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Revised Section 13(3) of the Federal Reserve Act

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On December 23, 2018, after significant market turmoil, Treasury Secretary Steven Mnuchin issued a statement that he had completed calls with the nation's six largest banks and that those banks had reported that "markets continue to function properly," and that they had sufficient liquidity to fund themselves.[1] This unexpected statement generated considerable commentary as to why the conversations had occurred in the first place[2] and was the first time since the dramatic events of the 2008–09 financial crisis that the government had focused on particular institutions and their liquidity. It thus seems appropriate to consider an important "weapon" in the U.S. government's arsenal when responding to significant liquidity events in the financial sector, and what happened to that weapon in the Dodd-Frank Act.

The weapon is section 13(3) of the Federal Reserve Act, which has permitted emergency lending to bank and nonbank companies by the Board of Governors of the Federal Reserve System (the Federal Reserve).[3] This article begins with consideration of section 13(3)'s enactment during the Great Depression and its history since, and then turns to some of its principal uses during the financial crisis. It concludes with a discussion of how the Dodd-Frank Act amended this provision and how, as amended, section 13(3) fits into the post-crisis regulatory scheme.

As an initial matter, section 13(3) was not part of a "banking bill" per se, and it was controversial even in 1932. It came about as part of the Hoover administration's response to the Great Depression, which was focused primarily on a new government enterprise, the Reconstruction Finance Corporation (RFC), created in early 1932.[4] The RFC responded to a series of bank failures in December 1931, and among other things, was a source of credit to banking institutions that were not members of the Federal Reserve as well as commercial enterprises like railroads.[5] Economic conditions continued to decline notwithstanding the RFC, and Congress continued to legislate, enacting the first Glass-Steagall Act: the Banking Act of 1932. This statute, *inter alia*, permitted the Federal Reserve, "in exceptional and exigent circumstances," to authorize emergency "advances" to member banks at a penalty rate of interest when satisfactorily secured.[6] Even this measure, however, was considered a temporary measure, originally expiring after one year.[7]

As 1932 continued, President Hoover wished to expand financing by the RFC. His desires were surpassed by House Speaker John Nance Garner of Texas, who in May 1932 introduced legislation to expand the RFC's lending authority "to any person."[8] Despite President Hoover's objections that this legislation authorized loans "on any conceivable security and for every purpose," a bill containing expanded RFC authority passed the House and Senate on July 9, 1932.[9] The expanded authority of the RFC concerned not only President Hoover, but also Federal Reserve Board member Charles Hamlin and Senator Carter Glass, the father of the Federal Reserve System, likely because it introduced competition to the Federal Reserve's lending powers.[10] Two days later, President Hoover vetoed the Garner bill, and Senator Glass introduced what became section 13(3) as an amendment to an appropriations bill that would ultimately become the Emergency Relief and Construction Act of 1932.[11]

The amendment expanded Federal Reserve authority at the expense of the RFC. It drew heavily from the expanded Federal Reserve authority to make advances to member banks in "exceptional and exigent circumstances" contained in the first Glass-Steagall Act, but was still somewhat limited in scope:

In unusual and exigent circumstances the Federal Reserve Board, by the affirmative vote of five members, may authorize any Federal Reserve Bank . . . to discount for any individual, partnership or corporation, notes, drafts, and bills of exchange of the kinds and maturities made eligible for discount under other provisions of this Act when such notes, drafts and bills of exchange are indorsed and otherwise secured to the satisfaction of the Federal Reserve Bank.[12]

In other words, the amendment permitted lending by discount only on such paper that was eligible for discount under other sections of the Federal Reserve Act—at the time, short-term paper like commercial paper.[13] The amendment was satisfactory to President Hoover and became law as Federal Reserve Act section 13(3) on July 21, 1932.[14]

Section 13(3) immediately met with a narrow Federal Reserve interpretation; the Federal Reserve initially took the position that the term "corporation" in the statute did not include nonmember banks and trust companies.[15] Moreover, section 13(3) was essentially an orphan provision: Federal Reserve Banks extended very few section 13(3) loans during the Depression itself, and it was only with the FDICIA in 1991 that Congress removed (having considered the stock market crash of 1987 and the need for broker-dealer liquidity) the limitation in section 13(3) that paper to be discounted had to be the same type of paper that was otherwise eligible for discount at a Federal Reserve Bank.[16]

