The Fed's Emergency Lending Evolves

The Fed is using emergency lending powers it invoked during the Great Recession to respond to COVID-19 — but it cast a wider net this time

BY TIM SABLIK

As COVID-19 swept through the United States, the Fed reached for its playbook from the last major crisis in 2008-2009. Now, just as then, the central bank's actions have been aimed at restoring markets to normal functions during a major economic shock. In an emergency meeting on Sunday, March 15, the Federal Open Market Committee lowered the Fed's interest rate target to effectively zero and pledged to use its "full range of tools to support the flow of credit to households and businesses."

"The cost of credit has risen for all but the strongest borrowers, and stock markets around the world are down sharply," Fed Chair Jerome Powell told reporters in a press conference following the meeting. "Moreover, the rapidly evolving situation has led to high volatility in financial markets as everyone tries to assess the path ahead."

Many firms, both financial and nonfinancial, rely on short-term debt to keep their operations running smoothly. In a crisis, the normal market for credit can grind to a halt — and with it, the ability of these firms to borrow. Lenders find it difficult to assess the credit risk of borrowers when the economy is changing rapidly, and they have an incentive to hold onto liquid assets as insurance against uncertainty. To prevent a credit crunch from rippling throughout the economy, central banks often step in to act as a "lender of last resort" during crises — an emergency source of credit for otherwise solvent firms until normal credit market functions are restored.

In keeping with this role, the Fed announced it would create several special lending facilities in the days following its March 15 meeting. Some of these were first used during the Great Recession of 2007-2009 and retired after the recovery. The Fed also announced new facilities to lend to corporations, small businesses, and municipalities. (See table.)

"It took years for the Fed to develop the tools during the 2007-2009 crisis necessary to ensure the adequate provision of liquidity and to manage threats to the financial system," says Kim Schoenholtz of New York University's Stern School of Business. "What's remarkable this time around is how, almost instantaneously, the Fed not only revived all of the critical liquidity tools that were developed in the previous crisis, but also added to them."

For each of these programs, the Fed invoked section 13(3) of the Federal Reserve Act, which authorizes the Fed to lend to a broader set of recipients during a crisis — or as Congress put it, in "unusual and exigent circumstances." Few would argue that the pandemic does not qualify as unusual, but deciding when and to whom the Fed should lend has been a debate among policymakers and economists that stretches back to the Fed's founding.

Lender of Last Resort ... for Whom?

The Fed was originally created to solve a problem of liquidity in the banking system. Seasonal demands for cash placed a strain on banks, leading to periodic banking panics. (See "Liquidity Requirements and the Lender of Last Resort," *Econ Focus*, Fourth Quarter 2015.)

The framers of the Federal Reserve Act sought to solve this problem by creating a system of regional Reserve Banks that could purchase short-term commercial loans from banks when demand for cash spiked. Member banks could get cash from their Reserve Bank by exchanging commercial paper for it at the discount window. (Originally, each Reserve Bank had a physical window where member banks came for these exchanges; today, discount window transactions are handled electronically.) While the Fed was empowered to make loans to banks, businesses and individuals couldn't walk into their local Reserve Bank and ask for a loan — the Fed was envisioned as a "banker's bank."

That began to change during the Great Depression. As banks failed throughout the country, the normal market for commercial credit collapsed. Legislators and President Herbert Hoover worried that it was not enough for the Fed to support banks if those banks were reluctant or unable to make loans for productive ventures. In 1932, Congress made the change to the Federal Reserve Act that authorized broader lending in "unusual and exigent circumstances." The new section 13(3) authorized Reserve Banks to lend directly to individuals and corporations in emergencies.

This new power put the Fed in the business of making commercial loans, but it used that authority sparingly. Reserve Banks made just 123 loans totaling $1.5 million between 1932 and 1936 (around $28 million in today's dollars). In a 2010 article in the University of Pennsylvania's *Journal of Business Law*, Alexander Mehra, a lawyer, argued that this was likely due to several restrictions contained in the original text of section 13(3). First, Reserve Banks were only authorized to lend to individuals and businesses against the same type of collateral that they accepted for

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lending to banks — short-term loans originating from commercial activity. Businesses, individuals, and investment banks were unlikely to have this type of collateral, making them ineligible for loans from the Fed.

