failures)? Since the emergency lending facilities are nominally "Federal Reserve" programs, it is possible under the current framework that the Fed could unfairly take the blame for terms that are actually dictated by the Treasury, with the result that the Fed's future independence, even for traditionally independent functions like monetary policy and liquidity provision, could be threatened.

IV. A Revised Framework for Non-Bank Emergency Lending

To mitigate the problems highlighted in the existing framework, this section proposes, in the short term, increased disclosure in connection with the creation and operation of emergency lending facilities. Going forward, however, structural reform is needed. Under that framework, the Fed would continue to serve in its traditional function as the lender of last resort by providing emergency liquidity to non-bank financial institutions without significant credit risk and against good collateral. Treasury, on the other hand, should be solely responsible for emergency lending to non-banks that pose significant credit risk and thus implicate fiscal policy.

This section outlines what that division of authority would look like in practice. Treasury—not the Fed—would be the ultimate arbiter of whether emergency lending to non-bank financial institutions poses significant credit risk, based on factors including overall market conditions and the presence or absence of good collateral. If the Treasury determines that an emergency lending program would pose "significant credit risk," then the Treasury would determine whether to lend and the terms of such loans. If the Treasury determines that an emergency lending program would *not* pose significant credit risk, then the Fed would have the sole authority to determine whether to lend and the terms of such lending. In order to serve this novel emergency lending function, Congress should provide the Treasury with standing emergency lending authority, either in the form of an emergency lending fund—on the model of the current Exchange Stabilization Fund—or authority to guarantee loans made by the Fed acting in its capacity as the agent of Treasury.

[103] *See* Congressional Budget Office, *Preliminary Estimate of the Effects of H.R. 748, the CARES Act, Public Law 116-136*, (Apr. 27, 2020), *available at* https://www.cbo.gov/system/files/2020-04/hr748.pdf.
[104] Victoria Guida & Aubree Eliza Weaver, *Morning Money: We're in a recession, by the way*, Politico (June 9, 2020), *available at* https://www.politico.com/newsletters/morning-money/2020/06/09/were-in-a-recession-by-the-way-788358 ("People familiar with the matter tell [Morning Money] that the Treasury Department has been more cautious on taking risk than the Fed. They're the ones ponying up taxpayer dollars, so this makes some sense.").

a. Disclosure as a Short-Term Solution

A significant motivation for the revised framework is that responsibility for the structure and terms of emergency lending should be made clear. Responsibility for the design choices made with respect to the CARES Act facilities was unclear. The approach proposed here is structural: define in law the relative responsibility of the Treasury and Fed. Where the Treasury establishes the program, Treasury would be responsible; the Fed could only be charged with execution failures. Where the Fed lends to non-banks without significant credit risk, the Fed would be entirely responsible.

As an initial matter, there should be full disclosure under the existing framework as to whom, as between the Treasury and the Fed, is responsible for the design of the facilities. This would be difficult to do during the actual crisis but could be done after the crisis has subsided. At that time, the Treasury and Fed could be required to issue a joint statement, laying out responsibility for major decisions about the structure and terms of the facility. Such disclosure might still not adequately assign responsibility when decisions were the product of compromises between the Fed and Treasury. Accordingly, disclosure is an important but limited step in dealing with accountability. Structural solutions would still be necessary.

b. Structural Change in the Longer Term

1. The Threshold for Lending

A threshold question that arises in connection with the use of any lending facility, whether established by the Fed or the Treasury, is the standard for when it can be used. Under current law, the Fed (upon the vote of at least five of the seven Fed Board members) is only permitted to establish a Section 13(3) facility for non-banks in "unusual and exigent circumstances."[105] The term "unusual and exigent circumstances" is not defined by statute or regulation, and there is virtually no legal authority interpreting what market conditions might meet that standard. But the history of the Fed's invocation of Section 13(3) indicates that it was never understood to require a potential threat to the stability of the financial system as a whole. When the Fed invoked Section 13(3) after it was first given that authority, its concern was not systemic risk; rather the Fed acted based on evidence that a significant number of potential borrowers were being turned away by banks. Likewise, when the Fed authorized Section 13(3) lending again in the 1960s, its concern was not systemic risk, but a market disruption affecting the liquidity of nonmember banks (to which the Fed could not lend through the discount window).[106]

Under the proposed framework, the appropriate threshold governing when emergency lending facilities can be established should be lower than the possibility of a systemic collapse, consistent with the Fed's historical interpretation of the "unusual and exigent circumstances" threshold.[107] In particular, the threshold governing lending with significant credit risk by Treasury should not require a credit crisis that threatens the stability of the U.S. financial system for Treasury to intervene. Rather, Treasury should be empowered to act in the event that disruptions in

[105] Federal Reserve Act, §13(3)(A).

