

The Journal of Financial Crises

Volume 2 | Issue 1

2020

The Legal Authorities Framing the Government's Response to the Global Financial Crisis

Scott G. Alvarez Esq.
Formerly, Federal Reserve System, Board of Governors

Thomas C. Baxter Jr., Esq.
Sullivan & Cromwell

Robert F. Hoyt Esq.
Barclays

Follow this and additional works at: <https://elischolar.library.yale.edu/journal-of-financial-crises>



Part of the [Administrative Law Commons](#), [Banking and Finance Law Commons](#), [Finance and Financial Management Commons](#), [Law and Economics Commons](#), and the [Public Law and Legal Theory Commons](#)

Recommended Citation

Alvarez, Scott G. Esq.; Baxter, Thomas C. Jr., Esq.; and Hoyt, Robert F. Esq. (2020) "The Legal Authorities Framing the Government's Response to the Global Financial Crisis," *The Journal of Financial Crises*: Vol. 2 : Iss. 1, 3-32.

Available at: <https://elischolar.library.yale.edu/journal-of-financial-crises/vol2/iss1/2>

This Article is brought to you for free and open access by the Journal of Financial Crises and EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact journalfinancialcrises@yale.edu.

The Legal Authorities Framing the Government's Response to the Global Financial Crisis

Cover Page Footnote

This essay expands on the authors' "The Legal Authorities Framing the Government's Response," in *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, forthcoming 2020.

The Legal Authorities Framing the Government's Response to the Global Financial Crisis

SCOTT G. ALVAREZ*
THOMAS C. BAXTER JR.† AND
ROBERT F. HOYT‡,§,**

Abstract

The 2007–09 global financial crisis required that the Federal Reserve, Treasury Department and Federal Deposit Insurance Corporation survey their various legal authorities and consider how they might be used to mitigate the meltdown of the United States financial system. This essay explores the range of legal authorities and procedural issues presented by key facilities implemented during the crisis, many of which were new and creative. This essay also provides valuable examples of how such authorities were used and describes how, in some instances, agencies worked together to design innovative interventions that no separate agency could have achieved alone.

* Scott G. Alvarez was General Counsel of the Federal Reserve Board of Governors during the financial crisis.

† Thomas C. Baxter Jr., now Of Counsel to Sullivan & Cromwell, was General Counsel and Executive Vice President of the Federal Reserve Bank of New York.

‡ Robert F. Hoyt, Group General Counsel at Barclays, was General Counsel of the Department of Treasury under Secretaries Henry M. Paulson, Jr., and Timothy F. Geithner.

§ The authors would like to express our appreciation to all the incredible lawyers at the Federal Reserve, the Treasury, and the Federal Deposit Insurance Corporation who worked diligently to ensure creative and responsible actions to mitigate the effects of the financial crisis while meeting the highest legal standards. The views expressed in this essay are strictly those of the authors.

** This essay expands on a chapter by the authors, "The Legal Authorities Framing the Government's Response," in *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, 2020. <https://yalebooks.yale.edu/book/9780300244441/first-responders>.

1. Introduction: The Evolving Need for Emergency Tools

The Federal Reserve, the Treasury Department, and the Federal Deposit Insurance Corporation (FDIC) each took strong and innovative actions to mitigate the 2007–09 Global Financial Crisis (GFC). These actions were well grounded in law and consistent with the direction of policymakers to do “everything possible” to address the crisis.

In some cases, the legal authority being applied was archaic or had not been used or interpreted for many years. In other cases, the law was being applied for the first time. In most cases, the legal authorities were built on the lessons of past crises involving “retail” panics and failures of depository institutions that were unlike the crisis that began in 2007.

Since many of these authorities were enacted, financial markets have evolved and changed in significant ways. By 2007, important markets, such as the repo and the commercial paper markets, and new intermediaries, like money market mutual funds and asset-backed securitization vehicles, had evolved to become critical sources of funding to businesses and consumers. Nonbanks rivaled depository institutions as intermediaries, becoming critical credit conduits to businesses, consumers, and investors.

Indeed, the 2007–09 crisis first manifested in the shadows of a financial system that did not exist during the years of the Great Depression or the 1980s and early 1990s, when the foundation for the emergency legal authorities of the federal agencies was built and last modified. The strong interconnections that had developed between nonbank financial firms and depository institutions increased both the scope and the depth of the impact that vulnerabilities in nonbank firms could have on banks and the financial system as a whole.

The agencies responded to this new set of challenges by using the legal authorities available to them in ways that were contemplated by the authors of those authorities and in ways that, while clearly permissible, were new and innovative. And, as happened during past crises, Congress also responded by enacting new authorities to address these new problems.

Because the system is dynamic and constantly evolving, every crisis is and will be different. An important lesson is that emergency authorities must evolve or be drawn broadly enough to accommodate this inevitable evolution. Laws that are too narrow in scope or that handcuff policymakers in fashioning a measured response can dramatically reduce the ability of the government to implement an effective response, resulting in an increase in the costs and pain inflicted on citizens and the economy. The government may choose not to intervene in a particular crisis, but it should have available to it an effective arsenal of tools that gives it the option to intervene if it chooses to do so.

Although legal authorities and new emergency tools can be and have been added during a crisis, typically this is too late; it is more effective and less costly if the tools are in place before a crisis starts. Early and forceful action to address problems as they emerge allows policymakers to mitigate, and in some cases prevent, any destabilizing effects.

In the wake of the GFC, Washington strengthened some of the tools to enhance the resiliency of financial firms and the financial system to help prevent and limit the damage during another crisis, and it added a new power that allows the government to “resolve” (close or liquidate), rather than support, the biggest struggling financial firms using funding from the banking industry itself, not from taxpayers.

At the same time, however, Congress took away from the agencies, or diminished the scope of, some of the legal tools that were essential in restoring stability in the last crisis, giving itself greater responsibility for addressing future emergencies.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, for example, took away the Fed’s power to lend to failing firms or to take assets off their balance sheets. In the future, the Fed may extend emergency credit only through broad-based facilities designed to help the financial system as a whole. Congress also took away Treasury’s ability to use the Exchange Stabilization Fund (ESF) to guarantee money market funds. And the FDIC has lost significant authority to provide assistance to the financial system, even if that assistance would prevent failures that pose systemic risk, without the concurrence of Congress.

This article begins by examining the legal authorities in place when the crisis started. It then focuses on three key areas—the Federal Reserve’s lending authority, Treasury’s emergency powers, and the Fed’s creation of broad-based lending vehicles—that were at the heart of the government’s response. It discusses the major legal issues and obstacles encountered by the agencies, as well as the innovative steps they took to move quickly, and legally, to deal with the crisis.

Basic descriptions of the government’s programs and policy decisions are outlined here to crystallize relevant legal issues and standards, but the details of these programs and actions are discussed elsewhere.¹ This essay also does not discuss the numerous legal issues attendant to the contracts and supporting agreements negotiated by the agencies in implementing their programs.

2. As the Crisis Unfolded: The Tools at Hand

The public often assumes that the government is subject to the same principle that applies to a private company—a company may do that which is not prohibited. But that is not correct: The government has the ability to do only what the law permits.

As the financial crisis began to unfold and deepen during the second half of 2007 and through September 2008, regulators looked closely at the tools available to address the situation.

¹ See, for example, *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, 2020.

Some were antiquated and cumbersome, and, taken together they amounted to a short list of narrowly circumscribed powers.

The president was authorized to declare a bank holiday that would close all banks but had no other special powers to deploy in a financial emergency. Treasury, unlike several foreign finance ministries, had no special emergency powers to address a financial crisis beyond controlling the ESF, worth about \$50 billion. The Securities and Exchange Commission could halt trading on the stock exchanges but could not provide emergency credit to a failing broker-dealer. And no one in the federal government had the authority to resolve players in the shadow banking system that were in trouble. Nor did any agency have the power to acquire troubled assets or to inject capital into even *traditional* financial firms, in stark contrast to some other countries—such as the United Kingdom and Switzerland—that were also being buffeted by the crisis.

The Federal Reserve's monetary policy tools were (and remain) powerful, but they could not be narrowly tailored to address the specifics of the crisis. Rather, these powers are designed and intended to address weaknesses in the broad economy.

The most robust tools available to address particular problems involved depository institutions, perhaps because their failure played such a prominent role in the Great Depression.

The Fed is authorized to make secured loans to depository institutions at any time. And the FDIC provides a strong backstop with deposit insurance—a tool designed to protect consumers and maintain confidence in depository institutions.

The FDIC is also empowered to resolve failing depository institutions. The agency is authorized not only to marshal assets to pay depositors and other creditors but also to manage the resolution in a way that minimizes the risk to the financial system. An important limitation requires the FDIC to resolve each institution in the manner least costly to the Deposit Insurance Fund. Congress wisely added a “systemic risk” exception to this limitation, permitting the FDIC, in extraordinary circumstances, to take other actions needed to address the potential effects on the system of depository institution failures. However, even this emergency exception did not extend to a nonbanking financial firm in distress, such as American International Group (AIG), Bear Stearns, or Lehman Brothers.

In fact, the dearth of tools to address nonbank financial firms was consequential in determining the government's response to the threats to the financial system and economy that emerged from this critical part of the system.

Indeed, until October 2008—deep into the crisis—the only tool available to address issues at nonbank financial firms was the Fed's emergency authority to lend on a secured basis.

Congress added two critical powers during the crisis.

The first authorized the government to place the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), both government-sponsored enterprises, into conservatorship to avert their disruptive failure and liquidation in bankruptcy.²

The second, created with the enactment of the Emergency Economic Stabilization Act (EESA),³ was the Troubled Assets Relief Program (TARP), which authorized Treasury to acquire troubled financial assets and inject capital into financial firms. The powers conferred by EESA were used in the ways anticipated by the proponents and in other ways that were innovative and evidenced interpretive agility. TARP contained a sunset date and is no longer available. Although not a new tool, as part of the TARP legislation Congress also increased deposit insurance, a tool created during the 1930s to decrease the likelihood of runs at depository institutions, to \$250,000 from \$100,000.

