Comments on the Federal Reserve's Section 13(3)
February 8, 2022

In my observation comparing the strengths and weaknesses of monetary and fiscal policy in providing economic stimulus (November 2021), I said that monetary policy is not very effective at targeting specific sectors of the economy. It operates through financial markets, where the interactions of those who want and those who supply financing determine the winners and losers. There is a notable exception, however: Section 13(3) of the Federal Reserve Act.

Section 13(3)

Until 2010, Section 13(3) of the Federal Reserve Act allowed a Federal Reserve Bank to lend to any individual, partnership, or corporation in "unusual and exigent circumstances." At least five of the seven members of the Board of Governors had to approve. This provision of the Act originated in the Depression in 1932. Relatively few loans were made using Section 13(3), at least partly because two years later another amendment to the Federal Reserve Act created Section 13(b), which was less restrictive and allowed the Reserve Banks to lend to established businesses that could not get financing from other sources. Even with Section 13(b), the Federal Reserve's commercial lending was limited, as the government's Reconstruction Finance Agency (RFC) offered borrowers better terms.

By the 1950s, thinking about the Federal Reserve's role had shifted. Monetary policy was given more emphasis; lending to business was not seen as an appropriate central bank responsibility. Section 13(b) was eliminated in the Small Business Investment Act of 1958.

Section 13(3) remained on the books – but unused. Loans from the Federal Reserve were limited to banks and other deposit-taking institutions. Section 13(3) was considered on several occasions, but there always seemed a better way. Until the Global Financial Crisis (GFC) of 2007-2009.

Before turning to the use of Section 13(3) in the GFC and its expansion in the Covid-19 recession of 2020, I will review the rationale for central banks as Lenders of Last Resort to banks.

Lender of Last Resort

Commercial banks and other deposit-taking institutions are vulnerable to "bank runs" because their liabilities are short-term and most of their assets are longer term and relatively illiquid. Deposits can be withdrawn with little, if any, notice. Bank assets, in contrast, are heavily oriented towards loans and securities. Cash and reserves that can be converted into cash almost immediately were traditionally a small fraction of total assets. Thus, a bank facing unexpectedly large withdrawal demands may not have sufficient cash to meet its obligations. And unless it can borrow the necessary funds, a bank experiencing a run will have to sell off assets quickly, often at deep discounts; it will likely stop renewing loans and may even call them in prematurely, jeopardizing the financial health of

borrowers. A run at one bank may trigger runs at others. The money supply may shrink, with negative effects on overall economic activity.

Runs were common in the United States in the 19th century. They also occurred occasionally in the United Kingdom, leading Walter Bagehot, editor of *The Economist* in the 1860s and 1870s, to call on the Bank of England, one of the earliest central banks, to function as a Lender of Last Resort (LOLR) in banking crises. The stylized role of the LOLR, as attributed to Bagehot, is to lend freely against good collateral at a penalty rate. This model continues to shape thinking today. As LOLR, central banks should lend freely to solvent banks that are facing runs, so that they can meet the withdrawal demands of depositors. The ability of depositors to withdraw their funds will reassure the public and help maintain confidence in the banking system, preventing contagion and widespread asset sales and the resulting economic fallout. Public awareness that a LOLR exists should discourage runs in the first place. However, the lending terms should be such that banks return to normal sources of financing when the crisis has passed.

Functioning as LOLR is now considered a core responsibility of central banks

For most of the post-WWII period, the LOLR function was seen as distinct from monetary policy – at least in the United States[1]. At the Federal Reserve, economists made recommendations about monetary policy while bank supervision departments managed lending reserves to banks at what is called the "discount window." Although the interest rate on discount window loans had been an early tool of monetary policy, the primary tool was the federal funds rate - the rate at which banks borrowed and lent reserves at the central bank to one another overnight. The Fed could change the federal funds rate through open market operations (the purchase and sale of government securities.) The rate on loans at the discount window was then adjusted to align with the federal funds rate. Thus, going into the GFC, monetary policy operated through the federal funds rate. The discount window was primarily a supervisory responsibility enabling individual banks to cope with shortfalls in reserves. With the Global Financial Crisis (GFC), however, the two functions came together. Not only did liquidity problems at banks threaten the economy, but also other financial institutions, besides banks, proved to be vulnerable to runs.