[106] See text accompanying notes 1–6. Adam J. Levitin, *In Defense of Bailouts*, 99 Georgetown L.J. 435, 496 (2011) ("[E]ven the "unusual and exigent circumstances" requirement does not necessarily indicate systemic risk, just market disruption.").

[107] Under current Section 13(13), the Fed can extend short-term loans to non-banks provided those loans are backed by Treasury securities or other debt that is fully guaranteed by the federal government. Federal Reserve Act, § 13(13). Although the Fed's Section 13(13) authority is not limited by statute to "unusual and exigent circumstances", the Fed has, by regulation, mandated that it can only exercise that authority in "unusual and exigent circumstances". 12 C.F.R. § 201.4(d)(13).

lending markets severely impair access to credit by borrowers in general or by borrowers in a broad-based sector of the economy, even if short of an emergency. That standard is consistent with the Fed's historical interpretation of the "unusual and exigent circumstances" threshold.[108]

2. Treasury's Responsibility for Lending with Significant Credit Risk

Loans to insolvent institutions and loans to institutions that have a substantial likelihood of becoming insolvent bear significant credit risk and should be regarded as implicating fiscal policy. Accordingly, under the proposed framework, the entire establishment and design of any such lending facility would lie with the fiscal authorities—the Congress and Treasury—and the facility should be identified as a "Treasury" facility. Of course, the Treasury should fully utilize the Fed's expertise in implementing any emergency lending program that poses significant credit risk. The Fed would continue to inform Treasury of market conditions and the need for action. But the responsibility for the design of the program and the lending terms would be with Treasury.

A key question is who should ultimately be responsible for making the determination whether lending poses significant credit risk. Since this determination could implicate the exercise of fiscal authority, Treasury should be the ultimate arbiter. Note that this differs from the United Kingdom's current arrangement, which—similar to the framework outlined here—distinguishes between emergency lending to "at-risk" firms (which requires Treasury approval) and normal lending (which does not).[109] The U.K.'s framework formally leaves the judgment as to whether firms are at risk to the Bank of England (the "**BoE**").[110] If the BoE determines that the borrower is not at risk, then it is free to lend without the approval of the HM Treasury. However, it is unclear in practice whether the BoE or HM Treasury would prevail under the U.K.'s framework in the event of a disagreement between the BoE and Treasury about whether a firm is at risk.

3. The Fed's Responsibility for Lending without Significant Credit Risk

To be clear, under the proposed framework, the Treasury would not be required to design and take responsibility for *all* facilities in which it determines there could be *any* credit risk. It might well decide, after consultation with the Fed about the anticipated design and terms of a potential facility, that the credit risk is not significant and let the Fed establish its own facility. If the Treasury determines a Fed facility does not pose significant credit risk, even in the absence of real collateral—for example, because it would only buy highly rated commercial paper issued by financial companies—then the Treasury could permit the Fed to establish its own facility. When Treasury permits the Fed to do so, it should disclose its reasons for doing so.

Ultimately, the decision about whether or not a proposed facility poses significant credit risk should be Treasury's to make. Where Treasury believes that a proposed facility poses significant credit risk—as was clearly the case with the Main Street facilities—Treasury would establish its own facility, identified as belonging to, and designed and controlled by, the Treasury.

[108] Under current Section 13(13), the Fed can extend short-term loans to non-banks provided those loans are backed by Treasury securities or other debt that is fully guaranteed by the federal government. Federal Reserve Act, § 13(13). Although the Fed's Section 13(13) authority is not limited by statute to "unusual and exigent circumstances", the Fed has, by regulation, mandated that it can only exercise that authority in "unusual and exigent circumstances". 12 C.F.R. § 201.4(d)(13).
[109] For a more detailed discussion of the U.K.'s emergency lending framework, see below text accompanying notes 122–123 and 133–137.
[110] Scott, *Connectedness and Contagion* at 112–114 (cited in note 3).

4. Does Lending Pose Significant Credit Risk?

On what basis should Treasury determine whether a lending program or facility involves significant risk of loss and thus, if so, should be the sole responsibility of the Treasury?

