# LEGAL AUTHORITY IN UNUSUAL AND EXIGENT CIRCUMSTANCES: THE FEDERAL RESERVE AND THE FINANCIAL CRISIS

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*This Article considers the scope of the Federal Reserve's emergency loan-making powers and analyzes their use during the recent financial crisis. It argues that many of the Fed's responses to the crisis exceeded the bounds of its statutory authority.*

*In unusual and exigent circumstances, § 13(3) of the Federal Reserve Act empowers the Fed to provide an uncapped amount of liquidity to the financial system. It may, with the approval of the U.S. Treasury, establish programs of broad-based eligibility and lend freely against sufficient collateral. Before its amendment by the Dodd-Frank Wall Street Reform and Consumer Protection Act, § 13(3) also allowed the Fed, acting alone, to extend credit to particular individuals, partnerships, and corporations. From 2008 to 2009, the Fed invoked this authority repeatedly to purchase assets, lend money, and establish schemes that sought to restore market stability. However, this Article argues that § 13(3) was and remains a loan-making power of narrowly defined scope. On this view, the Fed's asset purchases and certain of its lending activities raise great concerns. The impact of these concerns has yet to be addressed in the literature.*

*This Article first looks to the history of § 13(3) by tracing the development and use of the legislation. It then examines the transactional structures that the Fed created during the crisis and assesses these against the scope of its § 13(3) powers. Next, it evaluates the case for reform with which Congress was confronted, and its response in the Dodd-Frank Act. It concludes that the reforms to § 13(3) that the Act makes are to be welcomed overall, even though a key ambiguity remains in the statute.*

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*Finally, it traces the Fed's new authority in the area of systemic risk regulation.*

## I. INTRODUCTION

Section 13(3) of the Federal Reserve Act is a powerful legislative provision. At present, it empowers the Federal Reserve (the "Fed"), in unusual and exigent circumstances, to provide an uncapped amount of liquidity to the financial system. With the approval of the Treasury, the Fed may establish programs of broad-based eligibility and lend freely against sufficient collateral.

Before the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), § 13(3) was broader in scope. It permitted the Fed to provide credit to particular individuals, partnerships, and corporations. During the financial crisis of 2008-2009, the Fed used § 13(3) extensively. It made loans to some financial institutions and bought assets from others. It established broader schemes, open to a number of institutions, in order to restore market stability. And in at least one case, it refused to provide any credit, resulting in the failure of a major investment bank.

This Article has two goals. The first is to argue that many of the Fed's actions during the financial crisis exceeded the bounds of its statutory authority. This argument has yet to receive any sustained analysis in the literature. However, it is one with which Congress now appears to have agreed. The Article's second goal is to evaluate the most recent reforms of § 13(3) contained in the Dodd-Frank Act. These have the express purpose of realigning the Fed's role with that of a lender of last resort. They also seek to address various concerns about the scope of the Fed's authority.

Parts II and III of this Article trace the use and development of § 13(3) from its enactment to the time of the financial crisis. The purpose of Part IV is to set out the Fed's responses to the financial crisis and to analyze these against the scope of its § 13(3) powers.

Part V then seeks to ascertain the intended purpose of § 13(3). It considers the case for reform with which Congress was faced. It then goes on to evaluate the changes to § 13(3) made by the Dodd-Frank Act in light of the legislature's vision for § 13(3) – secured lending against sufficient collateral – and the Fed's departure from that vision. It examines an important ambiguity that remains in the statute. And finally, it demonstrates that the Fed's assumed responsibility for resolving systemic solvency risks now lies primarily in the province of another entity.

## II. THE FED'S POWERS: § 13(3) OF THE FEDERAL RESERVE ACT

In this Part, we will consider § 13(3) as it stood at the time of the financial crisis of 2008-2009. This approach will allow us to evaluate the legality of the Fed's actions during this period. Furthermore, when we come to assess the impact of the Dodd-Frank Act in Part V below, we will also be in a position to understand the key concerns to which Congress sought to respond.

At the time of the financial crisis, § 13(3) of the Federal Reserve Act (the "FRA") provided:

> In *unusual and exigent circumstances*, the Board of Governors of the Federal Reserve System, *by the affirmative vote of not less than five members*, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title,[1] to *discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange* when such notes, drafts, and bills of exchange are *indorsed or otherwise secured* to the satisfaction of the Federal reserve bank: *Provided,* that before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is *unable to secure adequate credit accommodations from other banking institutions*. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.[2]

1. 12 U.S.C. § 357 (2006). Section 357 empowers Federal Reserve Banks to set rates of discount. This provision states that each reserve bank may "establish from time to time, subject to review and determination of the Board of Governors of the Federal Reserve System, rates of discount to be charged . . . for each class of paper, which shall be fixed with a view of accommodating commerce and business, but each such bank shall establish such rates every fourteen days, or oftener if deemed necessary by the Board." § 357.

2. Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006). With the exception of the word "Provided," all emphasis is added.

For further discussion of § 13(3) and the other legal authority that the executive invoked during the crisis, *see generally* John M. Brandow et al., Davis Polk, Financial Crisis Manual, A Guide to the Laws, Regulations and Contracts of the Financial Crisis (2009), *available at* http://www.davispolk.com/files/Publication/d1ab7627-e45d-4d35-b6f1-ef356ba686f2/Presentation/PublicationAttachment/2a31cab4-3682-420e-926f-054c72e3149d/fcm.pdf (providing an overview of the events of the financial crisis and describing the pre-reform U.S. laws, regulations, and contracts relevant to financial institutions); Thomas Porter, *The Federal Reserve's Catch-22: A Legal Analysis of the Federal Reserve's Emergency Powers*, 13 N.C. BANKING INST. 483 *available at* http://www.law.unc.edu/documents/journals/articles/85.pdf (discussing the legal basis for the Bear Stearns bailout and the policy issues raised thereby); Christian A. Johnson, *Exigent*

This provision empowered the Fed to lend to "any individual, partnership, or corporation."[3] In more precise terms, the Fed could, *in unusual and exigent* circumstances, *discount* financial instruments for *such individuals, partnerships, or corporations* as were *unable to secure adequate credit* from other banks.[4] The financial instruments had to be *indorsed or otherwise secured*.[5] The process required the *affirmative vote of not less than five members*.[6] We will consider each of these statutory requirements in turn. Where appropriate, we will use the present tense to indicate features that remain in the statute.

### *A. Discounting*

Under § 13(3), the Fed[7] could authorize its Reserve Banks to *discount*

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*and Unusual Circumstances: The Federal Reserve and the U.S. Financial Crisis*, EUR. BUS. ORG. L. REV. (forthcoming 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1584731 (considering the Federal Reserve's responses to the crisis and assessing various options for reform); and Steven M. Davidoff & David T. Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (analyzing the way in which the government's deal-making during the financial crisis interacted with its legal authority).

3. Federal Reserve Act § 13(3).
4. *Id.*
5. *Id.*
6. *Id.*
7. The Federal Reserve System is the central banking system of the United States. It comprises a group of Federal Reserve Banks, which are overseen by a Board of Governors. Banks with federal charters ("national banks") must join. Banks with state charters ("state banks") may choose whether or not to join. *See generally* 12 U.S.C. §§ 222-223 (2010); RICHARD SCOTT CARNELL ET AL., THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 12-13 (4th ed. 2009). The text that follows will use the term the "Federal Reserve" and its abbreviation, the "Fed", interchangeably. However, references to the Fed's actions will refer primarily to those of its Board of Governors.

The Federal Reserve Banks are the means by which the Fed operates the payment system and implements its decisions on monetary policy. There is a Reserve Bank in each of twelve geographical districts in the United States. 12 U.S.C. §§ 222–223. Each has a nine-member board of directors. 12 U.S.C. § 302. Reserve Banks hold reserves on behalf of their member banks. 12 U.S.C. § 461. Member banks, in turn, own shares in Reserve Banks. 12 U.S.C. § 321–323.

The Board of Governors is an agency of the federal government. It has seven members, who are appointed by the President and confirmed by the Senate. 12 U.S.C. § 241. The Board has two main functions. First, it regulates state member banks and bank holding companies (and it oversees Reserve Banks). 12 U.S.C. § 248. The Fed shares its regulatory role with other agencies. The Office of the Comptroller of the Currency regulates national banks. § 1. The Federal Deposit Insurance Corporation regulates state nonmember banks. 12 U.S.C. § 266. A number of state agencies also oversee state banks. CARNELL ET AL., *supra*, at 61-63. Consumer protection is another facet of banking regulation. The Fed has authority under certain statutes to promulgate regulations for this purpose. *See, e.g.*, 12 C.F.R. § 226 (2010) (codifying Regulation Z, implementing the Truth in Lending Act); CARNELL ET AL., *supra*, at ch. 7.

certain financial instruments (notes, drafts, and bills of exchange) for any individual, partnership, or corporation.[8] The process of discounting has a precise meaning in this context. A discount is a loan.[9] When a bank

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The Board's second function is to implement monetary policy. It does so in two ways. The first is by means of its *open-market operations*. These involve the purchase and sale of U.S. government securities. David H. Small & James A. Clouse, *The Scope of Monetary Policy Actions Authorized Under the Federal Reserve Act* 1 (FEDS Working Paper No. 2004-40, 2004), *available at* http://ssrn.com/abstract=622342. In this way, the Fed is able to increase or decrease, respectively, the amount of money available in the economy. *Id.* These operations are directed by the Federal Open Market Committee (which consists of Reserve Bank presidents and members of the Board). 12 U.S.C. § 263. The second is by providing credit to banks at the *discount window* (which is operated by Reserve Banks).

The discount window provisions are contained in Federal Reserve Act § 13(2) and certain other provisions of the Act. These provisions indicate that Reserve Banks may make loans to banks against eligible collateral. Small & Clouse, *supra*, at 11. The term *discount window* should be distinguished from the process of *discounting* (i.e., loan-making). This does take place at the discount window, but it need not. It may also take place under the Federal Reserve Act § 13(3) (under which the collateral requirements are not so strict). *See infra* note 10.

8. Section 13(3) is not the only provision under which the Fed can make loans to nonbanks. 12 U.S.C. § 347(c) permits lending to nonbanks so long as they provide Treasury or agency securities as collateral. There is no requirement of unusual and exigent circumstances. However, because of the demanding collateral requirement, this provision would be of limited use in such circumstances. Small and Clouse point out that entities that hold such instruments could easily sell them in the open market. Small & Clouse, *supra* note 7, at 14.

9. BLACK'S LAW DICTIONARY 374 (2nd ed. 1910), *available at* http://books.google.com/books?id=R2c8AAAAIAAJ&pg=PA374. Black's defines a discount as "the taking of interest in advance." *Id.* (citing Fleckner v. Bank, 21 U. S. 338 (1823) ("A discount by a bank means a 'drawback or deduction made upon its advances or loans of money, upon negotiable paper or other evidences of debt . . . ."); Weckler v. First Nat'l Bank, 42 Md. 581, 592 (Md. 1875) ("The ordinary meaning of the term 'to discount' is to take interest in advance, and in banking is a mode of loaning money. It is the advance of money not due till some future period, less the interest which would be due thereon when payable."); and City Bank of Columbus v. Bruce, 17 N.Y. 507, 515 (N.Y. 1858) ("Discounting of a note by a bank is understood to consist in the lending of money upon it, and deducting the interest or premium in advance.")). The Dictionary also references *Nat'l Bank v. Johnston*, in which a discount was explained to be "the difference between the price and the amount of the debt, the evidence of which is transferred. That difference represents interest charged . . . ." 104 U.S. 271, 276 (U.S. 1881). *Cf.* 12 U.S.C. § 355 and discussion *infra* Part IV.A.1.ii (discussing purchases rather than discounts).

Section 13(3) was enacted on July 21, 1932. 12 U.S.C. § 343. The 1910 edition of Black's is the closest edition to this date that contains an entry for "discount." The term is not defined in the third edition (1933). *See also* Reves v. Ernst & Young, 494 U.S. 56, 77 (U.S. 1990) Rehnquist, C.J, dissenting on the facts) ("In construing any terms whose meanings are less than plain, we depend on the common understanding of those terms at the time of the statute's creation.")

In *Reves*, the majority of the Court held that certain demand notes issued by the Farmer's Cooperative of Arkansas and Oklahoma were securities within the meaning of § 3(a)(10) of the Securities Exchange Act of 1934. *Id.* at 70. Furthermore, the majority held

discounts a financial instrument for a borrower, it accepts that instrument as collateral and then lends out a sum of money that is less than the face value of the instrument.[10] In this way, the bank obtains an interest payment in advance.[11] There is a clear difference between a loan and an asset purchase. In a secured loan transaction, the borrower receives a loan and provides collateral. Ownership of this collateral remains in the borrower. The lender obtains only a security interest: the right to have recourse to these assets if the borrower defaults. In a purchase, on the other hand, the purchaser obtains ownership of an asset once the transaction has been completed.[12]

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that the exemption in that provision for "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months" did not apply to demand notes, because demand could potentially be made "many years or decades into the future." *Id.* at 73. In dicta, there is also some discussion, not of immediate relevance, as to whether this statutory exemption applies only to commercial paper. *Id.* at 70-71, 74-76, 79-82. Chief Justice Rehnquist, speaking for the minority, cited the third edition of Black's Law Dictionary and a legal treatise by Bigelow in support of the proposition that demand notes have an immediate maturity at the time of their issuance, and so come within the statutory exemption. *Id.* at 77. The majority rejected this argument, holding that that these sources articulated rules of state law, which could not provide an answer to the federal question before the Court. *Id.* at 72. In the present case, however, there is specific federal precedent as to the meaning of the term "discount."

10. Discounting for *banks* takes place at the discount window. Discounting for *nonbanks* takes place under § 13(3). When a Reserve Bank makes a discount at the discount window, it provides credit to a bank and takes as collateral "eligible paper representing loans made by the [bank] to its own customers." HOWARD HACKLEY, LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY 83 (Board of Governors of the Federal Reserve System 1973). Eligible instruments are primarily those that are issued or used for agricultural, industrial, or commercial purposes. 12 U.S.C. § 343 (2006). On the other hand, when a Reserve Bank makes a § 13(3) loan to a nonbank, the collateral requirements are not so strict. *See infra* Part III.A.

Certain instruments other than those set out in Federal Reserve Act § 13(2), 12 U.S.C. § 343 (2006) are also eligible for discount at the discount window. These are demand bills of exchange relating to the domestic shipment of agricultural goods, 12 U.S.C. § 344, acceptances relating to the shipment of goods and acceptances to create dollar exchanges, 12 U.S.C. § 346, and notes drawn for an agricultural purpose, 12 U.S.C. § 348. *See also* Small & Clouse, *supra* note 7, at 11 (discussing the permissible scope of discount-window lending).

11. The discount differs from the *haircut* that the bank applies to the value of the collateral. The haircut compensates the bank for the risk of default. Small & Clouse, *supra* note 7, at 13 n.29.

12. *See* Farmers & Mech. Bank v. Baldwin, 23 Minn. 198, 206 (Minn. 1876) ("Discounting a note and buying it are not identical in meaning, the latter expression being used to denote the transaction 'when the seller does not endorse the note, and is not accountable for it . . . .'" (quoting 1 Bouv. Law Dict. title *Discount*, citing Pothier, De l' Usure, 128)).

The point here is that when an instrument is discounted for a borrower (under a recourse loan transaction), he remains liable for any shortfall in the value of his collateral. When an instrument is purchased from a borrower, he is no longer liable for any shortfall. However, there is one case in which a loan can have the same effect as an asset purchase.

