Client Alert | Banking

Federal Reserve Board Limits Emergency Lending

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This Client Alert describes the potential impact of amendments to Regulation A on the availability of emergency lending in the next financial crisis.

The Federal Reserve Board on November 30, 2015 unanimously adopted amendments to Regulation A ("Final Rule") that will limit emergency lending available in the next financial crisis.[1] Notably, a banking and other financial institution should anticipate that emergency loans will be available only under a "broad based" program and then only to the extent that the institution is prepared to certify that it is solvent and that it has sufficient assets acceptable to pledge for any borrowing sought. The Final Rule seeks to restrict the Federal Reserve Board's long standing "lender of last resort" authority as required by the Dodd-Frank Act and as would be required by a number of bills introduced in the current session of Congress. It raises a central question of whether limiting that authority will leave the United States more – or less -- financially stable.

A Perspective on Emergency Lending Authority

The Federal Reserve Board's so-called "lender of last resort" authority was established by section 13(3) of the Federal Reserve Act.[2] Section 13(3) originally permitted the Federal Reserve Board on the approval of five governors to extend credit to individuals and entities in unusual or exigent circumstances where other credit was unavailable so long as the credit was indorsed or otherwise secured to the satisfaction of the lending Federal Reserve Bank. As Federal Reserve Board Chair Janet Yellen noted in her opening statement on passage of the Final Rule, this authority was used only sparingly and only in severe financial crises.[3] It was heavily used during the Great Depression. Secured loans were made to businesses and to individuals and were used to provide liquidity to various financial firms. It again was used in the aftermath of the 2008 global financial crisis after having been used perhaps no more than once in the intervening years since the Great Depression.[4]

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1 Federal Reserve Board, Release on Final Rule on Extensions of Credit by Federal Reserve Banks (Nov. 30, 2015)("Release"), available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151130a1.pdf and Board Staff Memorandum on Final Rule, available at http://www.federalreserve.gov/aboutthefed/files/board-memo-20151130.pdf.

2 12 U.S.C. § 343(3).

3 Opening Statement of Chair Janet Yellen (Nov. 30, 2015), available at http://www.federalreserve.gov/newsevents/press/bcreg/yellen-opening-statement-20151130.htm.

4 The Discount Window was made available to banks caught up in the financial problems of the Penn Central Railroad in 1970. Consideration was given to funding the City of New York in 1975, the FDIC in 1991 and the airlines following September 11, 2001, but no facilities were approved or established. Fettig, David, The History of a Powerful Paragraph, Federal Reserve Bank of Minneapolis Region (Jun. 2008)

In the 2008 global financial crisis, two distinct types of facilities were established. First, facilities were established to provide liquidity to financial companies and to primary dealers in US government securities, as well as to the commercial paper, money market fund and securitization markets. Second, emergency loans were made to fund the purchase of assets from a failing broker-dealer and its holding company and to provide an emergency credit facility to an insurer and its holding company. Both types of facilities were deemed necessary for the stability of the financial system and to stave off the intensification of the crisis.[5] The Dodd-Frank Act, however, distinguishes between the two.

As Chair Yellen acknowledged, the Board's authority to lend to a particular failing firm has been replaced by the orderly resolution framework that is meant to address the failure of a large financial firm.[6] That framework would permit funding of the surviving bridge entity by the FDIC should existing equity and bail-in of subordinated debt prove insufficient.[7] Nonetheless, Chair Yellen emphasized that "[t]he ability to engage in emergency lending through broad-based facilities to ensure liquidity in the financial system is a critical tool for responding to broad and unusual market stresses."

The Dodd-Frank Act permits only an emergency lending program with "broad-based eligibility" whose purpose is not to aid a failing financial company to avoid bankruptcy, resolution or insolvency or to remove assets from its balance sheet.[8] A program or facility must be limited only to borrowers that are not insolvent and that pledge sufficient security to protect taxpayers from losses. The Federal Reserve Board also would be required to report to Congress on the identity of borrowers, the terms of the loans made, including interest, fees and the collateral pledged and its value, and the expected cost of the program to taxpayers.