3. The Fed's Lending Authority: Providing Credit to Depository Institutions and Some Nonbanks

Credit for Depository Institutions

From its inception in 1913, the Federal Reserve has been authorized under a variety of statutory provisions to provide credit to depository institutions.⁴ The authority most used for such lending is Section 10B of the Federal Reserve Act (FRA), which permits lending during both normal and crisis times.⁵

Lending under Section 10B is subject to two important constraints: each advance must be "secured to the satisfaction of the [lending] Reserve Bank" and an advance, under most circumstances, may not be made for a term longer than four months.⁶ In their lending

² See the Housing and Economic Recovery Act of 2008 (HERA), Public Law 110-289, July 30, 2008.

³ Public Law 110-343, 122 Stat. 3765, Oct. 3, 2008.

⁴ Originally, the Federal Reserve was authorized only to discount various types of notes, drafts, and bills of exchange held by banks largely in the course of extending agricultural and trade credit (so-called real bills). (See, for example, Sections 4[8], 13[2], 13[6], and 13A of the Federal Reserve Act. See also, David H. Small and James A. Clouse "The Scope of Monetary Policy Actions Authorized under the Federal Reserve Act," July 19, 2004, 7-14, www.federalreserve.gov/pubs/feds/2004/200440/200440pap.pdf.) During the Great Depression in 1932, the Federal Reserve was given broad but temporary authority that could be exercised only "in exceptional and exigent circumstances" to make advances to member banks that did not otherwise have eligible notes, drafts, or bills of exchange that could serve as collateral so long as the credit was approved by at least five members of the Federal Reserve Board and the credit was secured to the satisfaction of the lending Reserve Bank (among other conditions) (47 Stat. 56, Section 2, Feb. 27, 1932). In 1935, this authority was broadened to allow advances to be made on a routine basis (that is, even if circumstances were not exceptional or exigent and the borrowing bank had eligible bills of exchange to post as collateral) and was made permanent (49 Stat. 705, Public Law 74-305, Section 204, Aug. 23, 1935). It was later codified in Section 10B of the Federal Reserve Act (105 Stat. 2279, Public Law 102-242, Section 142[a], Dec. 19, 1991).

⁵ 12 USC 347b.

⁶ Section 10B authorizes an advance for more than four months if the advance is secured by mortgages on one-to-four-family residences (12 USC 347b[a]). The Fed has always viewed the language and purpose of Section

activities, Reserve Banks have traditionally relied on collateral pledged by the borrowing depository institution to be secured. Depository institutions would typically pledge collateral in an amount that, after a haircut is applied, would equal or exceed the amount of credit extended by the Federal Reserve. The lending Reserve Bank would then take a first-priority perfected security interest in the collateral.⁷

Section 10B does not require that the loan be secured by collateral or that the estimated value of the collateral accepted exceed the amount borrowed; the statutory requirement is simply that the note be “secured to the satisfaction of the [lending] Reserve Bank.” Because the Act provides the Reserve Bank with complete discretion in determining whether a note is sufficiently secured, the Reserve Bank may take other factors and arrangements into account in making that determination.

Thus, a lending Reserve Bank could determine, for example, that a third-party guarantee provides adequate security for a loan to a bank without any collateral; or that expected increases in the value of collateral posted by a borrowing bank merit extending more credit than the current value of posted collateral; or that a pending payment due to the borrowing bank’s account from a third party is reliable enough that no or only a small amount of collateral is necessary. In determining whether a lending Reserve Bank is secured to its satisfaction, the Reserve Bank has judged whether it reasonably believes that it will be repaid in full.⁸ During the recent financial crisis, Federal Reserve advances to depository institutions were in fact always secured by collateral and always repaid in full with interest.

To meet the duration limitations in Section 10B, advances under that section are typically made on an overnight basis and may be extended or renewed each day with the agreement of the lending Reserve Bank if the depository institution remains able to repay the credit. One of the first actions taken by the Fed in the late summer of 2007 was to encourage

10B as authorizing extensions of credit, not grants or capital injections. Section 10B refers to “advances,” which are commonly defined as extensions of credit; establishes limitations on the duration of advances, which is characteristic of extensions of credit but not of grants or capital injections; and requires “security,” a common feature of credit but not of grants or capital injections. Because depository institutions typically pledge a variety of types of collateral at the Federal Reserve discount window, this portion of Section 10B is seldom relied on. In addition to the restrictions on duration and security, the Fed’s Board of Governors may set parameters for Reserve Bank lending, including requirements regarding the types and minimum amount of collateral. (See 12 USC 347b[a].) However, the Board has generally left the Reserve Bank with discretion to determine when, whether, and how it will become secured.

⁷ Before making a loan to a depository institution, the Reserve Bank typically perfects its first priority by taking possession of the collateral or otherwise acting to perfect its security interest in the collateral (for example, by filing a financing statement).

⁸ Howard H. Hackley, *Lending Function of the Federal Reserve Banks: A History* (Washington, D.C.: Board of Governors of the Federal Reserve System, May 1973). The Federal Reserve has long viewed the language and purpose of Section 10B as authorizing extensions of credit, not grants or capital injections. Section 10B refers to “advances,” which are commonly defined as extensions of credit; establishes limitations on the duration of advances, which is characteristic of extensions of credit, but not of grants or capital injections; and requires “security,” a common feature of credit but not of grants or capital injections (12 USC 347b[a]).

depository institutions to take advantage of its discount window to meet liquidity stresses and to make credit available for extended periods—up to 30 days rather than overnight.⁹

However, seeking credit from the Fed carries with it a level of stigma that discourages borrowing even when it is in the bank's best interests. Particularly during periods of stress, depository institutions depend on appearing strong, to keep the confidence—and deposits—of their customers. They develop a heightened sensitivity that borrowing from the Fed will be viewed by investors, counterparties, and customers as a sign that the institution is desperate and unable to obtain funding from other sources.

To remove this stigma, the Fed's Board of Governors authorized the establishment of the Term Auction Facility (TAF) in December 2007 to provide credit to depository institutions for periods as long as 85 days. One feature of the TAF was an auction format for determining the interest rate on credit it extended.

The Fed relies on Section 14(d) of the FRA to set its rate.¹⁰ That section authorizes the Reserve Bank to establish a rate on a periodic basis, subject to review and determination of the Board.¹¹ Section 14(d) also sets a substantive requirement that the rate “be fixed with a view of accommodating commerce and business.”¹²

Historically, the Fed set an interest rate for credit extensions using one of two methods—by establishing a specific numerical rate or by adopting a formula to calculate the rate.¹³ The legal question raised by the TAF was whether the rate could be set by auction.

An auction provided an elegant way to meet the substantive requirement of accommodating business and commerce. TAF provided depository institutions with access to a specific amount of credit to help meet the liquidity demands of their operations, including providing credit to businesses that would facilitate commerce. An auction provided a mechanism for setting the precise rate that would make that credit available to institutions most in need.

⁹ See Board of Governors of the Federal Reserve System, “Federal Reserve Board discount rate action,” Aug. 17, 2007, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20070817a.htm>.

¹⁰ Originally, Section 10B required that the interest rate on advances under that section be set at a premium over the highest discount rate charged by the lending Reserve Bank when discounting notes, drafts, and bills of exchange. (See 49 Stat 705, Public Law 74-305, Section 204, Aug. 23, 1935.) Congress deleted this requirement in 1980, and, with one exception, left the rate to be charged on advances under Section 10B to the discretion of the Fed. (See Public Law 96-221, Title I, section 106, March 31, 1980, 94 Stat. 140.) The exception applies to advances secured entirely by residential mortgages, where the statute requires the Federal Reserve to charge a rate that is equal to the lowest discount rate in effect at the lending Reserve Bank (12 USC 347b[a]).

¹¹ The attorney general decided in 1919 that the requirement that the Reserve Bank establish a rate “subject to review and determination of the Board” meant that the Board had the ultimate authority to determine the rate under Section 14(d) (32 Opinions of the United States Attorney General, no. 81, 1919). This allows the Board to ensure that uniform national rates are charged on Federal Reserve credit.

¹² See 12 USC 357.

¹³ See, for example, 12 CFR 201.51 (primary and secondary credit set at a specific rate; seasonal credit rate set using a formula that averages the target interest rate of the Federal Open Market Committee [FOMC] and the rate paid on three-month certificates of deposit).

To satisfy the procedural requirement that the Reserve Bank set the rate, subject to review and determination of the Board, the Fed analogized to its long-standing practice of setting rates for seasonal credit by formula.¹⁴ Seasonal credit from the Fed allows banks—typically community banks—to meet the fluctuating needs of farmers and vacation areas. Because seasonal credit is episodic and typically extended for several weeks, the rate was determined by applying a set formula—recommended by the Reserve Banks and approved by the Board—to various inputs when the credit was extended. It thus dispensed with the need to have the Reserve Bank recommend, and the Board approve, a specific rate for each credit when it was requested.

The TAF auction was functionally and substantively the same—the Reserve Banks recommended that the rate be set at a specific minimum level subject to a higher rate set through an auction that had certain characteristics and inputs. The procedural steps and structure of the auction would lead to a unique rate at each auction. Thus, rather than recommending an actual rate for lending to depository institutions that participated in the TAF, the Reserve Banks recommended a process with defined parameters that would lead to a specific rate at the time credit was extended. The Board approved this detailed auction approach, fulfilling the procedural requirements of Section 14(d).¹⁵

Emergency Credit for Nondepository Institutions

An important constraint in Section 10B is that it authorizes the Reserve Banks to extend credit only to a certain kind of borrower, the depository institution.¹⁶ Other constraints in the FRA (most notably, Section 23A) significantly limit the ability of a depository institution to pass on funds it borrows to its affiliates.¹⁷ Thus, Section 10B could not be used to lend to a depository institution affiliated with a nonbanking financial firm with the expectation that the depository institution would “on-lend” a significant amount of those funds to its affiliate. Consequently, lending by a Reserve Bank to a nonbanking firm (like Bear Stearns or AIG) or to a nonbank affiliate of a depository institution (such as the securities affiliate of Citibank or the nonbank holding company Bank of America) may be done effectively only by using the emergency lending authority provided in Section 13(3).