### B. *Notes, drafts, and bills of exchange*

Three types of financial instruments are eligible for discount under § 13(3). These are notes, drafts, and bills of exchange. A *note* is an unconditional promise to pay.[13] This is a two-party instrument in which A promises to pay B.[14] Both *drafts* and *bills of exchange*, which are synonymous terms, constitute orders to pay.[15] These are three-party instruments in which A orders that B make a payment to C.[16] Notes, drafts, and bills of exchange are all credit instruments. It has been stated that this list provides "virtually no restrictions on the form a written credit instrument must take in order to be eligible for discount."[17] However, corporate shares, which are not credit instruments, would appear to be ineligible for discount under § 13(3).[18]

### C. *Unusual and exigent circumstances*

A § 13(3) discount may only occur when circumstances are both unusual and exigent. This appears to be an objective test. The terms are not defined in the statute, but it is evident that they set a high threshold. In the event that the Fed determines that unusual and exigent circumstances exist, there is no statutory requirement that it announce this publicly. A strong argument against such an obligation is that the announcement may have a negative effect on market confidence and so catalyze a self-fulfilling prophecy.[19]

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This is when a bank makes a *non-recourse* loan to a borrower who defaults. Here, the bank will end up with ownership of the collateral in the same way as if it had purchased it. However, there is a conceptual distinction between these two transactions. In a loan transaction, the bank's goal at the outset is to lend money against the borrower's collateral, not to acquire it. The bank makes the loan on the understanding that there is *some* chance that it will be repaid.

13. U.C.C. §§ 3-103, 3-104 (2005); 3 WEST'S ENCYCLOPEDIA OF AMERICAN LAW 15–16 (2nd ed. 2005);. Small & Clouse, *supra* note 7, at 26-27.

14. 3 WEST'S ENCYCLOPEDIA OF AMERICAN LAW 15. Here, A is the *maker* and B is the *payee*. *Id*.

15. *Id.* at 16.

16. *Id*. Here, A is the *drawer*, B is the *drawee*, and C is the *payee*. A commonly used type of draft is a check, in which case a bank is the drawee. *Id.*

17. Small & Clouse, *supra* note 7, at 15.

18. Small and Clouse indicate that shares may constitute permissible collateral under § 10B of the FRA. Small & Clouse, *supra* note 7, at 12. However, this provision is concerned with the Fed's power to make an *advance*. In the case of an advance, a borrower provides his own promissory note (rather than making a pledge of third-party indebtedness). *See infra* note 79.

19. Thomas C. Baxter, Jr., Gen. Counsel, Fed. Res. Bank of N.Y., The Legal Position of the Central Bank, The Case of the Federal Reserve Bank of New York 6 (Jan. 19, 2009), http://lse.ac.uk/fmg/documents/events/conferences/2009/regulatoryResponse/1160_Baxter.p

### *D. For such individual, partnership, or corporation*

The Fed could lend to any individual, partnership, or corporation.[20] It is important to emphasize a feature of the statutory language contained in the proviso. Before extending credit to an individual, partnership, or corporation, the Reserve Bank had to obtain evidence that *such* individual, partnership, or corporation was unable to secure adequate credit accommodations from other banking institutions. Hence the recipient of the loan had to be the same party that was unable to obtain credit from elsewhere.[21]

### *E. Unable to secure adequate credit from other banks*

Normally, a borrower is "unable to secure adequate credit accommodations from other banking institutions"[22] *because* circumstances are unusual and exigent – and so in practice, these two requirements are fulfilled together.

### *F. Indorsed or otherwise secured*

Any financial instruments to be discounted must be indorsed (endorsed) or otherwise secured to the satisfaction of the Reserve Bank. The process of *endorsement* aims to provide the Bank with a measure of protection against loss. When a party unqualifiedly endorses commercial paper, it assumes secondary liability on that paper.[23] Following endorsement, the Bank can bring a claim against the endorser in the event

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20. A subsidiary issue, as Gordon and Muller point out, is whether the Fed can lend to a limited liability company (as it did in some of the cases to be considered below). Is this an individual, partnership, or corporation? The LLC form did not exist when the statute was amended in 1932. Even so, they look to the history of the bill, and note that it was expanded at a later stage to include "partnership." Jeffrey N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management* 41 (European Corporate Governance Institute Working Paper Series in Finance, Paper No. 277, 2010), *available at* http://ssrn.com/abstract=1553880. They suggest that "corporation" should also be read broadly. *Id.* This approach seems persuasive.

21. *But see infra* Part IV.A.1.ii (considering the argument that "such individual" may refer to not only the immediate borrower but also the beneficiary—the ultimate borrower).

22. Federal Reserve Act § 13(3).

23. WEST'S ENCYCLOPEDIA OF AMERICAN LAW, *supra* note 13, at 20 (discussing the process of unqualified endorsement and explaining that secondary liability occurs "when the individual who has the primary duty to pay defaults on his or her obligation."). *See also* U.C.C. § 3-204 (2005) (indicating that by endorsing an instrument, a party may incur liability on that instrument); HACKLEY, *supra* note 10, at 129 (indicating that under § 13(3), banks can seek repayment by resort to security or the endorsement of a third party).

that the issuer of the paper does not pay.[24]

An alternative way for a Reserve Bank to protect itself (and satisfy the statutory requirements) is to take some *security* for its loan. The phrase "secured to the satisfaction of" indicates that a Reserve Bank has some measure of discretion in the collateral it chooses to accept. But it does not follow that the Reserve Bank enjoys absolute discretion. It would seem that the borrower has to provide *some* appropriate security for the loan. If the Fed could make loans against no collateral, this would negate the statute's express reference to some security.[25]

### G. *By the affirmative vote of not less than five members*

This requirement relates to the voting procedure. At least five of the seven members of the Fed's Board of Governors must affirmatively vote to authorize the extension of credit by a Federal Reserve Bank.

Another section of the statute, § 11(r), provides an alternative voting procedure for cases where fewer than five members of the Board are available. If the Fed determines that emergency action is necessary to prevent serious harm to the financial system, there can instead be a unanimous vote by at least two members of the Board. The Fed used this procedure in one case.[26]

## III. THE HISTORY OF § 13(3)

We are now in a position to consider how § 13(3) developed and how it was used before the financial crisis. The legislative history indicates that the provision as enacted contained three important restrictions. These would have precluded many of the Fed's responses to the financial crisis, had they not been removed by a series of amendments. The provision's historical use reflects a similar point. Before 2008, the Fed used § 13(3) only sparingly. Loans were made only from 1932 to 1936, and these were limited in number.

24. *Id.* Can a borrower under § 13(3) endorse a note that it itself has issued? It would appear not. Such a transaction would constitute unsecured lending (backed only by the borrower's bare promise to pay). This goes against the requirement that a loan be endorsed or *secured* to the satisfaction of the Reserve Bank. Furthermore, such a transaction resembles an advance. *See infra* note 79.

25. *But see infra* Part IV.A.2 (assessing the argument that the Commercial Paper Funding Facility constituted an example of unsecured lending under § 13(3)).

26. *See infra* note 66 and accompanying text (discussing the Fed's overnight loan to Bear Stearns).

### A. *The legislative history of § 13(3)*

The Fed was first granted its § 13(3) lending powers by an amendment in the Emergency Relief and Construction Act of 1932.[27] Section 210 of this statute provided:

> Section 13 of the Federal Reserve Act, as amended, is further amended by adding after the second paragraph thereof the following new paragraph:
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> In unusual and exigent circumstances, the Federal Reserve Board, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, *notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount for member banks under other provisions of this Act* when such notes, drafts, and bills of exchange are *indorsed and otherwise* secured to the satisfaction of the Federal reserve bank: *Provided,* That before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Federal Reserve Board may prescribe.[28]

The *first* restriction in § 13(3) as enacted was that before a Federal Reserve Bank could discount a financial instrument, the instrument had to be "indorsed and otherwise secured" to the Bank's satisfaction. Even though the text appears to be both conjunctive and disjunctive ("and otherwise"), it was arguable that the collateral had to be *both* endorsed and secured. This constraint was modified by § 322 of the Banking Act of 1935, which replaced "and" with "or."[29] Thereafter, a Reserve Bank could accept either an endorsement or some security.

The *second* restriction in § 13(3) as enacted was more significant. A Federal Reserve Bank could discount for an individual only those financial instruments "of the kinds and maturities made eligible for discount for member banks."[30] This meant that loans to individuals, partnerships, and

27. Ch. 520, 47 Stat. 709 (1932) (providing for a public works program to create employment and extending the powers of the Reconstruction Finance Corporation, a government agency that made loans to banks and other companies).

28. *Id.* With the exception of "*Provided*," all emphasis is added.

29. The Banking Act of 1935, 12 U.S.C. § 228 (1935).

30. Federal Reserve Act § 13(3).

corporations were subject to the same collateral requirements as loans to member banks.

Lending to member banks takes place at a Reserve Bank's discount window.[31] Under the Federal Reserve Act § 13(2), Reserve Banks may accept as collateral notes, drafts, and bills of exchange that have been "issued or drawn for agricultural, industrial, or commercial purposes," or that have proceeds that will be used for such purposes.[32] Such instruments must have a maturity period of no more than ninety days.[33] Furthermore, instruments "issued or drawn for the purpose of carrying or trading in stocks, bonds or other securities," other than Treasury securities, are expressly ineligible for discount.

By specifying the collateral eligible for discount, the legislation as enacted limited the Fed's ability to extend credit to investment banks and other similar firms under § 13(3). The majority of their assets consist of investment instruments, against which no loans could then be made.

This constraint was abolished by § 473 of the Federal Deposit Insurance Corporation Improvement Act (the "FDICIA").[34] This provision

31. Federal Reserve Act § 19(e), 12 U.S.C. § 463 (1913) (stating that non-member banks could receive loans indirectly through member banks, but only with the Fed's permission). *Cf.* Federal Reserve Act § 19(b), 12 U.S.C. § 461 (1913) (indicating that at present, all depositary institutions that hold transaction accounts are entitled to the same discount and borrowing privileges as member banks). *See also* HACKLEY, *supra* note 10, at 119 (discussing cases where the Fed expressly authorized member banks to obtain loans for nonmember banks).

32. Federal Reserve Act § 13(2), 12 U.S.C § 343 (2006). The test for eligible paper under this provision looks to the nature of the underlying transaction rather than to the form of the paper. Small & Clouse, *supra* note 7, at 8 (citing HAROLD L. REED, THE DEVELOPMENT OF FEDERAL RESERVE POLICY (1922)). There are in fact two tests for eligible paper under the statute. Either the paper has its origins in a given commercial transaction (for example, where a company buys goods and provides its paper to the seller as payment), or the paper is subsequently used as collateral by another borrower who seeks funding for commercial purposes. *See* WH Steiner, *Paper Eligible for Rediscount at Federal Reserve Banks: Theories Underlying Federal Reserve Board Rulings*, 34 THE JOURNAL OF POLITICAL ECONOMY 327, 338-39 (1926) (stating that a paper may be eligible for discount "because *issued or drawn* for an agricultural or commercial purpose", or "because the *proceeds* have been or *are* to be *used* for an agricultural or commercial purpose").

33. *See* HACKLEY, *supra* note 10, at 14 (explaining that the reasoning behind the ninety-day maturity period is that such paper is highly liquid and "almost the exact equivalent of cash"). A longer maturity period applies to agricultural paper. The reasoning that underlies the distinction is that agricultural loans are normally made for a period that corresponds to the crop season. *Id.* at 43. Hence § 13A(1) of the FRA provides for a nine-month maturity period for notes "drawn for an agricultural purpose, or based upon live stock." This provision was added to the FRA by the Agricultural Credits Act of 1923, which was enacted in response to a decrease in farm prices during the 1920s. *Id.* at 44.

34. *See* Walker F. Todd, *FDICIA's Emergency Liquidity Provisions*, 29 FED. RES. BANK OF CLEVELAND ECO. REV. 16, 19 (1993), *available at* http://www.clevelandfed.org/research/Review/1993/93-q3-todd.pdf (stating that:

> [O]ne of the potentially troublesome aspects of the FDICIA amendment of

removed the phrase "of the kinds and maturities made eligible for discount for member banks under other provisions of this Act" from § 13(3).[35] As a result, all notes, drafts, and bills of exchange became eligible for discount, so long as they were endorsed or secured to the satisfaction of the Federal Reserve Bank.

The *third* restriction was procedural. Section 13(3) requires the affirmative approval of five of the Fed's Governors before a loan can be made. As indicated above, though, an alternative voting procedure has since been enacted. Section 11(r) states that there may instead be a unanimous vote of all (but at least two) available Fed Governors if the Fed determines that emergency action is necessary to prevent serious harm to the financial system.[36] If certain documentary requirements were met, then this procedure was sufficient for action to be taken under § 13(3).[37]

### *B. The Fed's use of § 13(3) before the financial crisis*

The Fed's Board of Governors issued a circular on July 26, 1932, five days after § 13(3) was enacted.[38] This became effective on August 1, 1932.[39] It gave Reserve Banks the authority for a period of six months to make loans under § 13(3).[40] This initial period of authority was extended for successive six-month periods lasting until July 31, 1936.[41]

The Fed did not prescribe any formal regulations. Instead, in its circular, it outlined the legal and procedural requirements that borrowers

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> Section 13 (3) is that it appears to reflect a motive or spirit that contradicts that of the FDICIA provisions intended both to limit Reserve Banks' loans to undercapitalized depository institutions and to make it more difficult for the Federal Reserve to treat an institution as too big to fail. If the amendment was intended to provide a vehicle for possible Federal Reserve treatment of a failing securities firm as too big to fail, then it arguably constitutes a contradictory extension of the same federal safety net that was retrenched in other parts of FDICIA. . . .).

35. Federal Deposit Insurance Corporation Improvement Act of 1991 § 473, 12 U.S.C. § 1811 (1991).

36. Federal Reserve Act § 11(r), 12 U.S.C. § 248(r) (2006).

37. *See id.* (listing the various requirements, for example that the Board's "written findings shall be included in the record of the action and in the official minutes of the Board, and copies of such record shall be provided as soon as practicable to the members of the Board who were not available to participate").

38. *Discounts for Individuals, Partnerships, and Corporations,* 18 FED. RES. BULL. 473, 518 (Aug. 1932), *available at* http://fraser.stlouisfed.org/publications/frb/1932/download/51730/frb_081932.pdf.

39. *Id.* at 474.

40. *Id.* at 474, 518.

41. Bd. of Governors of the Fed. Res. Sys., *Discounts for Individuals, Partnerships, and Corporations*, 22 FED. RES. BULL. 71, 123-24 (Feb. 1936), *available at* http://fraser.stlouisfed.org/publications/frb/1936/download/35757/frb_021936.pdf.

applying for credit from a Reserve Bank would have to follow. They had to state the purpose for which they would use the loan.[42] They had to provide evidence to demonstrate that their collateral was not only legally eligible but also acceptable from a credit standpoint.[43] Further, they had to provide a statement of the efforts they had made to obtain adequate credit accommodations from other banking institutions, including their names and addresses, the dates on which they applied for credit, and the reasons, if any, given for refusal of credit.[44] Reserve Banks were in turn obliged to ascertain that there was a reasonable need for such credit, and that the collateral was adequate to provide protection against losses.[45]

1. Lending from 1932–1936

Between 1932 and 1936, the Fed made loans to 123 entities.[46] The largest of these loans was for $300,000.[47] The aggregate amount of these loans was $1.5 million (about $23 million in today's dollars).[48]

It can be seen that lending under § 13(3) was limited during this period. There are three reasons why this was so. First, as we saw above, the provision as enacted contained collateral constraints.[49] Paper issued for the purpose of trading in investment securities was expressly ineligible for discount.[50] Second, another legislative provision (§ 13(b)) was added to the FRA in 1934.[51] This allowed Reserve Banks to make advances of working capital to established industrial and commercial firms that could not obtain credit from elsewhere.[52] Third, the Reconstruction Finance Corporation, formed in 1932, made loans to banks, insurance companies, and other

42. *Discounts for Individuals, Partnerships, and Corporations*, *supra* note 38, at 519.

43. *Id.*

44. *Id.*

45. *Id.* at 518.

46. HACKLEY, *supra* note 10, at 130. *See also* Baxter, *supra* note 19, at 5 (stating that borrowers included a typewriter manufacturer, a vegetable grower, and a brewer); Gordon and Muller, *supra* note 20, at 30 (noting that borrowers were primarily "industrial" firms rather than nonbank financial firms).