This is a difficult line to draw. A first criterion should be whether the lending takes place in an economic downturn or financial crisis where there are serious questions about the ability of borrowers to repay. Possible objective criteria can be used to determine whether this is the case. A second consideration is whether borrowers can provide adequate security, while recognizing that the existence of collateral does not by itself necessarily ensure lack of credit risk.

In all of the pandemic emergency lending facilities, only one—the Primary Dealer Credit Facility (the PDCF)—met the security requirement without any Treasury backing, since the dealers being financed were required to post high quality collateral. In fact, the collateral standards for the PDCF were equivalent to those used by the Fed for discount window lending.[111] Moreover, the Fed had recourse back against dealer participants in the event the collateral was insufficient to cover Fed losses.[112] The lack of significant credit risk in this facility was also underscored by the fact that institutions must meet high standards to qualify as primary dealers.[113] That there was no Treasury backing of this facility indicates that the Fed and Treasury believed that the dealer collateral and full recourse were adequate to protect against significant credit risk.

Unlike the PDCF, the other pandemic facilities lacked real security. In the case of the CPFF and the CARES Act facilities, Fed loans to the relevant SPV were merely backed by the assets purchased by the SPV, including unsecured debt, and the Fed only had recourse back to the SPV (which held the purchased assets), but no recourse back to the actual issuers whose debt the SPV purchased.[114] In the case of the MMLF, where no SPV was involved, and the Fed made loans directly to banks to purchase money market assets, including unsecured commercial paper, there was also effectively no security. The underlying assets that served as collateral were potentially unsecured and the Fed had no recourse back to the banks in the event the banks defaulted on their loans.[115]

We also recommend the prohibition outright of Fed lending to non-financial companies (as under Main Street) or purchasing the securities of non-financials (as under the CPFF, the

[111] *See. e.g.*, *Term Sheet for Primary Dealer Credit Facility (PDCF)* (Nov. 30, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201130a3.pdf ("The pledged collateral will be valued by Bank of New York Mellon according to a schedule designed to be similar to the margin schedule for lending by the discount window, to the extent possible.").

[112] Federal Reserve, *Term Sheet for Primary Dealer Credit Facility* (Jul. 28, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a8.pdf.

[113] Federal Reserve Bank of New York, *Primary Dealers, Expectations and Requirements*, https://www.newyorkfed.org/markets/primarydealers#:~:text=Be%20either%20(1)%20a%20broker,2)%20a%20state%20or%20federally (last visited Oct. 4, 2020).

[114] See: Federal Reserve, *Commercial Paper Funding Facility: Program Terms and Conditions* (Nov. 30. 2020), https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-terms-and-conditions; Federal Reserve, *Term Asset-Backed Securities Loan Facility* https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a6.pdf; Federal Reserve, *Primary Market Corporate Credit* Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf; Federal Reserve, *Secondary Market Corporate Credit Facility* (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

[115] Federal Reserve, *Money Market Mutual Fund Liquidity Facility* (Nov. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201130a2.pdf.

Secondary Market Corporate Credit Facility, and the Municipal Liquidity Facility). The assets of non-financial companies tend to be less liquid than those of non-financial companies; they are also less diversified than financial companies. As a result, they are more likely than financial companies to pose credit, rather than liquidity risk. The kind of lending the Fed engaged in through TALF would be more difficult to classify. On the one hand, the asset-backed securities to which the Fed was exposed through TALF included non-financial debt such as student and equipment loans; on the other hand, the loans made by TALF were to financial companies that were independent of the Fed.

c. Leverage and Funding

Under the proposed framework, Treasury's facilities could be implemented either through direct Treasury lending or through a Treasury guarantee of lending by another party, either the Fed or even private lenders. Importantly, any funds or guarantees provided by Treasury would have to be authorized by Congress. The Congress would, therefore, be able to limit the appropriation or guarantee however it sees fit. From a budgetary perspective, there is little difference between either approach. Under the Federal Credit Reform Act of 1990, both direct loans and loan guarantees by the federal government must be accounted for in the budget on an accrual, net-present-value basis.[116] That is how the $454 billion appropriation under the CARES Act was scored.[117] The treatment of a loan guarantee that, in the view of the CBO, exposed Treasury to an equivalent level of credit risk would receive the same treatment.