¹⁴ See 12 CFR 201.51.

¹⁵ See Board of Governors of the Federal Reserve System, “Federal Reserve and other central banks announce measures designed to address elevated pressures in short-term funding markets,” Dec. 12, 2007, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20071212a.htm>; see also Board of Governors of the Federal Reserve System, Minutes of the meeting of the Board of Governors, Jan. 21, 2008, <https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20080226a1.pdf>.

¹⁶ Section 10B and the other authorities in the FRA originally permitted the Fed to lend only to national banks and to state banks that chose to be members of the Federal Reserve System (47 Stat. 56, Feb. 27, 1932). In 1980, Congress authorized any depository institution that holds transaction accounts or nonpersonal time deposits (that is, accounts that are subject to the reserve requirements of the FRA) and any U.S. branch of a foreign bank that maintains reserves at a Reserve Bank to borrow from the Fed in the same manner and to the same extent as a bank that is a member of the Federal Reserve System (Public Law 96-221; 12 USC 461[b][7]; 12 USC 347d).

¹⁷ See 12 USC 371c.

During the crisis, Section 13(3) authorized the Fed to extend credit to any individual, partnership, or corporation under certain specified conditions.¹⁸ These conditions included that at least five members of the seven-member Board determine that circumstances are “unusual and exigent” and authorize the credit, and that the credit be “[e]ndorsed or otherwise secured to the satisfaction of the [lending] Reserve Bank.”¹⁹

Before 2008, the Fed had extended credit using its emergency authority only during the Great Depression.²⁰ During that period, it made approximately \$1.5 million in loans to individuals, partnerships, and corporations secured by various types of assets. Among the borrowers were a vegetable farmer and a typewriter manufacturer.²¹

In 2008, the Fed started to extend emergency credit to a very different group of borrowers, and in amounts that would add up to hundreds of billions of dollars.

The Collapse of Bear Stearns and a Missing Board Governor

The first extension of Section 13(3) emergency credit during the crisis came in March 2008, prompted by the rapid collapse of Bear Stearns, the smallest of Wall Street’s Big Five investment firms.²² There was no disagreement that the pressures experienced by the U.S. economy that month met the threshold requirement for invoking Section 13(3) that circumstances be unusual and exigent, and Bear had failed to find another banking firm willing to provide a credit lifeline.²³

¹⁸ See 12 USC 343. The Fed is also authorized to lend to nondepository borrowers under Section 13(13) of the FRA, which allows an advance to any individual, partnership, or corporation secured by U.S. government or agency securities (12 USC 347c).

¹⁹ See 12 USC 343. In 2008, Section 13(3) also required that the rate on the credit be set in accordance with Section 14(d) of the FRA, required the lending Reserve Bank “obtain evidence” that the borrower was “unable to secure adequate credit accommodations from other banking institutions,” and provided that any credit extended under that section was subject to any limitations, restrictions, and regulations prescribed by the Board (12 USC 343, 2008).

²⁰ The Fed announced its willingness to use its emergency lending authority under Section 13(3) during the 1960s, when savings associations came under severe pressure from high interest rates at a time when they were prohibited by statute from paying high rates to attract deposits. However, the crisis passed, and no loans were in fact extended by the Fed.

²¹ Hackley, 130. See also Parinitha Sastry, “The Political Origins of Section 13(3) of the Federal Reserve Act,” FRBNY Economic Policy Review, 27, citing Banking and Monetary Statistics, Board of Governors (1943), Table 88, Bills Discounted by Class of Paper, 340.

²² On March 11, 2008, several days before extending the Bear Stearns credit, the Fed announced that it would open a broad-based lending vehicle, the Term Securities Lending Facility (TSLF). Although the TSLF also relied on the authority provided in Section 13(3), it did not become operational until several weeks later (Board of Governors of the Federal Reserve System, “FOMC statement: Federal Reserve and other central banks announce specific measures designed to address liquidity pressures in funding markets,” March 11, 2008, <https://www.federalreserve.gov/newsevents/pressreleases/monetary20080311a.htm>).

²³ The requirement of “unusual and exigent circumstances” was intended to ensure that this extraordinary lending authority was used only during emergencies. (See, for example, Letter from Governor Hamlin, Federal Reserve System, to Senator Glass, July 9, 1932 [“I...personally would favor giving this power in emergencies to the Federal Reserve Banks.”].) Section 13(3) is ambiguous about what circumstances must be “unusual and exigent” and does not spell out whether they must involve the borrower, the general economy, a combination

The novel legal issue raised by the initial Bear Stearns credit, extended on Friday, March 14, involved the requirement of approval by at least five members of the seven-member Board. At the time, the Board had two vacancies, and one of the five sitting members was traveling and unreachable.

When the Board met that Friday morning to ensure that Bear Stearns had sufficient liquidity to make it through the day and into the weekend, only four members were present in Washington or available by phone to vote.²⁴

To authorize the loan with fewer than five members available to vote, the Fed relied on a provision of law added after the terrorist attacks on September 11, 2001, that allowed the Board to invoke Section 13(3) authority in the event that fewer than five members were in service or available at the time, so long as the vote by the Board was unanimous and the Board took certain other steps, including finding that immediate action was necessary.²⁵ The Board then voted 4–0 to provide funds to a nondepository institution for the first time since the 1930s.

of the two, or something else. When Section 13(3) was enacted in 1932, it appeared to be sufficient that the Fed find that general economic circumstances met those requirements, without making a finding about each borrower (Hackley, 128). Indeed, upon enactment in 1932, the congressional authors of the authority and the president declared to the Federal Reserve that economic circumstances at the time were unusual and exigent, and the president urged the Fed to invoke its new authority immediately and begin extending credit widely. (See Letter from President Herbert H. Hoover to Governor Eugene Meyer, quoted in Federal Reserve Board minutes, July 26, 1932, <https://fraser.stlouisfed.org/title/821/item/31232>; see also Sastry, footnote 199.) The Fed responded by making some 123 loans totaling only about \$1.5 million using this emergency authority. While the failure of any of these borrowers would have been painful to the borrowers and perhaps their customers, none would have disrupted the U.S. economy in any significant way. During the recent financial crisis, the Fed, in finding that circumstances were “unusual and exigent,” relied on the unusually weak and declining economy, as well as (in the case of lending to specific firms) the damaging shock to the already damaged economy from the unexpected failure of the firm, and (in the case of broad-based lending facilities) the importance to the economy of unfreezing credit in troubled financial markets

²⁴ The funding for Bear Stearns was originally conceived as a discount window loan under Section 10B to a depository institution, JPMorgan Chase Bank (JPMC Bank), which was a significant counterparty of Bear Stearns and had agreed to on-lend the funds to the firm but without recourse to itself. JPMC—the parent of JPMC Bank—ultimately acquired the firm. This type of on-lending arrangement ordinarily might not require invoking Section 13(3) because the credit being extended was to a bank, not a nonbank. However, in this case, all of the collateral posted as security was owned by Bear Stearns, and the loan would be made without recourse to JPMC Bank or any of its assets. For that reason, the Board determined that the loan was in principle to Bear Stearns and decided it must invoke Section 13(3).

²⁵ See 12 USC 248(r). For several days following September 11, 2001, five members of the Board could not be convened to authorize emergency lending. After that crisis, Congress reviewed and changed many of the nation’s emergency authorities. To ensure that the Federal Reserve could serve its critical role as lender of last resort in case of an emergency, Congress authorized fewer than five Board members to invoke Section 13(3) if action was necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the U.S. financial system and, despite the use of all means available, a sufficient number of Board members could not be contacted, among other requirements. Public Law 107-297, Section 301, Nov. 26, 2002; 116 Stat. 2340. Section 11(r) of the FRA also provides that, when there are fewer than five members of the Board in office, any action that requires a vote of at least five Board members may be taken upon the unanimous vote of all the members then in office (12 USC 248[r][1]). This provision allows the Board to continue to take a number of actions that require a vote of at least five Board members when the Board has three or more vacancies.

A Second Legal Issue: To “Discount” for Any Individual, Partnership, or Corporation

A second legal issue in extending credit to a nonbank under Section 13(3) was whether the borrower could provide its own promissory note to receive the credit or had to provide a note involving a third party. The distinction was crucial: A promissory note would facilitate the process enormously.

At the time, Section 13(3) authorized the Reserve Banks to “discount for any individual, partnership, or corporation [IPC], notes, drafts, and bills of exchange” (hereinafter, “notes”) under certain circumstances.²⁶ Section 10B, on the other hand, authorizes the Fed to “make advances” to depository institutions.

The Fed had long recognized that there was no legal distinction between an advance and a discount for purposes of Section 13(3). Both are extensions of credit.

When originally enacted, Section 13(3) authorized the Reserve Banks to “discount” only certain types of notes—specifically, notes “of the kinds . . . eligible for discount for member banks under *other* provisions of the [Federal Reserve] Act.”²⁷ In its initial authorization to Reserve Banks to exercise the lending authority under Section 13(3)—issued just five days after Congress enacted that authority—the Board recognized that the reference to notes “of the kinds...eligible for discount” had a practical and legal difference when the issuer of the note was considered.

