LENDING IN A CRISIS: REVIEWING THE FEDERAL RESERVE'S EMERGENCY LENDING POWERS DURING THE PANDEMIC AND EXAMINING PROPOSALS TO ADDRESS FUTURE ECONOMIC CRISES

HYBRID HEARING

BEFORE THE

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INTERNATIONAL DEVELOPMENT
AND MONETARY POLICY
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LENDING IN A CRISIS: REVIEWING THE FEDERAL RESERVE'S EMERGENCY LENDING POWERS DURING THE PANDEMIC AND EXAMINING PROPOSALS TO ADDRESS FUTURE ECONOMIC CRISES

Thursday, September 23, 2021

U.S. House of Representatives, SUBCOMMITTEE ON NATIONAL SECURITY, INTERNATIONAL DEVELOPMENT AND MONETARY POLICY, COMMITTEE ON FINANCIAL SERVICES. Washington, D.C.

The subcommittee met, pursuant to notice, at 10:07 a.m., in room 2128, Rayburn House Office Building, Hon. Jim A. Himes [chairman of the subcommittee] presiding.

Members present: Representatives Himes, Gottheimer, Torres, Dean, of Illinois, Auchincloss; Barr, Hill, Williams of Texas, Zeldin, Davidson, Gonzalez of Ohio, and Sessions.

Ex officio present: Representative Waters.

Chairman Himes. The Subcommittee on National Security, International Development and Monetary Policy will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, Members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

As a reminder, I ask all Members participating remotely to keep themselves muted when they are not being recognized by the Chair. The staff has been instructed not to mute Members, except when a Member is not being recognized by the Chair and there is inadvertent background noise.

Members are also reminded that they may only participate in one remote proceeding at a time. If you are participating remotely today, please keep your camera on, and if you choose to attend a

different remote proceeding, please turn your camera off.

For the benefit of the witnesses, in case you haven't been fully briefed, there will be Members who are participating in the hearing remotely and, consequently, they will appear on the various screens, and you will hear, just as you heard this sort of voice of God, those questions coming in via the audio, and so we will proceed. But not every Member will be in the room the whole time.

Today's hearing is entitled, "Lending in a Crisis: Reviewing the

Federal Reserve's Emergency Lending Powers During the Pan-

demic and Examining Proposals to Address Future Economic Crises."

I now recognize myself for 4 minutes to give an opening statement.

Last March, as COVID-19 tore through the economy, Congress and the Federal Reserve stepped up to prevent further chaos and to stabilize markets. With businesses shuttering, infection rates rising, and the stock market in a freefall, the Federal Reserve (Fed) took unprecedented action to keep credit flowing and instill confidence in our financial system.

From the onset of the pandemic, Chair Powell made it clear that the Federal Reserve would use its emergency lending tools to help families, cities, and businesses weather the storm.

Now, more than 18 months removed from their establishment, Congress should take this opportunity to measure their success, identify their shortcomings and limitations, and perhaps, most importantly, discuss ideas about how we should address the next economic crisis.

I came to this institution in 2009 amidst another economic crisis and a great deal of skepticism around Federal Reserve authorities. I never imagined that a mere decade later we would be using those authorities once again to save the economy.

So today, we will look at the three lending facilities that were stood up by the Fed and supported by CARES Act funds: the Secondary Market Corporate Credit Facility; the Municipal Liquidity Facility; and the Main Street Lending Program. While these three programs do not represent the full scope of the coronavirus toolbox, they offer valuable insight into how the Fed can help when the economy is in shock.

At a glance, and compared to other efforts like the widely-used Paycheck Protection Program (PPP), these facilities look like a blip on the radar, with relatively low rates of uptake. It is possible, however, that the Fed's commitment to supporting the economy itself helped calm the markets. Within days of the Fed announcing programs to bolster the corporate municipal bond markets, investors returned, liquidity increased, and further disaster was likely avoided.

We learned that the Fed could play a powerful role when it has the authority to make and execute plans. But this power only goes so far. Despite markets calming, the pandemic still forced hundreds of thousands of businesses to close and pushed unemployment rates to unacceptable levels.

In times of economic stress, perhaps the two most important institutions to stabilize the economy are Congress, with its physical power, and the Fed. As policymakers, Congress can learn from the accomplishments and setbacks we saw last year to determine how we should confront the next recession. The Fed should also learn from these experiences, seek feedback, and fine-tune its crisis playbook so it, too, will be ready to tackle future downturns.

Together, both Congress and the Fed must think seriously about how to improve on emergency lending efforts, especially when it comes to helping businesses, workers, and communities who are left behind in the best of times. As we saw last year, the time to discuss these ideas is when the economy is on the upswing, not during a crisis. The next economic crisis could be triggered by any number of factors at any time.

Chair Powell stated before this committee that the Fed would put its emergency tools away when the time was right. Congress' job is to make sure that those tools remain sharp and effective and ready to take on whatever challenge comes next.

With that, I would like to welcome our panel of witnesses, and

thank them for joining us today.

And I now recognize my friend, the ranking member from Ken-

tucky, Mr. Barr, for 5 minutes for an opening statement.

Mr. BARR. Thank you, Mr. Chairman, and I appreciate you holding this very important hearing. And I welcome our witnesses. Thank you all for being with us and for offering your insights on the Fed's emergency lending authorities.

As the COVID-19 pandemic raged, and the nation and the world were gripped with the economic uncertainty resulting from this Black Swan health crisis, Congress acted swiftly to contain the

damage and aid struggling individuals and businesses.

The Fed amplified the actions of Congress by providing unprecedented liquidity and broad-based economic support. Through its Section 13(3) emergency lending powers, the Fed was able to leverage support provided by Congress to serve as a backstop for various markets during times of severe stress and uncertainty.

Today, we will take a look back at the Fed's actions during the pandemic. A retrospective review of the emergency lending powers will help us better understand what worked, what didn't, and if and how the Section 13(3) authorities should be adjusted to improve the Fed's response to future crises.

Specifically, we will hear from witnesses about the Fed's Municipal Liquidity Facility, Main Street Lending Program, and Sec-

ondary Market Corporate Credit Facility.

At a time when States and municipalities were facing budgetary uncertainty due to lost tax revenue, decreased tourism, and broader economic challenges, the Municipal Liquidity Facility was designed to ensure that they could still access markets for financing.

The Main Street Lending Program was designed to aid those businesses that were perfectly healthy before the pandemic, but were too big to utilize the Paycheck Protection Program, yet too small to receive more targeted support.

The Secondary Market Corporate Credit Facility was intended to ensure that secondary corporate bond markets continued to function, allowing businesses across the nation to continue operating.

We hope to discuss today how we measure the success of these facilities. These three facilities distributed approximately \$38 billion, or just 2.3 percent of the funds available to the Fed for those purposes.

Does this metric suggest that the facilities were unsuccessful, or just the opposite, given that the mere presence of the facilities re-

assured investors and allowed markets to function?

Only two issuers utilized the Fed's Municipal Liquidity Facility. Does that indicate that the Fed did not accomplish Congress' goals for that facility or, once again, was the existence of the facility enough to normalize the markets, allowing issuers to finance their operations through standard market channels?

It is important to remember that these are emergency lending powers. The Fed is authorized under specific statutory cir-

cumstances to deploy these tools.

However, as the crisis abates and economic conditions improve, the Fed must put those tools back in the box. Reliance on and utilization of the Fed's emergency lending powers in excess of their intent risks blurring the lines between monetary and fiscal policy.

As we discuss these Emergency Lending Facilities today, we must also keep in mind the appropriate role of the Fed. The Fed is independent and conducts monetary policy. Fiscal policy is our responsibility as legislators.