Since a crisis can materialize quickly and require immediate action, Congress should act in advance to give Treasury standing authority. If Congress takes action in advance, then it is far more likely that it would be in the form of a guarantee, likely with a cap, rather than an appropriation that might never be used. To the extent Congress caps the Treasury's ability to guarantee losses at a specific dollar figure, then the Treasury must be careful to limit guaranteed lending to its best conservative estimate of losses that would be within the limits set by Congress. If the losses still exceeded the guaranteed limit, then there would likely still be an implicit guarantee, as there currently is under the deposit insurance system, to cover excess losses, with the clear expectation that Congress would cover the overrun.

d. The Fed's Role as Treasury's Agent

The Treasury may need the Fed to execute Treasury programs as its agent, due to its connection to the bank distribution channels. If the Fed were involved in this capacity, it would only be responsible for its failure to execute in accord with Treasury directions. If tapped to administer a Treasury emergency lending program, however, the Fed should rightly insist that it be operationally equipped to run any emergency lending program that it is being required to administer. Lack of operational capacity was a problem for the Small Business Administration (the SBA) in administering the Paycheck Protection Program, the forgivable loan program for the smallest businesses authorized by the CARES Act. Technical problems hampered the SBA's ability to process loan applications efficiently, and its systems were quickly overwhelmed by the number of applications

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[116] Federal Credit Reform Act of 1990, P.L. 101-508, § 504 (1990). Previously, they were accounted for on a cash-flow basis. *See* Mindy R. Levit, *Budgetary Treatment of Federal Credit (Direct Loans and Loan Guarantees): Concepts, History and Issues for Congress*, Congressional Research Service 4–5 (June 24, 2014).

[117] Congressional Budget Office, *Preliminary Estimate of the Effects of H.R. 748, the CARES Act, Public Law 116-136* (cited in note 103).

for emergency loans, though the SBA was ultimately able to process more than 5 million first-round PPP loan applications.[118]

If the Treasury calls on the Fed to act in this capacity, the Treasury should have the authority to require the Fed to engage in emergency lending. Section 15 of the Federal Reserve Act gives the Treasury the authority to deposit "moneys held in the general fund of the Treasury" with the Federal Reserve Banks, "which banks, when required by the Secretary of the Treasury, shall act as fiscal agents of the United States."[119] Historically, the Federal Reserve Banks' role as fiscal agents has involved the provision of various financial services for the Treasury, such as redeeming government securities, processing payments to and from the federal government, monitoring collateral for Treasury funds, and maintaining the Treasury's bank account.[120] The Treasury could also invoke this authority to require Federal Reserve Banks to extend loans, using Treasury funds, to risky borrowers.[121]

The current U.K. framework gives HM Treasury the authority, in exceptional circumstances, with parliamentary oversight, to direct the BoE to make risky loans to entities that the BoE does not judge to be solvent, on terms that HM Treasury dictates.[122] In the event of such direction, the BoE is considered to be acting as the Treasury's agent. The funds are placed in a special purpose vehicle ("**SPV**") that is segmented from the BoE balance sheet, and the SPV and the BoE are indemnified by the Treasury for losses. This authority was invoked during the COVID-19 pandemic. The COVID Corporate Financing Facility, established by the BoE at the behest of HM Treasury, directed the BoE to purchase eligible commercial paper in the primary and secondary market, including from middle-market firms that had not previously issued commercial paper, on terms comparable to those prior to the crisis.[123]

Under our proposed framework, the U.S. Treasury should similarly be empowered, through an amendment to Section 13(3) to direct the Fed, acting solely as the Treasury's agent, to open an emergency lending facility for risky borrowers on terms that the Treasury dictates, provided that any losses are borne by the Treasury. Since a lending facility of this sort would pose significant credit risk, it would involve the exercise of fiscal power. The Fed should not have the power to block such fiscal measures because it disagrees with the need for them or their specific design or

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[118] Stephanie Ruhle & Ben Popken, *Thousands of applicants, zero loans: Trump's small businesses lending program is a failure to launch*, NBC News, Apr. 4, 2020, *available at* https://www.nbcnews.com/business/business-news/thousands-applicants-zero-loans-trump-s-small-businesses-lending-program-n1176766; Lauren Fox, *Glitches hamper second round of small business loan funding*, CNN, Apr. 27, 2020, *available at* https://www.cnn.com/2020/04/27/politics/state-of-play-paycheck-protection-program-small-business-administration/index.html.

[119] Federal Reserve Act, § 15.