The only notes that could be presented for discount under the *other* provisions of the FRA at the time Section 13(3) was enacted were those that, put simply, were for agricultural, industrial, or commercial purposes.²⁸ A bank could not present its own promissory note for discount by a Reserve Bank under other provisions of the FRA because a bank’s activities were not considered to be agricultural, industrial, or commercial. Thus, a bank could present for discount only the note of a third party that was engaged in agricultural, industrial, or commercial transactions. However, the Board reasoned that because a bank could present a third-party note for discount that had the required purpose, that same note was eligible for discount if presented under Section 13(3) by the third-party issuer itself because the third-party note was “of the kind” eligible for discount if presented by a bank under other provisions of FRA.²⁹

²⁶ Section 14 of the FRA authorizes the Reserve Banks to purchase and sell certain limited types of notes in the open market (12 USC 353). The authority to discount a note directly with a borrower under Section 13(3) is separate and in addition to the authority conferred in Section 14 to purchase certain types of notes in open-market transactions and nothing in Section 14 limits or overrides the authority in Section 13(3)—or any other part of Section 13—to discount notes or extend credit. (Compare 12 USC 343 with 12 USC 353.) When extending credit to specific firms and through broad-based lending facilities during the recent financial crisis, the Fed relied on the authority of Section 13(3) and not on the open market authority conferred by Section 14.

²⁷ Public Law 72-302, Section 210, July 21, 1932; 47 Stat. 715.

²⁸ This is often referred to as the “Real Bills Doctrine.” For a detailed discussion of the history and purpose of the doctrine, see Hackley, 191.

²⁹ See Federal Reserve Board circular dated July 26, 1932, Paragraph III, printed in 1932 Federal Reserve Bulletin 518, 519, Aug. 1932. See also Hackley, 129, and Sastry, 24.

This recognition would turn out to be of critical practical and legal significance in making Section 13(3) a useful tool during both the Great Depression and the 2007–09 GFC. It made the administration of lending under Section 13(3) as straightforward as accepting a promissory note from the nonbank individual, partnership, or corporation. This reading was cemented with the repeal in 1991 of the requirement in Section 13(3) that notes be “of the kind” eligible for discount if presented by a bank—that is, repeal of the requirement that the note be for agricultural, industrial, or commercial purposes.³⁰

A Third Issue: Endorsed or Otherwise Secured to the Satisfaction of the Reserve Bank

Another legal issue revolved around the provision that each loan extended under Section 13(3) must be endorsed or otherwise secured to the satisfaction of the lending Reserve Bank.³¹

This provision imposes a limitation on Federal Reserve emergency credit, but with a fair degree of discretion. In 2008, Section 13(3) did not require the Fed to make a finding regarding the financial health of the borrower or regarding the solvency of the borrower. Instead, Section 13(3) focused on factors directly related to repayment of the credit—endorsement and other security. Thus, Section 13(3) authorized the Fed to extend credit that was both endorsed and secured—that is, credit with legal recourse to the borrower or a third-party endorser, with collateral to back up repayment. It also authorized credit that was endorsed but not otherwise secured—for example, credit backed only by a third-party guarantee. And, importantly, it authorized credit that was “otherwise secured” without an endorsement—that is, a secured loan that, if the borrower did not pay, left recourse only to the pledged collateral.³² This type of asset-based lending became one of the most important tools in the Fed’s emergency lending arsenal during the 2007–09 financial crisis.

But that raises the question, what level of security is enough?

³⁰ Congress repealed the requirement in Section 13(3) that notes be “of the kinds and maturities made eligible for discount for member banks under other provisions of [the FRA]” (in other words, that the notes be for an agricultural, industrial, or commercial purpose) in 1991. This change, made in response to the 1987 stock market crash, was designed to allow the Fed to lend under Section 13(3) to securities broker-dealers and other IPCs that were not considered to be engaged in agricultural, industrial, or commercial transactions (Public Law 102-242, Section 473, Dec. 19, 1991; 105 Stat. 2386). (See Remarks of Senator Chris Dodd, Congressional Record, 102nd Congress, 1st Session, S36131, Nov. 27, 1991: This provision “give[s] the Federal Reserve flexibility to respond to instances in which the overall financial system threatens to collapse.”)

³¹ Originally, Section 13(3) required that credit be *both* endorsed *and* secured to the satisfaction of the lending Reserve Bank (Pub. L. 72-302, Section 210, July 21, 1932). Congress amended that requirement in 1935 so that the note could be *either* endorsed *or* secured (Public Law 74-305, Section 322, Aug. 23, 1935; 12 USC 343). An endorsement works as a guarantee by the signer, such that if the instrument is not paid by the primary obligor, the endorser will take it up. It is, therefore, similar to collateral—both provide sources of repayment if the party extended credit does not repay.

³² Asset-based lending has long been recognized as an authorized activity for a bank. (See, for example, OCC Letter from John E. Shockey, Deputy Chief Counsel, OCC, March 29, 1976; OCC Banking Circular 215; OCC Examining Circular 223; OCC Interpretive Letter 1117, June 2009.)

The statute sets no specific level that must be obtained, instead leaving the determination to the Reserve Bank.³³ Indeed, the precursor of Section 13(3), which would have granted this emergency lending authority to the Reconstruction Finance Corporation, required that credit be “fully and adequately” secured, terms that do not appear in Section 13(3).

How, then, should the Reserve Bank exercise its discretion? Could the Fed extend credit with a level of security that it understood at the time would not be sufficient to provide for full repayment? In other words, could the Fed extend credit under Section 13(3) expecting to take a loss?

Every statute must be interpreted in harmony with its purpose, and the purpose of Section 13(3) (as exhibited both in its wording and in its legislative history) was to authorize the Fed to extend credit with the expectation of full repayment, not to make grants or inject capital.³⁴ Funds extended without the expectation of full repayment may be a credit in part, but they are a grant or capital injection to the extent repayment is not reasonably expected—and are not consistent with the language or purpose of the section.

Moreover, when Congress granted the Fed lending authority under Section 13(3), the Fed was empowered to act as a bank—the central bank and lender of last resort.³⁵ And at that time (and since), the Fed was a regulator of banks. As a regulator, it has long criticized bank lending as unsafe and unsound if the loan is made without the expectation and reasonable belief that it would be fully repaid with interest. In the case of lending to a troubled firm during a time of economic stress, repayment depends largely on the amount and quality of the security backing the credit.

To be consistent with the purpose of the statute, the security required to satisfy the lending Reserve Bank needed to be at a level sufficient for the bank to reasonably believe it would be fully repaid.³⁶

Two Complementary Key Innovations: Special Purpose Vehicles and Asset-Based Lending

In several cases, the Fed used special purpose vehicles (SPVs) to facilitate lending under Section 13(3). An SPV is a corporate entity established to own assets funded by debt without that debt becoming an obligation of the owner of the SPV if the SPV enters bankruptcy. SPVs turned out to be one of the most innovative tools used during the crisis.

³³ Section 10B also requires that all credit extended by the Fed to depository institutions under that section be “secured to the satisfaction of the [lending] Reserve Bank.”

³⁴ See Hackley, 129.

³⁵ Indeed, the Reserve Banks are chartered as banks and are empowered to engage in “the business of banking” (12 USC 341 [Seventh]). And Section 13(3) provides that the Fed may extend credit under that section only if it is not available from “*other* banking institutions” (emphasis added).

³⁶ Hackley, 129.

The Fed created one SPV, called Maiden Lane LLC, to facilitate the Bear Stearns loan and two more—Maiden Lane II LLC and Maiden Lane III LLC—to facilitate credit to AIG, the beleaguered finance and insurance giant.³⁷

In each case, JPMC and AIG provided independent capital to their respective SPV in the form of subordinated debt that functioned as the equity of the SPV, and the Fed provided senior funding.³⁸ Like an equity investor, the subordinated debt holder would not receive any repayment until the Fed was fully repaid.

In general, the use of an SPV to hold the assets allowed the Fed, as the managing member of the SPV, to better manage the collateral securing its loan, and thereby better ensure full repayment. Using SPVs avoided potential conflicts regarding the valuation of the assets and the timing of their sale that might have arisen had the collateral remained on the balance sheet of JPMC or AIG.

Importantly, the SPV also provided more transparency. SPVs allowed the Fed to make weekly reports on the collateral's value and the amount disposed during the previous week and to audit the collateral without interference. Indeed, financial statements for the SPVs used in the Fed's Section 13(3) lending were all fully audited by an independent outside accounting firm and made public along with the annual audited financial statements of the Federal Reserve System.³⁹

The SPVs also allowed the Fed to maximize the advantage of asset-based lending, which was a new type of lending for the agency. While the Fed believed at the time it extended credit to each SPV that the value of the collateral was sufficient to repay the loan, that expected value was less than the precrisis value of the collateral. The Fed, as the central bank, could be patient and allow the collateral to recover its precrisis value. So, the Fed negotiated—as a term of its senior loan—to receive a portion of the amount actually collected on the sale of the collateral in the event that amount exceeded what was needed to repay the Fed's loan and the investor's subordinated debt. This potential value would help compensate the Fed—and the taxpayer—for the risk of the credit and allow the taxpayer to share in a portion of the borrower's profit made possible by the Fed's loan. Indeed, that potential was realized, and the three SPVs collected billions of dollars in extra value for the taxpayer.

Although valuable innovations, SPVs and asset-based lending were not used in all of the Fed's emergency lending transactions. For example, as already noted, the Fed extended credit to

³⁷ The Reserve Bank served the incidental role of establishing and administering the SPV. Conducting these duties was clearly a useful and valuable part of effectuating the lending transactions authorized under Section 13(3) and reflected use of the incidental powers conferred on the Reserve Banks by Section 4, paragraph four of the FRA (12 USC 341 [Seventh]).

³⁸ JPMC provided \$1 billion in subordinated debt to Maiden Lane LLC. Similarly, AIG provided \$1 billion in subordinated funding to Maiden Lane II LLC, and \$5 billion in subordinated funding to Maiden Lane III LLC, with the Fed extending senior credit of about \$28.8 billion to Maiden Lane LLC, \$19.5 billion to Maiden Lane II LLC, and \$24.3 billion to Maiden Lane III LLC.

³⁹ See, for example, Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet, June 2009, <http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200906.pdf>.

depository institutions through its discount window and made other credit available to AIG and Bear Stearns directly, fully secured by collateral owned by the borrowers and retained on their balance sheets.

The availability of these different approaches adds flexibility that allows the Fed to “become secured” in various circumstances, and thereby protects the taxpayer in many types of emergencies.