The Fed is not an agent of social change or environmental activism, and asking it to take on that role compromises its independ-

ence.

This subcommittee has an important mandate of oversight of monetary policy, and as we exercise that oversight over Fed policy, I hope at some point, Mr. Chairman, in the near future, we will have a hearing specifically on inflation. The inflation data is staggering and concerning as perpetual accommodative monetary policy and blow-out fiscal spending make us all question whether it is truly transitory.

As the Wall Street Journal reported today, the Fed is looking at this as not so transitory, and I will quote: the message from the Fed's latest projections yesterday is that, "transitory is lasting an

awfully long time."

Our constituents are feeling the pain of inflation at the grocery store and at the gas pump, and Congress must do its part to make

sure we do not let it get out of control.

The economic response to the COVID-19 pandemic required collaboration between Congress, the Administration, the Fed, and the private sector. As we emerge from the pandemic, and economic conditions normalize, it is a useful exercise to look back at the impact our policies had.

Today's review of the Fed's Emergency Lending Facilities should

provide meaningful and helpful insight.

Mr. Chairman, I thank you for your leadership in holding this hearing. And I look forward to hearing from our witnesses today. And again, Mr. Chairman, thank you for convening this hearing.

I yield back.

Chairman HIMES. I thank the ranking member, and it is now my privilege to recognize the Chair of the full Financial Services Committee, the gentlewoman from California, Chairwoman Waters, for one minute.

Chairwoman WATERS. Thank you very much, Mr. Chairman, for

holding this important hearing.

Testifying before our committee in February 2020, Fed Chair Powell warned that the Federal Reserve's ability to help the economy in the power recognition would be limited.

omy in the next recession would be limited.

Remarkably, the pandemic was declared one month later, and the Fed exercised an unprecedented expansion of its tools to support the economy. I believe the Fed's actions were helpful in jumpstarting the recovery on Wall Street after a devastating shutdown due to the pandemic, and we had to work very hard with the Fed to talk about extending its support to States, cities, and small businesses.

We engaged the Chair on the terms that were offered to both small businesses and corporations. And I spent a considerable amount of time dealing with all of these facilities that were being created, particularly the Main Street Lending Program, where we engaged, again, with Chairman Powell on how he could be more helpful to very small businesses.

So, I look forward to hearing from this panel what worked, what didn't, and what reforms are needed to make sure the Fed's actions reach Main Street and not just Wall Street.

I yield back the balance of my time.

Chairman HIMES. I thank the chairwoman for her attendance and for her statement.

We now welcome the testimony of our distinguished witnesses.

First, we have my friend, the honorable Shawn Wooden, the treasurer of the State of Connecticut, and the president-elect of the National Association of State Treasurers, and the provider of the evidence to my belief that only good things come from the State of Connecticut.

Second, we have Mike Konczal, director of macroeconomic analysis and progressive thought with the Roosevelt Institute.

Third, June Rhee, director of master of management studies in

systemic risk with the Yale School of Management.

Fourth, Christopher Russo, a post-graduate research fellow with the Mercatus Center.

And, finally, Dr. Claudia Sahm, a senior fellow with the Jain Family Institute.

Witnesses are reminded that their oral testimony will be limited to 5 minutes. You should be able to see a timer on the desk in front of you that will indicate how much time you have left.

And by the way, please, when you are speaking, pull the microphone close—you can remove your mask and pull the microphone close to you. Otherwise, we won't be able to understand you.

I would ask that you be mindful of the timer, and quickly wrap up your testimony once your 5 minutes has expired, so that we can be respectful of both the witnesses' and the subcommittee members' time.

And without objection, your written statements will be made a part of the record.

Mr. Wooden, you are now recognized for 5 minutes to give an oral presentation of your testimony.

STATEMENT OF THE HONORABLE SHAWN T. WOODEN, TREASURER, STATE OF CONNECTICUT

Mr. WOODEN. Thank you.

Chairman Himes, Ranking Member Barr, and distinguished members of this subcommittee, I appreciate the opportunity to testify before you today.

Specifically, I would like to share with you Connecticut's experience with the Municipal Liquidity Facility, which I will refer to as the MLF in my testimony.

As president-elect of the National Association of State Treasurers, the bipartisan association of State treasurers from across the country, I have worked with my colleagues on this topic since the early days of the pandemic.

As treasurer of the State of Connecticut, I have three responsibilities relevant to today's hearing: investment of the State's pension and trust funds; management of the State's borrowing; and management of the State's cash, including maintenance of our liquidity.

For today's hearing, I am going to focus specifically on liquidity issues. Our experience in Connecticut, fortunately, was that the State and its municipalities were able to meet the pandemic's unprecedented impact on State and local governments' budgets and other fiscal challenges. This was due to prompt and effective Federal action and assistance, as well as the State's ability to adeptly draw on talent and quickly prepare.

At the—

[Technical issue.]

Mr. WOODEN. —its Fiscal Year 2020 budget projections to a

much larger \$934 million budget deficit.

During this time, in early spring 2020, I participated in weekly calls with treasurers from across the country to discuss in real time the challenges different States were facing. At that point, all States were revising their budget projections and liquidity positions. Several States moved ahead and put lines of credit and other short-term borrowing facilities to address what was at the time an unknown fiscal impact from the quickly-spreading COVID-19.

However, several significant and timely actions taken by the Federal Government provided substantial assistance to State and local governments and mitigated liquidity concerns. One was the

Federal Reserve's establishment of the MLF.

A quick look at events in the municipal market at the time shows that shortly after the declaration of the pandemic, the municipal market experienced tremendous volatility. The municipal bond yields rose dramatically as mutual fund investors pulled over \$41 billion of assets out of the municipal market in less than 3 weeks.

At that point, market fluctuation had deteriorated to the point that buyers and sellers had difficulty determining price, because investors were concerned about our government's ability to withstand the pandemic's related liquidity and revenue shocks.

The primary market was, essentially, shuttered for 2 weeks in mid-March, and municipal bond yields remained elevated even as

markets slowly reopened.

The Federal Reserve's initial actions helped shore up market liquidity. The creation of the MLF provided critical support for issuer solvency by standing ready to purchase short-term notes from State and local governments in an extremely uncertain economic environment, thereby helping State and local governments better manage cash flow pressures.

The MLF was designed and implemented to serve as a lender of

The MLF was designed and implemented to serve as a lender of last resort. Despite the limited utilization of the program, it provided a necessary backstop to a large market without replacing the normal municipal market mechanisms for raising capital to allevi-

ate liquidity concerns.

Today, I present seven changes for your consideration for the purpose of improving the MLF to be shelf-ready for the next fiscal crisis, and this reflects Connecticut's experience, as well as the experience of treasurers across the country, on a bipartisan basis, that was shared with Treasury at the time.

Number one, I recommend reducing the MLF's borrowing rates to more competitive taxable market rates that move with the mar-

ket.

Number two, I recommend removing the requirement for certification that borrowers are unable to secure adequate credit accommodations from other banking institutions. The above-market pric-

ing model makes that certification redundant.

Number three, I recommend making the requirement that Stateguaranteed borrowings of municipalities that borrow through the State be more flexible, and consider having the Federal Reserve assume some of the credit risk.

Number four, the MLF should be available for pooled borrowings, not one-off guaranteed borrowings for particular municipalities.

Number five, allow for longer credit terms, and we recommend that that will improve the relief available to issuers by extending the MLF credit facility for longer-term issuers.

Number six, make the program permanent. It would be valuable and forward-thinking for the Federal Reserve to put in place a permanent emergency MLF program and set parameters that consider the variety of States' needs and circumstances.