As is well known, section 13(3) saw great use during the financial crisis as a means of providing much-needed liquidity. Section 13(3) was the source of authority for Federal Reserve lending in connection with the JPMorgan-Bear Stearns acquisition and the support of American International Group (AIG), and it was the source of authority for such broader programs as the Term Securities Lending Facility (TSLF), Term Asset-Backed Securities Loan Facility (TALF), and Commercial Paper Funding Facility (CPFF).[17] The Federal Reserve's use of section 13(3) is now widely regarded as extremely successful in maintaining financial stability.

Congress responded to the Federal Reserve's use of section 13(3) by narrowing that authority in the Dodd-Frank Act. Such lending must now be made in connection with a "program or facility with broad-based eligibility," cannot "aid a failing financial company" or "borrowers that are insolvent," and cannot have "a purpose of assisting a single and specific company avoid bankruptcy" or similar resolution.[18] In addition, the Federal Reserve cannot establish a section 13(3) program without the prior approval of the secretary of the Treasury.[19]

Revised section 13(3) could be used to create facilities like the alphabet facilities of the financial crisis mentioned above, but the intent of the revisions was to preclude loans like those to JPMorgan/Bear Stearns and AIG. The Dodd-Frank Act instead takes a *prophylactic* approach to single financial company issues or issues raised by a number of financial companies contemporaneously affected—the enhanced capital and liquidity prudential standards of section 165, resolution planning, limitations on the exercise of default rights in qualified financial contracts, and prepositioning of capital and liquidity where necessary to advance going-concern value at the operating subsidiary level. However, there is most certainly a significant limitation of the ability of the Federal Reserve—or any government agency for that matter—to inject emergency liquidity in a time of crisis: for example, liquidity available in the first instance under the Orderly Liquidation Fund authority in Title II of Dodd-Frank is limited to 10 percent of the total consolidated assets of a failing financial company.[20]

The result, then, although differing significantly in the details, is not different in character from the way that section 13(3) was originally conceived—emergency lending power must have restraints. Certainly, just as in 1932, a much less-constrained approach to Federal Reserve lending does raise policy concerns—among them the ability of the government to pick and choose among failing firms, damage to the credibility of the Federal Reserve should an emergency loan fail, and what open-ended emergency lending means for the taxpayer. It may be time, however, to take a fresh look at revised section 13(3) and determine how to balance those issues against the historical reality that financial panics and crises usually come unexpectedly, and often for reasons not considered threatening at the time. The prophylactic approach that the Dodd-Frank Act takes in guarding against and preparing for large-firm failure may be only as successful as the ability of future policymakers to anticipate a significant crisis. Nor has the issue of financial firm interconnectedness disappeared in the years after 2008. As in 1932–1933, Congress will not necessarily act with dispatch in a crisis. It was fortunate, after all, that before coming to Washington, former Chairman Bernanke had focused on the Great Depression in his academic life.

FOOTNOTES

[1] Damien Paletta & Josh Dawsey, Treasury Secretary Startles Wall Street with Unusual pre-Christmas Calls to Top Bank CEOs, Washington Post, Dec. 23, 2018.

[2] Id.

[3] 12 U.S.C. § 343(3).

[4] See Parinitha Sastry, The Political Origins of Section 13(3) of the Federal Reserve Act, FRBNY Economic Policy Rev., Sept. 2018, at 15.

[5] See id. at 16–17.

[6] This provision was contained in new section 10B of the Federal Reserve Act. See id. at 18.

[7] See id. at 18 n.144.

[8] See id. at 19.

[9] See id. at 20.

[10] See id.

[11] See id. at 20–21.

[12] See id. at 23.

[13] See id.

[14] See id.

[15] See id. at 25.

[16] Pub. L. 102-242, Title IV, § 473, 105 Stat. 2386.

[17] See Sastry, supra note 4, at 3.

[18] 12 U.S.C. § 343(3).

[19] Id.

[20] 12 U.S.C. § 5390(n)(6).