The Exception to the Exception: Lehman Brothers

The security requirement in Section 13(3) was central in every lending decision made by the Fed, but it was no more consequential than in the case of Lehman Brothers.

Going into the weekend of September 13–14, 2008, Barclays, a British banking organization, indicated an interest in acquiring Lehman, the fourth-largest U.S. investment firm.⁴⁰ Had Barclays decided to acquire Lehman on that Sunday, it would have needed time to finalize documentation and obtain regulatory and shareholder approvals. To ensure that creditors did not continue their run on Lehman during that period, an open-ended guarantee of Lehman’s obligations was needed, like the one provided by JPMC when it acquired Bear Stearns. But on that Sunday, Barclays said it could not issue that type of guarantee without a shareholder vote, which would produce a substantial delay and introduce uncertainty about whether Barclays could finalize the acquisition.

The question became whether the Fed could use its Section 13(3) authority to provide an open-ended guarantee of Lehman’s trading obligations in the interim or, in the alternative, provide a loan to Lehman of sufficient size to allow it to continue to operate.

The answer was no. Lehman had no one willing to endorse credit extended by the Fed (and as noted earlier, Barclays could not provide the endorsement). Moreover, the unlimited nature of the guarantee to bridge the gap until Barclays obtained the required approvals and the information from firms that had evaluated Lehman’s financial statements during the weekend about the significant losses embedded in its assets (indicating far less value than Lehman’s financial statements suggested) raised strong doubt whether Lehman had sufficient collateral to secure the full repayment of the size and type of credit it needed. Consequently, the Fed was not positioned to be secured to its satisfaction.

As a legal matter, this eliminated Section 13(3) as a useful tool for rescuing Lehman, and, after Barclays withdrew its interest for its own reasons, Lehman filed for bankruptcy protection on Monday, September 15. As noted, Section 13(3) authorizes the Fed to extend credit, not to make grants or provide capital.

⁴⁰ Bank of America also expressed an interest in acquiring Lehman at the start of that weekend, but, after reviewing Lehman’s assets, determined that Lehman was not a desirable acquisition. Instead, Bank of America struck a deal to acquire Merrill Lynch.

Lehman's broker-dealer subsidiary presented a different matter. Although it was a major business of Lehman's, the broker-dealer represented less than half of Lehman's assets and held few of Lehman's troubled assets. Importantly, Lehman's broker-dealer needed a more limited amount of financing and had sufficient valuable assets to support borrowing from the Federal Reserve. This allowed the Federal Reserve to use its Section 13(3) authority to lend to Lehman's broker-dealer in the week after Lehman's announcement of its bankruptcy filing and before the acquisition of the broker-dealer by Barclays.⁴¹

AIG: A Legal Challenge

AIG required more attention and support from the Fed and Treasury than any other nonbank financial firm, and the transaction with AIG was the only one that produced a legal challenge. Circumstances were clearly unusual and exigent, and AIG faced collapse because other financial institutions and investors had determined, despite the encouragement of the Treasury and Federal Reserve, not to provide the funding AIG needed—two critical conditions for invoking Section 13(3). Importantly, unlike Lehman, AIG had substantial assets it could pledge to secure credit from the Federal Reserve, including shares of several large and viable insurance subsidiaries.

The Fed relied on Section 13(3) initially to extend a revolving line of credit to AIG and to provide additional credit using two SPVs, modeled after the SPV used for Bear Stearns. After TARP was enacted, Treasury provided capital to AIG by acquiring securities that the firm issued. Together, these actions prevented the firm's collapse and the systemic consequences.

The novel legal issue in the rescue was whether the FRA permitted the Fed to establish some of the specific loan terms. The Fed charged a penalty interest rate and a loan commitment fee on the revolving line of credit extended to AIG under Section 13(3). In addition, the Fed required AIG to pay fees to cover the cost of documenting the loan arrangement. Importantly, following the example of the private parties negotiating credit to AIG during Lehman weekend, the Fed negotiated for AIG to provide consideration in the form of equity—a so-called equity kicker—as consideration for obtaining emergency credit from the Fed. Certain AIG shareholders challenged the Fed's authority to obtain some of the specific loan terms, in particular, to require AIG to provide equity as consideration for receiving the emergency credit. That challenge was unsuccessful.⁴²

Charging a penalty rate and noninterest compensation in connection with extending credit is a long-standing and common practice in banking and a proper exercise of the Fed's emergency lending authority under the FRA. In previous cases, the Fed had required borrowers to pay noninterest compensation, in the form of fees and premiums, under both Sections 13(3) and 10B of the FRA. These forms of consideration were imposed to cover the expenses in extending credit, including the costs associated with negotiating and

⁴¹ This collateralized lending was not sufficient, however, to prevent Lehman—the parent company of the broker-dealer—from entering bankruptcy. The broker-dealer was excluded from the parent bankruptcy filing and was governed by a resolution process under the Securities Investors Protection Act.

⁴² See *Starr International Co., Inc. v United States*, No. 2015-5103, 2015-5133 (Federal Cir. 2017).

documenting the credit and valuing collateral as well as the potential costs of litigation, and are commonly charged by banks.⁴³

The requirement that AIG provide convertible shares, amounting to approximately 79 percent of its outstanding common stock, as one of the conditions for the credit was negotiated to provide the American people with the upside potential that could result from the Fed's successful rescue of AIG—a potential that was, in fact, realized.⁴⁴ An equity kicker is a common feature of lending to a troubled debtor. It both compensates the lender for the extra risk of lending to a troubled borrower and postpones the lender's receipt of that value until a more benign time for the borrower. And it was a proper exercise of the authority granted to the Fed under the FRA, which imposes no limits on the types or amounts of interest or other consideration for lending that the Fed may charge.⁴⁵

In addition, Section 13(3) specifically provides that Reserve Bank lending under that section must conform to any "limitations, restrictions, and regulations as the Board . . . may prescribe." The FRA does not curb the discretion of the Board in setting those limitations, restrictions, and regulations. The Board was apprised that the Reserve Bank sought authorization to receive fair and appropriate compensation for credit extended by the Reserve Bank. In AIG's case, the Board made its authorization of the initial credit subject to the Reserve Bank's obtaining a form of equity as compensation.⁴⁶

Moreover, Section 4 of the FRA authorizes the Reserve Banks "to exercise . . . such incidental powers as shall be necessary to carry on the business of banking" in connection with any authority granted by the FRA.⁴⁷ National banks (and many state banks) have long been permitted to receive an equity kicker as supplementary compensation for the risks of extending credit and, as noted earlier, to charge noninterest fees and other forms of compensation in connection with extending credit.⁴⁸ This is clearly part of the business of banking and within the incidental powers granted by Section 4.

⁴³ See, for example, 12 CFR 7.4002(a) (authorizing national banks to impose noninterest fees and other charges in connection with their business activities); see also OCC Interpretive Letter 932 (Aug. 17, 2001), footnote 2 (charging noninterest fees and other premiums is inherent in the business of banking). It is noteworthy that the Fed reduced the original interest rate charged to AIG to help avoid a downgrade of AIG by the credit rating agencies based on their fear that AIG might not have the capacity to service its indebtedness to the Fed.

⁴⁴ The Fed transferred these shares to the AIG Credit Facility Trust created for the benefit of Treasury. Treasury, which used TARP funds to provide capital to AIG, ultimately exchanged and sold these shares to receive repayment for those funds.

⁴⁵ See 12 USC 343.

⁴⁶ See Board of Governors of the Federal Reserve System, "Federal Reserve Board, with full support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to \$85 billion to American International Group (AIG)," Sept. 16, 2008, <http://www.federalreserve.gov/newsevents/pressreleases/other20080916a.htm>.

⁴⁷ 12 USC 341 (Seventh).

⁴⁸ See, for example, 12 CFR 7.1006 (national banks are authorized by rule to accept warrants and other evidence of shares of profit, income, or earnings of a business in connection with lending); OCC Interpretive Letter 620, July 15, 1992; OCC Interpretive Letter 421, March 14, 1988; see also, for example, Illinois Department of Financial and Professional Regulation, "Index of Activities and Investments Permissible for Illinois Banks and

To interpret the FRA as permitting the Fed to receive only interest compensation for providing credit is to read a limitation into Section 13(3) that does not exist and to limit the central bank (and, by extension, the taxpayer) to what is less than fair and adequate compensation for taking on the extra risks and expenses of lending during an emergency. This approach would also have the deleterious effect of rewarding the shareholders of the troubled debtor who did nothing to curtail the debtor's risk appetite.

Ring-Fencing: Three Agencies Do Together What No Single Agency Could Do Alone

During the fall of 2008, Citigroup, which at the time was one of the largest financial institutions in the world with over \$2 trillion in total assets, experienced large losses and came under significant financial pressure at its primary subsidiary bank, Citibank (which had approximately \$1.2 trillion in assets), as depositors, in particular foreign-sourced depositors, began to withdraw sizable amounts of deposits and limit their relationships with Citigroup and Citibank.⁴⁹ The failure of Citigroup and Citibank at that time would have had catastrophic effects on the economy and the financial system.

Citigroup was concerned about a portfolio of approximately \$306 billion in largely real estate-related assets. Although EESA authorized the Treasury to acquire troubled assets from financial firms, the Treasury had already committed nearly \$300 billion in TARP funds to its Capital Purchase Program and AIG, so acquiring the entire Citigroup portfolio would have required using most of the remaining funds available under TARP. That would have left the Treasury largely out of ammunition in the event other emergency actions were necessary.

Consequently, the Treasury, the FDIC, and the Federal Reserve partnered to use each agency's unique legal authority to craft an inter-agency solution. This required close cooperation among the agencies and involved using different tools available to each agency to create an effective—even if somewhat cobbled together—backstop arrangement.