In Connecticut, we found that legislative changes to our statutes would be necessary in order to implement the prior program.

And lastly, if I may, Mr. Chairman, create a bank-managed program which would be much more efficient to execute.

Thank you for this opportunity.

[The prepared statement of Mr. Wooden can be found on page 65 of the appendix.

Chairman HIMES. Thank you, Mr. Wooden, and I will be equivalently elastic on the time for the other witnesses.

With that, Mr. Konczal, you are now recognized for 5 minutes to give an oral presentation of your testimony.

STATEMENT OF MIKE KONCZAL, DIRECTOR, MACROECONOMIC ANALYSIS, ROOSEVELT INSTITUTE

Mr. KONCZAL. Good morning, and thank you for inviting me to testify at this hearing.

My name is Mike Konczal, and I am the director of macroeconomic analysis at the Roosevelt Institute.

I would like to discuss the Emergency Lending Facilities that the Federal Reserve used to respond to the COVID-19 crisis, and I would like to make three points.

First, the Municipal Liquidity Facility (MLF) and the Secondary Market Corporate Credit Facility (SMCCF) were more successful than people realize. We see dramatic effects if we look not just at the total number of loans made, but instead at their overall impact on interest rates.

Second, these programs are an evolution of unconventional monetary policy in our era of low interest rates and are likely to stay with us.

And third, there are multiple ways to improve these facilities,

going forward.

Take the MLF and municipal debt markets as the first example. During March 2020, yields on municipal debts dramatically increased. The MLF was poorly-designed to address this crisis. Its original narrow terms meant it was very difficult for any subnational entity to qualify, especially cities with the highest concentration of Black and Brown residents.

Even as the Fed expanded the eligibility threshold throughout that summer, only two borrowers took advantage of the program, borrowing only \$6 billion out of the \$500 billion available for lend-

ing through this program.

Yet, the interest rates municipalities faced dropped dramatically throughout this period. A wave of research over the past year has found that this decrease was driven by the announcement of the MLF and its subsequent expansions.

Research from the Federal Reserve Bank of New York found that municipalities eligible for the expanded terms at the end of April

saw their interest rates decline around 70 basis points.

Research from the Federal Reserve Bank of Dallas found that the MLF kept rates from rising between an estimated 5 and 8 percent as the economy deteriorated.

Researchers at the Federal Reserve Bank of Chicago found an impact of 110 basis points for a sample of U.S. States. This research argues that the MLF disproportionately benefited municipalities with higher credit risk.

There are many studies summarized in my written testimony, and though they all use different methodology, they all point in the

same direction.

This same story plays out in the corporate sector. Interest rates on corporate bonds spiked during March 2020. Although the purchases of the SMCCF were only \$13 billion, a trivial amount in the world of corporate debt, the impact was dramatic.

Researchers across studies find a dramatic drop in the interest rate corporations faced, with the general conclusion that most of

the impact occurred before the Fed even bought anything.

These two programs mirror each other. Even though the Federal Reserve purchased virtually nothing and incurred no fiscal costs, the chance that it could was enough to drive down borrowing costs and calm markets for these sectors.

It is through this lens, seeing asset purchases as an extension of unconventional monetary policy that sets long-term interest rates for users of funds in the economy, that the impact and promise of these programs make the most sense.

We will likely still need such programs in the future. Unconventional monetary policy is necessary during periods of low interest rates, and over the past several decades, interest rates have fallen across countries.

Right now, the 10-year Treasury rate is around 1.3 percent, which is below the 6 decades preceding the pandemic. Economists are engaged in debates over why interest rates have fallen, with popular theories including increasing wealth inequality, the aging of the population, and more concentration in sectors across our economy. These trends are likely to stay with us.

And, indeed, this expansion of unconventional monetary policy is also happening at other central banks across the world. Multiple other central banks created or expanded already existing corporate bond purchase facilities in 2020, in response to the COVID crisis, including the central banks of England, Europe, Japan, and Canada.

Luckily, there are multiple ways to improve these facilities. The Federal Reserve should research how expansive it can make eligibility requirements for any future Municipal Lending Facility. This has significant benefits with low costs. The eligibility does matter

quite a bit in who gets to benefit from this.

The Federal Reserve should remove or reduce its penalty rate for any future programs like these. The penalty rate makes perfect sense for times in which we want to guard against moral hazard, especially in a financial crisis. But when programs are being used as part of a general toolkit of unconventional monetary policy and rate setting, the penalty rate makes less sense.

And third, beyond program design, there are general policy changes that should be considered. Better regulation of open-ended mutual funds can help prevent debt markets from seizing in crises

on such short notice.

Also, these facilities are no substitute for fiscal policy. Better automatic stabilizers would help maintain income and spending in a recession and take some of the pressure off unconventional policy.

Thank you for your time, and I look forward to any questions you

may have.

[The prepared statement of Mr. Konczal can be found on page 36 of the appendix.]

Chairman HIMES. Thank you, Mr. Konczal.

Ms. Rhee, you are now recognized for 5 minutes to give an oral presentation of your testimony.

STATEMENT OF JUNE RHEE, DIRECTOR, MASTER OF MANAGE-MENT STUDIES IN SYSTEMIC RISK, YALE SCHOOL OF MAN-**AGEMENT**

Ms. Rhee. Thank you.

Chairman Himes, Ranking Member Barr, and members of the subcommittee, thank you for inviting me to testify at this hearing.

My name is June Rhee. For the past 6 years, I have been re-searching at the Yale Program on Financial Stability on interventions used by the government and central banks in response to financial crises around the world.

The focus of my research has been on market liquidity and capital injection programs. In these remarks, I will focus on my research in market liquidity programs by the Fed during the global financial crisis (GFC) and the COVID-19 pandemic based on papers I have co-authored.

We define market liquidity programs as interventions for which the key motivation is to stabilize liquidity in a specific wholesale funding market, which encompasses the three facilities we are focusing on today in our hearing.

The Fed is allowed to extend loans to nonbanks in normal times and its power to purchase market instrument is limited. Therefore, the Fed relied on its authority under Section 13(3) of the Federal Reserve Act to lend to nonbanks in unusually exigent circumstances.

The Fed also created special purpose vehicles, or SPVs, to purchase specific instruments and lend money to them using its emergency authority. The SPVs, in turn, purchased assets to help restore liquidity in troubled markets.

Lending under 13(3) also requires the Fed to be secured to its satisfaction. The Fed has taken a variety of paths to make sure it is secured to its satisfaction. In one facility during the GFC, it required borrowers to pay fees, which in aggregate function does a loss reserve.

In another facility, it required money market funds or other investors that elected to sell assets to the SPV to then purchase subordinated debt issued by the SPV equivalent to 10 percent of the value of the assets they sold.

It is also relevant to note that of all of the Fed's lending facilities established under 13(3) during the GFC, only one facility received credit protection from the Treasury, which is quite different from this time around.

In part because the Fed's indirect asset purchase programs during the global financial crisis were more complex than the direct asset purchase programs set forth by other central banks around the world, the implementation took a little bit—for some of the programs, the implementation took a little bit more time.

The ability to roll out a program quickly can provide benefits in some cases, serving as a bridge as other programs are put together. Fed economists involved in constructing some of these programs have also stated that, in hindsight, an earlier rollout of some of these programs might have made them more effective.

Ultimately, however, whether an intervention was indirect or direct does not seem to have had much influence on its effectiveness.

Following the GFC, the Dodd-Frank Act added some restrictions to Section 13(3). Under the revised law, the Fed retains the ability to conduct market-wide liquidity programs, but it now must obtain the Treasury Secretary's approval before establishing such a program.

