How Available Is the ESF for New Fed Facilities?

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Original post here.

When Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act on March 27, 2020, it allocated $500 billion to the Exchange Stabilization Fund (ESF), $454 billion of which was for the Treasury Secretary to support Federal Reserve lending facilities. The Secretary committed $195 billion of these funds to provide credit support to some of the programs the Fed set up under its Section 13(3) emergency lending authority. The Consolidated Appropriations Act, 2021 signed into law on December 27 definitively closed these facilities and rescinded funds "not needed to meet the commitments, as of January 9, 2021, of the programs and facilities established."

The 13(3) programs that received equity funding from the Treasury under the CARES Act purchased corporate bonds and loans, municipal bonds, and asset-backed securities (the Corporate Credit Facility (CCF), Main Street Lending Program (MSLP), Municipal Liquidity Facility (MLF), and Term Asset-backed Securities Loan Facility (TALF)). These programs ultimately made about $40 billion in loans and asset purchases, a fraction of the stated limit of almost $2 trillion.

Congress also forbade the Treasury Secretary from using the ESF for any future 13(3) program that is "the same as" any of the CARES Act facilities, except for the TALF. The Secretary is otherwise free to use the Fund "for any purpose" previously permitted. In other words, the Treasury may use the Fund to support any 13(3) facilities not precluded by the "same as" language.

The two parties may not agree exactly how broadly to interpret the scope of the "same as" language. Still, Congress did not amend the Section 13(3) language in the Federal Reserve Act. The unamended Section 13(3) and remaining discretion for the Secretary to invest in Fed facilities leave policymakers with a potentially potent tool for the rest of this crisis.

Given the still-uncertain economic outlook and the changing presidential administration, some are looking to new ESF-supported Fed facilities as a possible policy lever in 2021 under the next Treasury Secretary. This post describes how much ESF funding is available, or could be available, to the next Secretary.

The Exchange Stabilization Fund

Congress established the ESF as part of the Gold Reserve Act of 1934 and has given it only minor modifications since. Legislators designed the ESF as a tool to stabilize the exchange value of the dollar and, more broadly, to support "orderly exchange arrangements and a stable system of exchange rates." When the International Monetary Fund (IMF) created Special Drawing

Rights (SDRs) in 1969, Congress provided that the Treasury would hold any SDRs in the ESF. The IMF uses SDRs as a reserve asset to supplement the global stock of currency reserves.

The Secretary has discretion over the use of the ESF, subject to the President's approval. In pursuit of orderly exchange rates, the Secretary may use ESF funds to "deal in gold, foreign exchange, and other instruments of credit." While originally used very narrowly, to intervene in foreign exchange markets and provide bridge loans to foreign countries, Treasury has interpreted that authority more broadly in recent decades.

After Congress rejected a proposal for a loan to Mexico during its economic crisis in the mid-1990s, the Clinton administration announced a rescue package that included up to $20 billion in loans from the ESF.

In September 2008, Treasury used the entirety of the approximately $50 billion in the Fund as an insurance reserve to provide a sweeping guarantee and stem the run on money market mutual funds (MMFs). Within weeks, Congress passed legislation banning use of the ESF for this express purpose in future crises. (Congress lifted this ban temporarily at the outset of the COVID-19 crisis, though Treasury did not ultimately exercise the authority.)

In the early days of the COVID-19 crisis in 2020, the Fed announced several 13(3) facilities to stem the pandemic-induced market volatility. Before the CARES Act was passed, the Treasury committed $50 billion of existing ESF funds to these facilities. These funds were to provide credit protection to the facilities to assist the Fed in meeting the legal requirement that its 13(3) facilities are "secured to the satisfaction" of the Fed. Later, the Treasury replaced $30 billion of that funding with CARES Act funds, while non-CARES ESF funds remained committed to the Commercial Paper Funding Facility (CPFF) and Money Market Mutual Fund Liquidity Facility (MMLF).

With the CARES Act, Congress allocated $500 billion in new funds to the ESF to support the response to the COVID-19 crisis. Congress assigned $454 billion to support Fed lending facilities; it also set aside $46 billion for loans to the aviation industry and firms critical to national security.

The Fed intended to leverage Treasury's ESF investment with Fed lending at a ratio of approximately 10-to-1, depending on the riskiness of the underlying assets. In this way, these ESF investments could have backed Fed lending of as much as $4 trillion. However, as noted, in December 2020, Congress wrote new legal restraints that prevent the Treasury from using the ESF to support Fed facilities that are "the same as" the CCF, MSLP, or MLF.

How Much Is Really Available in the ESF?

Recent articles have offered competing depictions of how much unused funding remains in the ESF, with estimates ranging from $50 billion to almost $80 billion.

Following the rescission of the CARES Act funds, the ESF has approximately $85 billion in unencumbered assets, consisting of:

- $11.2 billion in U.S. Treasury securities
- $51.9 billion in SDRs
- $12.6 billion in liquid, euro-denominated assets
- $8.9 billion in liquid, yen-denominated assets

However, the ESF also has $8.5 billion in committed, but undisbursed, credit protection to the MMLF (in addition to the $1.5 billion already injected). Netting that amount, it appears that the ESF has about $76 billion available.

Can Foreign Exchange Support Dollar-Based Facilities?

It need not matter that most of these assets are not denominated in US dollars. The Treasury could simply request the Fed convert any SDRs into dollars. The Fed would be legally obligated to comply with this request.

There are also mechanisms by which the Treasury could use euro- and yen-denominated assets to support dollar-based 13(3) lending facilities.

First, the Fed has a limited authority to engage in foreign exchange "warehousing" for the Treasury. The Fed is authorized to swap dollars with the Treasury's foreign exchange; this standing authority is for up to $5 billion, though the Fed voted to expand it temporarily to as high as $20 billion in 1995 to support the assistance to Mexico. Ultimately, the Treasury did not use the warehousing capability and hasn't since 1992.