47. HACKLEY, *supra* note 10, at 130.

48. Baxter, *supra* note 19, at 13.

49. *See infra* Part III.A (explaining that before the FDICIA, § 13(3) loans to individuals, partnerships, and corporations were subject to the same collateral requirements as loans to member banks). For this reason, notes, drafts, and bills of exchange "issued or drawn for the purpose of carrying or trading in stocks, bonds, or other investment securities," other than U.S. government securities, were ineligible for discount. Federal Reserve Act § 13(2), 12 U.S.C. § 343 (2006).

50. Federal Reserve Act § 13(2).

51. Industrial Advances Act, 12 U.S.C. § 352a (1934).

52. *But see* the Small Business Investment Act of 1958, 15 U.S.C. § 696 (2009) (repealing the Industrial Advances Act).

businesses on more attractive terms.[53]

2. Lending from 1937–2008

In later years, the Fed did occasionally activate its § 13(3) authority to lend. However, it did not actually make any further loans until 2008. For example, in 1966, for an eight-month period, the Fed authorized Reserve Banks to lend to mutual banks and savings and loans associations, which were then under liquidity pressures.[54] In 1969, for a seven-month period, it authorized Reserve Banks to lend to banks facing competition for deposits from higher-yielding investments.[55]

In 1970, the Penn Central Railroad suffered from financial difficulties. The Fed stated that it would provide assistance at the discount window to businesses that held its commercial paper.[56] Overall, though, no liquidity crisis arose, and so the Fed made no loans. In 1975, the Fed refused to provide credit to the City of New York, which was then undergoing financial difficulties. Instead, it acted as fiscal agent for loans made by the Treasury to the City.[57] It assumed a similar role when the corporations Lockheed and Chrysler sought credit in 1971 and 1979, respectively.[58]

In 1980, the Fed activated its § 13(3) authority in contemplation of making a loan to a Michigan non-member bank.[59] Finally, in 1991, the Fed refused to make a $25 billion loan to the Bank Insurance Fund of the Federal Deposit Insurance Corporation, despite requests by the Treasury and the Chairman of the Corporation.[60]

## IV. THE FEDERAL RESERVE AND THE FINANCIAL CRISIS

The Fed used § 13(3) a number of times during the financial crisis. It provided assistance to individual firms. It also established broader schemes to restore market stability. In the analysis that follows, we will adopt a structural classification. From the standpoint of statutory authority, it will be argued that the most problematic cases are those in which the Fed used §

53. David Fettig, *Lender of More than Last Resort*, THE REGION, Dec. 2002, at 44–45, *available at* http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3392.

54. *See* Baxter, *supra* note 19, at 5.

55. *Id.* at 5–6.

56. Anna J. Schwartz, Senior Research Fellow, The Nat'l Bureau of Econ. Research, The Misuse of the Fed's Discount Window, Speech at the Sixth Annual Homer Jones Memorial Lecture at St. Louis University, 62–63 (Apr. 9, 1992), http://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf).

57. *Id.*

58. *Id.*

59. Baxter, *supra* note 19, at 6.

60. Schwartz, *supra* note 56.

13(3) to purchase assets and those in which made loans against instruments other than credit instruments. We will consider asset purchases first. By way of comparison, we will next consider loan transactions, most of which fall more clearly within the scope of the Fed's § 13(3) authority. Finally, we will consider the highest profile case in which the Fed made no use of § 13(3): that of Lehman Brothers.

### *A. Asset purchases*

In a number of cases, the Fed used § 13(3) to buy assets from troubled financial institutions. In form, these transactions were structured as loans. But in substance, they permitted the Fed to move assets off the balance sheets of these institutions and onto its own.[61]

We saw above that when the Fed used § 13(3), the provision contemplated only secured loan transactions. How, then, was the Fed able to effect these asset purchases? The answer came in the form of a special purpose vehicle (SPV). An SPV is an entity with distinct corporate personality from its parent. It is formed to carry out a specific task – here, an asset purchase.[62]

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61. *See* Baxter, *supra* note 19, at 13 (explaining that to achieve this result, the Fed created SPVs "[w]hen we created Maiden Lane I to facilitate the JPMC-Bear merger, this lawyer was thinking the SPV would stand with its own balance sheet, independent of the Federal Reserve. The accounting professionals taught me that, because of post-Enron reforms directed toward SPV accounting, the SPV needed to be reflected on the Federal Reserve's balance sheet. And we have followed that professional advice.").

62. The composition of the Fed's balance sheet has been altered significantly by the actions that the Fed took during the crisis. As of November 4, 2010, the Fed's total assets stood at $2.3 trillion. Of these assets, 46% were mortgage-backed securities (MBS), and 37% were Treasury securities. Federal Reserve Statistical Release, Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks (November 4, 2010), *available at* http://www.federalreserve.gov/Releases/H41/20101104. This can be contrasted with the position at the beginning of 2008. At that time, the Fed had total assets of $926 billion. Of these assets, 80% were Treasury securities. The Fed held no mortgage-backed securities. Federal Reserve Statistical Release, Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks (January 3, 2008), *available at* http://www.federalreserve.gov/Releases/H41/20080103.

It should be emphasized that the vast majority of the Fed's mortgage-backed securities were purchased under its Mortgage-Backed Securities Purchase Program. This was established pursuant to Federal Reserve Act § 14(b), which, as we shall see below, permits the Fed to purchase and sell Treasury and agency securities. Fed. Res. Bank of NY, *Frequently Asked Questions: MBS Purchase Program* (Feb. 17, 2010), http://www.newyorkfed.org/markets/mbs_faq_100217.html. The Fed used this program to purchase MBS issued or guaranteed by Fannie Mae, Freddie Mac, and Ginnie Mae. *Id.* It purchased $1.25 trillion of these securities between January 2009 and March 2010. *Id.*

The Fed's authority to purchase governmental securities under Federal Reserve Act § 14(b) is beyond doubt. However, as we shall see below, the Fed also purchased securities issued and backed only by *private* parties by using § 13(3). *See infra* Part IV.A.1.ii. It is

The Fed created SPVs in four cases. First, it provided assistance to JPMorgan Chase ("JPMorgan") in its purchase of Bear Stearns. Second, it purchased commercial paper from issuers under the Commercial Paper Funding Facility (CPFF). Third, it purchased money market instruments from money market mutual funds (MMMFs) under the Money Market Investor Funding Facility (MMIFF). Finally, it provided assistance to American International Group (AIG). Once the Fed had created SPVs for these purposes, it lent money to them using § 13(3). The SPVs in turn purchased assets from the troubled institutions. These assets served as collateral for the Fed's loans to the SPVs.

There are three reasons why this transactional structure exceeded the scope of the Fed's § 13(3) authority. The first is the *loan/asset-purchase* distinction. The second is the requirement of a loan *to the party that needs assistance*. And the third is the *discount/advance* distinction. We will develop these points with reference to the case of Bear Stearns and JPMorgan. We will then apply them to subsequent transactions that used the same structure.

There is one additional concern: whether the loans were in fact secured to the satisfaction of the Fed at the time it made them. However, this point lies beyond the scope of this analysis. This is so primarily because of the difficulties of valuing collateral. Hence we shall assume below, unless there is a clear indication otherwise, that loans that were secured were backed by sufficient collateral.

1. Bear Stearns and JPMorgan

*i. Background*

Bear Stearns was an investment bank. Because it lacked deposits, it was dependent on the securities repurchase market for its credit. Many of its investments were in mortgage-backed securities (MBS).[63] In March 2008, Bear Stearns started to experience severe difficulties in obtaining credit. Its lenders declined to extend the terms of their existing loans, or refused to make new loans.[64] Between March 10 and March 13, 2008, its cash reserves fell from $18 billion to $2 billion.[65]

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this exercise of legal authority that raises the most important concerns.

63. S. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, 109TH CONG., REP. PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: BRIDGE LOAN TO THE BEAR STEARNS COMPANIES, INC. THROUGH JPMORGAN CHASE BANK, N.A., 1, *available at* http://www.federalreserve.gov/monetarypolicy/files/129bearstearnsbridgeloan.pdf.

64. *Id.* at 2-3.

65. DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 153–54 (Crown Publishing Group 2009).

The Fed made an overnight loan to Bear Stearns on March 14, 2008.[66] The purpose of this loan was to enable Bear Stearns to meet its immediate obligations in the securities repurchase market and to prevent its bankruptcy so that it could explore alternatives.

However, even after this emergency loan, Bear Stearns's cash reserves and stock price continued to decrease.[67] JPMorgan emerged as a potential purchaser of the company. However, it did not wish to acquire all of Bear Stearns's assets. In particular, it sought to avoid purchasing Bear Stearns's illiquid MBS. So on March 16, 2008, two days after its first loan to Bear Stearns, the Fed agreed to acquire these assets.[68]

To achieve this goal, the Fed created an SPV. This was a limited liability company called Maiden Lane. The Fed authorized the Federal Reserve Bank of New York (the "New York FRB") to lend up to $30 billion to Maiden Lane.[69] Maiden Lane would use this money to purchase Bear Stearns's illiquid assets, which would serve as collateral for the New

66. S. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, 109TH CONG., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: BRIDGE LOAN TO THE BEAR STEARNS COMPANIES, INC. THROUGH JPMORGAN CHASE BANK, N.A. 1, *available at* http://www.federalreserve.gov/monetarypolicy/files/129bearstearnsbridgeloan.pdf.

The transaction took place in two stages. First, the New York Federal Reserve Bank lent $12.9 billion to JPMorgan at the discount window. *Id.* at 3. This loan was made without recourse. Second, JPMorgan lent the same amount to Bear Stearns. In each case, $13.8 billion of Bear Stearns' assets provided collateral for the loan. *Id.* JPMorgan's loan to Bear Stearns was secured by these assets, and so was the New York FRB's loan to JPMorgan.

To make this loan, the Fed invoked Federal Reserve Act § 11(r). It did so because one of the Governors, Frederic Mishkin, was abroad and could not be contacted, leaving only four others to approve the decision. The Fed. Res., Minutes of the Board of Governors of the Federal Reserve System 3 (Mar. 14, 2008), *available at* http://www.federalreserve.gov/newsevents/press/other/other20080627a1.pdf. As required by this provision, the Fed found that the loan to Bear Stearns was necessary to prevent serious harm to financial stability. S. COMM. ON BANKING, HOUSING, & URBAN AFFAIRS, *supra* at 3. In support of its findings, the Fed cited the fragile condition of the financial markets, the prominent position of Bear Stearns in those markets, and the expected "contagion" that would result from its failure. *Id.* at 2. In a later report, the Fed expanded on its reasoning. Bear Stearns was a "major borrower and lender in the repurchase agreement market." *Id.* Its failure would have resulted in a significant drop in the availability of short-term financing, and possibly in threats to the solvency of other large and highly leveraged financial institutions. *Id.* at 3.

67. WESSEL, *supra* note 65, at 166.

68. BD. OF GOVERNORS OF THE FED. RES. SYS., PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 5 (2009).

69. FED. RES. BANK OF N.Y., MAIDEN LANE LLC: A SPECIAL-PURPOSE VEHICLE CONSOLIDATED BY THE FED. RES. BANK OF N.Y. 7 (2009), *available at* http://www.newyorkfed.org/aboutthefed/annual/annual08/MaidenLanefinstmt2009.pdf.

York FRB's loan.[70]

In turn, JPMorgan agreed to lend $1 billion to Maiden Lane.[71] Its loan was made subordinate to the New York FRB's loan.[72] In this way, JPMorgan would bear the first $1 billion of any losses among the illiquid assets that Maiden Lane had purchased. The Fed would bear any remaining losses. JPMorgan also agreed to guarantee Bear Stearns's ongoing trading obligations between signing and closing.[73]

*ii. Assessment*

We will now set out in greater detail the three reasons why this transactional structure exceeded the scope of the Fed's § 13(3) authority. The first point concerns the *loan/asset-purchase* distinction. We argued above that at the time the Fed used § 13(3), the language of the statute contemplated a loan transaction, not an asset purchase. This transaction was a loan, but only in form. The Fed extended credit to Maiden Lane so that Maiden Lane could purchase Bear Stearns's illiquid assets. The primary goal of the transaction was to remove these assets from Bear Stearns's balance sheet, and so facilitate its acquisition by JPMorgan.

By way of comparison, Reserve Banks do have the authority to purchase and sell certain assets in their open-market operations. FRA § 14 expressly grants this power to Reserve Banks. However, the power is limited in scope. Reserve Banks can purchase and sell only a defined list of assets, including Treasury and agency securities. Securities issued and backed by corporations do not appear on this list.[74] Hence the Fed used §

70. *Id.* According to Maiden Lane's financial statements for the year ending 2008, the Bear Stearns assets consisted largely of mortgage-related securities, whole mortgages loans, a total return swap with JPMorgan, and certain mortgage commitments. *Id.*

71. *Id.* at 12.

72. *Id.*

73. Press Release, JPMorgan Chase and Bear Stearns Announce Amended Agreement (Mar. 24, 2008), http://www.jpmorgan.com/cm/cs?pagename=JPM_redesign/JPM_Content_C/Generic_Detail_Page_Template&cid=1159339104093&c=JPM_Content_C (setting out the key terms of the amended merger agreement). JPMorgan agreed to pay a higher price per share: $10 rather than $2. *Id.* When the loan closed on June 26, 2008, there had been adjustments in the values of the assets that Maiden Lane had purchased from Bear Stearns. Overall, the New York FRB lent Maiden Lane $28.8 billion, and JPMorgan lent Maiden Lane $1.1 billion. BD. OF GOVERNORS OF THE FED. RES. SYS., PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 9 (2009), *available at* http://www.federalreserve.gov/monetarypolicy/files/129periodicupdate02252009.pdf.

74. Federal Reserve Act § 14, 12 U.S.C. §§ 353-359 (2006). In full, the assets eligible for purchase by the Fed under Federal Reserve Act § 14 are: gold (§ 14(a)), debt issued or guaranteed by the US government or its agencies (§ 14(b)(1)), debt issued by state, local and

13(3), a provision that then made no reference to the Fed's ability to buy and sell, to effect the purchase of privately issued securities in a transaction that would have been impermissible under § 14 itself. It is difficult to see how the Fed's loan-making power under § 13(3) could have encompassed such a purchase.[75]

The second point concerns the requirement of a loan *to the party that needs assistance*. We argued above that § 13(3) required that the borrower be the same party that had difficulty obtaining credit from elsewhere: the

foreign governments (§ 14(b)(1)), and three kinds of private debt. *Id*. The first two are cable transfers (foreign exchange) and bankers' acceptances (orders to pay that become promises to pay after a banker accepts them). Small & Clouse, *supra* note 7, at 26-28.

The Fed may also purchase bills of exchange. From member banks, it may purchase bills of exchange "arising out of commercial transactions." Federal Reserve Act § 14(c). And in the open market, it may purchase bills of exchange "of the kinds and maturities . . . made eligible for rediscount" by the Federal Reserve Act. *Id.* at § 14. A bill of exchange is a three-party instrument in which A orders that B make a payment to C. *See supra* Part II.B.