Congress is considering further steps to limit the Federal Reserve Board's lender of last resort authority. For example, two sister bills introduced in the Senate and the House[9] would require increased Federal Reserve Board accountability by, among other things, defining "broad based" to mean that at least five companies are eligible to participate in the emergency lending program and by making a bridge financial company established by the FDIC to resolve a covered company or insured depository institution ineligible to participate in any Federal Reserve emergency program. A more recent bill introduced in the House would make certification from the borrower that it is not insolvent a requirement for participation in an emergency lending facility.[10] The sister House and Senate bills also would require the Board to establish a minimum interest rate for an emergency lending facility, which in the Senate version is defined as at least 500 basis points greater than the rate on a commensurate term Treasury note. The House version also would require the Board to terminate any emergency facility within 60 days of ceasing to make loans or extend credit under the facility and to disclose in 60 days that an emergency facility has been terminated, including information as to the borrowers. The standalone House bill would exclude from eligible collateral under an emergency lending facility any equity securities issued by the borrower.

Perhaps in an attempt to stave off further action by Congress to limit its emergency lending authority, the Federal Reserve Board adopted a Final Rule that addresses the additional restrictions proposed by members of Congress in addition to those required by the Dodd-Frank Act. But it may not go far enough, at least for some members of Congress. House Financial Services Chair Jeb Hensarling is still calling for passage of his bill, in particular, of its requirements for a supermajority vote of both the Federal Reserve Board and the Federal Reserve Bank presidents to establish an emergency loan facility.[11]

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5 Speech of Chairman Ben Bernanke, Federal Reserve Conference on Key Developments in Monetary Policy (Wash. DC, Oct. 8, 2009).

6 Opening Statement of Chair Janet Yellen (Nov. 30, 2015), available at http://www.federalreserve.gov/newsevents/press/bcreg/yellen-opening-statement-20151130.htm.

7 Dodd-Frank Act §§ 204(d) and 206.

8 Dodd-Frank Act § 1101.

9 S 1320, Bailout Prevention Act of 2015 (114th Cong, introduced on May 13, 2105) and HR 2625, Bailout Prevention Act of 2015 (114th Cong., introduced on Jun. 3, 2015).

10 H.R. 3189, Fed Oversight and Modernization (FORM) Act of 2015 (114th Cong. 2015) (introduced on Jul. 23, 2015 and passed House on Nov. 19, 2015).

11 Financial Services Committee Press Release, *Fed's Emergency Lending Rule Leaves the Door Wide Open to Future Taxpayer-Funded Bailouts* (Nov. 30, 2015), available at http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=399995.

The Provisions of the Final Rule

The Final Rule requires any emergency lending facility established by the Federal Reserve Board to include each of the following:[12]

Broad-Based Eligibility

An emergency lending facility must have broad-based eligibility that is designed to provide liquidity to an identifiable market or sector of the financial system.[13] A program may not be established if:[14]

- "fewer than five entities would be eligible to participate in the program" when it is established (whether or not they actually do participate) or
- the program "is designed for the purpose of assisting one or more companies avoid bankruptcy, resolution under Title II. . . or other Federal or state involving proceeding" or
- the program "is designed for the purpose of aiding one or more failing financial companies."

Defining "broad-based" based on at least five eligible participating entities would seem a direct nod to virtually identical provisions in the pending Senate and House bills. The Final Rule, like the bills before Congress, does not specify how the Federal Reserve Board is to determine or document eligibility. As the Board notes in the Release, all of the facilities established under its lender of last resort authority during the 2008 financial crisis would have met the three "broad based" criteria, save the loan to Bear Stearns and the credit facility established for AIG.[15] As the Release notes establishing a facility that groups five or more "failing" firms also would not pass muster.[16]

Solvency Requirement

An emergency lending facility may not extend credit to any entity that is "insolvent" or that plans to lend the proceeds to an insolvent entity. For a Federal Reserve Bank to lend to an entity the Federal Reserve Board must obtain proof that the entity is not insolvent. Insolvency is defined as any entity in bankruptcy, Title II resolution, or any other Federal or state proceeding or that in the 90 days before extending credit "generally is not paying its undisputed debts as they become due."[17] That raises the query whether credit could be extended to a company that is balance sheet insolvent. As provided in the Dodd-Frank Act, the Final Rule allows that the Board and the lending Federal Reserve Bank may rely on a written certification from the chief executive officer or other authorized officer of the borrowing entity that the entity is not insolvent, i.e., is not in bankruptcy, resolution or other insolvency proceeding and "generally" has not failed to pay its undisputed debts as they become in the 90 days preceding a borrowing.