Under the arrangement, Treasury would acquire \$20 billion of Citigroup's preferred stock, thereby immediately augmenting Citigroup's capital base. The preferred stock paid a penalty dividend rate that was designed to both compensate the Treasury for the extra risk of its investment and encourage Citigroup to redeem the preferred stock as soon as the emergency passed. This step was clearly within the Treasury's authority under EESA to acquire financial instruments.⁵⁰

The Treasury, FDIC, and Fed then partnered to provide a backstop or "ring-fence" for Citigroup's portfolio of troubled assets. The government reviewed and had to agree to the

their Subsidiaries," Oct. 1998, <https://www.idfpr.com/Banks/CBT/COMCL/POSB/BTSTBKPW.asp> (regarding Illinois state banks).

⁴⁹ See FDIC, *Crisis and Response: An FDIC History, 2008–2013* (Washington, D.C.: FDIC, 2017), 80-8. Financial Crisis Inquiry Commission (FCIC), *The Financial Crisis Inquiry Report* (2011), 379-381. [//fcicstatic.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf](http://fcicstatic.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf).

⁵⁰ See Section 101 and accompanying definition at Section 3(9)(A) of EESA; 12 USC 5211 and 5202.

selection of the assets put inside the ring-fence to ensure that the assets met the various restrictions in EESA and other statutes (for example, the portfolio could not include equity securities, any domestic housing-related assets that were originated after March 14, 2008, or any foreign assets). Citigroup was required to bear \$39.5 billion in losses on the identified portfolio before calling on the government backstop. That amount reflected an estimate by agency examiners of the potential losses embedded in the portfolio over ten years and was somewhat higher than the loss estimate made by Citigroup for the portfolio.⁵¹

If there were additional losses beyond that amount, the government would help mitigate 90 percent of those losses, with the Treasury providing the first \$5 billion through TARP and the FDIC providing the next \$10 billion through a loss-sharing agreement. Treasury and the FDIC received a total of \$7 billion in additional preferred stock and as warrants.⁵²

The Treasury relied on its authority under EESA to acquire troubled assets to support its role in the ring-fence. The FDIC invoked the “systemic risk” exception provided in the FDI Act. The FDI Act generally requires the FDIC to resolve a troubled insured depository institution in the manner least costly to the FDIC and prohibits the agency from providing assistance to an affiliate or a shareholder of a troubled insured depository institution.⁵³

However, at the time, the FDI Act provided an exception from these prohibitions if the Treasury secretary, after consultation with the president and with a recommendation of two-thirds of the FDIC board members and two-thirds of the Federal Reserve Board members, determined that compliance with the least-cost requirement and affiliate-assistance prohibition “would have serious effects on economic conditions or financial stability,” and other action by the FDIC “would avoid or mitigate [these] adverse effects.”⁵⁴ If this systemic risk exception is invoked, the FDIC may take other actions, including providing assistance to an affiliate or parent of the insured bank, to mitigate risks to the financial system.⁵⁵

The Treasury secretary (after consulting the president), the FDIC, and the Fed all agreed that the failure of Citigroup and Citibank during the fall of 2008 would greatly threaten financial stability and have serious effects on an already deteriorating economy and financial system. By participating in the backstop, the FDIC would significantly lessen the chance of failure for Citibank and the deleterious effects that failure would have had on the FDIC insurance fund,

⁵¹ See SIGTARP, “Extraordinary Support Provided to Citigroup, Inc.,” SIGTARP Report 11-002, Jan. 13, 2011, 19-20. As noted in that SIGTARP Report, Citigroup’s responsibility for losses was increased to \$39.5 billion before the agreement was finalized to account for various substitutions in the assets ultimately placed in the pool and various other factors.

⁵² See Department of Treasury, “Summary of Terms,” Nov. 23, 2008, www.treasury.gov/press-center/press-releases/Documents/cititermsheet_112308.pdf.

⁵³ See 12 USC 1823(c)(4) and 1821(a)(4)(C), respectively.

⁵⁴ See 12 USC 1823(c)(4)(G).

⁵⁵ See 12 USC 1823(c)(4)(G); see also 12 USC 1821(a)(4)(C).

other insured institutions, and the economy. On that basis, the secretary, FDIC, and Fed invoked the systemic risk exception.⁵⁶

If losses on the portfolio exceeded the amount covered by Citigroup, the Treasury, and the FDIC, the Federal Reserve committed to provide an emergency loan under section 13(3) of the FRA in an amount representing 90 percent of the remaining assets, secured by all the remaining assets in the pool, to help finance the remaining pool. All the assets in the portfolio served as collateral for the Fed loan and were ring-fenced—that is, the assets and any collateral securing those assets (the portfolio included secured loans) as well as other rights to obtain repayment of the assets remained in the portfolio to serve as repayment of any Fed loan. With that security, and because the loss protection provided by Citigroup, the Treasury, and the FDIC was so significant, the Fed did not expect either to be called on to extend emergency credit to Citigroup under Section 13(3) or to take losses if it was required to provide funding. In other words, the Fed believed it would be repaid even as it did not expect to be called on to lend. Indeed, the Fed was not called on to provide a loan to Citigroup.

The inter-agency backstop was immediately successful: it restored market confidence in Citigroup and relieved the financial pressure on Citigroup and Citibank. Importantly, the backstop also carefully controlled and compensated the government for the risk of loss on the asset guarantee.⁵⁷ Citigroup did not fail, and, a year later, it redeemed the \$20 billion of preferred stock issued to the Treasury. Following termination of the backstop agreement, the Treasury and FDIC sold their interests in the stock they received in exchange for the guarantee, retaining the profit from those sales, and Citigroup paid the Fed a termination fee of \$50 million as compensation for the Fed's willingness to lend.

Bank of America requested a similar ring-fencing arrangement following its acquisition of Merrill Lynch during the winter of 2008–09 and the announcement of significant losses on the Merrill acquisition. That arrangement was never finalized. However, the mere public announcement that Bank of America was negotiating a ring-fence with the government relieved financial pressure on that institution. As with Citigroup, Bank of America paid a termination fee to the government as compensation for that benefit.

The ring-fencing arrangements represented cooperative and innovative actions by three agencies with different but complementary legal authorities. They also illustrate how a strong show of support by the government can restore public confidence with only the promise of, or only a minimal expenditure of, government funds.

4. Going Forward

The credits extended by the Fed using Section 13(3) authority in the AIG case, like those extended in the case of Bear Stearns, were all fully repaid with interest. And the government funds expended in the combined actions of the Treasury, FDIC, and Fed in devising ring-

⁵⁶ See *Crisis and Response: An FDIC History*, 67, 77-85.

⁵⁷ See SIGTARP Report 11-002, 41-42.

fencing arrangements for Citigroup and Bank of America were all fully recovered at a profit (without the Fed lending any funds). On the other hand, Section 13(3) was unavailable for extending credit to Lehman because the firm could not meet the statutory requirement of providing sufficient security or endorsement to satisfy the Fed that its loans would be fully repaid.

The fact that Bear Stearns and AIG were rescued, and Lehman filed for bankruptcy has fed a debate about whether the Fed should have done more to rescue Lehman, particularly in light of the damage to the financial system that its failure caused.

Although it is true that the outcome for Lehman was stark and singular, unlike that of Bear Stearns and AIG, it is simply untrue that the Fed did not try to fashion a durable rescue. But the rescue had to be accomplished within the parameters fixed by statute, and because Lehman failed in mid-September, the statutory powers available in that case had to be evaluated before TARP existed. For the Fed, this meant reliance on Section 13(3), which authorized emergency lending only with the expectation of repayment.

Congress visited this debate in the Dodd-Frank Act and confirmed that the Fed should not take the risk of loss on credit to failing firms. Congress also amended Section 13(3) to require that collateral pledged to the Fed have a lendable value sufficient to protect taxpayers from losses and that the Treasury approve of such lending. In effect, the changes codified two aspects of the Fed's approach in extending credit during the crisis. As a further protection against potential loss from emergency credit, Congress amended Section 13(3) to prohibit the Fed from lending to failing firms to save them from insolvency or to take assets off their balance sheets. Rather, in future crises, the Fed is permitted to extend emergency credit under Section 13(3) only through broad-based lending facilities designed to provide liquidity to the system more generally.

These new restrictions will prevent the Fed from extending credit as it did in the cases of Bear Stearns and AIG (and from designing ring-fencing programs like those for Citigroup and Bank of America). Moreover, the powers granted the Treasury under EESA have expired, and the FDIC's authority under the systemic risk exception in the FDI Act has been removed unless Congress acts. Instead, Dodd-Frank provides emergency liquidation authority that allows the government to manage the resolution of troubled financial firms.

5. The Treasury's Emergency Authority: The Money Market Fund Guarantee Program and TARP

In the days following the failure of Lehman and the near failure of AIG, it became clear that policymakers needed additional tools to address the deepening crisis beyond the Fed's limited authority to extend credit.

Using the Exchange Stabilization Fund to Support Money Market Mutual Funds

In mid-September 2008, Treasury did not have broad powers to address a financial crisis. But it did have control over the ESF, and it used that authority in an extraordinary and innovative way to stem the runs on money market mutual funds that threatened the financial system following Lehman's failure.

On September 19, the department unveiled its Temporary Guarantee Program for Money Market Funds. With this program, Treasury agreed to guarantee the share price of any publicly offered eligible money market mutual fund that agreed to participate in the program by purchasing assets from qualifying money market mutual funds at the amortized cost of the asset, plus accrued but unpaid interest. Each fund was required to pay the Treasury an insurance premium to participate.

The program would not have been successful without a credible backstop of funding. The only source of funds that Treasury could call on was the ESF. Using it to guarantee money market mutual funds was certainly novel and creative. Importantly, it was also well within the discretion of the secretary under Section 10 of the Gold Reserve Act.

In 2008, Section 10 provided that:

(a)(1) The Department of the Treasury has a stabilization fund. The fund is available to carry out this section, Section 18 of the Bretton Woods Agreement Act (22 U.S.C. 286e-3), and Section 3 of the Special Drawing Rights Act (22 U.S.C. 286o), and for investing in obligations of the United States Government those amounts in the fund the Secretary of the Treasury, with the approval of the president, decides are not required at the time to carry out this section

(2) Subject to approval by the president, the fund is under the exclusive control of the secretary... Decisions of the secretary are final and may not be reviewed by another officer or employee of the government.