Second, the Treasury can simply sell the currency on the open market. The Treasury need not invoke the warehousing arrangement nor seek that the Fed expand it. The yen and euro are both reserve currencies with daily trading volumes that exceed $1 trillion. The Treasury may be able to sell the $22 billion of assets denominated in these currencies without disrupting the market or accepting material discounts.

Third, the Treasury can use the currencies as they are. When it used the ESF in 2008 to guarantee over $3.2 trillion of money market mutual fund (MMF) assets, almost half of the approximately $50 billion of ESF funds committed were denominated in foreign currencies. Yet, the commitment was largely effective in easing the run on those funds. Providing credit protection to the Federal Reserve could function largely the same way.

New Funds Absent Legislation?

Congress designed the ESF to be self-financing. While the CARES Act provided supplementary funds to the ESF that Congress later rescinded, the ESF is not subject to the normal budgetary appropriations processes. Even absent new congressional supplementation, however, the Fund's available resources could be augmented in several ways.

Earnings

The Fund retains any earnings on its guarantees or investments. For instance, its credit protection agreement provided to the MMLF and its equity protection stake in the CPFF grant it 90% of any profits earned by those facilities. The MMF guarantee program of 2008 ultimately generated $1.2 billion in premium income. These retained earnings ultimately increase the resources of the Fund.

In 2013, for instance, despite the fact that the 2008-era TALF still had outstanding loans, the Fed returned the Treasury's remaining subordinated investment (from TARP funds, not the ESF) early because they both agreed the TALF's retained earnings provided sufficient credit protection. Given that when the ESF is used for guarantees or 13(3) facilities, such funds are typically leveraged many times over, even marginal earnings can substantively expand the Fund's reach.

IMF Allocations

As noted, the ESF holds the U.S.'s SDRs. If members of the IMF can agree to a new SDR allocation in response to the pandemic, the IMF can create any amount less than $649 billion without the explicit approval of the U.S. Congress. Based on its IMF quota, the U.S. Treasury would receive 17% of any new SDRs created, or up to $113 billion if the IMF created the maximum.

However, there is no sign that the IMF's member countries plan to create new SDRs in response to the COVID crisis. The October G20 Finance Meeting communiqué, as in July and April, said only that policymakers "discussed the possibility" of an SDR allocation and that "there was no consensus on the issue."

When the IMF agreed to a $250 billion allocation in 2009 in response to the Global Financial Crisis, the ESF received $43 billion. Any new allocation in response to COVID-19 would similarly bolster the ESF's resources.

Equity Allocation

Funds could flow back into the ESF from the relatively dormant liquidity facilities aimed at money markets that have funding from the ESF. The MMLF and CPFF each have $10 billion of equity (or equity-like) protection courtesy of non-CARES Act ESF funds. After peaking at over $50 billion of outstanding loans in April, the MMLF now has less than $3 billion of credit extended; the CPFF peaked at almost $13 billion in June and now has no credit extended.

Yet, these facilities may in some sense be a prerequisite to more novel credit facilities due to legal requirements from both the Fed and the Treasury. From the Fed's side, it must vote that "unusual and exigent circumstances" are present before standing up Section 13(3) facilities. If the money markets are functioning smoothly—that is, to the point that Fed's 13(3) facilities aimed at short-term funding markets can be retired—it may be the case that conditions simply don't meet the exigent circumstances requirement from the perspective of the Fed.

From the Treasury's side, there are some guardrails on the use of ESF funds. Notably, Treasury's lawyers rejected on legal grounds the Federal Reserve Bank of New York President Tim Geithner's suggestion to use thTe ESF in March 2008 to facilitate the rescue of Bear Stearns (p. 155). At the time of the Bear Stearns episode, the Fed had not yet opened any 13(3) facilities. Much like the Fed's exigent circumstances hurdle, if money markets are functioning normally enough that policymakers let the MMLF and CPFF retire, the Treasury may determine that there is not enough risk to the dollar's value to permit the ESF's use in 13(3) credit facilities.

However, there is also potential middle ground here. Despite limited takeup of late, the Fed and Treasury have continued to extend the MMLF and CPFF, currently in place until March 31, 2021, due to unusual and exigent circumstances.

Notably, the MMLF and CPFF as designed have no leverage limits. While they both received $10 billion in subordinated protection from the ESF, there is no fixed maximum on the ratio to which that protection can be leveraged, in contrast to the CARES Act facilities. The MMLF's 2008-era predecessor, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), did not utilize any subordinated funding. The CPFF and MMLF both peaked several quarters ago at fractions of their 2008 takeup. None of the 13(3) facilities set up during the GFC suffered losses.

These experiences could justify the Fed and Treasury operating these facilities with less equity. In a letter to the Congressional Oversight Commission in June, Fed Chair Jerome Powell and Treasury Secretary Steven Mnuchin said that "the agencies will rigorously assess the adequacy and appropriateness of the 13(3) facilities' [equity] coverage and the corresponding allocations of CARES Act funds" and signaled a willingness to use the "full scope of authority provided by section 13(3)" if adjusting the level of credit protection was necessary.

A reassessment that determined the Fed could operate the MMLF and CPFF with less equity would allow the Fed and Treasury to return funds to the ESF for use in other facilities, even in a scenario in which these two facilities continued to operate.

To be clear, funding market disruption is not a requirement for invoking 13(3). The Fed can use Section 13(3) facilities in the absence of material banking or funding market distress, but must still at least obtain evidence that credit is not available on reasonable terms from other banking institutions.

Whether or not the Fed would invoke 13(3) in that case, however, remains an open question.