Also, it is required to report to Congress detailed transaction-level information on any loan extended under a Section 13(3) program within 7 days.

Disruptions caused by the COVID-19 pandemic, again, drove the Fed to open market liquidity programs, some like GFC-era ones and some new ones, using Section 13(3) authority.

Armed with the know-how from the GFC, the Fed was able to quickly reintroduce four GFC-era market liquidity programs. It also introduced new programs, and the three programs that we are talking about today are the new programs that the Fed introduced.

For the reopened programs, the Fed—much of the design was the same as their GFC-era counterparts. However, unlike the GFC-era facilities, again, the COVID-19-era facilities, aside from two facilities, received Treasury's credit protection.

The relevance of this is that the Consolidated Appropriations Act 2021, signed into law on December 27, 2020, definitively closed these CARES Act facilities and rescinded funds not needed to meet

the commitments as of January 9, 2029, of the programs and facilities established.

The Act preserves the Fed's authority under Section 13(3). However, the Act removed Treasury's authority to use funds to support a Fed facility that is the same as the three facilities that we are talking about here today.

The Act made an exception for the Term Asset-Backed Securities Loan Facility (TALF), which is a facility that was also opened during the GFC era. How broadly the Treasury will interpret the, 'same as," language in the future remains an open question.

Therefore, if the Fed wanted to create a lending facility that falls

within the scope of the Act in the future, it may have to find other ways to secure the loans to its satisfaction, such as using risk management techniques used during the GFC-era facilities.

But there also may be some need for the Treasury to support a future lending facility. If you are comparing a GFC facility versus the COVID-19 facility, the COVID-19 facility with the Treasury support was able to accept a much broader range of eligible collateral than a similar facility that was open during the GFC era.

Of course, all Fed lending facilities under Section 13(3) will con-

tinue to require the Treasury Secretary's approval.

This concludes my remarks, and thank you. I welcome all questions.

The prepared statement of Ms. Rhee can be found on page 47 of the appendix.

Chairman HIMES. Thank you, Ms. Rhee.

Dr. Sahm, you are now recognized for 5 minutes.

STATEMENT OF CLAUDIA SAHM, SENIOR FELLOW, JAIN **FAMILY INSTITUTE**

Ms. Sahm. Thank you.

I greatly appreciate the opportunity to give remarks on the Municipal Liquidity Facility. I am going to focus on three ways that this emergency facility for State and local governments could be improved for the next crisis.

First, we should tailor the eligibility and the loan terms so that they are specifically for State and local governments experiencing financial distress.

To do so, use economic conditions, particularly conditions in the local labor markets, to make those determinations, and finally, improve the administrative systems so that it is as easy as possible for those who need the relief to access it.

We know that swift and effective relief is absolutely essential in times of crisis. I began at the Federal Reserve in 2007. In my first year, I watched the global financial crisis in the Great Recession have an incredible toll on families, small businesses, and communities, and that lasted for years.

This time, you all stepped in very aggressively, and boldly, and what Congress did and what the Federal Reserve did early in the crisis, in particular, was a godsend.

But when you are innovative and bold, you can always do better, and so it is the perfect time to reflect, hold those accountable who were in charge of implementing these policies, and to prepare for the next crisis.

Before I go through the proposals in more detail, I just want to focus on the stated purpose of the Municipal Liquidity Facility, as it is stated on the Federal Reserve's website, to help State and local governments better manage the cash flow pressures they are facing as a result of the increase in State and local government expenditures related to the COVID-19 pandemic and the delay and decrease of certain tax and other revenues.

We have talked about the success metrics. The municipal bond market did stabilize. It stabilized quickly. It took a little longer for those that didn't have as good a credit rating, but we got there.

That is success and it should be recognized.

That said, two loans were made to State and local governments, and we know that there were more than two that were suffering

during this crisis and continued to, so let us do better.

The key features that we have talked about, the size and that only about $11\frac{1}{2}$ percent of the loans were accessed, the eligibility was, largely, by population. We now know that a lot of the budget stresses were not concentrated in some of our large States and cities.

We need to get the money to who needs it and, as was mentioned before, the State and local governments only had access to bonds up to 3 years of maturity. They were more than that for corporations.

So with the first proposal to target eligibility, as I said, we know that population was not enough. The Fed had to reverse course and lower the population thresholds in August. That was too long to wait for that. And if we do better targeting, then it will be the State and local governments that most need the aid and we can, potentially, reduce penalty rates.

We can subsidize those rates because you aren't opening up to all institutions. You can be very targeted and tailored in the relief.

Now, it is a big question of, how do you do that targeting? I suggest using local economic conditions. The Bureau of Labor Statistics puts out very detailed subnational statistics. No one can influence them, and they do tell us about the hardships that workers are facing and businesses in a crisis.

And finally, administering these programs is essential. The signing ceremonies are not enough. The Fed announcements are not enough. The cash has to get to those who are eligible and those

who need the relief.

Innovation is hard. The Fed stood up a facility that did not exist before this crisis. It was delayed relative to the facilities that were directed at Wall Street. The terms had to be adjusted. There was a lot of debate among Fed and Treasury about exactly who should be eligible. That created uncertainty for State and local governments.

We can't do a one-size-fits-all approach. State and local governments, nearly all of them, have balanced budget requirements. They have really faced a lot of uncertainty in terms of revenues. We need to make it easier for them.

I just think the Federal Reserve is a way that Congress can get money out. Congress needs to lead, but the Fed can be a very effective way to implement the policies and the relief that you want to see done. Thank you.

The prepared statement of Dr. Sahm can be found on page 57 of the appendix.]

Chairman HIMES. Thank you, Dr. Sahm.

Mr. Russo, you are now recognized for 5 minutes.

STATEMENT OF CHRISTOPHER M. RUSSO, POST-GRADUATE RESEARCH FELLOW, MERCATUS CENTER AT GEORGE MASON UNIVERSITY

Mr. Russo. Good morning.

Chairman Himes, Ranking Member Barr, and members of the subcommittee, thank you for inviting me to speak today about the Fed's Emergency Lending Facilities.

My name is Christopher Russo. Before joining the Mercatus Center at George Mason University, I advised senior Fed officials on a range of monetary policy decisions.

Today, I urge you to safeguard the Federal Reserve's independence by keeping the Fed out of credit policy. Really, my arguments can be boiled down to just three points.

First, the Fed's role as the lender of last resort is essential to achieving its monetary policy objectives, these same objectives that you have given it.

Second, 10 of the Fed's Emergency Lending Facilities cross red

lines from monetary policy into credit policy.

And third, crucially, using the Fed for credit policy damages its independence, making it less effective in the next crisis.

I think we will agree on my first point, that the Fed as a lender of last resort is essential to achieving the goals you have given it: maximum employment; and price stability.

Congress created the Fed for exactly this reason, following a dash for cash on Wall Street in 1907 that led to a banking panic and then a contraction on Main Street, a massive one. To be clear, it is 1907, not 2007.

And we have known what to do since 1802. The Fed, as the lender of last resort, lends to banks without limit in a timely manner, based on good collateral and at a penalty rate.

Those five elements of the lender-of-last-resort doctrine are essential. They have been developed during hundreds of years of financial crises, since we started having them.

The purpose of the lender of last resort is liquidity, not credit, and all five points matter for that purpose. The Fed's first test came in 1929. Faced with yet another banking panic, the Fed dramatically failed.

It did not lend to banks without limit or in a timely manner, and in doing so, healthy banks were forced to fail. These mistakes compounded what would have been a bad, but a once-in-a-few-years recession into the Great Depression.