In ordinary circumstances, then, the Fed may purchase bills of exchange as set out in Federal Reserve Act § 13(4) (demand bills of exchange relating to the domestic shipment of agricultural goods), § 13(6) (acceptances relating to the shipment of goods and acceptances to create dollar exchanges), and § 13(2) (bills of exchange secured by agricultural paper). The Fed may also purchase bills of exchange eligible for discount under § 13(2) (those issued or drawn for agricultural, industrial, or commercial purposes – or that have proceeds that will be used for such purposes – with a maximum maturity period of ninety days). *See supra* note 10 (setting out instruments eligible for discount at the discount window); Small & Clouse, *supra* note 7, at 34 (setting out assets eligible for purchase in the open-market). It is possible to argue that § 13(3) expands the range of bills of exchange that the Fed can purchase under § 14. This is because § 13(3) is a provision under which these instruments are "made eligible for rediscount," as required by § 14. In this way, Small and Clouse suggest that in "unusual and exigent circumstances," the Fed may be able to purchase bills of exchange that are endorsed or secured as required by § 13(3). *Id.* at 30-31. However, they note that the point remains unsettled. *Id.*

We can make two further points in connection with this analysis. The first is that the Fed did not invoke § 14 when it set up any of its SPV transactions. It made reference to § 13(3) alone. As such, it did not resolve the question whether § 13(3) extends the range of bills of exchange that are eligible for purchase under § 14. The second point is that corporate securities are not bills of exchange. And commercial paper is not a banker's acceptance. Hence the Fed's purchases of mortgage-backed securities and collateralized debt obligations from Bear Stearns and AIG would not have come within the scope of § 14. *See infra* Part IV.A.4. Neither, in turn, would its purchases of commercial paper and money-market instruments under the CPFF and the MMIFF. *See infra* Parts IV.A.2-3.

75. There is a possible counter-argument. I am grateful to Professor Howell Jackson for raising it with me. The argument is that a non-recourse loan on which the borrower defaults has the same effect as an asset-purchase. To illustrate this, let us suppose that instead of using the SPV structure, the Fed had made a large non-recourse loan to JPMorgan to facilitate its acquisition of Bear Stearns. If JPMorgan decided to default on the loan, the Fed would be left with an interest in the collateral, which it would then sell in an attempt to recoup its losses. The outcome in this scenario is the same as that in the purchase transaction. However, as we pointed out *supra* note 12, these transactions are analytically distinct. Once more, in a loan transaction, the bank's goal at the outset is to lend money against the borrower's collateral, not to acquire it.

loan had to be made to *such* individual, partnership, or corporation.[76]

On the present facts, Maiden Lane was the borrower. Bear Stearns, on the other hand, was the party unable to secure credit from elsewhere. We can say that Bear Stearns was the *beneficiary* of the New York FRB's loan transaction, because it was able to sell various illiquid assets.[77] Even so, one party received a loan, and a different party had difficulty obtaining credit.[78]

A response to this argument would be to say that our focus on the word "such" may be textually correct, but that it may result in inefficiencies. It requires that the Fed make loans only directly to the party that requires them. A court interpreting the statute might instead have concluded that there were strong arguments in favor of the Fed's being able to make loans indirectly through another entity. For example, the Fed may have wished, for reasons of transactional efficiency, to create one company through which it could make loans to a series of other companies. For this reason, a court might have read the language of the statute broadly, so that *such* individual referred not only to the immediate borrower but also to the beneficiary: the ultimate borrower.

Even so, on the present facts, it is difficult to see where the Fed achieved any increase in transactional efficiency. It made a loan to only one beneficiary. The more persuasive view must instead be that the Fed incorporated the SPV so that it could fit its transaction within the loan form and so effect the asset purchase that we criticized above.

76. *See supra* Part II.D.

77. Or perhaps this was JPMorgan, because it was able to buy Bear Stearns. Regardless, the analysis stands unchanged.

78. The Fed's minutes of March 16, 2008 do make reference to the statutory requirement of a loan to the party that needs assistance. *See* The Fed. Res., Minutes of the Board of Governors of the Federal Reserve System 2 (Mar. 16, 2008), *available at* http://federalreserve.gov/newsevents/press/other/other20080627a2.pdf (stating that the Fed authorized the New York FRB to "make a nonrecourse loan of up to $30 billion . . . if [the New York FRB] found that adequate credit accommodations were not available to the *borrower* from other banking sources") (emphasis added). However, the Fed did not go on to consider the question whether it was indeed lending to a borrower that found itself in this position.

There remains a counter-argument: that Maiden Lane was itself unable to secure adequate credit from other banking institutions. The steps in this argument are as follows. At the moment of its incorporation, Maiden Lane had no assets. It had one sole purpose: to purchase certain assets from Bear Stearns. It is difficult to see why anyone other than its parent would lend to such a company. Any other lender might refuse to make a loan because it would be plain to that lender that the Fed would shortly make a loan to its own SPV. This argument seems strained. However, if it is correct, then the Fed will be able to avoid the requirement of a borrower's being unable to secure credit every time it places an SPV between itself and the beneficiary of the transaction. And so it seems likely that the courts would reject this analysis because, *ex hypothesi*, it negates one of the conditions of the statute.

The third point concerns the *discount/advance* distinction. It can be argued that in this transaction, there was no discount within the meaning of § 13(3). We saw above that discounting involves lending against a financial instrument at a discount from the face value of that instrument. It follows that the borrower must have existing assets to begin with, before it receives any loan. However, in the present transaction, Maiden Lane did not have any assets at the time of its incorporation. Instead, it used the Fed's loan to purchase Bear Stearns' securities. Only after this purchase was it able to provide any collateral for the Fed's transaction. A loan secured by the borrower's own pledge of future payment is an *advance*, not a discount.[79]

However, this concern could perhaps have been resolved. If Bear Stearns's assets had been transferred to Maiden Lane first, before the Fed extended credit against them, then the statutory requirement of a discount may have been met.

2. The Commercial Paper Funding Facility (CPFF)

We will now go on to apply these and other arguments to another case in which the Fed effected an asset purchase: that of the CPFF. An additional point to reemphasize at this stage is that, as we have seen, § 13(3) requires financial instruments against which loans are to be made to be endorsed or otherwise secured to the satisfaction of the Reserve Bank. This is the requirement of *endorsement or security*.

79. When a Reserve Bank makes an advance at its discount window, it extends credit in exchange for the borrower's *own* promissory note. Ordinarily, the borrower must also provide some security for its promise to pay. *See* Federal Reserve Act § 13(8), 12 U.S.C. § 347 (2006) (stating that Reserve Banks can make ninety-day advances to individual member banks on notes that are secured by such financial instruments as are eligible for discount or purchase under the other provisions of the FRA); § 10B (stating that Reserve Banks can make advances to individual member banks on their time or demand notes where such notes are secured to the satisfaction of the Reserve Bank); § 10A (stating that Reserve Banks can make advances to groups of member banks on their unsecured demand notes, provided they have no assets available for discounting); § 13(13) (stating Reserve Banks can make advances to any individual, partnership, or corporation on notes that are secured by Treasury or agency securities). *See also supra* note 10 and accompanying notes; Regulation A, 12 C.F.R. § 201.4(d) (2001) (explaining that, in accordance with § 13(13) FRA, Reserve Banks can make advances to nonbanks only against Treasury or agency securities).

Advances are made more often than discounts. *See* Gordon & Muller, *supra* note 20, at 29 n.100 ("In general loans made to depository banks through the discount window have been in the form of 'advances,' evidenced by a promissory note from the borrower, on the security of the borrower, rather than a 'discount' on third-party indebtedness pledged by the borrower. This is because the loan transaction is straight-forward and the collateral requirements are looser.").

*i. Background*

Commercial paper is short-term, high-quality debt issued by corporations. In the days following the bankruptcy of Lehman Brothers (which will be considered below),[80] the market for new issuances of commercial paper began to decline.

Money market mutual funds (MMMFs) and other investors became reluctant to invest in commercial paper.[81] Those that continued to invest did so at high interest rates and on a short-term basis, such as overnight.[82] As a result, many corporations had to make payments on their maturing commercial paper by issuing new paper (thereby "rolling over" their paper). To meet the credit needs of these corporations in the longer term, the Fed created the CPFF on October 7, 2008.[83]

The CPFF, which expired on February 1, 2010, purchased newly issued commercial paper from corporate issuers.[84] It purchased both asset-backed and unsecured commercial paper.[85] To create this program, the Fed incorporated an SPV: the Commercial Paper Funding Facility LLC. It made a series of loans to the SPV, via the New York FRB.[86]

Certain fees were also applicable. Each issuer had to pay a fee in order to use the CPFF.[87] Furthermore, issuers of unsecured paper had to pay a "credit enhancement fee" of 100 basis points before the SPV would purchase their paper.[88] These fees were intended to provide the SPV with some protection against losses.

80. *See infra* Part IV.C.

81. Press Release, Bd. Of Governors of the Fed. Res. Sys., Board Announces Creation of the Commercial Paper Funding Facility (CPFF) to Help Provide Liquidity to Term Funding Markets (Oct. 7, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081007c.htm.

82. *Id.*

83. Fed. Res. Bank of N.Y., *Commercial Paper Funding Facility: Frequently Asked Questions* (Oct. 19, 2009), http://www.ny.frb.org/markets/cpff_faq.html [hereinafter *Commercial Paper Funding Facility*].

84. *Id.* In fact, primary dealers acted as intermediaries between the Fed's SPV and the issuers. *Id.*

85. Asset-backed commercial paper is commercial paper secured by an underlying asset. Unsecured commercial paper, on the other hand, is backed by the issuer's bare promise to pay.

86. *Commercial Paper Funding Facility*, *supra* note 83.

87. *Id.*

88. FED. RES. BANK OF N.Y., COMMERCIAL PAPER FUNDING FACILITY LLC, A SPECIAL-PURPOSE VEHICLE CONSOLIDATED BY THE FEDERAL RESERVE BANK OF NEW YORK, FINANCIAL STATEMENTS FOR THE PERIOD OCTOBER 14, 2008 TO DECEMBER 31, 2008, AND INDEPENDENT AUDITORS' REPORT 10 (2009), *available at* http://www.newyorkfed.org/aboutthefed/annual/annual08/CPFFfinstmt2009.pdf.

*ii. Assessment*

Once more, it will be argued that this transactional structure went beyond the scope of the Fed's § 13(3) authority. It is closely analogous to the structure used in the Bear Stearns-JPMorgan transaction. The Fed created an SPV, then extended loans to it that were to be used for the purchase of certain assets. However, an important difference in this case is that the assets to be purchased were *unsecured* as well as asset-backed.

Two of the arguments made above are once more applicable in the present case. First, there remains a concern about the *loan/asset-purchase* distinction. Again, this SPV effected asset purchases rather than loans. Second, there is also a concern about the requirement of a loan *to the party that needs assistance*. Here, the borrower (the SPV) was not the same party as that which had difficulty obtaining credit from elsewhere (the issuer of commercial paper).

The *discount/advance* distinction does not seem to be a concern here because, as we have seen, issuers had to pay fees in order to use the CPFF. Hence the SPV did have some existing assets with which to collateralize its loans from the Fed. However, there is a further concern in the context of this transaction: that the requirement of *endorsement or security* was not met. By purchasing *unsecured* commercial paper under the CPFF, the Fed went against the statutory requirement that financial instruments being discounted must be endorsed or secured.

It may be argued in response that the Fed enjoys some measure of discretion in this area: a loan need only be secured to the *satisfaction* of the Reserve Bank. However, as concluded above, the most persuasive reading of the statute looks at the need for *some* security.[89] An issuer's promise to pay provides no such security.

There is a counter-argument: that the Fed secured its loans by imposing fees on issuers who sold their commercial paper to the CPFF. We saw above that issuers of unsecured commercial paper had to pay a surcharge of 100 basis points before their paper would be eligible for purchase. Even if we include the registration fees collected from all participants, the total amount of collateral was fractional at best. Nevertheless, it remains possible to argue that by collecting these fees, the Fed secured its loans to its own satisfaction.

3. The Money Market Investor Funding Facility (MMIFF)

*i. Background*

Money market mutual funds (MMMFs) are financial institutions that

89. *See supra* Part II.F.

invest in high-quality debt instruments, such as Treasury bills and commercial paper.[90] They issue shares to their investors that can be redeemed for cash. Because they invest in low-risk instruments, they are ordinarily able to maintain a stable net asset value of $1 per share.

The Reserve Primary Fund is one such fund. It had invested $785 million (1.2% of its total assets) in Lehman's commercial paper. Once Lehman filed for bankruptcy, the fund was unable to meet the cumulative requests for redemptions. It therefore suspended these requests, and it also began to sell off its asset-backed commercial paper (ABCP). On September 16, 2008, it cut the price of its shares to 97 cents per share, thereby 'breaking the buck' and setting in motion a run on money markets.

In response, on September 19, 2008, the Fed created the Asset-Backed Commercial Paper Money Market Fund Liquidity Facility (AMLF) (which we shall examine below when we come to consider loan transactions).[91] This facility made loans to depository institutions that would purchase asset-backed commercial paper (ABCP) from money market mutual funds (MMMFs).

However, the AMLF was not the Fed's only response to the difficulties faced by MMMFs. Later, on October 21, 2008, it also created the Money Market Investor Funding Facility (MMIFF). This facility was intended to purchase money-market instruments from MMMFs, including commercial paper, certificates of deposit, and bank notes. However, no purchases were ever made under the program, which expired on February 1, 2010.[92]

To create it, the Fed incorporated a series of SPVs. It planned to make loans to them via the New York FRB. The SPVs would purchase money market instruments for 90% of their value in cash.[93] To cover the remaining 10%, they would issue subordinated ABCP to the MMMFs. In this way, the MMMFs would absorb the first 10% of losses.

*ii. Assessment*

For reasons similar to those given above, it will be argued that this

90. Money market mutual funds emerged in the 1970s in response to Regulation Q, which permitted the Fed to limit interest rates on demand deposits. Because money market mutual funds issue demand equity, they came outside the scope of this Regulation. It was phased out in 1982. CARNELL, ET AL., *supra* note 7, at 23-25.

91. *See infra* Part IV.B.3.

92. BAIRD WEBEL & MARC LABONTE, CONGRESSIONAL RESEARCH SERVICE, GOVERNMENT INTERVENTIONS IN RESPONSE TO FINANCIAL TURMOIL REPORT 22 (Feb. 1, 2010), *available at* http://www.fas.org/sgp/crs/misc/R41073.pdf.

93. THE FED. RES., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: MONEY MARKET INVESTOR FUNDING FACILITY 2 (2008), *available at* http://www.federalreserve.gov/monetarypolicy/files/129mmiff.pdf.

transactional structure went beyond the scope of the Fed's § 13(3) authority. First, the transaction did not observe the *loan/asset-purchase* distinction. Second, there was no loan *to the party that needs assistance*. Third, it seems that the requirement of *endorsement or security* was not met. This is so if we assume that the facility purchased unsecured as well as secured commercial paper. Its terms do not address this point.[94]

Finally, it is also possible that the *discount/advance* distinction would not have been met. There is no indication that MMMFs had to pay fees to use this program. If they did not, then the SPVs would not, before making purchases, have had any assets with which to collateralize their loans from the Fed.

4. AIG

Above, we considered transactions that effected asset purchases. The case of AIG is a hybrid case insofar as it involved both asset purchases and loans. We will argue that only the loan elements of this transaction came within the scope of the Fed's statutory authority.

*i. Background*

AIG is a large holding company. Its primary business is the provision of insurance.[95] It does this through a number of state-regulated subsidiaries.[96] It also has a financial services business.[97] This subsidiary, AIG Financial Products (AIGFP), was counterparty to a number of credit default swaps (CDS) (contracts that transfer the risk of default from a party purchasing protection to a party providing it).[98] By writing such swaps, AIGFP provided protection to a number of entities, such as financial institutions, pension funds, and municipalities.[99]

AIG had been operating a securities lending program under which it lent out securities held by its life insurance subsidiaries in exchange for

94. The terms of the facility do not indicate whether it was restricted to secured paper. Fed. Res. Bank of N.Y., Money Market Investor Funding Facility: Program Terms and Conditions (June 25, 2009), http://www.newyorkfed.org/markets/mmiff_terms.html. However, Scott suggests that unsecured paper was eligible for purchase. *See* HAL S. SCOTT, THE GLOBAL FINANCIAL CRISIS (Foundation Press 2009) at 28 ("[T]he actual assets of the SPV [were] generally uncollateralized.").

95. U.S. GOV. ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM, STATUS OF GOVERNMENT ASSISTANCE PROVIDED TO AIG 4 (Sept. 2009), *available at* http://www.gao.gov/new.items/d09975.pdf.