Second, each loan required the approval of five of the Fed's governors, a difficult procedural hurdle to clear. Finally, Congress had also created the Reconstruction Finance Corporation (RFC) in 1932. The RFC was a government-sponsored enterprise also tasked with making loans to individuals and businesses. Those loans were generally available at more favorable terms than loans from the Fed, which may further explain why the Fed had few takers.

Another reason section 13(3) saw little use was that it was soon superseded by a further amendment to the Federal Reserve Act in 1934 — the addition of section 13(b). That amendment placed fewer restrictions on the Fed's ability to lend to businesses and saw much wider use. In the first year and a half, the Fed made nearly 2,000 section 13(b) loans totaling $124.5 million ($2.3 billion today).

The Fed's Board of Governors was initially supportive of these new lending powers, stating in a 1934 press release that they would "aid in the recovery of business, the increase of employment, and the general betterment of conditions throughout the country." But as with section 13(3), the Fed's section 13(b) lending would also be overshadowed by the RFC. The RFC continued to be the industrial lending agency of choice, and, aside from a brief resurgence during World War II, the volume of the Fed's section 13(b) loans dropped significantly after 1935.

In the postwar period, Fed leaders began to question whether the central bank should be involved in making loans to businesses and individuals. In 1957, then-Fed Chair William McChesney Martin told Congress during testimony that while there might be a role for the government to address gaps in private sector lending, it was not one that the Fed should play. Rather, he said it was the preference of the Board of Governors for the Fed to "devote itself primarily to the objectives set for it by the Congress, namely, guiding monetary and credit policy so as to exert its influence toward maintaining the value of the dollar and fostering orderly economic progress."

It took decades after the Fed's founding, but eventually economists and political leaders came to see the benefits to the economy of the Fed having monetary policy independence.

"The question is whether it is appropriate to burden a central bank that has the mandate of achieving price stability and maximum sustainable employment with also managing the supply of credit directly to nonfinancial organizations, such as businesses, corporations, or municipalities," says Schoenholtz. "Those credit allocation decisions are politically fraught. Back in the 1930s, I don't think anybody really understood the long-run benefits of having an independent central bank."

Congress ultimately agreed to remove those credit allocation powers from the Fed. The Small Business Investment Company Act of 1958 struck section 13(b) from the Federal Reserve Act and transferred those powers to the Small Business Administration (SBA). But

The Fed's COVID-19 Emergency Lending Programs

Facility	Announced	Launched	New?	Description
Primary Dealer Credit Facility	March 17	March 20	No	Extend credit to primary dealers
Commercial Paper Funding Facility	March 17	April 14	No	Provide a liquidity backstop to U.S. issuers of commercial paper
Money Market Mutual Fund Liquidity Facility	March 18	March 23	No	Makes loans available to eligible financial institutions secured by high-quality assets purchased from money market mutual funds
Primary Market Corporate Credit Facility	March 23	June 29	Yes	Purchase corporate bonds from eligible issuers
Secondary Market Corporate Credit Facility	March 23	May 12	Yes	Purchase corporate bonds from eligible issuers in the secondary market
Term Asset-Backed Securities Loan Facility	March 23	June 17	No	Lend to holders of certain asset-backed securities backed by consumer and small-business loans
Paycheck Protection Program Liquidity Facility	April 9	April 16	Yes	Supply liquidity to financial institutions making PPP loans
Municipal Liquidity Facility	April 9	May 26	Yes	Purchase short-term notes from eligible U.S. states, counties, and cities
Main Street Lending Program	April 9	June 15	Yes	Lend to small- and medium-sized businesses and nonprofit organizations that were in sound financial condition before the COVID-19 pandemic

SOURCE: Federal Reserve Board of Governors section 13(3), the original emergency lending authority granted to the Fed, remained on the books.

Emergency Lending Makes a Comeback

In the decades after the Great Depression, the Fed invoked section 13(3) on a few occasions but did not actually make any loans. The emergency lending power remained unchanged and dormant until the passage of the 1991 FDIC Improvement Act, or FDICIA. The act removed the restriction that emergency loans could only be made against the same collateral accepted from banks at the discount window. Any securities that the Fed approved could now suffice as collateral.