The Fed has learned the lesson from the Great Depression, in my view, as former Fed Chairman Bernanke vowed never again.

I also think we will agree on my second point, that recent emergency lending programs crossed red lines from monetary policy into credit policy. Fed Chairman Powell said so himself. Ten of the Emergency Lending Facilities were designed to assist Congress and the Treasury in allocating credit, not liquidity, to the broad financial system.

These credit programs don't meet the five requirements I outlined for a lender of last resort. They lend to nonbanks at favorable

rates and with shady collateral, with respect.

For example, the Fed's Municipal Loan Facility made direct loans, as we have recognized here, only to the State of Illinois and the New York MTA. The Fed can't create new savings from nothing. It can only shift them around. And like any government subsidy, it benefits some, as has been described, but the unseen harm comes to others, and that is less recognizable in some of the studies that have been done.

I would also mention that when we talk about the effect of the Fed on markets in these and other actions, market volatility, price volatility, that itself is not dysfunction. That itself is not illiquidity.

So for all of those reasons, I hope we will agree on my third point, that involving the Fed in credit policy damages its independence and its effectiveness.

Congress recognized this in the 2010 Dodd-Frank Act after the global financial crisis. Congress specified that emergency lending is for unusual and exigent circumstances. It must be broad-based and only for the purpose of providing liquidity to the financial system.

Congress put these restrictions in place because in the global financial crisis, the Fed had lent to nonbanks on Wall Street and it lent credit—it wasn't involved in liquidity—because these firms were deemed too-big-to-fail.

Congressmen, Congresswomen, it is the same principle. Whether it is nonbank borrowers on Wall Street, K Street, or yes, even Main Street, credit policy is political and it is not the Fed's proper role.

So, I ask you to resist this siren call of turning the Fed from our central bank into our piggy bank. Whether the Fed finances green energy or the construction of a border wall or anything else, it would subject the Fed to immense political pressure.

The damage to the Fed's independence would harm its effectiveness in the next crisis, and as we saw in the Depression, that does

not end well.

Congress regularly asks the Fed to take on more power. As far as I know, the Fed is the only government agency to refuse.

Instead, I ask, like Fed officials have many times, that you safeguard their independence so they can do the important jobs you have given them.

Thank you again. I look forward to answering all of your questions

[The prepared statement of Mr. Russo can be found on page 53 of the appendix.]

Chairman HIMES. Thank you, Mr. Russo. I now recognize myself for 5 minutes for questions.

Mr. Wooden, let me start with you. You are the one sitting State Treasurer on the dais right now. There have been proposals made to make these programs more permanent, more predictable, and more stable.

One of the things Congress does worry about and should worry about is moral hazard, the idea that if that backstop is out there,

it may cause folks in your position to know that it is there and,

therefore, perhaps be less prudent in the decision-making.

How would a State Treasurer think about that, and how can Congress be made more comfortable that if these programs were more predictable and just simply there, that we wouldn't see less prudent behavior on the part of decision-makers at the State and municipal level?

Mr. WOODEN. Thank you for that question.

And, first, let me say I think just based on the numbers alone and what actually happened with the program, it was an unmitigated success in terms of stabilizing the markets.

Part of the discussion—and as a treasurer, I am Main Street. I see day to day on the front line what is happening with governments and essential services and concern about meeting payroll.

The moral hazard argument is that this program was structured and implemented as a lender of last resort, in terms of that standard was met.

Now, I think there is reasonable disagreement and debate on whether or not there should have been the penalty associated with it and off-market rates. But it did the job in terms of being a lender of last resort.

And so I think there was, in fact, zero harm of moral hazard in this event, and that was proved out by the fact that there were only two issuers that utilized it.

But there were many issuers, like the State of Connecticut and others, who benefited and helped stabilize our access to the marketplace in a way that did not harm government but helped government and helped Main Street and Connecticut.

Chairman HIMES. Thank you, Mr. Wooden.

I have one more question that I just want to throw out there as sort of (inaudible). I have watched or participated now, sadly, in any number of interventions in the market. I wasn't in Congress, but the Mexico bailout, then, of course, the infamous Wall Street bailout, the auto industry, and now everything that we have done.

That is not the way markets are supposed to work. But those of us in Congress are put in the position of choosing between doing something which buttresses markets, not the way they are supposed to work, or watching the apocalypse unfold.

One of the things, if we are going to continue to do these programs, I would point out that I think that all of the programs I just mentioned actually didn't cause any loss to taxpayers and, in fact, in many cases, provided a gain to taxpayers.

But one of the challenges is that these programs are perceived by my constituents and, I think, by Americans as always benefiting the corporation or management. Why? Because the proceeds are often used to pay bondholders.

And so, workers and others are left to say, wait a minute, once again, you are bailing out the corporation I work for and what do I get? And in many instances, those workers are laid off.

Now, you don't need to be too far to the left of the political spectrum to say that is a problem. So my question is, and I posed this question to Fed Chair Powell some time ago, how can these programs be thought of and restructured in ways that at least alter

the perception that they are all about corporations and businesses servicing their debts rather than standing by their workers?

Dr. Sahm, you are the first one with the mask off so—

Ms. SAHM. Okay. I buzzed in.

I think there was a big step forward in this crisis. You have two new facilities that lend directly to Main Street. Putting those on equal footing in terms of terms, eligibility, how fast they get started, that is a big step forward. And so, I really applaud that attempt to get money directly to Main Street and I think that is what people want to see.

We don't want Wall Street to go down, but we don't want Main Street to either.

Chairman HIMES. So you are saying, and I agree with you, that if we make these credit facilities available to smaller businesses, that mitigates some of the sense of, we are just bailing out the banks?

But what else? The Federal Reserve hasn't—and maybe the answer is there is nothing you can do. You just, as an elected official, need to explain to people that when you stabilize Delta Airlines, you are doing a good thing for the economy, even if Delta Airlines turns around and lays off employees.

But is there anything we can do to try to address that perceptual

Ms. Sahm. Fiscal policy. I don't think in a crisis people care where the money is coming from, whether it is the Fed helping keep interest rates low or it is Congress getting stimulus checks in their pocket.

I think it is more about the concerted, all-hands-on-deck approach. That would—

Chairman HIMES. Thank you. I am out of time, but I appreciate that response.

With that, I now recognize the distinguished ranking member of the subcommittee, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

Let us talk about how we measure the success of these emergency liquidity programs. Members of Congress heard from market participants that TALF, in particular, and the corporate credit facilities were a psychological backstop, and even if the utilization wasn't there, that the markets weren't seized, that they actually functioned because there was this psychological backstop that was there.

And so, I mentioned in my opening statement that it is important that we grasp how to measure the success of these facilities. Looking simply at utilization or take-up makes them, perhaps, look unsuccessful, but a broader look at the market and credit conditions in this unprecedented economic shutdown and evaluating it through the lens of the Fed serving just as a backstop but not as necessarily a provider of credit might indicate that they were successful.

So, Mr. Russo, how would you evaluate the performance of the Fed's facilities and what metrics should we actually use to judge their success?

Mr. Russo. Congressman, thank you for that great question.

As an economist, I think it is important to look at the benefits of a policy as well as the drawbacks. One thing that hasn't been mentioned already in terms of the drawbacks of such a policy is, first, there is only so much real economic savings to be allocated. Again, that is all the Fed can do; they can allocate savings.

So when the Congress or the Fed or anybody else decides to allocate more savings to New York and Illinois, they are taking away from somewhere else. You don't see where, but that is a real drawback

The second thing I will mention is that by trying to peg prices—in this case, an interest rate—for credit, you do make some better off and some worse off, like any subsidy.

