

CRUEL AND UNUSUAL CIRCUMSTANCES: THE FED’S USE AND MISUSE OF PENALTY RATES

Posted on [June 21, 2021](#) by [Steven Kelly](#)

After a [political](#) and [legislative](#) showdown at the end of 2020, Congress closed the Fed’s most novel Section 13(3) emergency lending facilities—the ones aimed most directly at Main Street. These facilities—supported by Treasury funds allocated by the Coronavirus Aid, Relief, and Economic Security (CARES) Act—lent only a [fraction](#) of their stated maximum lending limits, leaving many criticizing the programs’ overly punitive terms, particularly the interest rates offered to prospective borrowers.

The Municipal Liquidity Facility (MLF), for example, lent only \$6.4 billion to state and local municipalities—of a stated \$500 billion maximum. The Main Street Lending Program (MSLP), after accelerating in its final days, peaked at \$16.6 billion in lending to mid-sized, Main Street businesses—of a maximum \$600 billion.

Fed critics said the terms weren’t generous enough; the Fed pushed back by citing [Regulation A](#). In ascribing the strict lending terms to that regulation, however, the Fed abdicated its broad authority from Section 13(3) of the Federal Reserve Act to lend broadly and on such terms as the Fed Board prescribes.

Regulation A and Emergency Lending

“Reg A,” which the Fed last [amended](#) in 2015, is the [set](#) of regulatory rules guiding, among other things, the Fed’s 13(3) emergency lending. In 2010, the Dodd-Frank Act [called](#) for the Fed to update Regulation A with rules reflecting the Act’s new emergency lending stipulations—requirements that Section 13(3) facilities be broad-based, to solvent borrowers, approved by the treasury secretary, and other updates. After the Fed rolled out its suite of COVID-19 emergency lending facilities, officials cited Regulation A when justifying some of the programs’ harsher terms.

The Fed and Treasury pointed to Reg A as one of the reasons for the relatively [short](#) maturity limit of the MLF ([p. 73](#), [p. 33](#)). Boston Fed President Rosengren highlighted Reg A as the reason the Fed demanded each MSLP borrower certify that it was unable to secure adequate credit from other banking institutions ([p. 90](#)). And, perhaps most controversially, the Fed blamed its charging of a “penalty rate” to the requirements of Reg A ([pp. 33, 119](#)). Notably, Regulation A [does not mandate](#) the former two stipulations, and the latter condition is included only in Reg A, not Section 13(3). Skanda Amarnath, Alex Williams, and Arnab Datta of Employ America [have called](#) for the Fed to rescind this “penalty rate” language in the rule, noting that the Federal Reserve Act, even as amended by Dodd-Frank, contains no language requiring a penalty rate.

-- SEARCH --

-- CATEGORIES --

[Case Studies](#) (14)

[Climate Change](#) (47)

[Corporate Governance](#) (104)

[COVID-19](#) (41)

[Economics](#) (88)

[FinTech](#) (89)

[Regulation](#) (183)

[Uncategorized](#) (3)

-- TRENDING --

[Beyond Data: What are the Behavioural Barriers that Slow Investor Action on Climate Change and How Can These be Overcome?](#)

posted on July 31, 2020

[The Economic Costs and Opportunities in Addressing Climate Change](#)

posted on July 30, 2020

[Carillion Plc: A Governance Case Study from the UK](#)

posted on July 18, 2018

However, even short of such action, it should also be noted that Regulation A only provides guidelines for lending that is, well, consistent with Regulation A. The Fed has broad discretion under the terms of the Federal Reserve Act, even following the 2015 issue of the stricter Reg A, to fulfill its role as lender of last resort.

Regulation A and Crisis-Fighters’ Discretion

The Fed has shown a willingness to use its flexibility with respect to emergency lending terms in the past. While Regulation A did not prescribe a “penalty rate” at the time of the Global Financial Crisis (GFC), [it did require](#) a rate “above the highest rate in effect for advances to depository institutions.”

However, the Fed’s first GFC-era 13(3) credit extension, to provide a bridge loan to Bear Stearns, [charged](#) only the primary credit rate. The primary credit rate is the rate charged at the Fed’s standing discount window and is the *lowest* rate available to banks.

When the Fed agreed the subsequent weekend to lend \$29 billion to the Maiden Lane special purpose vehicle to take assets off Bear’s balance sheet and assist JPMorgan’s acquisition of Bear, the Fed [again](#) lent at the primary credit rate. Concurrent with “Bear Stearns weekend,” the Fed [lowered](#) the primary credit rate’s spread over the federal funds rate to just 25 basis points.

The Fed also charged the primary credit rate under 13(3) facilities for the benefit of large broker-dealers and money market funds with the Primary Dealer Credit Facility (PDCF) and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), each of which peaked at about \$150 billion in credit outstanding.

Additionally, the Fed [opened a credit line](#) with Fannie Mae and Freddie Mac in July of 2008 [under Section 13\(13\)](#) of the Federal Reserve Act. Section 13(13) is similar to 13(3) emergency lending, but the former is easier to invoke. Section 13(13) allows the Fed to lend beyond banks with a simple majority of the Fed Board’s approval and [without](#) a finding of exigent circumstances (though Fed regulation does call for such) if the loan is collateralized by Treasuries, agency securities, or their equivalents. The Fed could thus lend directly to Fannie and Freddie, [against their own securities](#).

However, like 13(3) emergency lending, Reg A similarly called for the Fed to do 13(13) lending at a rate above the highest rate in effect for advances to depository institutions. In the event, however, the Fed again established the agencies’ facility (which ultimately went unused) at the primary credit rate. Regulation A was circumvented.