96. *Id.*

97. *Id.*

98. *Id.* at 8.

99. SCOTT, *supra* note 94, at 42-45. By the end of 2008, the size of AIG's CDS portfolio was $527 billion. *Id.* at 43.

cash.[100] AIG used these funds to purchase other securities, such as MBS.[101] When the value of these securities declined, AIG was obliged to post additional collateral for its counterparties.[102] Furthermore, when credit rating agencies downgraded their ratings on AIG in May 2008, it was again obliged to post additional collateral under the terms of its CDS agreements.[103] AIG suffered a further rating downgrade in September 2008.[104] By this stage, a number of counterparties refused to transact with it, and it faced severe liquidity problems.[105]

The Fed was concerned that AIG might default on its CDS. In the Fed's view, this would have led to a "steep decline in confidence in the global banking system and possibly to the collapse of other major financial institutions."[106]

a. Initial structure

On September 16, 2008, the Fed authorized the New York FRB to lend up to $85 billion to AIG under § 13(3).[107] This lending took place under a two-year revolving credit facility.[108] The loan was secured by pledges of many of the assets of AIG and its subsidiaries (other than its state- and foreign-regulated subsidiaries).[109] As additional compensation to the government, AIG issued preferred stock in trust for the Treasury.[110]

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100. U.S. GOV. ACCOUNTABILITY OFFICE, *supra* note 95, at 8.

101. *Id.*

102. *Id.* at 11.

103. *Id.*

104. *Id.* at 12.

105. *Id.* AIG had posted $19.7 billion of collateral by the end of August 2008. *Id.*

106. BD. OF GOVERNORS OF THE FED. RES. SYS., PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 11 (2009), *available at* http://www.federalreserve.gov/monetarypolicy/files/129periodicupdate02252009.pdf.

107. *Id.*

108. *See* THE FED. RES., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: SECURITIES BORROWING FACILITY FOR AMERICAN INTERNATIONAL GROUP, INC. 3 (2008), *available at* http://www.federalreserve.gov/monetarypolicy/files/129aigsecborrowfacility.pdf ("The Securities Borrowing Facility has the same maximum duration as the September Facility (September 16, 2010) in order to allow the company to conduct an orderly disposition of certain of its assets").

109. U.S. SENATE COMM. ON BANKING, HOUS., & URBAN AFFAIRS, REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: SECURITIES BORROWING FACILITY FOR AMERICAN INTERNATIONAL GROUP, INC. 5-6 (2008), *available at* http://banking.senate.gov/public/_files/FederalReserveReportonSecuredCreditFacilityAIG.pdf.

110. *Id.* at 7.

This stock was convertible into 79.9% of AIG's common stock.[111]

Next, on October 8, 2008, the Fed provided further funds to AIG under § 13(3). It authorized the New York FRB to borrow $37.8 billion of investment-grade securities from AIG under AIG's securities lending program in exchange for cash collateral.[112]

b. Revised structure

On November 10, 2008, the Treasury and the Fed together restructured the Fed's investment following the creation of the Troubled Asset Relief Program (TARP).[113] The Treasury purchased $40 billion of preferred stock in AIG. AIG used these proceeds in part to repay $25 billion of the Fed's loans.[114] In this way, the size of the Fed's credit facility was reduced from $85 billion to $60 billion.[115] Next, the Fed created two further credit facilities for AIG. These were two new SPVs: Maiden Lane II and Maiden Lane III LLC.

Maiden Lane II received a $19.5 billion loan from the New York FRB. It used this loan to purchase AIG's residential MBS portfolio.[116] AIG used these funds and others of its own to pay back the Fed's $37.8 billion loan of October 8, 2008.[117] It then terminated its securities lending program.

Maiden Lane III received a $24.3 billion loan from the New York FRB.[118] It used this loan to purchase from AIG's counterparties those

111. *Id.*

112. *See* Press Release, Bd. of Governors of the Fed. Res. Sys., Board Authorizes Federal Reserve Bank of New York to Borrow Securities from certain regulated U.S. insurance subsidiaries of AIG (Oct. 8, 2008), http://www.federalreserve.gov/newsevents/press/other/20081008a.htm (describing the transaction). In effect, though, AIG itself borrowed cash from the Fed and provided securities as collateral.

113. TARP was created by the Emergency Economic Stabilization Act 2008 ("EESA"). It made available up to $700 billion of funds. 12 U.S.C. § 5225 (2008). Initially, it was envisaged that these would be used to purchase troubled assets from financial institutions. However, the Treasury later decided to make capital investments instead. Press Release, U.S. Dept. of Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* http://www.ustreas.gov/press/releases/hp1207.htm.

114. SCOTT, *supra* note 94, at 44.

115. The interest rate on this facility was also reduced, from 850 basis points above three-month LIBOR to 300 basis points above three-month LIBOR. *Id.* at 44.

116. Fed. Res. Bank of N.Y., *Maiden Lane Transactions*, http://www.newyorkfed.org/markets/maidenlane2.html (last visited Sept. 28, 2010) [hereinafter *Maiden Lane Transactions*].

117. SCOTT, *supra* note 94, at 44. Hence, as Scott points out, "this represented a restructuring of existing debt rather than an injection of additional funds." *Id.*

118. *Maiden Lane Transactions*, *supra* note 116.

collateralized debt obligations (CDOs)[119] on which AIG had written CDS.[120] As part of these transactions, each counterparty agreed to terminate its CDS contracts with AIG.[121]

c. Re-revised structure

On March 2, 2009, the Treasury and the Fed restructured their investments once more. The Treasury created a new five-year equity capital facility, under which AIG could obtain $30 billion of capital in exchange for newly issued preferred stock.[122]

The Fed restructured its revolving credit facility. It reduced the size of this facility from $60 billion to $25 billion.[123] In exchange, the Fed received stock interests in certain of AIG's subsidiaries.[124] Furthermore, the Fed authorized the New York FRB under § 13(3) to lend $8.5 billion to AIG's life insurance subsidiaries.[125]

*ii. Assessment*

The above series of transactions can be classified into loan arrangements and asset purchases. The Fed made certain loans to AIG under § 13(3). Later, these loans were restructured, such that the Treasury assumed greater risk. These actions appear to have come within the scope of the Fed's § 13(3) authority. The loans were secured by the assets of

119. CDOs are asset-backed or synthetic securities. These represent interests in a set of underlying assets or referenced obligations. HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY AND REGULATION 566–567 (Foundation Press) (2009) [hereinafter SCOTT II].

120. *Maiden Lane Transactions*, *supra* note 116.

121. *Id.*

122. BD. OF GOVERNORS OF THE FED. RES. SYS., PERIODIC REPORT PURSUANT TO SECTION 129(B) OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 8 (2009), *available at* http://www.federalreserve.gov/monetarypolicy/files/129periodicupdate02252009.pdf. The Treasury also exchanged its preferred stock for shares with terms that more closely resemble common equity. *Id.*

123. U.S. SENATE COMM. ON BANKING, HOUS., & URBAN AFFAIRS, REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: RESTRUCTURING OF THE GOVERNMENT'S FINANCIAL SUPPORT TO THE AMERICAN INTERNATIONAL GROUP, INC. 6 (2009), *available at* http://banking.senate.gov/public/_files/AIGMarch2009RestructuringReportFinal.pdf.

124. *Id.* at 9.

125. *Id.* at 5 (describing the Fed's decision to extend credit to AIG and outlining the terms of the agreement). In more precise terms, the Fed authorized the New York FRB to make loans to certain SPVs to be established by these subsidiaries. *Id.* The SPVs would repay these loans from the net cash flows they received from blocks of life insurance policies held by the parent insurance companies. *Id.*

AIG and its subsidiaries.

In contrast, it appears that the set of transactions effected by Maiden Lane II and III went beyond the scope of the Fed's authority. The primary concerns once more are the *loan/asset-purchase* distinction and the requirement of a loan *to the party that needs assistance*.

*B. Loan transactions*

The transactions in this group resemble more closely the paradigmatic loans that are contemplated by § 13(3). For the most part, then, it will be argued that these transactions fell within the scope of the Fed's § 13(3) authority.

However, the remaining concerns are two-fold. The first is whether the requirement of a loan *to the party that needs assistance* was met. The second is whether the Fed did in fact lend against appropriate collateral. But as we stated above, an examination of the quality of collateral lies beyond the scope of this analysis. We shall assume once more, unless there is a clear indication otherwise, that those loans that were secured were backed by sufficient collateral.

We shall consider four lending facilities.[126] The first is the Term Securities Lending Facility (TSLF), under which the Fed lent out Treasury securities to primary dealers. The second is the Primary Dealer Credit Facility (PDCF), under which the Fed provided overnight loans to primary dealers. The third is the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), under which the Fed made loans

126. The Fed also invoked § 13(3) when entering into certain arrangements with Citigroup and Bank of America pursuant to the Treasury's Asset Guarantee Program. BD. OF GOVERNORS OF THE FED. RES. SYS., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: AUTHORIZATION TO PROVIDE RESIDUAL FINANCING TO CITIGROUP, INC. FOR A DESIGNATED ASSET POOL (2008), *available at* http://www.federalreserve.gov/monetarypolicy/files/129citigroup.pdf; BD. OF GOVERNORS OF THE FED. RES. SYS., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: AUTHORIZATION TO PROVIDE RESIDUAL FINANCING TO BANK OF AMERICA CORPORATION RELATING TO A DESIGNATED ASSET POOL (2009), *available at* http://www.federalreserve.gov/monetarypolicy/files/129bofa.pdf. Under this program, the Treasury and the FDIC agreed to bear a portion of any losses in designated pools of assets held by these two financial institutions. On November 23, 2008 and January 15, 2009, the Fed authorized its Reserve Banks to make § 13(3) loans to Citigroup and Bank of America, respectively, in the event that they incurred losses in amounts greater than those agreed to be borne by the Treasury and the FDIC. *Id*. The Fed made no loans under these programs, which have since been terminated. *Id.*; *Road to Stability, Asset Guarantee Program*, FINANCIALSTABILITY.GOV, http://www.financialstability.gov/roadtostability/assetguaranteeprogram.htm (last updated Oct. 3, 2010). Had any loans been made, it seems the only § 13(3) concerns raised thereby would have been as to the kinds of instruments eligible for discount, because corporate shares were not expressly excluded from the scope of the arrangements. *See supra* Part II.B.

to banks and other financial institutions that purchased commercial paper. Finally, we shall consider the Term Asset-Backed Securities Loan Facility (TALF), under which the Fed made loans to investors that were used to purchase asset-backed securities.

1. The Term Securities Lending Facility (TSLF)

*i. Background*

Primary dealers are large financial institutions that trade directly with the Fed.[127] They purchase and sell Treasury and other securities on its behalf, and so help it conduct its open-market operations.[128] Unlike commercial banks, primary dealers (and securities dealers more generally) do not have a base of deposits with which to finance their operations.[129] Instead, they borrow funds in the credit markets. Much of their borrowing takes place in the securities repurchase market.[130]

In this market, primary dealers enter into repurchase agreements, the effect of which is to allow them to borrow funds against their own securities. These transactions are structured as purchases. A dealer sells a security to a lender, and agrees to repurchase it at a fixed price on a specified date.[131] The lender has possession of the security until the dealer repurchases it. The lender is entitled to sell it in the event that the dealer defaults. It has further protection in the form of the haircut that it applies to the value of the collateral.

Repurchase agreements help to ensure the efficient allocation of capital in financial markets. For dealers, they are a source of funds for transactional activities. For lenders, they are a relatively safe way of lending out surplus funds for a short term: typically overnight, but perhaps for up to two weeks.

By March 2008, lenders had become reluctant to enter into these agreements. They were concerned about the solvency of borrowers, as well

127. Fed. Res. Bank of N.Y., *Primary Dealers* (Sept. 2008), http://www.ny.frb.org/aboutthefed/fedpoint/fed02.html.

128. *Id.*

129. Tobias Adrian et al., *The Federal Reserve's Primary Dealer Credit Facility*, 15 CURRENT ISSUES IN ECO. AND FIN. 1, 5 (Aug. 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1473444 (explaining that "[w]hile traditional commercial banks hold nontradable bank loans on the asset side of their balance sheets and nontradable deposits on the liability side, dealers hold tradable securities on the asset side.").

130. At the end of 2007, repurchase transactions made up 38% of broker-dealers' total liabilities. *Id.* at 2.

131. Most repurchase agreements (including the Fed's) are actually structured as triparty agreements. The third party is a clearing bank, at which the borrower posts collateral and receives funds. *Id.*

as the value of the securities pledged as collateral.[132] MBS were perceived as particularly risky.[133] A number of lenders chose to lend only against the safest securities, such as Treasury securities.[134] Those lenders that continued to lend against riskier securities applied sharp haircuts.[135]

In response, on March 11, 2008, the Fed created the TSLF. This facility, which expired on February 1, 2010,[136] lent out Treasury securities to primary dealers, who provided their own securities (including MBS) as collateral.[137] The New York FRB was authorized to lend out a total of $200 billion of Treasury securities.[138] These loans were allocated by weekly auction.[139]

The program was not designed to be a long-term response to liquidity problems in the credit markets. Each loan had a maturity of twenty-eight days.[140] Furthermore, loans were made with recourse, so that dealers were obliged to repay the Fed for any decline in the value of the collateral that they had pledged.[141]

*ii. Assessment*

The TSLF appears to have come within the scope of the Fed's § 13(3) authority. This facility made a series of loans to primary dealers that were collateralized by their debt securities.[142] This transactional structure seems to fulfill the requirements set out in § 13(3).[143]

2. The Primary Dealer Credit Facility (PDCF)

*i. Background*

Even after the Fed had averted the collapse of Bear Stearns, other primary dealers still faced their own difficulties obtaining credit in the repurchase markets. And so on March 16, 2008 (the same day on which

132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. Fed. Res. Bank of N.Y., *Term Securities Lending Facility: Program Terms and Conditions* (June 25, 2009), http://www.ny.frb.org/markets/tslf_terms.html.
137. *Id.*
138. Press Release, Bd. of Governors of the Fed. Res. Sys., FOMC Statement: Federal Reserve and Other Central Banks Announce Specific Measures Designed to Address Liquidity Pressures in Funding Markets (Mar. 11, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080311a.htm.
139. *Id.*
140. *Id.*
141. WESSEL, *supra* note 65, at 152.
142. Fed. Res. Bank of N.Y., *supra* note 136.
143. *See supra* Part II.B.

the Fed provided funds for the Bear Stearns acquisition), the Fed opened a new lending facility for primary dealers: the Primary Dealer Credit Facility (PDCF).

The PDCF, which expired on February 1, 2010,[144] provided secured overnight loans to primary dealers.[145] It was analogous to the existing discount window program for banks. However, there were two important differences. First, discount window loans had a longer maturity period, of up to ninety days. Second, a broader range of collateral was eligible to be pledged at the PDCF than at the discount window: all collateral eligible for pledge in triparty repurchase agreements with the Fed.[146] A haircut was applied to this collateral.

*ii. Assessment*

Initially, it appears that the PDCF came within the scope of the Fed's § 13(3) authority. As at the TSLF, the Fed made a series of secured loans to primary dealers (but of cash rather than of Treasury securities). However, the PDCF did not restrict instruments eligible for discount to credit instruments.[147] And as we saw above, corporate shares do not appear in the enumerated list of instruments eligible for discount.[148]

3. The ABCP Money Market Mutual Fund Liquidity Facility (AMLF)

*i. Background*

We saw above that MMMFs faced difficulties in September 2008, once Lehman Brothers filed for bankruptcy and the Reserve Primary Fund

144. Press Release, Bd. of Governors of the Fed. Res. Sys., Federal Reserve Announces Two Initiatives Designed to Bolster Market Liquidity and Promote Orderly Market Functioning (Mar. 16, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080316a.htm.

145. Fed. Res. Bank of N.Y., *Primary Dealer Credit Facility: Program Terms and Conditions* (June 25, 2009), http://www.newyorkfed.org/markets/pdcf_terms.html.