(b) Consistent with the obligations of the government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates, the secretary or an agency designated by the secretary, with the approval of the president, may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary.⁵⁸

While Section 10(a)(1) begins by simply recognizing that the ESF exists, Sections 10(a) and (b), read together, make clear that the secretary enjoys broad discretion in investing the assets in that fund. The breadth of this discretion was recognized by previous Treasury

⁵⁸ 31 USC 5302(a) and (b).

Departments, in particular in developing the response of the United States to the Mexican debt crisis in 1995.⁵⁹

The secretary reasoned that using the ESF to help stem runs on the money market industry was consistent with Congress's intent in creating it. The runs were threatening to spread the destabilizing stresses on the financial system beyond the United States. There was significant volatility in the value of the dollar against both the euro and the yen during this period; runs on U.S. money market funds were destabilizing exchange rates as foreign investors sought to quickly liquidate their positions in them.⁶⁰ Forcing fire sales of assets by money market funds to meet the demands of investors would cause a further deterioration of the U.S. economy as well as declines in the dollar's value.

The program was successful in stopping the industry's erosion. In October, while the program was beginning and before its extension by the secretary,⁶¹ Congress enacted legislation allowing ESF to continue to support the money market fund guarantee.

At the same time, Congress enacted legislation prohibiting the secretary from using the ESF to provide a guarantee in the future.⁶² With this tool removed and TARP now expired, Treasury is left with no emergency tools to address a future crisis.

The Emergency Economic Stabilization Act and TARP

As delinquencies in residential mortgages increased, financial asset values continued to drop and financial firms—both banks and nonbanks—had increasing difficulty raising capital to offset the losses from declining asset prices. It became apparent that the United States lacked certain emergency tools that were proving to be effective in other countries.

In particular, neither the Treasury nor the Federal Reserve had emergency authority to take action to stabilize asset prices or to inject capital into struggling but viable financial firms. Moreover, the resolution regime available for most nondepository institutions was bankruptcy, a court-administered process that focused on satisfying creditors without taking account of the systemic consequences of a firm's failure or the manner of its resolution.

⁵⁹ See, for example, the Report of the Government Accountability Office on Mexico's Financial Crisis, GGD-96-56, [gao.gov/assets/160/155366.pdf](https://www.gao.gov/assets/160/155366.pdf).

⁶⁰ See Steven Shafran, "Money Market Funds: Collapse, Run, and Guarantee," *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, forthcoming 2020.

⁶¹ The program was initially set to expire after three months but was extended until September 18, 2009.

⁶² See 12 USC 5236; Public Law 110-343, Section 131, Oct. 3, 2008; 122 Stat. 3797.

To address these weaknesses, Congress, at the urging of the president, the Treasury, and the Federal Reserve, enacted EESA on October 3, 2008.⁶³ EESA, in turn, established the TARP, with potentially \$700 billion available to purchase troubled financial assets.⁶⁴

Throughout TARP's existence, Treasury developed programs designed to stabilize the financial system and alleviate the housing crisis. The most successful use of TARP injected much-needed capital into financial firms by acquiring equity stakes in the firms.

This capital injection effort resulted from the realization by policymakers, soon after the enactment of EESA, that it would be more effective, quicker, and operationally easier to implement a program that would inject capital directly into financial firms than it would be to put into place a program that attempted to price, acquire, and liquidate troubled assets of financial firms.⁶⁵ Although the wisdom of this approach was criticized by some in Congress, its legal basis was never in doubt.

Section 101 of EESA authorized the secretary to establish TARP "to purchase...troubled assets from any financial institution, on such terms and conditions as are determined by the secretary, and in accordance with this Act..." Section 3(9)(B) of EESA defined "troubled assets" to include "any other financial instrument that the secretary, after consultation with the chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability. . . ." ⁶⁶ After EESA's passage, the Treasury secretary and the Fed chairman determined that securities issued by qualifying financial firms were troubled assets and the purchase of these assets would be the most effective way to quickly promote stability by providing viable firms with capital to offset the devaluation of other assets they held. In accordance with the other terms of EESA, the Treasury received warrants or other convertible shares from financial firms in which the TARP injected capital, and, as part of the program, imposed restrictions on the compensation received by management of the financial firm receiving capital.

The authority provided by EESA through TARP to purchase troubled assets—including the capital of financial firms—to prevent disorderly failures and systemic shocks was one of the most effective tools for addressing the vulnerabilities in the system during the crisis. It was also controversial because of the many policy issues it raised about the appropriate level of government involvement in distressed firms. In the United States, that authority expired

⁶³ Public Law 110-343, 122 Stat. 3765, Oct. 3, 2008.

⁶⁴ See 12 USC 5211(a)(1). For a complete discussion of TARP's terms and conditions, see Timothy G. Massad and Neel T. Kashkari, "Implementing TARP: The Administrative Architecture of the Troubled Assets Relief Program," *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, forthcoming 2020.

⁶⁵ See, for example, Ben S. Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* (New York: W.W. Norton, 2015), 337–39; and Henry M. Paulson, Jr., *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (New York: Business Plus, Hachette Book Group, 2010), 336–38.

⁶⁶ 12 USC 5202(9)(B). The purchase of securities issued by a financial institution is fully consistent with the factors the secretary is required to consider in acquiring "troubled assets." (See 12 USC 5213[1] through [9].)

on October 3, 2010; it remains, however, a tool within the arsenal of many foreign governments.

6. The Federal Reserve's Creation of Broad-Based Lending Facilities, Swap Lines, and Other Actions

Before 2008, the Fed had provided emergency credit under Section 13(3) strictly on a firm-by-firm basis, making only a small number of loans to nondepository institutions. During the crisis, it was evident that lending to specific firms would not be sufficient to address the liquidity needs of the overall economy, which had grown more complex and interconnected since the 1930s. For example, manufacturing corporations that funded their payrolls and operations by borrowing on a short-term basis in the commercial paper market were finding it difficult to find investors for that paper. And auto loans, credit card loans, small business loans, and student loans were becoming less available because investors that ordinarily would fund these types of credit through securitizations backed by these loans were holding on to their liquidity in the face of the financial turmoil and not investing in them.

The Fed responded in an innovative way: It created broad-based lending facilities that were designed to relieve pressures on liquidity felt by entire markets, not just by specific firms.⁶⁷

The basic purpose of these facilities was the same as that of traditional emergency lending to specific borrowers—to provide liquidity to allow large numbers of borrowers to conduct sound transactions involving good assets whose value was uncertain because of financial turmoil. The innovation was that each facility would allow large numbers of borrowers to access central bank liquidity on the same terms and conditions so long as the funding was used to support a given market. In other words, the facility was not designed simply to provide liquidity to a single identified borrower to be used for the borrower's individual needs. Altogether, hundreds of borrowers participated in the broad-based facilities.

Because these facilities involved lending to nonbanks, they were based on the powers in Section 13(3).

The facilities raised a number of legal issues of first impression. Two related questions involved the finding of “unusual and exigent” circumstances⁶⁸ and the collection of evidence that borrowers were unable to secure adequate credit accommodations from other banking institutions.⁶⁹ In addition, as with the emergency loans to specific firms previously

⁶⁷ These included the Primary Dealer Credit Facility (PDCF), Term Securities Lending Facility (TSLF), Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Single-Tranche Term Repurchase Agreements, Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF), and Term Asset-Backed Securities Loan Facility (TALF).

⁶⁸ Each lending facility was authorized with the approval of a supermajority vote of the Board.

⁶⁹ The rate on credit extended under each broad-based lending facility was set in accordance with Section 14(d) of the FRA, which, as noted above, requires that it be set “with a view to accommodating commerce and business.” (See 12 USC 357.) This approach resulted in different rates for different facilities. For example, the rate most helpful for “accommodating commerce and business” with a facility designed to provide liquidity to

discussed, careful attention was paid to ensure that the borrower's promise to repay was secured to the satisfaction of the lending Reserve Bank.

The Fed approached the determination of "unusual and exigent" circumstances in the same way that Congress had in enacting Section 13(3) and as explained earlier.⁷⁰ The required finding focused not on the borrower but on economic conditions and the role that a particular market played in the broader economy. The economy was experiencing unusual pressures and distress, greater than anything since the Depression, 75 years earlier. For each market targeted by a broad-based lending program, statistical evidence and observations of market conditions were gathered to show that it was contracting or experiencing extraordinary stresses.

These statistics and anecdotes also helped fulfill the requirement in Section 13(3) that the Reserve Bank "obtain evidence that [the borrowing] individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions." That requirement was designed to ensure that the Fed did not supplant private-sector lenders and become the lender of first resort.⁷¹

In the case of the broad-based facilities, evidence from participants in each targeted market indicated that credit was becoming increasingly difficult to obtain. Market data revealed that activity and liquidity were diminishing, rates and spreads were rising, and credit was either not available or less available to consumers and businesses.⁷² The Reserve Banks continued to monitor the markets throughout the life of each facility. As evidence accumulated that a particular market was becoming active and could be sustained without Fed liquidity support, a termination date was set for its facility.

money market funds, such as the AMLF, was one that would encourage lending to money market funds under stress while also taking into account legal and credit factors, such as the duration of the credit and the types of collateral posted. However, the rate on the AMLF was not an appropriate rate to charge on a facility, like the TALF, that was intended to fund the asset-backed securities (ABS) market, which involved a different and broader category of borrowers, a longer duration for the credits, and different collateral and repayment risks. Importantly, accommodating commerce and business during an emergency also allowed the Fed to establish rates that compensated it for the greater risks of lending in such a stressful economic period and that were higher than would be the case during normal times, thereby discouraging borrowers from using the facilities as markets began to normalize.

⁷⁰ See Hackley, 128; see also Letter from President Herbert H. Hoover to Governor Eugene Meyer, quoted in Federal Reserve Board minutes, July 26, 1932, <https://fraser.stlouisfed.org/title/821/item/31232>; and Sastry, footnote 199.