For example, Illinois got better rates if we buy the arguments that were put forth before, on these municipal loans. That gave a worse return to the pensions that own those bonds or that finance that new investment.

Again, I think there is a complicated cost-benefit analysis we could do here. But I would just remind you of those other sides of the ledger. And, again, it is not really the Fed's role to be doing credit policy.

Mr. BARR. Yes, let me stick with you and the point that you are making. Some of our colleagues have suggested that the Fed should take a more active role in addressing social or environmental issues. Some have even gone as far to suggest that the long-run changes in weather patterns due to climate change are emergencies and, thus, necessitate the Fed using its 13(3) emergency lending powers to directly finance green energy.

Mr. Russo, what would the impact be on the Fed's independence if it strayed outside of its mandate and actually took a more active role in social and environmental issues?

Mr. Russo. I believe that its independence would be irreparably damaged, and in doing so, it would weaken its independence and its effectiveness in the next crisis.

Mr. BARR. Mr. Russo, I want to ask you now about the penalty rate. Some have contended that the terms and rates and some of your fellow panelists here have contended that the terms and rates of some of the Fed's facilities are too onerous, resulting in lower uptake if prices were more aligned with market rates.

As you know, the Fed is required by regulation to charge a penalty rate at a premium to market rates in normal circumstances. This is, in part, to ensure that the Fed maintains its role as a backstop and provider of liquidity rather than replacing private markets.

What impact would an adjustment to the requirement of the Fed to charge a penalty rate have on its role in the economy, and could that change its role from a backstop to a direct competitor with private entities?

Mr. RUSSO. Not, "could," but, "would," sir. Thank you again for that question.

To give you some context here, the Fed's loan to Illinois that was a direct loan had an interest rate of about 3 percent. We have seen the inflation in the last year. In real terms—not dollar terms, but in real terms inflation adjusted, that is a negative return.

Just to summarize, when we reduce any of those five criteria I set out for a lender of last resort, you no longer have a lender of last resort and that includes getting rid of penalty rates.

Mr. BARR. Yes, I think preserving the role as lender of last resort

is very important in not displacing the private sector.

Final question to Mr. Russo, in the 115th Congress, when I chaired this subcommittee, I sponsored a package of Federal Reserve reform bills, which included a bill called the Congressional Accountability for Emergency Lending Programs Act. Mr. Hill was part of this effort.

The bill would require the affirmative vote of a greater portion of the Federal Open Market Committee (FOMC) than is currently required. It would also require an additional and enhanced role from Congress to authorize these emergency lending authorities.

Of course, the CARES Act did interject the Congress in approving some of the emergency lending that we saw in the pandemic.

But what are your thoughts on a bill like this to strengthen the congressional role to limit the Fed's emergency lending powers? Not eliminate 13(3), but just provide a little better accountability, involve more of the members of the FOMC in this?

Mr. Russo. Thank you, sir. I believe the Congress plays an important role in the oversight of the Federal Reserve. I can't comment on that legislation specifically, and I don't endorse legislation. But I would be happy to work with your office on these issues, going forward, if that would be helpful.

Mr. BARR. Thank you, Mr. Chairman, for your indulgence. I yield

back.

Chairman HIMES. Thank you to the ranking member.

The Chair of the full Financial Services Committee, Chairwoman Waters, is recognized for 5 minutes.

Chairwoman WATERS. Thank you very much, Mr. Himes.

I would like to continue the discussion that you have initiated around maximizing the public interest.

Mr. Konczal, we know that emergency financial system assistance is sometimes necessary to rescue our economy when it is in crisis. But carrying out this assistance in a way that protects workers and has other reasonable conditions attached is critical.

For example, in 2009, the Treasury Department extended \$62 billion in assistance to General Motors and Chrysler, which helped to save 1.5 million jobs. However, Treasury was eager to exit its investment as quickly as possible. It sold its stake in both companies without securing any improvement in workers' wages or other corporate practices, and its sale came at a loss, even though GM and Chrysler were profitable just a few years later.

Last year, we set aside \$17 billion in the CARES Act to help national security firms like Boeing. We put conditions on that assistance, including workforce maintenance requirements. Boeing did not end up using that aid, instead, opting to sell a corporate bond after the Fed's actions unfroze the corporate bond market. Because the corporate bond market didn't have the same strings attached as the CARES Act national security bonds, Boeing proceeded to lay off 12,000 workers.

Mr. Konczal, what ideas should Congress consider to ensure future emergency lending programs are carried out in a way that is in the public interest and maximizes the vital goals of full employment and economic stability?

Mr. KONCZAL. Thank you for that question. So, a few thoughts on that.

One is that, in so much as a lot of these facilities are setting market-wide interest rates and bringing them down when traditional monetary policy is weaker at doing that, it is very hard to put on conditions at that point.

So, you want to think about fiscal policy. You want to think about managed settlements, particularly in times of crisis, like we

did with the airlines.

I contrast these programs with the Payroll Protection Program. As compared to these programs, the Payroll Protection Program had significant take-up, approximately \$500 billion with 5 million loans.

And there, you had a downside from the point of view of business but an upside from the point of view of the public of having significant terms on those loans, particularly payroll.

In exchange for that, there was the upside to the business of having those loans turned into grants. With these emergency lending programs, it is very difficult to have that kind of balance because we are working through interest rates.

So you can try to put penalties on. The Primary Market Corporate Credit Facility, which would have made direct loans to corporations had no untake because it had a penalty rate

porations, had no uptake because it had a penalty rate.

The Main Street Lending Facility, for instance, had some obligations that mirrored the Payroll Protection Program but also saw limited uptake.

So one needs to think about the balance of upside and downside for the business in terms of making sure that we can carry out programs so we can carry out public obligations in exchange for support.

I also think that automatic stabilizers are quite important. I think unemployment insurance, the expansion in the CARES Act and the American Rescue Plan was very important in helping ensure that workers got through this and got an equitable shake of

the downturn that we went through.

And finally, direct support to cities and municipalities in the

American Rescue Plan was incredibly important.

Chairwoman Waters. Thank you very much. Let me just say that despite the fact that in emergency assistance to these companies, certainly, you are concerned with the economy and what is happening and how can we protect having a safe and sound economy, et cetera. But I certainly would not like to think that we can excuse these corporations from using our leverage to ensure that they protect workers in some way. Don't you agree that both can be done?

Mr. KONCZAL. Yes, absolutely, and I think there are some models we can look back at. What happened with the airlines, I think, is

one possible role and model, going forward.

Legislation has been introduced about a bailout manager that I think is really worth discussing and thinking through and reassessing. You look at the Main Street Lending Facility, which put a ban on buybacks and dividends for firms that took them and that

was enforced, and the sky didn't fall when we banned buybacks and dividends or slowed the rates at the largest banks.

And so, there are obligations that can be put in place that we saw a limited version of that worked perfectly fine and still left corporations in a perfectly good place to be able to expand in this recovery.

Chairwoman WATERS. Thank you very much. I yield back.

Chairman HIMES. Thank you.

The gentleman from Texas, Mr. Sessions, is now recognized for 5 minutes.

Mr. Sessions. Mr. Chairman, thank you very much. I want to thank the panel that is here before us today and I want to engage

several of the members of the panel.

Ms. Rhee, I listened very carefully when you talked about liquidity, and liquidity in the marketplace is always an indication to me about what is available and what exists and those sorts of measures, and I, with great interest, listened and I appreciate your comments.