The Federal Reserve Board is specifically permitted to rely on the officer's certification to establish that an entity is solvent and therefore eligible to participate in any emergency lending program. That would put the burden of compliance with the solvency requirement squarely on the certification of the borrower's CEO or other officer. The Final Rule permits a certification of solvency if the entity "generally" has not failed to pay its undisputed debts, but does not define "generally." Presumably the failure to pay one or some nominal number (or amount?) of undisputed debts would not prevent an officer's certification, but that would be for the entity to determine.

A Federal Reserve Bank could lend without an officer's certification but, where one is required, the certifying officer (not the borrower) has an obligation to immediately notify the lending Federal Reserve Bank "if any information in the certification changes."[18] Because the "generally paying undisputed debts" provision applies only to the 90 days preceding the date of borrowing under a facility or program, notice would not likely be required of any change in generally paying undisputed debts unless the borrower draws additional funds on the facility. A borrower that is or becomes insolvent could not borrow additional funds or participate in any

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[12] Where the requirement cited applies to an "entity" that is meant to include a "person or entity."

[13] Regulation A § 201.4(d)(4).

[14] Regulation A § 201.4(d)(4)(iii).

[15] Release at 14.

[16] Release at 14-15.

[17] Regulation A § 201.4(d))(5)(emphasis added).

[18] Regulation A §201.4(d)(5)(v) (emphasis added).

other emergency facility.[19] Where a certification is found to include a “knowing material misrepresentation,” any amounts borrowed and all interest and fees would become immediately due and payable and the Board would refer the matter to law enforcement authorities for criminal and civil action.[20]

Penalty Interest Rate

The Federal Reserve Board retains the authority to set the interest rate on any facility. But the interest rate would have to be at a “penalty level” that represents a premium to the market rate under normal circumstances, encourages repayment of the credit, and discourages use of the facility as the unusual or exigent circumstances that motivated the program recede.[21]

The Final Rule does not adopt any floor requirement on the rate as proposed in the Senate bill (e.g., at least 500 basis points above the corresponding Treasury security). The Final Rule permits the interest rate to be set by auction, provided that any rate determined by auction would have to be a “penalty” rate.[22] The determination of whether the rate is a “penalty” would depend on how the Federal Reserve Board determines comparable loan terms and maturities in normal times, the risk of repayment, the collateral supporting the credit, its purpose, terms and duration, and any other factors the Board deems relevant.[23]

Security Interest

Any borrowings under an emergency loan facility have to be indorsed or otherwise secured “to the satisfaction of the lending Federal Reserve Bank” and require the lending Federal Reserve Bank to assign a lendable value to all collateral at the time credit is initially extended.[24]

The Final Rule defers to the Federal Reserve System’s well-established methods for valuing collateral rather than adopting specific mandatory collateral requirements as some commenters had suggested or as would be required by at least one of the bills in Congress. The Release notes in this regard that the Federal Reserve Banks would use their routine practices of assigning haircuts to collateral as described in the Federal Reserve Discount Window and Payment System Risk Collateral Margins Table and the Federal Reserve Collateral Guidelines.[25]

Loan Term

An emergency facility must be approved by at least five governors and have no more than a one-year term, unless extended by a vote of at least five governors and the approval of the Treasury Secretary.[26]

In perhaps a nod to pending bills, Chair Yellen in the Board meeting approving the Final Rule asked if a shorter than one-year term could be used. The Board staff noted that retaining a one-year term on emergency facilities was preferable to establishing a shorter term in order to give the Board needed flexibility.

Public Disclosure

Within seven days of setting up a facility, the Board must make publicly available a description of the program and advise Congress of the details of the program.[27]

Short-Term Emergency Credit

The Board can authorize a Federal Reserve Bank to extend credit on any terms for up to 90 days if that credit is secured by US government or agency obligations.[28]

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[19] Regulation A § 201.4(d)(5)(vi).

[20] Regulation A § 201.4(d)(5)vii).

[21] Regulation A § 2014.(d)(7)(ii).

[22] Board Staff Memorandum at 6.

[23] Regulation A § 201.4(7)(iii).

[24] Regulation A § 201.4(6).

[25] Release at 21. See also, Federal Reserve Discount Window and Payment System Risk Website at http://www.frbdiscountwindow.org/index.cfm.

[26] Regulation A § 201.4(9)(i) and (ii).

[27] Regulation A § 201.4(9)(iii).

[28] Regulation A § 201.4(13).

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