When the GFC began in the summer of 2007, it was initially seen by the Federal Reserve and other central banks as a liquidity problem, with big banks and other large financial institutions reluctant to lend to one another. The Fed's first action was to put on its LOLR hat and issue a press release reminding banks that they could borrow from the central bank's discount window. Banks were reluctant to do so, however; they were concerned that market participants would learn of their borrowing and perceive their banks as financially stressed or poorly managed. Accordingly, for the rest of 2007, the Federal

[1] For most of this time, the Federal Reserve did not charge a penalty rate. The rate on discount window loans was slightly below the federal funds rate. To discourage excessive reliance on these central bank loans, the Fed relied on "counselling" borrowers to manage their reserves more effectively. This created a stigma about borrowing from the Fed and in 2003 the Fed adopted a penalty rate approach, with no counselling. However, the stigma persisted.

Reserve tried to make borrowing reserves at the discount window more palatable - reducing the penalty over the federal funds rate, broadening acceptable collateral and lengthening terms, and instituting an auction of central bank reserves. Meanwhile, the Fed was easing monetary policy by reducing the federal funds rate. The discount rate was reduced in tandem.

Return of Section 13(3)

Section 13(3) was not used for roughly 70 years. Then, in March 2008, it was employed to facilitate the acquisition of the investment bank, Bear Stearns, by JP Morgan Chase.

Bear Stearns found itself facing the equivalent of a bank run. While it did not have deposits, Bear Stearns' financing was heavily dependent on short-terms repo loans, including overnight loans. When lenders in the repo market abruptly stopped rolling over loans to Bear Stearns, the firm faced imminent bankruptcy. Bear Stearns sought a buyer. The most promising possibility was JP Morgan Chase, which as Bear Stearns' clearing bank knew the firm best. Chase was interested but leery of some Bear Stearns' assets.

The Federal Reserve – as well as the U.S. Treasury – was very worried about the potential fallout from a bankruptcy of Bear Stearns. Financial markets were already jittery. Bear Stearns had connections to a host of other financial institutions, banks and non-banks, domestic and foreign. Fearing a financial panic, the Fed used 13(3) to make a loan that would buy time for Bear Stearns to look for an acquirer. But almost immediately it was apparent that Chase was the only option. To enable Chase to go forward with the acquisition, a special purpose vehicle (SPV)was created at the Federal Reserve Bank of New York and the New York Fed lent the SPV funds to acquire $30 billion in securities from Bear Stearns that Chase did not want. In lending to the SPV, the Fed used its authority under Section 13(3.)

At roughly the same time, the Fed also invoked Section 13(3) to establish two lending facilities to assist primary dealers, the large securities firms approved to engage in open market operations with the Fed. Most are affiliated with large banks; some are investment banks. The Term Securities Lending Facility (TSLF) allowed the primary dealers to borrow highly liquid securities (Treasury and agency securities) from the Fed, putting up less liquid securities as collateral.[2] The Primary Dealers' Credit Facility (PDCF) essentially made the discount window available to primary dealers.

In the fall of 2008, responding to the financial turmoil following the failure of Lehman Brothers, the Federal Reserve created additional lending facilities using the authority of Section 13(3). The Commercial Paper Funding Facility (CPFF), which created a SPV to buy commercial paper directly from issuers, is noteworthy because the Fed bought paper from non-financial firms as well as financial institutions. Under the AMLF,[3] the Federal Reserve

[2] The TSLF was announced March 11, before the Bear Stearns loans, but did not operate until after (March 27.)
[3] Asset-backed Commercial Paper Money Market Mutual Fund Liquidity Facility.

Bank of Boston made loans to banks so they could buy securities being sold by money market mutual funds experiencing a wave of redemptions. The Term Asset Backed Securities Loan Facility (TALF), announced in November 2008, provided loans at attractive rates to holders of high-quality asset backed securities (ABS) and backed by these securities. In all three cases, the goal was to help borrowers dependent on these financial markets. Thus, the goal of the TALF was to increase demand for ABS and, indirectly, for the student loans, small business loans and credit card loans underlying these securities and, ultimately, to help students, businesses and other borrowers needing credit.

Among the most controversial uses of Section 13(3) was lending to the insurance giant American International Group (AIG.) AIG had gotten into difficulty by investing funds generated by its securities lending program in mortgage-backed securities that subsequently fell in value and by engaging in credit default swaps in which AIG paid out if the values of certain collateralized debt obligations declined. The Federal Reserve was concerned about the potential impact of an AIG failure on its insurance subsidiaries and their policyholders. Also, if AIG could not honor its credit default obligations, that would put additional pressure on the investment banks and other counterparties to these contracts, which were already highly stressed. More generally, AIG was a very large actor in financial markets in the United States and around world. Its failure would have been disorderly and extremely disruptive. The Fed quickly agreed to provide a line of credit of up to $85 billion to AIG; in return, the U.S. Treasury received an 80 percent equity interest in AIG. The support for AIG was restructured several times.