Dr. Sahm, in looking at your written testimony on page—well, the pages aren't here, so maybe 5 pages back, you talk about changes in State revenues during COVID. And I note, among others, Delaware, a huge increase of revenue to the State, and I don't know whether this was above what was projected or what it could be

Did this include Federal money that would flow in or just revenue generated by the State?

Ms. SAHM. No, these were just revenues by the State, but they include, say, corporate profit, income taxes. So, that is an important piece of Delaware.

The point of that chart is mainly to show that there are wide variations in the tax revenue shortfalls, and to your point or to your question, largely, the shortfalls were less than expected in March of 2020.

Mr. Sessions. Yes, and in looking at those, I looked at California as being a significant increase. Is that an indication about business as usual and increases in a, "COVID era," or what would you look at that and draw a conclusion about?

Ms. SAHM. Year to year, we do expect increases in tax revenues. So the particular numbers, say, for the State of California, I wouldn't generalize so broadly in terms of how much relief they got in this crisis.

And also, this is only the tax side. Expenditures rose in a lot of places. Again, I think that that is a really good argument as to why the Municipal Liquidity Facility could have been better targeted, and you might argue that the direct aid that was in the American Rescue Plan could be also to where there is really economic distress.

Mr. Sessions. Yes. And I think that is a point, going back to Ms. Rhee, you need to look at the liquidity to see how sick the patient is or how well the patient might be to draw that conclusion.

Mr. Russo, in looking at your testimony, which, I really appreciate, today, the Wall Street Journal has an article that I engaged the president of the Dallas Fed on—really, he engaged me on it—and that is the Fed prepares to pull back on stimulus.

The president of the Dallas Fed talked to me about how he believed—and I think the word is, "tamper"—put a brake on, reduce. The Wall Street Journal today talks about, really, what I think should be part of this hearing. So, I am going to make it part of the hearing.

The projections Wednesday show half the officials expect interest rates would need to rise. The main catalyst—going to another paragraph—of the problem is the fact that inflation has accelerated

faster than anticipated and it is remaining elevated.

At some point, there is danger to what we are doing, isn't there? Can you lend too much money or accelerate the marketplace beyond normal? What would you say about that?

Mr. Russo. Sir, thank you for the question.

I think what you have articulated there is correct. The Fed often looks at what they say are balances of risk. In the last decade, the balance of risk has really been to the downside for recession and for low inflation or even deflation.

Entering the coronavirus pandemic, my perception is that they were trying to address that immediate issue with as much monetary stimulus as they could, and I approve of those actions—things like lowering interest rates to zero, doing large-scale asset purchases, acting as an actual lender of last resort.

Those, I think, are on point. And so long as the Fed remains independent, they can modify those actions as appropriate to keep inflation on track and that is, again, I think, the important thing,

their independence to be able to do that.

Mr. Sessions. Thank you.

One question to the panel. And anybody can answer this. During the last 2 years, there has been an extensive amount of national debt that was taken on, in the trillions. What would we anticipate the interest rates to be next year, just off that new loan amount?

Has anybody looked at that, the interest payments that we will need to make in 2023, just based upon the extension of monetary money in the last 2 years?

Mr. Russo. Sir, based on where we are right now, in general, interest rates are predicted to remain low, at least into next year.

Going further out, you might have more uncertainty.

There is a question, though, as you have raised, I think you are alluding to, that the unsustainable rise in debt could lead to a situation either through a debt crisis, or not even a crisis, in which you have sustained higher interest rates. That is an economic possibility. We have seen many times in history before—

Mr. SESSIONS. Mr. Chairman, if I could just have one more minute, sir?

I am talking about the fact that we will have to pay interest.

Mr. Russo. Yes.

Mr. Sessions. New interest payments based upon what has occurred over the last 2 years. What is that incremental amount? Has anybody figured that out at near zero interest rates, but we still have to pay interest on this. Does anybody know what that might be?

Mr. Russo. Sir, I don't have that number. But I would be happy

to talk to you afterwards and get that number for you. Mr. Sessions. Right. Thank you very much.

Mr. Chairman, thank you very much.

Chairman HIMES. Thank you. The gentleman from New York, Mr. Torres, is now recognized for 5 minutes.

Mr. Torres. Thank you, Mr. Chairman.

Mr. Russo, I know you had a brief exchange with the ranking member regarding climate change. My first question is, do you think climate change is an emergency?

Mr. Russo. Sir, thank you for the question. With respect, I am not an expert on climate change. I am here to talk about monetary

policy where I have expertise, not my personal views.

Mr. Torres. Right, but whether climate change is an emergency will determine whether it poses a risk to the financial stability of

I have a question for Mr. Konczal. The House Select Committee on the Coronavirus Crisis found that the credit facilities of the Fed lend disproportionately to oil and gas companies.

Do you think that the Fed is planting the seeds of long-term financial instability in lending so heavily to fossil fuel companies?

Mr. KONCZAL. The studies about the SMCCF, basically, found that it helped industries across-the-board, and that specific study found that it under-lent to finance and over-lent to many other industries, including oil and gas.

The Fed should be accountable to that and should answer Members' questions about whether or not their distribution of the assets

they purchased in the SMCCF is correct or not.

I think the biggest issue right now is the systemic risk that climate poses to the financial system. There are very basic and easy supervisory actions that they can take outside the rulemaking process to force companies and banks to disclose their exposures to cli-

Notably, insurance companies and asset managers like BlackRock are trying to get this information and they have a very difficult time doing that. That is the perfect spot for regulators to

Mr. Torres. The stabilization of credit conditions during COVID, it has been said, had more to do with the announcement of the lending facilities rather than the lending facilities themselves.

But as has been noted, these lending facilities, particularly the Main Street and the Municipal Liquidity Facility, have been shown to be ineffective.

Do you think that undermines their ability to be a psychological backstop in the future, and does that strengthen the case for reforming them?

Mr. Wooden?

Mr. WOODEN. Just to clarify, did you say they have been shown to be ineffective or effective?

Mr. Torres. Ineffective. The Municipal Liquidity Facility had only two borrowers and, as I understand the Main Street Lending Program, even though it had \$600 billion of capacity, it only lent \$16 billion. So, that is hardly a success story, in my mind.

Mr. WOODEN. I believe it is a success story, not because of the amount of capital, which represented about 2.3 percent programmatically, but because of what it did for the market and the access it provided and that stability at a time of extreme volatility.

I think that is one extremely important metric of success. As we have touched upon, actual delivering of capital and support to municipalities across this country in that metric was not as successful. But the first metric-

Mr. Torres. No, I will concede the point about psychology. But

how do we restructure these programs to be more effective?

Mr. WOODEN. In the recommendations in my written testimony, standing up a program now because speed is key. But what happens, and we have seen this with virtually every fiscal stimulus support program is it goes so fast and there is so much that is

And that is why I am recommending standing up a program not for permanent ongoing usage but in advance. So, we look at issues of size of municipalities. In the State of Connecticut, there wasn't one municipality that could benefit from it as initially structured to when it was revised. But standing these up in times of fiscal distress will allow us to execute more quickly and address some of

these deficiencies that we are highlighting today.

Mr. Torres. Mr. Konczal, according to Moody's, corporations are 63 times more likely to default on loans than States and municipalities, and yet States and municipalities, as well as small busi-

nesses, were subject to a much steeper penalty rate.

I have the impression that the Fed is much more favorable to corporations and Wall Street than to Main Street and States and localities. Is that a fair analysis, or what is your impression?

Mr. Konczal. That is absolutely true that as an empirical matter, in the financial research that municipalities default much less than their equivalent credit ratings from the ratings agencies, which put them at a huge disadvantage for accessing capital for our schools and for our roads and everything else.