[120] Donna A. DeCorleto & Theresa A. Trimble, *Federal Reserve Banks as Fiscal Agents and Depositories of the United States in a Changing Financial Environment*, 2004 Fed. Res. Bulletin 435, 436–37 (Autumn 2004).

[121] Operations of the Treasury's Exchange Stabilization Fund, which typically include buying and selling foreign currency but have also included short term loans to emerging market countries, are conducted through the Federal Reserve Bank of New York in its capacity as Treasury's fiscal agent. *Exchange Stabilization Fund*, Fedpoint (May 2007), https://www.newyorkfed.org/aboutthefed/fedpoint/fed14.html.

[122] HM Treasury, Bank of England, and Prudential Regulation Authority, *Memorandum of understanding on financial crisis management* §25 (2012), *available at* https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/resolution-planning-and-financial-crisis-management.pdf?la=en&hash=57D8302D2AE09F004E67BEF19A554547CAD2D47B.

[123] *See Letter from Rishi Sunak, Chancellor of the Exchequer HM Treasury, to Andrew Bailey, Governor of the Bank of England* (Mar. 17, 2020), *available at* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/873222/20200317_-_CX-Gov_Letter_re_CCFF_vF.pdf. *See also* Bank of England, *Covid Corporate Financing Facility*, https://www.bankofengland.co.uk/markets/covid-corporate-financing-facility (last visited Oct. 4, 2020).

terms. But the Fed should still be able to object on the ground that it does not have the operational capacity to carry them out. Granting the Treasury this authority, however, would require a revision of the current emergency lending framework. Section 15 is probably not sufficient authority, since it would not cover the case where the Treasury provides an indemnity as opposed to supplying the Fed with funds.

To the extent that a Treasury lending program enlists the Fed as the Treasury's agent, it again raises the concern with the Fed, an independent agency, picking winners and losers. To address that concern, Treasury programs should generally avoid delegating the Fed significant discretion to determine program eligibility, and any Treasury program that does so should make its terms clear and transparent. The Fed should then seek to operate the program to reduce the need to pick winners and losers by delegating authority to do so to a third party or operating on a strict first-come, first-serve basis.

e. Loans vs. Purchases

Pursuant to the revised framework proposed here, Congress should also clarify that the Fed's ability to provide emergency liquidity to non-bank financial institutions—either when doing so does not involve significant credit risk or when the Fed is acting as Treasury's agent for a fiscal program—is not limited to lending but also extends to the purchase of debt or other interests directly from issuers or on the secondary market. In other words, the Fed's ability to provide emergency support to non-bank financial institutions should depend on the substance of that support, not its form.

f. The Fed as Bank Regulator

In addition to its role conducting monetary policy and acting as a lender of last resort, the Fed is the most important bank regulator. In order to incentivize banks to use some of its facilities, such as the MMLF and its financing of bank loans to small businesses through the Paycheck Protection Program Liquidity Facility, the Fed (in its capacity as a bank regulator) specified that banks need not hold capital against assets acquired pursuant to these programs.[124] In addition, it exempted these assets from the Liquidity Coverage Ratio.[125]

Theoretically, the relaxation of these requirements increases the Fed's exposure to losses from riskier banks. While this may be unlikely in present circumstances, given what appears to be the strong capital and liquidity positions of the banks, together with the relatively small share of bank assets generated by these programs, there remains the conceptual concern that such actions do increase Fed credit risk. However, these are actions clearly within the Fed's regulatory authority. While one could argue that the Treasury should call the shots on regulatory relief to accompany

[124] Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Money Market Mutual Fund Liquidity Facility*, 85 Fed. Reg. 16232 (March 23, 2020); Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, *Regulatory Capital Rule: Paycheck Protection Program Lending Facility and Paycheck Protection Program Loans*, 85 Fed. Reg. 20387 (April 13, 2020).

[125] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation & Office of the Comptroller of the Currency, *Federal bank regulatory agencies modify liquidity coverage ratio for banks participating in Money Market Mutual Fund Liquidity Facility and Paycheck Protection Program Liquidity Facility* (May 5, 2020), *available at* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200505a.htm.

its own programs, the proposed framework would leave regulatory decisions where they normally lie, with the Fed.

g. Should the Revised Framework be Extended in Whole or in Part to Banks?