The Federal Reserve did not suffer losses on its 13(3) loans. The funds were eventually paid back. Nevertheless, there was something of a backlash. Many people were angry that big commercial and investment banks, which had contributed to financial crisis, had received assistance, while many small businesses could not get credit and home-owners who became delinquent on mortgages faced foreclosure. Some also thought that allowing unelected Federal Reserve officials to have such power over the allocation of credit was not democratic.

In any event, the Federal Reserve's authority under 13(3) was curtailed in the Dodd-Frank financial reform legislation of 2010[4]. Going forward, the Federal Reserve would need the support of the Secretary of the Treasury to invoke 13(3.) (In fact, Secretary Paulson was consulted regularly in the GFC.) Also, Section 13(3) could no longer be used to make loans to a single entity; it could only be used to lend through a "program or facility with broad-based eligibility." Thus, it could not be used to lend to a future AIG but might be used to lend to insurance companies meeting certain eligibility conditions.

Section 13(3) and the Covid Crisis

Despite concerns about the Fed's use of Section 13(3) in the GFC, lending under 13(3) was a major part of the Fed's response to Covid-19 – or at least it was intended to be.

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

In early 2020, when it became apparent that the world was confronted with a fast-spreading, lethal virus, governments at all levels in many countries, including the United States, reacted by shutting down significant segments of their economies. The combination of public fear of covid and government shutdowns guaranteed a severe recession. This was not a recession that central banks and traditional monetary policy were well-equipped to handle. The problem was not that households needed to be encouraged to consume more and businesses to invest more. In many cases, households and businesses were precluded by their governments from normal economic activities. And in any event, central banks' primary monetary policy tool, the short-term interest rate, was already very low. Nevertheless, there were some things central banks could do.

If interest rates were not already near zero, they could reduce them. They could increase their balance sheets and expand the money supply by buying securities. And with governments borrowing heavily to provide support to workers who could not work and businesses that could not operate, there were plenty of securities to buy. As LOLR, they could prevent financial panic from aggravating the situation. And in a combination of LOLR and monetary policy, they could try to ensure that businesses and other entities that had been solvent before covid struck had access to financing until the crisis had passed.

The Federal Reserve did all these things. At the outset in mid-March, it lowered the federal funds rate, its short-term policy rate, from 1 ½ percent to almost zero. It also lowered the rate on discount window loans and eliminated the penalty. It aggressively purchased Treasury securities, in the process expanding banks' reserve accounts and increasing its own balance sheet from roughly $4 trillion to $7 trillion in just three months. It also resurrected most of the broad-based lending facilities that it had created in the GFC using Section 13(3) – the PDCF, the CPFF, the MMLF[5] (very similar to 2008's AMLF), and the TALF. And it created new lending facilities intended to provide financing to non-financial businesses and other organizations expected to have difficulties accessing credit because of the economic fallout from covid.

These new programs involved the Fed more directly in providing credit to non-financial activities. The Primary and Secondary Market Corporate Credit Facilities (CCF) were aimed at supplying credit to larger businesses by allowing the Fed to buy both new and outstanding corporate bonds and exchange traded funds. The Main Street Lending Program (MSLP) was intended to encourage banks to lend to small and medium-sized businesses by buying these loans. Under the Municipal Liquidity Facility, the Fed would buy notes issued by states and large counties and cities. The Fed also lent to lenders making Paycheck Protection Program (PPP) loans, taking the loans as collateral and freeing lenders to make more loans.

Treasury Secretary Mnuchin approved all these Section 13(3) lending programs, as required by Dodd-Frank. Indeed, of the initial $2 trillion fiscal response to the crisis, the Coronavirus Aid Relief and Security (CARES) Act passed in March 2020, $454 billion was intended to protect the Federal Reserve from losses that might arise from its lending

[5] Money Market Mutual Fund Liquidity Facility.

programs. At the time, it was said that this degree of protection could have supported something like $4.5 trillion in lending by the Fed.

In fact, the lending programs were little used. The peak assets of all the individual facilities created under Section 13 (3) liquidity facilities amounted to just $222 billion. [6]

The lending facilities for non-bank financial institutions, notably the PDCF for primary dealers and the MMLF for money market mutual funds, were up and running very quickly. The Fed had experience with these programs from 2008. However, financial markets calmed down very quickly and after an initial flurry of activity, use of these facilities wound down. It is likely that the availability of these facilities reassured financial markets and contributed to the return of calm. Their existence obviated the need for them.