As discussed in a 1993 article by Walker Todd, then an assistant general counsel and research officer at the Cleveland Fed, there was growing recognition among policymakers in the aftermath of the savings and loan crisis of the 1980s and 1990s and the stock market crash of 1987 that liquidity crises could happen outside of the traditional banking sector. If the Fed lacked the tools to address those liquidity needs directly, such problems could spill out into financial markets, resulting in crises similar to the banking panics of the 19th century that the Fed was created to prevent.

This became apparent during the financial crisis of 2007-2008, when troubles at large nonbanks created liquidity problems for the whole financial system. For the first time since the 1930s, the Fed made emergency loans under section 13(3) to a variety of financial and nonfinancial firms when traditional credit markets seized up. These programs were open to all qualifying firms in broad segments of financial markets. The Fed also invoked section 13(3) to offer direct assistance to support the resolution of specific firms deemed "too big to fail." This included assisting in JPMorgan Chase's purchase of Bear Stearns and extending credit to American International Group to prevent its bankruptcy.

After the crisis subsided, legislators debated whether the Fed had gone too far in its emergency lending. Providing liquidity on a general basis seemed in keeping with the central bank's role as a lender of last resort, but providing direct assistance to specific firms was more controversial. It placed the Fed in the role of potentially picking financial winners and losers.

In the Dodd-Frank Act of 2010, Congress placed new restrictions on the Fed's emergency lending powers. The Fed was no longer authorized to lend directly to individual firms. Instead, emergency loan facilities had to be available through a "program or facility with broad-based eligibility." Dodd-Frank also required that any emergency assistance needed to be "for the purpose of providing liquidity to the financial system, and not to aid a failing financial company." Finally, any loans the Fed made needed to be adequately secured to "protect taxpayers from losses," and the lending programs required "prior approval of the Secretary of the Treasury."

Fed officials supported these changes. In 2009 testimony before the House Committee on Financial Services, then-Fed Chair Ben Bernanke acknowledged that the "activities to stabilize systemically important institutions seem to me to be quite different in character from the use of Section 13(3) authority to support the repair of credit markets." While he argued that directly intervening to stabilize systemically important firms was "essential to protect the financial system as a whole ... many of these actions might not have been necessary in the first place had there been in place a comprehensive resolution regime aimed at avoiding the disorderly failure of systemically critical financial institutions."

At the same time, Bernanke and his successors supported giving the Fed some flexibility to respond to liquidity emergencies where and when they emerged.

"One of the lessons of the crisis is that the financial system evolves so quickly that it is difficult to predict where threats will emerge and what actions may be needed in the future to respond," Powell said in a 2015 speech while he was a Fed governor. "Further restricting or eliminating the Fed's emergency lending authority will not prevent future crises, but it will hinder the Fed's ability to limit the harm from those crises for families and businesses."

The Next Chapter

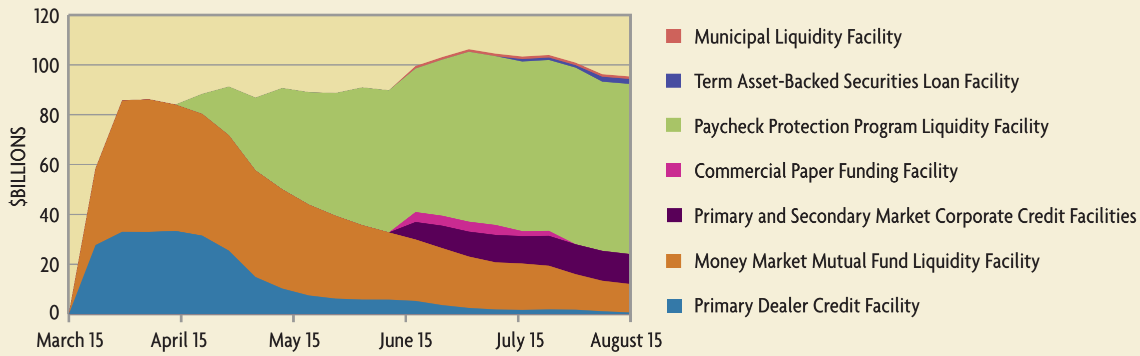
The Fed would call upon its emergency lending powers a few years later during the COVID-19 pandemic. Initially, the Fed revived many of the same facilities it had used in 2007-2009 to make credit available to financial firms that can't access the discount window. But it also created new facilities to extend credit to a wider range of parties.