⁷¹ See Hackley, 129.

⁷² For example, the AMLF and MMIFF were created to help stem runs on money market funds. Market evidence showed that these runs were threatening to destabilize the value of assets held by the funds, reduce confidence in financial markets generally, and reduce the liquidity available to consumers and businesses that relied on the funds. TALF was created to provide liquidity to the ABS market, which had virtually ceased to function, resulting in sizable reductions in the availability of auto loans, student loans, small business loans, and similar securitized credits. CPFF was created because the commercial paper market was failing to supply credit to corporations, and the PDCF was a response to a dramatic reduction in the funding available in the triparty repo market.

As noted earlier, a central element of Section 13(3) is that credit be endorsed or otherwise secured to the satisfaction of the lending Reserve Bank. In the case of the broad-based facilities, this requirement was generally met by having the borrower post collateral. The type of collateral was market specific. For example, collateral pledged under TALF, which was designed to unfreeze segments of the asset-backed securities market, consisted of securities backed by consumer credit-card receivables, auto loans, student loans, or small business loans.

Credit extended under CPFF, targeted to the commercial paper market, was secured in a new manner. This market involves the issuance of highly rated short-term debt, known as commercial paper, by financial and nonfinancial companies to underwrite their lending activities or commercial operations.

CPFF was originally conceived as a vehicle that would be owned and funded by private investors or by the Treasury using TARP funds. The Treasury and/or investors would hold an equity or subordinated position and the vehicle would obtain credit from the Fed secured by the commercial paper held by the vehicle. However, it soon became apparent that the same stresses that were reducing liquidity in the commercial paper market were discouraging investors from funding a commercial paper vehicle, even with Fed liquidity, and the Treasury was moved to focus on other priorities.

The challenging question for CPFF was how to fulfill the “[e]ndorsed or otherwise secured” requirement. Commercial paper may be either secured or unsecured. Secured commercial paper was already supported by assets of the issuing corporation. This provided justification for its discount, since Section 13(3) authorized the discount of a secured note, backed by the collateral pledged by the issuer. In considering unsecured commercial paper, Fed lawyers and economists explored the novel idea that CPFF could include a pool of assets and funds—an insurance pool—that would be available to cover losses on commercial paper that might default. Insurance is a form of endorsement. Indeed, for example, credit insurance providing that the insurer will repay a debt in the event of the borrower’s death, disability, or other specified event is a guarantee or endorsement of repayment.

CPFF required all participants to pay fees to obtain funding for commercial paper. To create a pool of funds to protect against losses from defaults on unsecured paper, issuers of uncollateralized paper would be required to pay a special premium to CPFF. The size of the premium was tied to the amounts expected to be needed to cover any losses. The combined pool of fees paid by all participants that issued commercial paper and the special fees paid by issuers of unsecured paper would be available to absorb losses on the unsecured paper, mutualizing those losses much as an insurance fund would.

Thus, the non-asset-backed commercial paper acquired by CPFF was supported by the obligation of the commercial firm to repay, and the credit of the borrower was enhanced by the funds in the pool of premiums collected by CPFF. This enabled the lending Reserve Bank to conclude that the credit extended through CPFF was secured to its satisfaction.

CPFF and the other broad-based lending facilities were successful in restoring the functioning of their respective markets. When Congress repealed the Fed's authority to lend to specific IPCs under Section 13(3), it specifically retained the authority in that section to create this type of broad-based lending vehicle.

Swap Lines with Foreign Central Banks

In December 2007, the Federal Reserve announced the establishment of swap lines with the European Central Bank and the Swiss National Bank. It subsequently established swap lines with 12 additional foreign central banks. The swap lines helped ensure a supply of dollars to foreign central banks for their use in supplying U.S. dollar liquidity to foreign markets. The Fed had established swap lines a number of times before, dating back to the early 1960s, although the purposes for setting up the swap lines varied.

Swap lines with foreign central banks are permitted under Section 14 of the FRA, which authorizes the Fed to purchase and sell foreign currency.⁷³ In the case of the swap lines during the global financial crisis, the Fed sold a fixed amount of dollars to a foreign central bank in exchange for a fixed amount of foreign currency based on the exchange rate at the time of the swap agreement, and the foreign central bank agreed to sell back to the Fed the original amount of dollars in exchange for the original amount of foreign currency on the expiration of the swap term. The foreign currency received by the Fed was held in an account at the foreign central bank in the name of the Fed. The foreign central bank could then use the dollars it received in the swap for transactions between the foreign central bank and counterparties needing dollar liquidity. Upon termination of the swap term, the foreign central bank was required to repay the Fed the same amount of dollars originally purchased from the Fed, with interest, regardless of whether the foreign central bank had profited or lost on its use of the dollars acquired in the swap. Also, upon termination, the foreign currency held by the Fed would be paid back.

Thus, the swap lines represented a purchase and resale of foreign currency at a set price, as authorized under Section 14 of the FRA.⁷⁴ Moreover, although foreign central banks used dollars mostly to lend to banks in their home countries that needed dollars, the Fed did not take the risk of those subsequent transactions because the Fed was not a party to them and the foreign central bank was obligated to repurchase its foreign currency from the Fed regardless of the success of the foreign central bank's use of those dollars. And, because the Fed was required only to return to the foreign central bank the same amount of foreign

⁷³ 12 USC 353. Section 14 authorizes the Reserve Banks to purchase and sell "cable transfers," among other assets. The term "cable transfer" refers to the technology used at the time of the enactment of the FRA to conduct foreign currency transactions—instructions to transfer foreign currency between accounts were sent by international cable.

⁷⁴ The Fed also entered into a reciprocal arrangement where the Fed could purchase foreign currency from a foreign central bank. The terms of the reciprocal side of a swap agreement were the same as those described earlier, only in reverse, with the Fed purchasing foreign currency from a foreign central bank in exchange for dollars. This reciprocal side of a swap provided the Fed access to foreign currency, for example, to lend to borrowers in the United States. This reciprocal arrangement was also a purchase and sale of foreign currency authorized under Section 14 of the FRA.

currency the Fed had received from the foreign central bank when it originally purchased dollars from the Fed, the Fed did not take foreign exchange risk in the swap line.

Other Actions

A number of other actions were taken by the Fed, Treasury, and the FDIC to mitigate the crisis.

These included the Temporary Liquidity Guarantee Program (TLGP) implemented by the FDIC, Single-Tranche Term Repurchase Agreements established by the Fed, and a number of TARP investment programs undertaken by the Treasury.

Although each of these programs represented an important effort by the sponsoring agencies, all of them (with the exception of TLGP, which relied on a novel review of the FDIC Act) relied on relatively straightforward interpretations of the underlying legal authority. The legal basis for the approach to the TLGP taken by the FDIC is well and fully explained elsewhere.⁷⁵ The FDIC's authority to reinstitute a TLGP in a future crisis was significantly inhibited by Dodd-Frank, which prohibits the agency from establishing a debt guarantee program like TLGP without Congress's consent. The change essentially requires enactment of a new authorizing law.⁷⁶

7. Conclusion

The legal authorities available to the Fed, Treasury, and the FDIC during the financial crisis shaped and constrained their responses. The authorities allowed the government to take some actions that had worked in the past. They also allowed the agencies to act in innovative ways that may not have been imagined by the authors of the empowering laws.

Policymakers were united in a view that everything “possible” should be done within the bounds of the law to mitigate the crisis (and their lawyers explored every avenue). Yet in certain situations, such as the collapse of Lehman and the credit extended to AIG, the law did not permit the government to take actions that it wanted to take.⁷⁷

The initial response to the crisis was to add supervisory tools—such as stress test requirements, enhanced prudential standards, swap margin requirements, and other

⁷⁵ See *Crisis and Response: An FDIC History*, 35-43; see also Michael H. Krimminger, “The Temporary Loan Guarantee Program,” *First Responders: Inside the U.S. Strategy for Fighting the 2007–2009 Global Financial Crisis*, edited by Ben S. Bernanke, Timothy F. Geithner, Henry M. Paulson, Jr., with J. Nellie Liang. New Haven: Yale University Press, forthcoming 2020.

⁷⁶ See Sections 1104, 1105, and 1106 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, July 21, 2010; 124 Stat. 1376.

⁷⁷ For example, quite apart from the matter of extending emergency credit to these firms, the government did not have authority to close or liquidate a nondepository institution in a manner that, unlike bankruptcy, allowed consideration of the impact of the resolution on financial stability.

authorities designed to improve the resiliency of the financial system—so that future crises could be avoided.

And the government now has authority to resolve systemically important financial firms in a manner that both provides funding backed by the banking industry (and not the taxpayer) and empowers policymakers to maintain financial stability and limit damage to the economy. This authority, while untested and undoubtedly imperfect, puts a new tool in the crisis management toolbox that is an alternative to government lending or capital support.

At the same time, though, Congress imposed significant limitations on the emergency authorities used by the agencies during the last crisis, thereby making Congress more deeply responsible for developing a response to the next crisis. In the next crisis, it will be up to Congress to decide in real time during the frenzy of a crisis whether to make available some of the emergency tools that helped stem the last crisis, such as providing emergency credit to nondepository institutions outside of a broad-based market facility (as was done by the Fed), supporting the money market fund industry (as was done by Treasury), and establishing an industry-backed debt guarantee program (as was done by the FDIC). And Congress will again have to determine—in the midst of the crisis—whether to provide capital to the financial system on an emergency basis, as it did in enacting EESA.

This reservation of power may limit moral hazard and impose market discipline if Congress ensures that both large and small entities are exposed to failure during the next crisis. Still, narrow or limited emergency authority could prevent policymakers from acting quickly and effectively to help the broader economy and could result in more damage to a wider range of consumers and businesses.

An alternative approach would be to provide a wide and mighty arsenal of emergency powers subject to strong, workable governance requirements, ensuring that these tools are used only during an emergency and only to the extent necessary.

Limiting the authority to act during a financial crisis will not prevent a crisis. But it will shape the government's response to that crisis—and fundamentally determine its cost to the nation.