The lending facilities for non-financial organizations took time to develop. The Paycheck Protection Program Liquidity Facility was relatively straightforward. The Fed's role was to provide liquidity to banks and other small business lenders so they could make more loans; but the lending decisions were made by the banks and the PPP loans were guaranteed by the Small Business Administration. In contrast, setting up the Primary and Secondary Market Corporate Credit Facilities, the Main Street Lending Program, and the Municipal Liquidity Facility was challenging. These programs did entail credit risk. These were loans, not grants. Even with backup funding from Treasury, the Fed did not want to lose money. The goal was to sustain the operations of businesses and other organizations until the situation returned to normal. But how long would that be? A business that could survive a shutdown for three months might not be able to handle six. The Fed had little experience in lending to non-financial borrowers. What should be the criteria for eligibility? How should it balance need and creditworthiness?

The Federal Reserve's approach to most of its liquidity facilities was to create special purpose vehicles (SPVs.) The Federal Reserve Bank of New York, or in the case of the MMLF and the Main Street Lending Program, the Boston Fed, would then lend to the SPV, which would buy the securities or loans that the Fed wanted to support. Where possible, the Fed would try to establish eligibility criteria in advance. Thus, for the Secondary Market Corporate Credit Facility, only bonds that had been rated as investment grade were eligible for purchase by the SPV. The New York Fed also engaged Black Rock Financial Markets Advisory as the investment manager for the SPV, thereby drawing upon existing private sector expertise in making investments.

For the Main Street Lending Program, the Boston Fed also tried to take advantage of existing expertise. Small and medium-sized businesses depend heavily on bank loans for financing, rather than capital markets. Thus, the Main Street programs focused on

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[6] Table 2 of Changes in Federal Reserve Assets in Federal Reserve Balance Sheet Developments, November 2021 shows the peak assets of the individual liquidity facilities. https://www.federalreserve.gov/monetarypolicy/files/balance_sheet_developments_report_202111.pdf. The peaks were at different times; so the overall peak was less.

maintaining business lending by banks and other depositories by purchasing 95 percent participations in eligible loans. Lending banks were supposed to assess the borrowers' financial condition, with the required retention of 5 percent of the loan providing an incentive to be conscientious. The eligibility conditions for the Main Street programs were re-written several times in response to public comment, generally making more businesses eligible for help. Under the Main Street umbrella, lending facilities were also established for non-profit organizations.

By the time the new lending facilities for nonfinancial businesses and state and city governments were ready for business, the economy had made a substantial recovery and access to credit had become a less pressing concern. Treasury Secretary Mnuchin decided to terminate the programs. The Federal Reserve objected, but most of the lending facilities wound down at the end of 2020 or in spring 2021. For the Federal Reserve, this may have been fortunate.

While the Fed took some criticism for not getting its lending facilities up and running more quickly, it might have received more had it succeeded. If it had lent on a much large scaler, it would likely have suffered losses and come under criticism for lending to organizations that failed. Since the securities and loans purchased through the various facilities were public information, it is also likely that the Fed would have been criticized for supporting businesses that some people thought did not need or deserve help. It would have been attacked for supporting firms in disfavored industries or linked to unpopular political figures at the same time as it was assailed for not providing financing to organizations in favored industries or associated with popular figures or that simply needed help. It would become a political focal point. Imagine the dilemma posed by a state or large city that borrowed from the Fed's Municipal Liquidity Facility and then fell in arrears. Would the Fed be able to take any action to encourage payment?

While the Federal Reserve should perhaps consider itself lucky not to have had much use of its new Section 13(3) lending facilities, the precedent has been set for engaging the central bank in the allocation of credit. A lot of effort went into designing facilities that could lend to a wide variety of activities – large and smaller businesses, non-profit organizations, state and some local governments - on a large scale. In the future, the Fed could probably set up such programs much more rapidly than it did in 2020 – for better or worse.

References

Much of the information about the use of 13(3) in 2020 came from the website of the Board of Governors of the Federal Reserve System, particularly the Reports to Congress Pursuant to Section 13(3) of the Federal Reserve Act in response to COVID-19.
https://www.federalreserve.gov/publications/reports-to-congress-in-response-to-covid-19.htm

Also, Federal Reserve Balance Sheet Developments, November 2021.
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And here are some interesting references on history and use of Section 13(3) in the Global Financial Crisis.

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