The proposed revision of the framework for non-bank emergency lending invites the question whether the revised framework should be extended to banks. On the one hand, the Fed's current authority allows it to engage in bank lending that poses significant credit risk, which might argue that the reform should be extended to emergency bank lending as well. On the other hand, in practice the Fed has not used its bank lending authority this broadly, and in fact has constrained it through its own regulation. That belies the necessity of significant changes to the Fed's existing authority to lend to banks.

Currently, emergency lending to banks is governed not by Section 13(3) of the Federal Reserve Act, but by Section 10B, the so-called "discount window". That statute only requires that emergency lending to banks be secured "to the satisfaction" of the Fed. This discretionary standard was the same one used in Section 13(3) before Congress amended that provision in the Dodd-Frank Act to require collateral that is sufficient to protect taxpayers from losses and is assigned a lendable value.[126] Section 10B currently allows the Fed—on its own, without Treasury approval—to make loans to at-risk (and even insolvent) banks at a premium rate, if it considers the collateral sufficient (although it rarely does so).[127] The Fed has imposed limitations on its discount window authority: under applicable regulations the Fed can only extend credit to undercapitalized banks if doing so is "consistent with a timely return to a reliance on market funding sources" or "would facilitate the orderly resolution of serious financial difficulties" of the bank.[128]

In addition, Section 10B sets time periods beyond which the Fed cannot lend to undercapitalized banks without incurring a potential liability to the Federal Deposit Insurance Corporation (the "**FDIC**"). Specifically, subject to certain exceptions, the Fed is required to make the FDIC whole for losses incurred as a result of the Fed lending to: (i) any undercapitalized bank for more than 60 days in any 120-day period; or (ii) any critically undercapitalized bank beyond the fifth day after the institution becomes critically undercapitalized.[129] The Fed's liability to the FDIC is capped at the lesser of: (i) the loss the Fed would have incurred if the increased lending beyond the specified time period had been unsecured; and (ii) the interest earned by the Fed on the increased lending beyond the specified time period.[130] The Fed is required to report to Congress any liability it incurs to the FDIC as a result of lending to an undercapitalized bank within six months

[126] Scott, *Connectedness and Contagion* at 91–92 (cited in note 3).
[127] 12 C.F.R. § 201.4(a) ("A Federal Reserve Bank may extend primary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is in generally sound financial condition in the judgment of the Reserve Bank."); § 201.4(b) ("A Federal Reserve Bank may extend secondary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is not eligible for primary credit…"); §§ 201.104–110 (describing eligible collateral for discount window loans). In nearly two decades, the highest average weekly usage of the Fed's secondary credit facility was less than $1 billion. See Board of Governors of the Federal Reserve System (US), Assets: Liquidity and Credit Facilities: Loans: Secondary Credit: Week Average, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WSC, February 5, 2021.
[128] 12 C.F.R. § 201.4(b).
[129] Federal Reserve Act, § 10B(b). These limitations were added by Section 142 of the Federal Deposit Insurance Corporation Improvement Act of 1991, in response to concerns that the Fed's discount lending would impose losses on the FDIC by keeping banks afloat long enough for uninsured depositors to withdraw their money from insolvent banks. *See* Frederic S. Mishkin, *Evaluating FDICIA* 17 (Dec. 1996), https://www0.gsb.columbia.edu/faculty/fmishkin/PDFpapers/FDICIA96.pdf.
[130] Federal Reserve Act, § 10B(b)(3)(B).

of incurring it.[131] These consequences reflect Congress' past concerns with the Fed making risky loans to banks. It appears that the Fed may design its lending to banks to avoid being penalized and disclosing that they have done so.[132]

It is worth noting that the U.K. restricts emergency lending to banks and non-banks in the same way. The U.K. approach emerged out of a confusion of roles between the BoE and HM Treasury in the 2008 financial crisis, particularly as it concerned the rescue of Northern Rock.[133] Under the current arrangement, the U.K. divides emergency lending authority into two parts. First, there is *normal* lending to banks and other borrowers specified by the BoE, a list which now includes primary dealers, broker-dealers, and central counterparties. It appears that BoE, on its own, can further expand this category at its discretion. Second, there is *emergency lending* to banks and non-banks.[134] In the U.K., emergency lending is governed by a Memorandum of Understanding between BoE and the Treasury,[135] which permits the BoE to make loans to solvent but "at risk" firms with the approval of the Treasury. It appears, despite the absence of published guidance on the point, that Treasury approval would come with a Treasury indemnity of BoE losses.[136] (As noted above, the current U.K. framework also gives HM Treasury the further authority, in exceptional circumstances, to direct the BoE to make loans to entities that the BoE does not judge to be solvent on terms dictated by HM Treasury.[137])

That said, there does not appear to be any compelling reason to extend our proposed revised emergency lending framework to banks. The Fed has used its discount window authority appropriately, constrained by its regulations and historical practice, to engage in liquidity provision by lending against good collateral. Moreover, extending the revised framework to banks would require involving Treasury in bank lending, historically an area where the Fed has had broad autonomy. Accordingly, the Fed should continue to remain independent and able to make any loans to banks without the approval of the Treasury.

