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Redux: Outlook for 13(3) and Fed Crisis Response

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After a weekend of congressional negotiations in which the Federal Reserve's emergency lending authority hung in the balance, the Fed's Section 13(3) authority appears to remain intact.

Section 13(3) of the Federal Reserve Act gives the Fed the authority to lend to entities other than banks in emergencies. It has been a central component of the Fed's crisis response during the COVID-19 pandemic, as it was in the Global Financial Crisis of 2007-09 (GFC).

Language limiting this authority became a last-minute sticking point in the negotiation over the latest economic relief and omnibus appropriations legislation. Following recent disputes over some of the more novel Section 13(3) facilities that the Fed created since the pandemic began, some members of Congress raised starkly opposing views on the future scope of these COVID-specific facilities after they expire on December 31. The legislative text last week would have permanently amended the Fed's 13(3) authority to prevent any facilities similar to the novel facilities it created in response to COVID-19.

However, the final bill did not include this language. In the version passed by Congress on December 21, the legislation leaves the Fed's existing authorities in place, closes the emergency facilities in which the Treasury has invested CARES Act appropriations, and limits the Treasury's ability to participate in such facilities in the future.

Background

In the Coronavirus Aid, Relief, and Economic Security (CARES) Act, passed on March 27, Congress allocated $454 billion to the Treasury's Exchange Stabilization Fund (ESF) to provide loss-bearing support for Fed facilities to lend to a variety of businesses, nonprofits, and government entities. Of that amount, the Treasury committed $195 billion to four Federal Reserve programs. The Treasury has disbursed a total of $102.5 billion of that committed amount to the Fed. To date, the Fed has committed $25 billion of loans and asset purchases under these programs.

Under the Federal Reserve Act, any emergency lending must be "secured to the satisfaction" of the Fed. Section 13(3) programs also require the ongoing approval of the Treasury Secretary, under 2010 revisions to the Act.

The 13(3) programs that have equity funding from the Treasury under the CARES Act allow the Fed to purchase 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)). The Fed programs leverage the Treasury's equity as much as 10 or 14 times, depending on the type of loan or asset purchased. Having the Treasury backstop aided the Fed in meeting the requirements of Section 13(3) and influenced its eligibility criteria.

In November, citing "Congressional intent," Treasury Secretary Steven Mnuchin said that he would not extend the four emergency lending facilities that use funds from the CARES Act after December 31. He asked the Fed to return the Treasury's unused funds for those facilities, all but approximately $25 billion – the amount the Fed has extended to borrowers under the four facilities. The Fed first said it would prefer the facilities to remain available, but Chair Jerome Powell later said that the Fed would defer to

Secretary Mnuchin's interpretation of the law. On December 17, the Congressional Research Service issued a memorandum saying a court would likely disagree with Mnuchin's interpretation.

Mnuchin's decision meant that the Fed would return about $78 billion of the $102.5 billion it has received and retain $25 billion. Mnuchin also stated that the Treasury would then transfer $429 billion of the $454 billion set aside for Fed programs from the ESF into Treasury's General Fund – a fund that requires specific congressional approval to access.

A recent YPFS post discussed the possible future of the Fed's CARES Act facilities, which were then set to lapse on December 31. The new relief bill specifically prevents the Fed from resurrecting these facilities.

The New Legislation

Section 1003 of the new legislation immediately rescinds $429 billion of the $454 billion allocated to the Treasury by the CARES Act to support the Fed's Section 13(3) emergency lending programs. This measure will prevent the Treasury from reinstating any of the $195 billion of equity support it previously committed to the CARES Act facilities. The legislation will also prevent a further injection of equity under the CARES Act's Section 4027(c)(1)(A), which had allowed the Treasury to use uncommitted funds from the $454 billion until 2026 to amend existing investments.

The new bill also definitively closes the CARES Act facilities on December 31 by prohibiting the Fed from making any new loans or asset purchases under such programs. Previously, the Treasury had said it would leave $25 billion of equity to support the outstanding credit of the facilities. Before the new act closed the facilities, the Fed and a future Treasury Secretary could have potentially leveraged this equity to support as much as $250 billion of lending. Additionally, Section 1005 of the legislation explicitly prohibits the Fed from "authorizing transfer of such funds to a new [or modified] program or facility established under Section 13(3)."