Through the Primary and Secondary Market Corporate Credit Facilities, the Fed can purchase bonds directly from large, highly rated corporations and supply loans for companies to pay employees and suppliers. The Main Street Lending Program, announced in April and launched in June, offers five-year loans to businesses that are too small to qualify for the Fed's other corporate credit facilities. The Municipal Liquidity Facility makes loans available to state and local governments. And the Fed's largest new program to date is the Paycheck Protection Program Liquidity Facility, which provides liquidity to financial institutions participating in the SBA's Paycheck Protection Program (PPP). Businesses can take out loans through the PPP that can be forgiven if they use the money to retain workers on payroll. The Fed has agreed to provide credit to financial institutions making PPP loans, accepting those loans as collateral. Since the PPP loans are guaranteed by the federal government through the SBA, the Fed faces no risk of losses on this program.

While the Fed has announced a wider range of emergency lending programs than in 2007-2009, the total dollar amount of loans has been smaller so far. As of mid-August, the Fed had about $96 billion in outstanding section 13(3)

Once More Unto the Breach

Federal Reserve Emergency Loans Outstanding



NOTE: Values for the Main Street Lending Program were zero or rounded to zero on the scale of this chart during this period. Main Street Lending Program loans outstanding totaled $226 million as of Aug. 12.

SOURCE: Federal Reserve Board of Governors

loans. (See chart.) In fact, the Fed began to wind down some of the first programs launched in March as financial markets stabilized from the initial disruptions of the pandemic.

The Fed's emergency lending during the pandemic has been shaped by the changes made to section 13(3) by Dodd-Frank. All the lending facilities have broad-based eligibility rather than being open only to a specific firm or a small set of firms. The Fed obtained permission from the secretary of the Treasury before creating each facility, and the Treasury has provided a backstop against losses for any facilities that are not inherently risk free. Those Treasury funds were appropriated through the Coronavirus Aid, Relief, and Economic Security, or CARES, Act.

There is some precedent for the Fed providing liquidity support during a pandemic. During the Spanish Flu outbreak of 1918, banks faced liquidity strains. A recent paper by Haelim Anderson of the Federal Deposit Insurance Corporation, Jin-Wook Chang of the Federal Reserve Board, and Adam Copeland of the New York Fed found that banks that were members of the Federal Reserve System were able to continue or even expand lending during the pandemic because of their access to central bank liquidity, while nonmember banks curtailed lending. The researchers argued that this highlights the importance of the Fed having the flexibility to act as a lender of last resort to financial firms outside of the traditional banking sector.

But such flexibility may come at a price. "If markets know the Fed can be relied upon as a liquidity backstop, the Fed can nip market disruption in the bud," says Alex Wolman, vice president for monetary and macroeconomic research at the Richmond Fed. "We saw that play out during the current crisis — initial market volatility in March subsided after the Fed took action. On the other hand, an expectation that the Fed will act as a backstop may distort market prices and encourage excessive leverage in the long run. It can be challenging for a central bank to balance these considerations."

Indeed, some Fed scholars have argued that the newly created programs designed to lend to businesses and governments step beyond the boundaries Dodd-Frank established around emergency lending. In a May working paper, Lev Menand of Columbia Law School argued that the new facilities created to extend credit to businesses and municipalities sidestep the Dodd-Frank requirement that section 13(3) lending should be for the purpose of "providing liquidity to the financial system" since the recipients are not financial firms. Instead of amending the Federal Reserve Act to loosen restrictions on Fed emergency lending, when Congress appropriated the funds for these facilities in the CARES Act, it simply stated that they were for the purpose of providing liquidity to the financial system.

"If lending directly to business is a way to provide liquidity to the financial system, then any lending meets the requirement and the words added [to the Federal Reserve Act] in 2010 have no meaning," Menand wrote.

After largely walking away from lending to nonfinancial firms for decades, the Fed has found itself acting as a lender of last resort for more than just banks during two crises in the span of a dozen years. This has sparked renewed discussion among economists and policymakers over just what it means to be a lender of last resort. **EF**

Readings

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