In a confidential [memo](#) from the Fed’s Legal Division documenting the legal advice given to the Board with respect to the rescue of Bear Stearns, the Fed described its discretion with respect to Regulation A. A key passage is worth quoting at length [emphasis added]:

Section 13(3) allows the Board to authorize any Federal Reserve Bank to extend credit to any [individual, partnership, or corporation] “during such periods as the said board may determine” and “subject to such limitations, restrictions and regulations as the [Board] may prescribe.” The Board, therefore, has complete statutory discretion to determine the timing and the conditions of lending under section 13(3). Regulation A represents one exercise of that authority in the form of an ongoing authorization to the Reserve Banks to lend under section 13(3) when the conditions in Regulation A are met. Regulation A does not limit the Board’s power to authorize lending under section 13(3) in other circumstances and under other limitations and restrictions.

Penalty Rate Exceptions and the COVID-19 Crisis

[Central Banks in the Hot Seat: How Should Central Banks Join the Fight Against Climate Change?](#)

posted on February 10, 2020

[Designing a Prudential Supervisory Framework for Climate Change in the U.S.](#)

posted on July 16, 2020

-- ARCHIVES --

Select Month▼

-- SUBSCRIBE TO THE FINREG BLOG --

Receive email notifications when new posts are written.

Your email:

Enter email address...

SubscribeUnsubscribe

-- CONNECT WITH US --



The Fed's COVID-19 response did seem to acknowledge at least once that Reg A is but "*one exercise of [Section 13(3) lending] authority*": with respect to its program for buying corporate bonds on the secondary market. The Fed's general counsel told ([p. 43](#)) the Congressional Oversight Commission that the Fed does not interpret Regulation A's penalty rate provision as applying to secondary market purchases.

As a result of this interpretation, the Secondary Market Corporate Credit Facility (SMCCF) was able to pay higher prices to restore functioning to the corporate bond market than it otherwise could have. Rather than act in a "dealer of last resort" capacity putting a floor under the market, the Fed was able to [pay market prices](#) for corporate bonds and [quickly restore](#) this market.

It's also not clear that the 2020 iteration of the PDCF applied a penalty rate this time around either. The [facility](#), which was available to lend against anything from Treasury securities to equities (which, notably, are ineligible for the discount window), lent at the primary credit rate. At the outset of the pandemic, the Fed [lowered](#) the primary credit rate to the same as the upper bound of the federal funds rate—down from a 50-basis-point spread. This took the primary credit rate to 25 basis points, where it [remained](#) throughout the life of the PDCF. The federal funds rate, as the target of the Fed's standard monetary policy, is by definition *not a penalty rate*.

Notably, several stakeholders pushed for the Fed to offer MLF credit at the fed funds rate; 13 advocacy groups and over 50 members of Congress signed a [letter](#) to that effect, and Rep. Rashida Tlaib introduced [legislation](#) calling for the same.

Amarnath, Williams, and Datta [argued](#) that Regulation A's penalty rate provision, by being unduly punitive in some instances (they highlight the MLF), may even bring an emergency facility in conflict with Section 13(3)'s requirement that a facility be "broad-based." Similarly, the CARES Act's Section 4003(c)(3)(D) suggested, but did not require, that the treasury secretary use some of the CARES Act funds to support a Fed lending facility that lent to mid-sized enterprises at a rate of 2% ([p. 193](#)). CARES made no mention of any requisite exemption from Regulation A or Section 13(3). The MSLP instead charged LIBOR plus 3%.

These again show instances where, short of wholly revoking the "penalty rate" language, the Fed should be willing to utilize its available flexibility with respect to Regulation A if it wants its crisis lending to be effective.

Going Forward: Regulation A in Future Crises

Certainly, Regulation A does not exist just to be ignored. However, given the Fed's discretion with respect to effecting Reg A—discretion it's used thoughtfully in the past—the Fed should be responsible for explaining why the rule's strict application is appropriate in any given situation. A global pandemic, with very little moral hazard to go around, would likely have been a satisfactory answer to those applying any scrutiny of such deviations.

Future events can be much milder than the GFC or COVID-19 and still require the invocation of Section 13(3). Indeed, the Board invoked, but never lent under, Section 13(3) twice in the 1960s under much less dire circumstances. Furthermore, the Board extended the life of several facilities in [November 2020](#) and [unanimously](#) re-determined that the "unusual and exigent circumstances" standard was met in [March 2021](#), despite much more benign market conditions than earlier in 2020.

If the Fed had been more flexible with Reg A in early-2020, any Board renewals of the 13(3) facilities circumstances into late-2020 and 2021 likely would have called for tightening the facilities' terms to be more consistent with the rule. In those instances, deviating from Regulation A would be harder to justify.

Bear Stearns, Fannie Mae, Freddie Mac, and other banks and broker-dealers writ large were the beneficiaries of deviations from Regulation A when a severe crisis called for such. Yet, when a pandemic-induced recession sent unemployment to 14.9%, the highest level since the Great Depression, the major employers that are Main Street businesses and state/local municipalities got no such deference. That decision simply does not square with the Fed’s maximum employment mandate and its “complete statutory discretion to determine the timing and the conditions of lending under section 13(3).”

In the past, the Fed has done better. It should do better in the future.

[Steven Kelly](#) is a Research Associate at the Yale Program on Financial Stability.

Posted in [Corporate Governance](#), [COVID-19](#), [Regulation](#)

[← Previous](#)

[Next →](#)

[Leave a Reply](#)