V. Conclusion

In response to the COVID-19 pandemic, the Federal Reserve assumed a novel role: engaging in *credit* provision rather than *liquidity* provision, particularly with respect to lending to non-

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[131] Federal Reserve Act, § 10B(b)(3)(D).

[132] *See* R. Alton Gilbert, Kevin L. Kliesen, Andrew P. Meyer, & David C. Wheelock, *Federal Reserve Lending to Troubled Banks During the Financial Crisis, 2007-2010*, 94 Federal Reserve Bank of St. Louis Review 221 (May/June 2012) (the Fed limited lending to undercapitalized and critically undercapitalized banks during the financial crisis).

[133] *See* Ian Plenderleith, *Review of the Bank of England's provision of emergency liquidity assistance in 2008–09* 51 (Oct. 2012), *available at* https://www.bankofengland.co.uk/-/media/boe/files/news/2012/november/the-provision-of-emergency-liquidity-assistance-in-2008-9. "The purpose of this review is to learn lessons to inform the way the Bank conducts ELA operations for individual financial institutions. Such support operations will, in due course, be conducted under the new Crisis Management Memorandum of Understanding, which was published in January 2012. The review will build on the lessons learned in relation to the ELA provided to Northern Rock in 2007, as set out in the Treasury Committee's report 'The Run on the Rock'"; *See also* Bank of England, *Court of the Bank of England commissions a set of reviews to learn lessons* (May 21, 2012), *available at* https://www.bankofengland.co.uk/-/media/boe/files/news/2012/may/court-of-the-boe-commissions-a-set-of-reviews-to-learn-lessons.

[134] Financial Services Act of 2012, c. 21, Part 4, *available at* http://www.legislation.gov.uk/ukpga/2012/21/part/4/enacted; HM Treasury, Bank of England and Prudential Regulation Authority, *Memorandum of understanding on financial crisis management* at §1 (cited in note 122).

[135] *Id.*

[136] Scott, *Connectedness and Contagion* at 112–114 (cited in note 3).

[137] HM Treasury, Bank of England, and Prudential Regulation Authority, *Memorandum of understanding on financial crisis management* at §25 (cited in note 122).

financial companies. This unprecedented intervention has raised the concern that the Fed was engaged in fiscal policy, which is properly the sphere of elected authorities. Because of limits placed on the Fed's non-bank lending authority by the Dodd-Frank Act, when the Fed assumed the role of the credit provider of last resort, it did not do so on its own; it needed the approval of and financial backing from the Treasury, with funds appropriated by Congress in the CARES Act. Collaboration between the Fed and Treasury blurred the lines of political accountability, raising concerns that the Fed might bear the blame for failures that are the responsibility of the Treasury. In the short run, absent legislative change, there needs to be much more transparency about the relative responsibility for Section 13(3) facilities as between the Fed and the Treasury.

In the longer run, this report proposes a revised framework for emergency lending to non-banks, including purchases of non-bank debt and lending to non-financial companies. Within this framework, emergency non-bank lending that presents significant credit risk should be viewed as constituting fiscal policy and be the sole purview of the Treasury. The arbiter of whether significant credit risk is present would be the Treasury.

The Treasury would manage lending facilities that pose significant credit risk, with the Fed serving only in an advisory and operational role. In our view, lending to non-financial companies should be regarded per se as involving significant credit risk and be the sole purview of the Treasury. The Treasury would also have the power to direct the Fed, acting solely in its capacity as the Treasury's agent, to make loans, purchase assets or even operate an emergency lending facility, provided the Fed is operationally equipped to carry out the Treasury's direction. The Fed, on the other hand, would continue to be responsible for emergency non-bank lending and asset purchases that *do not* pose significant credit risk. Finally, the report considers whether the proposed framework should be extended to emergency lending to banks and concludes that there is no compelling reason to alter the current framework for bank lending.

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