146. *Id.* The Fed expanded the group of eligible securities on September 14. Previously, the range of eligible collateral had included only investment-grade equities and securities (as well as collateral that could be pledged in the Fed's open-market operations). *See* Press Release, Bd. of Governors of the Fed. Res. Sys., Federal Reserve Board Announces Several Initiatives to Provide Additional Support to Financial Markets, Including Enhancements to its Existing Liquidity Facilities (Sept. 14, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm (announcing this change).

147. Fed. Red. Bank of N.Y., *Primary Dealer Credit Facility: Program Terms and Conditions* (June 25, 2009), http://www.ny.frb.org/markets/pdcf_terms.html (stating that eligible collateral at the PDCF included "all collateral eligible for pledge in triparty funding arrangements through the major clearing banks" which encompasses equity as well as debt).

148. *See supra* Part II.B.

"broke the buck".[149] In response, on September 19, 2008,[150] the Fed created the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) (and later, it also created the MMIFF, which we examined above).[151]

The AMLF, which expired on February 1, 2010, sought to prevent other MMMFs from selling their asset-backed commercial paper in a falling market. By doing so, they were increasing the demand for redemptions and heightening their liquidity problems. The AMLF made non-recourse loans to depository institutions and bank holding companies. These loans were used to purchase ABCP from MMMFs that were experiencing significant demands for redemption.[152] The collateral for the loans was the purchased ABCP.[153]

*ii. Assessment*

Initially, this structure appears to be similar to that involved in the Bear Stearns-JPMorgan transaction. The Fed made a loan to an entity that used it to purchase assets. These assets constituted the security for the loan. Even so, we will conclude that this transaction actually came within the scope of the Fed's § 13(3) authority. Why would this be the case?

The answer is that here, there was no impermissible asset purchase by the Fed, or by an SPV controlled by the Fed. Instead, the purchased ABCP was brought onto the balance sheets of the *depository institutions* rather than onto the balance sheet of a Fed-created entity.[154]

In this way, the Fed did not exceed the bounds of its § 13(3) powers. It made loans to depository institutions. They then purchased assets, which appeared on their own balance sheets. Section 13(3) contemplates a loan transaction. It does not then constrain what the borrower goes on to do with that loan.[155] Overall, then, the *loan/asset-purchase* distinction was

149. *See supra* Part IV.A.3.i.

150. THE FED. RES., REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: ASSET-BACKED COMMERCIAL PAPER MONEY MARKET MUTUAL FUND LIQUIDITY FACILITY 1 (2008), *available at* http://www.federalreserve.gov/monetarypolicy/files/129amlf.pdf (describing the background, structure, and basic terms of the AMLF).

151. *Id.*

152. *Id.* MMMFs eligible to participate had to have experienced outflows of at least 5 percent of net assets in a single day or at least 10 per cent of assets within the previous five business days.

153. *Id.* at 3. Eligible ABCP had to be purchased after September 19, 2008. *Id.* It had to be issued by a U.S. entity, and to receive a high rating from a credit-rating agency. *Id.* The maturity of the ABCP could not exceed 120 days (if banks were purchasing it) or 270 days (if nonbanks were purchasing it). *Id.*

154. *Cf.* Baxter, *supra* note 19, at 13 (describing purchases by the Fed's own SPVs).

155. Assuming that the borrower is not the Fed, which (as we have argued above) has the

met in this case.

Is this analysis persuasive? One could argue in response that there is no difference in substance between the AMLF and the Bear Stearns-JPMorgan transaction. Maiden Lane is a distinct corporate entity. It is just as separate from the Fed as are the financial institutions that borrowed under the AMLF. But the counter-argument is that the Fed manages and controls Maiden Lane's assets. In contrast, it has no control over the assets of the financial institutions that received loans under the AMLF.

On the present facts, then, the Fed did not itself purchase ABCP from MMMFs in order to move this paper onto its own balance sheet and so make the purchase of an MMMF a more attractive prospect for another private party. It made loans to financial institutions, so that they themselves could purchase ABCP and hence provide liquidity to MMMFs facing redemption.

Even so, there remains a concern about a loan *to the party that needs assistance*. The borrowers (the depository institutions) were not the parties that were unable to receive credit from elsewhere (the MMMFs).[156]

4. The Term Asset-Backed Securities Loan Facility (TALF)

*i. Background*

Securitization is a process by means of which entities can more easily transfer loans away from their balance sheets.[157] First, they create pools of these loans. Next, they sell interests in these pools to investors. The interests take the form of securities. This process can be advantageous for banks because they may then be able to originate further loans. Furthermore, investors in the securities may benefit from diversification because of their interests in a large underlying pool of assets.

Asset-backed securities (ABS) derive value from their underlying assets. Examples of ABS include securities created from automobile loans, credit card loans, and leases of equipment (but not, by convention, mortgage-backed securities, which are referred to separately as MBS).[158]

In October 2008, new issues of ABS came to a halt. The Fed was concerned because, as it pointed out, ABS markets "historically have

specific statutory power under § 13(3) to make secured loans, and not to purchase assets.

156. It is possible to argue that the depository institutions would themselves have faced difficulties obtaining credit had the pressures faced by the MMMFs not been resolved, but this argument is forward-looking and does not appear to be persuasive. The AMLF was created at a time when the MMMFs were the parties facing difficulties obtaining credit from elsewhere. The transaction sought to respond to the MMMFs' liquidity concerns, not those of the banks.

157. *See* SCOTT II, *supra* note 119, at 568-574 (discussing asset securitization and issues that the financial crisis has raised with respect to credit markets).

158. *Id.*

funded a substantial share of credit to consumers and businesses."[159] Disruption of these markets could, in its view, "significantly limit the availability of credit to households and businesses of all sizes," and so contribute to a further weakening of economic activity.[160] In order to reopen the ABS markets, and to further promote the flow of credit to businesses and households, the Fed created the Term Asset-Backed Securities Loan Facility (TALF) on November 25, 2008.[161] It expired on June 30, 2010.[162]

The TALF made loans to investors who purchased AAA-rated ABS.[163] The securities themselves served as collateral for these loans, which were made without recourse.[164] Up to $200 billion was allocated to the facility.[165] Securities eligible for purchase included automobile loans, credit card loans, and student loans.[166] After an expansion of the program, commercial mortgage-backed securities (CMBS) also became eligible for purchase.[167]

Each loan was subject to a haircut. This haircut provided some protection to the Fed. It also ensured that investors retained some monetary stake in their purchases. In the event that investors did not repay their loans, the Fed could sell their securities to TALF LLC, an SPV that it created.[168] The Treasury agreed to bear the first $20 billion of losses by this SPV, by providing it with a loan in this amount. The Fed bore the remainder.[169]

159. Fed. Red. Bank of N.Y., *Term Asset-Backed Securities Loan Facility: Frequently Asked Questions* (July 21, 2010), http://www.newyorkfed.org/markets/talf_faq.html.

160. *Id.*

161. Press Release, Bd. of Governors of the Fed. Res. Sys., Federal Reserve Announces the Creation of the Term Asset-Backed Securities Loan Facility (TALF) (Nov. 25, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20081125a.htm.

162. Fed. Res. Bank of N.Y., *supra* note 159.

163. Fed. Res. Bank of N.Y., *Term Asset-Backed Securities Loan Facility: Terms and Conditions* (July 21, 2010), http://www.newyorkfed.org/markets/talf_terms.html [hereinafter Fed. Res. Bank of N.Y. II].

164. *Id.*

165. *Id.*

166. *Id.* Also included were loans guaranteed by the Small Business Administration, loans relating to business equipment, leases of vehicle fleets, and insurance premium finance loans. *Id.*

167. Press Release, Bd. of Governors of the Fed. Res. Sys., Federal Reserve Announces that Certain High-Quality Commercial Mortgage-Backed Securities will become Eligible Collateral under the Term Asset-Backed Securities Loan Facility (May 19, 2009), http://www.federalreserve.gov/newsevents/press/monetary/20090519b.htm.

168. Fed. Res. Bank of N.Y. II, *supra* note 163.

169. *Id.* After the program closed to new lending on June 30, 2010, this commitment was later reduced to $4.3 billion. *Id.*

*ii. Assessment*

The TALF appears to have come within the scope of the Fed's § 13(3) authority. The appropriate analysis is similar to that which we set out above in the case of the AMLF.[170] The Fed did not itself purchase securities and bring them onto its own balance sheet. Instead, the Fed sought to facilitate purchases of ABS by other private investors. For this reason, the transactional structure is not the same as those that we considered in the SPV cases above, where the Fed's SPV acquired the assets at the outset.

However, there remains a concern about a loan *to the party that needs assistance*. The borrowers (the private investors) were not the parties who were unable to receive credit from elsewhere (those seeking to issue and sell ABS).

*C. No legal authority: Lehman Brothers*

Above, we considered a number of cases in which the Fed effected both asset purchases and loan transactions. In all of these cases, the Fed invoked its § 13(3) authority. However, there remains one important case in which the Fed took no action under the statute. This is the case of Lehman Brothers.

1. Background

Lehman Brothers ("Lehman") was an investment bank that made large investments in MBS. Like Bear Stearns, it started to face significant liquidity problems when its creditors refused to lend against its assets. On September 10, 2008, it announced a $3.9 billion quarterly loss.[171] Its shares had fallen 45% the previous day, and more than 90% since the beginning of the year.[172]

The Fed did not use § 13(3) to provide credit to Lehman. Lehman subsequently filed for Chapter 11 bankruptcy on September 15, 2008. The Fed had made certain attempts to prevent this outcome. It has been stated that the Fed tried to find a buyer for Lehman, and that there were two potential candidates: Barclays Bank ("Barclays") and Bank of America. Bank of America, however, eventually declined to enter into a deal –

170. *See supra* Part IV.B.3.ii (analyzing the transactional structure of the AMLF).
171. Ben White, *Lehman sees $3.9 billion loss and plans to shed assets*, N.Y. TIMES, Sept. 10, 2010, *available at* http://www.nytimes.com/2008/09/10/business/worldbusiness/10iht-11lehman.16037408.html.
172. *Id.*

possibly because it sought greater assistance than that which the government was willing to provide.[173] At the time, Bank of America was also in negotiations to purchase Merrill Lynch. On September 14, 2008, it announced that it would do so.

Thereafter, Barclays was the only remaining candidate. The Fed declined to provide any public funding to Barclays. Instead, it put together a consortium of investment banks.[174] This consortium agreed to lend billions of dollars to an SPV created by the Fed that would acquire Lehman's illiquid assets. Barclays would then purchase Lehman's remaining assets.[175]

However, there was a difficulty with the proposed transaction. Any deal between Barclays and Lehman would take more than a month to close after the contract had been signed. The Treasury insisted that Barclays guarantee Lehman's trading obligations in the interim. Its concern was that Lehman's partners would otherwise cease to do business with the firm, and so render it worthless.[176] Under U.K. stock-exchange listing rules, Barclays would have to hold a shareholder vote before it could provide a guarantee.[177] However, there was insufficient time to hold such a vote. It has also been suggested that the U.K. Financial Services Authority, after consulting with the U.K. government, refused to waive this requirement.[178]

Ultimately, Lehman's holding company filed for bankruptcy. However, while the proceedings were ongoing, Lehman's broker-dealer, financed by loans from the PDCF, continued to operate.[179] In the course of the bankruptcy, Barclays ultimately purchased this broker-dealer (as well as Lehman's U.S. office) for $1.75 billion.[180]

We can put forward two views about the Fed's decision-making in Lehman's case. The first is a view that the Fed has expressed publicly: that it had no legal authority to save Lehman. The second is that the Fed did have this legal authority, but chose not to use it. We will examine each of these views in turn.

173. *See* ANDREW ROSS SORKIN, TOO BIG TO FAIL 279, 300, 319 (2009) (stating that Bank of America offered to share the first $1 billion of losses on Lehman's assets with the government. It asked the government to bear a further $40 billion of losses, and later raised this figure to $70 billion).

174. *Id.* at 302-03 (describing one of the working groups created to develop a structure for investment in the failing bank).

175. *Id.* at 336 (stating that the consortium agreed to provide $33 billion in order to absorb losses, so that Barclays could then acquire $3.5 billion of Lehman's more liquid assets).

176. *Id.* at 324.

177. *Id.*

178. *Id.* at 346, 348 (suggesting that the U.K. government was concerned about Lehman's exposure to risk and the limited information available in the circumstances).

179. *Id.* at 358.

180. *Id.* at 454-55.

### *i. The Fed did not have the legal authority to save Lehman*

In an October 2009 presentation at Harvard Law School, Thomas C. Baxter, Jr., General Counsel to the New York FRB, set out the Fed's view of its own legal authority. The Fed concluded that it could use § 13(3) to lend and to purchase assets, but that it could not use it to provide an ongoing guarantee for a private merger agreement.[181]

Ben Bernanke, the Chairman of the Fed's Board of Governors, had put forward a different analysis based not on the absence of a guarantee but on the inadequacy of Lehman's collateral. In a December 2008 speech in Austin, he stated that Lehman's available collateral "fell well short of the amount needed to secure a Federal Reserve loan sufficient to pay off the firm's counterparties and continue operations."[182] He contrasted Lehman's case with that of AIG, where there was sufficient collateral, and that of Bear Stearns, where JPMorgan was willing to provide a guarantee of the firm's trading obligations. Bernanke concluded that Lehman's failure was "unavoidable, given the legal constraints."[183]

### *ii. The Fed did have the legal authority to save Lehman, but did not use it*

Other commentators point to political rather than legal constraints. They put forward the idea that the Fed may have had the legal authority to save Lehman, but that it chose not to use it.[184] In support, they cite statements by Treasury and Fed officials at the time of Lehman's bankruptcy.

For example, Hank Paulson, then Treasury Secretary, gave a press conference on September 15, 2008 at which he stated that he "never once considered that it was appropriate to put taxpayer money on the line in resolving Lehman Brothers."[185] Furthermore, when speaking before the Senate Committee on Banking later in September 2008, Ben Bernanke

181. Thomas C. Baxter, Jr., General Counsel, Federal Reserve Bank of New York, Address at Harvard Law School's International Finance Seminar: Lessons Learned From the Financial Crisis, Address (Oct. 19, 2009) [hereinafter Baxter II].

182. Ben S. Bernanke, Chairman of the Federal Reserve, Remarks at the Greater Austin Chamber of Commerce, Austin, Texas (Dec. 1, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm.

183. *Id.*

184. *See* SORKIN, *supra* note 173, at 303 (stating that Timothy Geithner "reiterated [Hank] Paulson's decree: 'There is no political will for a federal bailout.'"); WESSEL, *supra* note 65, at 21-24 (describing the political pressure brought to bear on Paulson and Bernanke after the rescue of Bear Stearns and quoting statements by a Fed official to the effect that a decision was made to let Lehman fail).

185. Susanne Craig et al., *AIG, Lehman Shock Hits World Markets*, WALL ST. J., Sept. 16, 2008, *available at* http://online.wsj.com/article/SB122152314746339697.html.

stated that the Federal Reserve and the Treasury "*declined* to commit public funds" to support Lehman.[186] Although Lehman's failure posed risks, its troubles "had been well known for some time, and investors clearly recognized . . . that the failure of the firm was a significant possibility."[187] Thus, the Fed "judged that investors and counterparties had had time to take precautionary measures."[188] It can be argued that these comments reflect a deliberate political decision to let Lehman fail.[189] Nevertheless, the Fed has not made any statement to this exact effect. In fact, in his October 2009 presentation, Thomas C. Baxter, Jr., categorically stated that no policymaker made a decision to let Lehman fail.[190] One final point made by commentators is that the Fed and the Treasury may have prepared no alternatives to the Barclays transaction because they had expected this deal to succeed.[191]

2. Assessment

An assessment of the claim that Lehman's failure was rooted in political rather than legal decision-making goes beyond the scope of the present analysis. We also lack the information necessary to make such an assessment. We shall therefore take the Fed's legal claims at face value and evaluate only these. The first is that the Fed did not have the legal authority to guarantee Lehman's ongoing obligations. Insofar as § 13(3) is concerned with the provision of individual loans, this conclusion may be correct.