Section 1005 also removes some of the Treasury Secretary's discretion in using the ESF. It says that the ESF "shall not be available for any program or facility established under section 13(3) … that is the same as any such program or facility" that Treasury invested in with CARES Act ESF funds, except the TALF.

Section 1006 of the legislation states that, aside from the restrictions described above regarding the specific facilities in which the Treasury Secretary has already injected CARES Act Funds, "nothing in this Act shall be construed to modify or limit the authority of the Board of Governors of the Federal Reserve System under section 13(3) . . . as of the day before the date of enactment of the CARES Act." This section clarifies that the restrictions being imposed are limited to the Treasury's ESF authority and the existing CARES Act facilities. Previous wording applied broad limits to the Fed's 13(3) authorities; Congress ultimately removed this language from the final text and said that 13(3) remains unchanged.

Taken together, these sections serve as a limitation on the equity support the Treasury can offer the Fed via the ESF to meet the latter's security requirement for 13(3) facilities. The Treasury no longer has the authority to use ESF funds to support a Fed facility that is "the same as" the MLF, CCF, or MSLP. How broadly the Treasury will interpret the "same as" language in the future remains an open question.

If the Fed wanted to create a 13(3) facility that falls within the scope of the new language, it would have to find other ways to secure the loans to its satisfaction. The Treasury will not be able to assist the Fed in meeting that standard with ESF funds. The new legislation does not newly preclude the Fed from intervening in any particular asset or market via new facilities, and the Fed will face the same security requirements under 13(3) that it faced before and after the passage of the CARES Act.

Going Forward: 13(3) in Practice

As always, the Fed can construct 13(3) facilities that do not use any equity funding when it deems itself sufficiently secured by other risk-management techniques, such as haircuts or safer collateral. The Fed utilized this method during the COVID-19 crisis when constructing the Primary Dealer Credit Facility (PDCF) and Paycheck Protection

Program Liquidity Facility (PPPLF) and several times during the GFC. Of course, all 13(3) facilities will continue to require the Treasury Secretary's approval.

If the Fed deems an equity cushion in a 13(3) facility required in order to be "secured to [its] satisfaction," but can't source it from Treasury, the Fed can obtain the protection of a first-loss tranche by other means. The Fed put this strategy to use several times in 2008 during the GFC. During the Fed's first iteration of the Commercial Paper Funding Facility (CPFF), once-expected equity funding ended up being withheld by the Treasury (pp. 344-345). The Fed secured itself to its satisfaction by requiring borrowers to pay insurance premiums, which functioned as loss reserves; requiring the up-front payments assured a sufficient equity cushion for the facility as a whole. When the Fed established the Money Market Investor Funding Facility later in 2008 to support money market funds facing redemptions, it required firms that elected to sell assets to this facility to take a subordinated debt position in the facility equivalent to 10% of the amount they sold. The Maiden Lane programs the Fed set up to facilitate the purchase of assets from Bear Stearns and AIG also required the sellers to take first-loss equity positions.

Of the myriad 13(3) facilities set up during the GFC, only the 2008 TALF used subordinated funds from the Treasury. None of the 13(3) facilities set up during the GFC suffered losses.

Under the new law, the Treasury can still provide equity protection to 13(3) facilities using non-CARES Act ESF funds, as long as the facilities are not "the same as" the MLF, CCF, or MSLP. Approximately $75 billion remains in the ESF that the Treasury can use for this purpose, providing some flexibility for the Treasury Secretary and Fed Chair to set up such structures as they deem necessary. The Fed's current CPFF and Money Market Mutual Fund Liquidity Facility (MMLF) both have equity cushions courtesy of these funds. The CCF and TALF, as the Fed originally announced them, were to have equity infusions of this kind. The Fed also stated prior to the passage of the CARES Act that it intended to "announce soon the establishment of a Main Street Business Lending Program." Later, when the Fed officially announced the MSLP, Congress had passed the CARES Act and the Treasury was able to use it to provide equity support.

While the new legislation pared back the Treasury's ability to use ESF funds to assist the Fed in constructing 13(3) facilities, the final text explicitly preserved the Fed's crisis-lending authorities. With the Treasury Secretary's agreement, the Fed has broad authority and a wide range of tools to use to combat crises as they arise.

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