However, we can make two points in response. First, the Fed's approach is not dispositive. The logically prior question is whether the ongoing guarantee of Lehman's assets – on which the Fed insisted – was necessary in the first place. It is true that in the case of Bear Stearns, JPMorgan did provide such a guarantee to creditors. The private

186. Ben S. Bernanke, Chairman of the Federal Reserve, Remarks before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Sept. 23, 2008), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20080923a1.htm) (emphasis added).

187. *Id.*

188. *Id.* A related point that Bernanke does not make expressly is that Lehman had had access to the PDCF since March 16, 2008, and so would have been able to borrow from the Fed if it had chosen to do so. *See* ROSS SORKIN, *supra* note 173, at 285 ("At least in the Bear case, there was some legitimate fear of systemic risk. The Federal Reserve's discount window hadn't yet been opened to investment banks, and so there was some chance of a larger liquidity panic.") (quoting *Lehman's Fate*, WALL ST. J., Sept. 12, 2008, at A16, *available at* http://online.wsj.com/article/SB122117590254125801.html).

189. *See* SORKIN, *supra* note 173, at 282 (suggesting that Paulson sought to avoid the "political liability of putting up government money for Lehman.").

190. Baxter II, *supra* note 181.

191. WESSEL, *supra* note 65, at 21.

consortium in Lehman's case, on the other hand, did not. Its members only agreed to acquire Lehman's illiquid assets so that Barclays could purchase the rest. However, no such ongoing guarantee was given in the case of AIG. This renders questionable the argument that such a guarantee was necessary.

The second point is that the Fed could conceivably have made a large series of loans to Lehman under § 13(3). These loans would have had the same effect as that of an ongoing guarantee, ensuring that Lehman continued to trade until the deal with Barclays closed. However, the counter-argument is that such a step would not have been helpful. The market had lost confidence in Lehman's ability to trade. For this reason, providing a series of loans would not have resolved Lehman's difficulties.[192] This approach, however, moves away from arguments about legal authority and towards arguments about practicality and appropriateness of response. It does not convincingly demonstrate that a series of loans would certainly have exceeded the limits of § 13(3).

The Fed's second claim, as articulated by Ben Bernanke, is more persuasive. This is the claim that Lehman's assets would not have provided sufficient collateral for a § 13(3) loan. We have seen that § 13(3) requires financial instruments to be secured to the satisfaction of a Reserve Bank. Therefore, a decision that a security constitutes insufficient collateral is one that a Reserve Bank is entitled to make.

However, we can once more make two points in response. First, we might question whether Lehman's assets would have remained insufficient even after the private consortium had acquired its illiquid assets. It is conceivable that after the involvement of the consortium, the Fed could have guaranteed Lehman's trading obligations until the Barclays deal closed. But the counter-argument is that the decision not to do so was ultimately a judgment within the scope of the Fed's discretion. Again, we lack the information necessary to assess the quality of Lehman's assets as against those of Bear Stearns, or those of AIG, to which the Fed provided credit one day later.

The second argument is stronger. Under the CPFF, the Fed purchased *unsecured* commercial paper from issuers.[193] Lehman's collateral, insufficient though it might have been, would certainly have constituted better security for a loan than an issuer's promise to pay.[194]

192. Baxter II, *supra* note 181.

193. *See supra* Part IV.A.2.

194. *But see supra* Part IV.A.2.ii (suggesting that the CPFF fees did constitute some security for the loan).

## V. CONGRESS'S VISION FOR § 13(3): THE CASE FOR REFORM

So far, the purpose of our analysis has been to assess the Fed's actions during the financial crisis against its statutory powers. We have argued that § 13(3) did not support the interpretative weight that the Fed then sought to bring to bear on it. Where does this conclusion lead us?

One answer is that the point should be recognized expressly. Various people associated with the Fed have made statements acknowledging that it reached the bounds of its legislative mandate. For example, former Federal Reserve Chairman Paul Volcker said that the Fed "judged it necessary to take actions that [extended] to the very edge of its lawful and implied powers."[195] On the other hand, in 2009, Thomas C. Baxter, Jr., stated that the Fed "will do whatever it takes, within the bounds of the law, to deal with [the] financial crisis."[196] The conclusion of this Article is rather different: that the Fed not only reached the bounds of its legislative powers, but that it exceeded them.

Another answer is that it had become necessary to alter the legislation. One option would have been to amend § 13(3) in order to give the Fed the powers it sought to assume during the crisis. However, Congress, in passing the Dodd-Frank Act, chose a different approach. This legislation has made a number of important amendments to § 13(3). When we come to analyze these below, we will see that they resolve a number of concerns about the statute, even though others do remain.

To help us evaluate the reforms, we shall first set out the counterfactual. What was the case for reform before Congress acted? In particular, what vision did the legislature have for § 13(3) and how did the Fed's activity depart from that vision? Once we have asked these questions, we will be in a position to consider what effects the reforms have had and whether they have been successful.

### *A. The Intended Purpose of § 13(3)*

Let us begin by asking what vision Congress might have had in enacting § 13(3). How was it intended to be used? We saw above that the section allowed the Fed, in times of emergency, to make secured loans to entities that could not obtain credit from elsewhere. What sort of entities might these be?

Commercial banks have always been able to borrow at the Fed's discount window, and so they have no need for § 13(3). Investment banks,

195. Hal S. Scott, *The Reduction of Systemic Risk in the United States Financial System*, 33 HARV. J.L. & PUB. POL'Y 671, 723 [hereinafter Scott III] (noting former Chairman Volcker's concerns that the financial system had failed the test of the marketplace).

196. Baxter II, *supra* note 181.

however, were not eligible for discount window loans at the time of the crisis. As corporations, though, they were eligible for § 13(3) loans: either by means of individual bailouts or under the PDCF. Even so, it should be pointed out that the largest investment banks that survived the crisis are now bank holding companies.[197] As such, they can now borrow at the discount window at any time. They are also subject to the Fed's oversight.

There remains one residual category: that of § 13(3) lending to nonbanks. Under what sort of circumstances might the legislature have envisaged this occurring? The most appropriate recipients of § 13(3) loans would seem to be nonbanks with some significant connection to the financial system. From the Fed's perspective, this is surely the most relevant sense of "unusual and exigent" circumstances. It is true, as we saw above in our survey of the history of § 13(3) lending, that the Fed did extend credit to industrial (rather than financial) nonbanks between 1932 and 1936. Even so, such industrial lending was limited in scope, and the Fed ceded its role in this area to other entities.[198] At present, it no longer seems possible to conceive of the Fed's making a loan to a nonbank unless the failure of such an entity would have a significant effect on the financial system.

### *B. Systemic risk*

It follows from the above analysis that the concern underlying § 13(3) was one about systemic risk. According to Scott, this term has two meanings. First, there is the *chain reaction* problem: the possibility that the failure of one entity will affect others. More precisely, this is the risk that "the failure of one significant financial institution [might] cause or significantly contribute to the failure of other significant financial institutions as a result of their linkages to each other."[199]

Second, there is the possibility of an *exogenous shock* that may have a simultaneous impact on a number of financial institutions. These sources of systemic risk are related: an exogenous shock can trigger a chain reaction. At the time of the crisis, § 13(3) had an entity-specific focus that permitted lending to individual entities as well as to groups. In this way, it was well positioned to address both of these concerns.

Scott goes on to set out three causes of financial chain reactions.[200] First, there are imitative runs. Here, after a bank fails, depositors in another

197. Namely Bank of America (which acquired Merrill Lynch), Goldman Sachs, JPMorgan (which acquired Bear Stearns), and Morgan Stanley.

198. *See supra* Part III.B.1.

199. *See* Scott III, *supra* note 195, at 673 (discussing the reduction of systemic risk, and noting that this is the central problem for financial regulation).

200. *See* SCOTT, *supra* note 94, at 11-12; *see also* Scott III, *supra* note 195, at 673–75.

bank assume that their bank will also fail, and so they withdraw their funds. Second, there are interbank deposits, where one bank places its deposits with another. Finally, there is counterparty risk, or interconnectedness. Scott points out that when we are considering nonbanks, this is the most relevant source of systemic risk.[201] Here, an institution may fail because its counterparty cannot settle a derivative position. Even so, the extent of losses (and failures) will depend on the value of the collateral that the institution holds.[202]

What effects can systemic risk (and actions taken to prevent it) have? One is a governmental bailout made at the taxpayers' expense. Another is an increase in moral hazard. This is the concern that private institutions that have been rescued by the government, or know that they will be, may become less concerned about the effects of their own risk-taking. They may take fewer steps to protect themselves against future losses.

Section 13(3) contained an important means of protection against moral hazard. Entities receiving loans had to provide satisfactory collateral. The Fed could also look to the assets of the borrower in the event of a shortfall. In this way, the borrower, and not the Fed, would still bear the main effects of its own risk-taking. Moreover, by making loans only against satisfactory collateral, the Fed was also less likely to experience losses. Thus, overall, the conditions for lending in § 13(3) sought not only reduce moral hazard but also to protect the Fed itself.

It appears persuasive to say that at the time of the crisis and beforehand, § 13(3) sought to contain systemic risk. But we must qualify our conclusion in one important respect. Section 13(3) as enacted sought only to contain systemic *liquidity* risks. For this reason, the Fed's role as a systemic risk regulator was embryonic. When faced with the problem of a chain reaction or an exogenous shock, the Fed could, according to the statute, respond only by lending against satisfactory collateral. But during the crisis, the Fed in fact used § 13(3) to respond to systemic *insolvency* risks. It took on the role of systemic risk regulator as such, despite the confines of the statute and its duties as a central bank.

One possible response is to argue that the flexibility that § 13(3) provided to the Fed during the financial crisis proved advantageous. The Fed was able to act quickly, long before Congress enacted EESA on

201. *See* SCOTT, *supra* note 94, at 12 (acknowledging that it is difficult to estimate the severity of this form of risk, as well as the degree of interconnectedness among institutions).

202. For example, in March 2009, Goldman Sachs stated publicly that it had adequate collateral to protect itself against the consequences of a default by AIG. Scott III, *supra* note 195, at 675. Despite this, Goldman Sachs received the largest portion of the Fed's $85 billion loan to AIG. *Id.* Perhaps, then, AIG's rescue did not follow from concerns about systemic risk as such but rather from concerns about the losses that AIG's investors would have had to bear if the firm had failed.

October 3, 2008.[203] However, the Fed also made a series of ad hoc decisions, rescuing some entities and letting others fail. And so the other argument, with which Congress appears to have agreed, is that these actions were problematic. A dedicated systemic risk regulator, had one existed at the time, may have been able to act more quickly and coherently. In fact, the Dodd-Frank Act creates such a specialized entity. We will return to consider its role below.[204]

### *C. The Dodd-Frank Wall Street Reform and Consumer Protection Act*

#### 1. Overview: The Amendments to § 13(3)

We are now in a position to examine the amendments to § 13(3) contained in the Dodd-Frank Act. This legislation makes a number of changes to § 13(3). First, it sets out a clear vision of § 13(3) and its function. Second, it prohibits lending to single and specific entities. Third, it seeks to ensure that the Fed receives sufficient collateral for its loans. Fourth, it requires input by the Treasury into the Fed's decision-making. Finally, it sets out detailed reporting obligations. We will examine each of these points in turn.

The first point concerns the newly stated purpose of the legislation. As amended, § 13(3) now states that future emergency lending will occur under a set of policies and procedures (to be established by regulation) designed to ensure that "any emergency lending program or facility is for the purpose of providing liquidity to the financial system."[205]

The second point is that the Fed can no longer lend to "any individual, partnership, or corporation." Instead, it can discount notes, drafts, and bills of exchange for "any participant in any program or facility with broad-based eligibility."[206] Hence the Fed can no longer make loans to individual entities. It cannot, by its emergency lending programs and procedures, seek to "aid a failing financial company," or to "remove assets from the balance sheet of a single and specific company."[207] Nor can it seek to help a single and specific company avoid bankruptcy.[208]

This point is further emphasized by one of the criteria that the Comptroller General must use when exercising his new powers to audit § 13(3) facilities (which we will discuss in greater detail below). The

203. The House of Representatives had earlier rejected EESA in bill form on September 29, 2008. Office of the Clerk, H.R., *Final Vote Results for Roll Call* (Sept. 29, 2008), 674, http://clerk.house.gov/evs/2008/roll674.xml.

204. *See infra* Part V.C.2.iii.

205. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101, 12 U.S.C. § 5301 (2010).

206. *Id.*

207. *Id.*

208. *Id.*

Comptroller must consider whether the credit facility "inappropriately favors one or more specific participants over other institutions eligible to utilize the facility."[209]

The third amendment concerns collateral. The test in the previous legislation is preserved. Once more, the financial instruments to be discounted must be endorsed or otherwise secured to the satisfaction of the Federal Reserve Bank. However, further guidance now accompanies this test. In determining whether a loan is satisfactorily secured, Reserve Banks must now assign a "lendable value" to all collateral that they receive for their loans, in a manner consistent with "sound risk management practices."[210] The security for emergency loans must be "sufficient to protect taxpayers from losses."[211] Insolvent borrowers are expressly prohibited from borrowing under the Fed's § 13(3) programs. We saw above, when considering the distinction between targeted individual loans and programs of broad-based eligibility, that the Fed cannot seek to aid failing financial companies or to help them avoid bankruptcy.

The fourth amendment to § 13(3) ensures future executive input into the Fed's decision-making. Before the Fed can establish any § 13(3) program or facility, it must now obtain the approval of the Secretary of the Treasury.[212]

Finally, by its other provisions, the Dodd-Frank Act seeks to ensure that the Fed's past and future § 13(3) decision-making is made more transparent.[213] The Comptroller General now obtains the power to conduct reviews and on-site examinations of the Fed, its Reserve Banks, and its credit facilities, such as the SPVs established under § 13(3).[214] The Comptroller General may also assess the Fed's discount window lending and its open-market operations. The relevant criteria are the adequacy of financial reporting, the effectiveness of security and collateral policies, and, as we have seen, whether the facilities inappropriately favor one or more specific participants over others.[215]

The Government Accountability Office is also to conduct a one-time audit of all the Fed's actions from December 1, 2007 until the date of the

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209. *Id.* at § 1102.

210. *Id.* at § 1101.

211. *Id.*

212. *Id.*

213. Previous legislation had already sought to address such concerns. EESA § 129 required that the Fed, within seven days of invoking § 13(3), provide Congress with a report justifying its actions and stating the terms under which it lent. Emergency Economic Stabilization Act of 2008 § 129 (2008). It had to update these reports every sixty days. *Id.* But this obligation was limited in duration. It covered only the period from March 1, 2008 to October 3, 2008. *Id.*

214. Dodd-Frank Act § 1102.

215. *Id.*

legislation's enactment.[216] This audit will cover all of the Fed's § 13(3) activities. The Fed itself is also subject to new disclosure obligations. By December 1, 2010, it must publish on its website various details about its past § 13(3) programs, such as the identity of those who received assistance, the value of that assistance, and the specific rationale for each program.[217] The Fed will also be required to disclose information about its future § 13(3) activities, and to publish this on its website after the termination of its programs.[218]

2. Assessment

We have seen that the Dodd-Frank Act makes a number of wide-ranging modifications to § 13(3). Overall, we will argue that these are to be welcomed. Our analysis will proceed in three parts. First, we will set out one remaining caveat as to the *loan/asset-purchase* distinction, the status of which appears to remain ambiguous in the legislation. Second, we will evaluate the thrust of the changes that the Act makes and attempt to explain these in the light of the concerns we have previously raised. Third, we will touch upon the systemic risk problem. We will seek to demonstrate that § 13(3) has now resumed the role it was intended to have: that of regulating systemic liquidity risks.

*i. A remaining ambiguity in the legislation*

Throughout our analysis, we have argued that § 13(3) provides the Fed with defined powers of limited scope. It may lend freely against sufficient collateral, which is the classic function of a central bank.[219] In this way, it can provide liquidity to entities that are otherwise solvent. We have also sought to demonstrate that § 13(3) does not support the full scope of the Fed's past activity. Although the statute permits only secured lending, the Fed also invoked it to purchase assets.

Does the current provision address this concern? It might, but the point remains ambiguous. The newly amended § 13(3) preserves the basic structure of the previous legislation. Once more, the Fed can discount financial instruments for entities that cannot secure adequate credit from

216. *Id.* at § 1109.
217. *Id.*
218. *Id.* at § 1103.
219. KENNETH N. KUTTNER, THE FEDERAL RESERVE AS LENDER OF LAST RESORT DURING THE PANIC OF 2008 1 (2008), *available at* http://www.capmktsreg.org/pdfs/The_Federal_Reserve_as_Lender_of_Last_Resort_during_the_Panic_of_2008.pdf (explaining that "[t]here is a long history of central banks providing liquidity during banking panics" and setting out Bagehot's view that a lender of last resort should lend freely, but at a penalty rate, against good collateral).

other banks. The amending legislation states that § 13(3) is a provision about the Fed's "emergency *lending* authority."[220] It also states that the Fed cannot use it to "*remove assets* from the balance sheet of a single and specific company."[221] These provisions appear to support the *loan/asset-purchase* distinction that we have drawn throughout our analysis.

On the other hand, it can also be argued that the main emphasis of these provisions lies elsewhere. Their purpose may be to ensure that the Fed cannot discriminate between entities that are equally in need of assistance. On this view, the Fed is prohibited from removing assets *from the balance sheet of a single and specific company* – not from purchasing assets per se.

Therefore, it can be argued that the Fed is still exercising its "emergency lending powers" when it incorporates an SPV and then makes loans to it for the purpose of purchasing assets. In fact, the amended statute, with its requirement that the Fed establish schemes of "broad-based eligibility," may even contemplate such asset purchases – so long as they occur on a wide scale.

In other words, Congress's main concern may have been about the distinction that the Fed drew between Bear Stearns, AIG, and issuers of commercial paper on the one hand and Lehman on the other. Hence the thrust of the newly amended legislation may be to proscribe arbitrary decision-making rather than asset purchasing as such. If this is the correct reading of Congress's intention, then this Article suggests that the true interpretation of the statute should be otherwise. To the extent that the Fed uses § 13(3) to circumvent restrictions elsewhere in the FRA, it exceeds the bounds of its statutory authority.

Why do we emphasize this point? There are two reasons. These are equally applicable in situations where the Fed lends against insufficient collateral and where it purchases assets. The first concern is political. The money that the Fed lends out under § 13(3) is not appropriated by the conventional process. Furthermore, during the financial crisis, there was no formal requirement for any executive supervision over the Fed's loan-making activity.

The second concern is economic. To make a loan, the Fed prints money, and so inserts high-powered money into the financial system.[222] To offset the effects of this increase in reserves, which would otherwise lead to inflation, the Fed has to sell Treasury bills in the open market. In this way,

220. *Id.* at § 1101 (emphasis added).
221. *Id.* (emphasis added).
222. Unless it lends out Treasury bills against privately issued securities such as performed at the TSLF. *See supra* Part IV.B.1. This exchange of securities has no effect on the amount of reserves in the financial system. KUTTNER, *supra* note 219, at 5.

it reduces the amount of money in the system.[223] The difficulty is that the Fed has a limited supply of Treasury bills. When its own supply runs out it must seek more from the Treasury.[224] But if the Fed becomes reliant on the Treasury, it may no longer enjoy the same degree of independence to carry out monetary policy.[225]

For these reasons, we might argue that the Fed should have no authority to lend against insufficient collateral and to purchase assets. These powers, if ever to be exercised, should go to another entity, such as the Treasury. Such a step would ensure that funds are appropriated through the political process. It would also ensure that bailouts do not have an adverse effect on the money supply, because the Treasury can finance its own spending with debt.

Congress has now accepted the first limb of this argument, seeking to preclude the Fed's lending against insufficient collateral, but perhaps not the second, which cautions against asset purchases. Even so, we can point out that under the new statute, asset purchases by means of an SPV structure would now be subject to stringent collateral requirements. In this way, our concerns may now have been mitigated. Furthermore, there is now executive input into the § 13(3) process, in the form of approval by the Secretary of the Treasury. Therefore, the most important remaining concern may be about legal authority.

*ii. A return to the lender of last resort model*

Lending freely against sufficient collateral,[226] and so acting as a lender of last resort, is one of the classic functions of a central bank.[227] By its actions, the central bank seeks to address liquidity concerns. It allows solvent banks to keep operating when they would otherwise fail for lack of reserves. We saw above that the Fed's lending to banks takes place at its discount window. The satisfactory collateral requirement in § 13(3) went

223. In October 2008, after the enactment of EESA, the Fed was permitted to pay interest on bank reserves. Emergency Economic Stabilization Act 2008 § 128 (2008). This is another method of decreasing the amount of money in the system, because it encourages banks to deposit money with the Fed.

224. In fact, during the financial crisis, the Treasury operated its Supplementary Financing Program. It sold Treasury bills in the open market and deposited the proceeds with the Federal Reserve. Press Release, U.S. Dep't. of Treasury, Treasury Announces Supplementary Financing Program (Sept. 17, 2008), http://www.ustreas.gov/press/releases/hp1144.htm.

225. In response, we might question the extent to which the Fed really is independent. Commentators suggest that the Treasury played a significant role in shaping the Fed's actions (under § 13(3) and otherwise) during the financial crisis. *See generally*, *e.g.*, SORKIN, *supra* note 173; WESSEL, *supra* note 65. .

226. But at a penalty rate. KUTTNER, *supra* note 219, at 1.

227. *Id.*

some way towards aligning the Fed's role as a regulator for systemic liquidity risks with its role as lender of last resort at the discount window.[228]

However, we also saw that the statutory terms at the time of the crisis were imprecise. Was "secured to the *satisfaction* of the Federal Reserve Bank"[229] an entirely subjective test? We pointed out above that it could conceivably require no collateral. But we argued that it could not operate in this way: at the very least, the borrower would have to provide some security.[230]

What about transactions in which the Fed made § 13(3) loans against collateral of low quality? These would appear to have been acceptable under the terms of the statute at the time the Fed used it. In such cases, by definition, there is a substantial likelihood that the loan will not be repaid in full. Consequently, the Fed is likely to incur losses. These are ultimately borne by the taxpayer, because the Fed remits the profits it makes to the Treasury.[231]

The Dodd-Frank Act responds to these concerns. It realigns § 13(3) once more with the classic function of a central bank: lending freely against sufficient collateral. As we saw above, the provision's expressly stated purpose is now to help the Fed provide liquidity to the financial system. The Act also seeks to clarify the ambiguity as to collateral in the previous legislation. Satisfactory collateral is that which is sufficient to protect taxpayers from losses.[232] A Reserve Bank is required to apply "lendable values" to all the collateral it receives,[233] so it can no longer be argued that the test is wholly subjective.

The approach taken in the Dodd-Frank Act is preferable to that in the earlier House Bill, which has been discarded. For the purposes of that Bill, in order to meet the "secured to the satisfaction" standard, a Reserve Bank's governors would have to have believed there was a "99 percent likelihood" that both the interest and the principal on the relevant loan would be repaid.[234] The Bill would also have capped § 13(3) lending at $4

228. In the case of nonbanks, the Fed's loans seek to provide liquidity in the sense of short-term funding, rather than in the sense of reserves. *Id.* at 4.

229. Federal Reserve Act § 13(3) (emphasis added).

230. *See supra* Part II.F.

231. For example, in 2009, the Fed made a profit of $52.1 billion. Of this, $46.1 billion went to the Treasury. Press Release, Bd. of Governors of the Fed. Res. Sys., Reserve Bank Income and Expense Data and Transfers to the Treasury for 2009 (Jan. 12, 2010), http://www.federalreserve.gov/newsevents/press/other/20100112a.htm.

232. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1101, 12 U.S.C. § 5301 (2010). Presumably, the collateral must be sufficient to protect taxpayers from losses as to both the principal and the interest, but the provision does not specify this.

233. *Id.*

234. The Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1701 (2009).

trillion.[235] Finally, in order to lend under § 13(3), the Fed would have required the approval not only of the Secretary of the Treasury and the President but also of the majority of the members of the Financial Stability Oversight Council (FSOC).[236]

These rejected proposals would have set out a series of high procedural hurdles for the Fed to meet before it could engage in lending. They would also have capped the extent of its lending powers. However, as Scott points out, after we put in place appropriate restrictions on collateral, there is little need for other procedural hurdles.[237] Again, one of the functions of a central bank is to provide liquidity in times of emergency. The extent to which we should politicize the Fed's ordinary activities (when it makes loans against sufficient collateral) is therefore questionable.

On this view, we might also wish to question whether the Dodd-Frank Act ought to have incorporated the requirement for the Fed to seek Treasury approval before it can make § 13(3) loans. The most persuasive response is that this may be a helpful check, and that approval is unlikely to be withheld in the appropriate circumstances.

*iii. Systemic risk regulation*

Above, we suggested § 13(3) has always been concerned with the provision of liquidity to the financial system. However, during the financial crisis, the Fed used it in a different way. By creating SPVs to purchase assets, the Fed assumed the role of a regulator for systemic solvency risks.

The problem is that § 13(3) as it then stood did not provide an overarching framework for systemic risk regulation. It was susceptible to use on an ad hoc basis, and the Fed did so use it during the crisis. As a result, it is difficult to draw from its actions any coherent set of principles by which to predict future decision-making. On the other hand, it is arguable that predictability in decision-making was necessarily difficult to achieve given the time constraints and the complexity of the crisis.

The concern about ad hoc (and perhaps arbitrary) decision-making explains one of the key changes made to § 13(3) by the Dodd-Frank Act. We saw above that the Act prohibits lending to single and specific entities. The Fed can instead establish only programs of broad-based eligibility.

235. *Id.* Although it was not clear whether this referred to any given loan transaction or to loans made over a certain period (such as the lifetime of the provision).

236. *Id.*; *infra* Part V.C.2.iii.

237. *See* Scott III, *supra* note 195, at 725 ("To the extent that the Federal Reserve is loaning against adequate high quality collateral, these procedural safeguards are overkill and unnecessarily limit the independence and flexibility of the Fed to respond to crisis.").

But, given all that we have said above about the permissible containment of systemic liquidity risks, does this modification not appear problematic? Let us imagine that we are faced with a chain reaction problem. Only one entity is illiquid and so requires a loan. However, if it fails, many others will also fail. Here, providing credit to that entity alone would be precisely the right step to take. But § 13(3) as amended precludes the Fed from taking such a step.

There are two possible responses to the concern we have just raised. The first is to say that it will be rare for one institution alone to require help. For this reason, it is usually of greater help to the financial system when the Fed develops wider-reaching programs for a number of institutions. But this argument merely sidesteps the concern instead of addressing it.

The more persuasive response is to consider another important legislative step that Congress has taken in the Dodd-Frank Act. It has demonstrated a preference for *ex ante* solutions to systemic risk concerns. It has created a new systemic risk regulator: the Financial Stability Oversight Council (FSOC). The members of this body are the Secretary of the Treasury, the Chairman of the Fed's Board of Governors, the Chair of the FDIC, and the Director of the new Bureau of Consumer Financial Protection, as well as other federal and state regulators and an independent member with insurance expertise.[238]

The FSOC may require nonbank financial companies to come under the supervision of the Fed if their failure could, by reason of their size, nature, or interconnectedness, pose a threat to U.S. financial stability.[239] Also, pursuant to a declaration of systemic risk,[240] it may itself order the liquidation of failing financial companies that pose a significant risk to U.S. financial stability. This must take place in a manner that mitigates risk and minimizes moral hazard.[241]

A full analysis of the powers of the FSOC lies beyond the scope of this Article. Suffice it to say that § 13(3) is no longer the chief legislative means of regulating systemic risks. This role has now passed to another body established precisely for this purpose.

### *D. The way forward*

Kuttner argues that giving bailout duties to the Fed "obscures its core objectives" and "unnecessarily [links] monetary policy to the rescue of

238. Dodd-Frank Wall Street Reform and Consumer Protection Act § 111, 12 U.S.C. § 5301 (2010).
239. *Id.* at § 113.
240. *Id.* at § 203.
241. *Id.* at § 204.

failing institutions."[242] The premise of this argument is that the Fed should only be a lender of last resort: it should engage only in collateralized lending to solvent entities. Throughout our analysis, we have seen that this restricted view of the Fed's § 13(3) powers finds strong textual support in the statute itself. And Congress has now made it entirely clear that § 13(3) must only be used to respond to concerns about liquidity.

But what of bailout duties? Are they not – at least in some sense – inextricably linked with the Fed's core duties? Its express goals in carrying out monetary policy are to maintain economic growth and to promote maximum employment, stable prices, and moderate long-term interest rates.[243]

Even so, we have seen that there are strong arguments against the Fed's being able to protect the financial system by *all* conceivable means. It should not be able to lend against insufficient or no collateral. Congress has now accepted these arguments. The Fed retains its power to provide liquidity to the financial system. And the FSOC now obtains the power to resolve systemically important nonbanks (as well as to require the Fed's supervision of such entities).

Above, we have sought to argue that the advantage of moving asset purchase and unsecured lending powers away from § 13(3) and to some other legislation is that future decision-making is thus likely to occur under a more coherent and comprehensive set of rules. And if any funds are to be used to aid insolvent institutions (a step that Congress has expressly rejected in the Dodd-Frank Act),[244] they will have to be appropriated by a clear process.

Two points remain to be made by way of conclusion. The first is that the recent amendments to § 13(3) are to be welcomed. They resolve a number of ambiguities in the statute. They also realign the Fed's role with that of a central bank, classically conceived. However, there may remain an ambiguity in the statute as to asset purchases. The position taken in this Article is that these do not fall within the scope of § 13(3), and ideally should not, however broad-based a program of participation the Fed might decide to create. Nevertheless, the amended rules about satisfactory collateral appear to mitigate many of the concerns raised. Even so, it should also be pointed out that these legislative amendments only resolve concerns as to the future. The effects of the Fed's past activity still remain.

The second point is that the creation of a dedicated systemic risk regulator in the form of the FSOC, acting together with the Fed, is also to be welcomed. If the FSOC is provided with a coherent set of principles by which to operate, the effect will be greater stability in decision-making than

242. *See* KUTTNER, *supra* note 219, at 12.
243. Federal Reserve Act § 2a, 12 U.S.C. § 225a (2006).
244. *See supra* Part V.C.1.

was ever attainable under § 13(3).

## VI. CONCLUSION

This Article has considered the Federal Reserve's emergency decision-making during the financial crisis. It has analyzed § 13(3) of the Federal Reserve Act, a legislative power that the Fed used extensively when formulating its responses to the crisis.

By way of background, it traced the historical development and use of this provision. Next, it sought to assess its scope. It concluded that at the time of the crisis, § 13(3) permitted the Fed to make secured loans to entities that could not obtain credit from other sources. With this view of the statute in mind, it analyzed a number of the transactional structures that the Fed created during the financial crisis. It concluded that the Fed's asset purchases and its loans against corporate shares exceeded the bounds of its statutory authority.

Finally, it considered the intended purpose of the legislation: the containment of systemic liquidity (rather than solvency) risks by means of secured lending against sufficient collateral. It evaluated the reforms of § 13(3) in the Dodd-Frank Act, and concluded that these are to be welcomed overall. They set out a clear vision for § 13(3) and resolve a number of concerns. Even so, an important ambiguity as to the Fed's ability to purchase assets remains in the law. In closing, this Article then traced the authority of the FSOC, a new entity created by the Act that now acts together with the Fed in the sphere of systemic risk regulation.