I think the Fed was very selective and material even on how it picked its discount rate it applied and where it applied it, and in the future it should be held much more accountable and much

more standardized about how it does that.

Mr. Torres. My time has expired.

Chairman HIMES. Thank you.

The gentleman from Texas, Mr. Williams, is now recognized for 5 minutes.

Mr. WILLIAMS OF TEXAS. Thank you, Mr. Chairman.

And thank you all for being here today.

The Federal Reserve took extraordinary measures during the pandemic because there was so much economic uncertainty surrounding the virus.

Now, looking back, it seems like we may have misjudged the level of government involvement that was necessary to keep busi-

nesses aloft with some of these lending facilities.

The private sector was willing and able to help businesses, and many of the Federal Reserve actions were not utilized to the extent

that we assumed they would be needed.
So if we misjudged the need for these facilities when we were in the heart of the pandemic, then we should not continue the practice of having the Federal Reserve competing, as we have talked about today, with the private sector when they are able to provide proper liquidity for businesses.

Mr. Russo, can you talk about some of the unintended consequences if we try to make these emergency measures permanent and constantly have the government competing with the private sector, which, I believe, is the power of America, the small businessman?

Mr. Russo. Thank you, sir, for that question. I think it is a very

important one.

Let us take a step back and look at the economics. What are we doing when we set up an Emergency Lending Facility to provide credit, not liquidity? We are setting a price. We are setting a price for credit of States, municipalities, corporations, and businesses on Main Street.

Can the government set prices as well as a market? In my view as an economist, no, they cannot. I believe that is supported by over a hundred years of academic research on this issue.

We get outcomes that are not the outcomes we could achieve via market as a market is able to bring together all the sort of information that a central planning board cannot.

Mr. WILLIAMS OF TEXAS. Okay. Thank you.

I am greatly concerned that some Democrats in Congress are looking to the Federal Reserve and other regulators to enact their radical agendas when they fail to get them passed in Congress.

As some of you may be aware, I am in the car business. I have been a car dealer for 52 years, and I was targeted under Operation Choke Point when some of our agencies took a more proactive approach to achieve their policy goals.

For those of you who may not remember, the Obama Administration decided which legal industries posed a risk of money laundering and, therefore, must be debanked and denied financial services. I was involved in that.

Bureaucrats behind closed doors were targeting legal American businesses, and there was no recourse if you were being targeted by our own government.

I am concerned the Federal Reserve will get back into the business of picking winners and picking losers if we set up permanent lending facilities with specific policy objectives.

So, again, Mr. Russo, can you talk about some of the risks that could happen when the Federal Reserve sets up facilities with specific policy goals outside of their dual mandate?

Mr. Russo. Yes, sir, and I share your concerns in what you have

articulated very much.

In general, when the Fed has less independence to set interest rates and to do its large-scale asset purchases, it politicizes that process. But these are not political questions—the appropriate Fed funds rate, for example.

But by involving Congress, you will make the Fed less effective not only in its everyday interactions or its everyday actions like choosing how much to buy on Wall Street.

But even more than that, in a time of crisis, reducing the Fed's independence has been shown in the past to reduce its effectiveness in a crisis.

Let me give you one important example. Back in the Great Depression, the Reconstruction Finance Corporation (RFC), set up by Congress, was like a lender of last resort. Congress, unfortunately, leaked the list of borrowers to the RFC and that created great stigma for those borrowers, worsening the effect of the Fed's interventions for the next hundred years. There is now stigma around the Fed's discount window.

So, there are real risks here that are not easily understood when you involve Congress in the monetary policy decisions of the Federal Reserve.

Mr. WILLIAMS OF TEXAS. I have a minute left.

Mr. Russo, I am going to let you have that time. I wanted to give you the opportunity to talk about inflation and some questions that you would like to get answered from Chairman Powell since he will be before our committee next week.

Mr. Russo. Thank you, sir.

Let me just emphasize that I agree with the monetary policy actions taken by the Federal Reserve. They have gotten national income up to where it would have been in the absence of the pandemic, and in my view and the view of my colleagues at the Mercatus Center at George Mason University, that is a good metric for how a successful monetary policy is going to be.

One question I would ask Chair Powell is, where, in his mind,

are thresholds for reexamining his views about inflation, which, as

you and others have articulated, he views as transitory?

We have seen inflation expectations rise, and again, I don't want to be an alarmist here. I believe that inflation is transitory. But in his view, if we have inflation expectations from, say, 3 to 4 percent or to 5 percent, where would be pause and reexamine? I think that would be a very important question to ask him.

Another question, and I think he would be reluctant to answer but I think it is important to ask anyway, is what is his timeframe

for thinking about average inflation targeting?

Over the past 6 years, we have averaged 2 percent inflation, according to the Fed's preferred measure. With all the inflation we have had, again, we have gotten national income right back on track. How long a window is he looking at?

Mr. WILLIAMS OF TEXAS. Thank you.

Mr. Chairman, I yield back. Chairman HIMES. Thank you.

The gentlewoman from Pennsylvania, Ms. Dean, is now recognized for 5 minutes.

Ms. DEAN. Thank you, Mr. Chairman. And thank you to all of our witnesses today.

And I am really delighted that the chairman chose to have this hearing to examine and measure what successes we had in this past year during an incredibly challenging time to health and to our economy, and to learn what we can learn for the future, to do it better in the future when other crises arrive.

One thing I wanted to look at is a possible barrier that we believe took place last year. In July of last year, at our hearing on monetary policy and the state of the economy, I asked Chairman Powell about Nationally Recognized Statistical Rating Organizations (NRSROs), and the Fed or Treasury's decision to accept only ratings from the big three for businesses applying to Emergency Lending Facilities.

We saw that the lending facilities were underused during the pandemic. I will start with Mr. Konczal, do you believe that accepting only the three big rating agencies was a barrier to some businesses in their application for support?

Mr. KONCZAL. I believe the fundamental barrier for uptake on a lot of these programs, for the physical loan uptake, was the fact that there was a downside from the point of view of a business of

having a penalty rate but no corresponding upside.

So once the market stabilized, many borrowers could turn to the market and, thus, really what the Fed was doing was setting the interest rate in the same way it sets the short-term interest rate.

I don't know enough about the nature of the ratings agency busi-

ness right now to answer.

Ms. Dean. Ms. Rhee, would you care to comment on that? Would it have helped if small businesses who had acceptable credit ratings with other nationally recognized rating agencies would have

been able to apply?

Ms. Rhee. I am specifically informed on the national rating agencies part of it. But one of the reasons why the Fed does have all the requirements and the barriers that goes in is, really, these facilities are really meant to be emergency. It is really meant to be short term. We talked a lot about how it acts as sometimes a kind of a restarter for the market, a backstop for the market.

So in some sense, I think just focusing on the utilization itself is really not a fair judgment on whether a program was effective or not. There are various factors that you look at, and also look at what really was the intention of these facilities when they were

first announced by the Fed and the Treasury.

We need to remember that when the Fed is enacting these 13(3) authorities, and announcing these facilities, it is really in the hopes of returning the markets back to normal, and then also exiting pretty quickly so that it is not affecting the markets in the long term.

Ms. DEAN. I appreciate that, and my questions are a way of putting in a shameless plug for legislation that I introduced last year, along with Chairwoman Waters and Ranking Member Barr, which we did pass in a bipartisan way, that would have the Fed treat all national credit rating agencies uniformly.

I hope we will be able to do that so the barriers to small businesses, women-owned businesses, minority-owned businesses, will

be reduced in any way that we can.

I think I still have a moment.

Treasurer Wooden, in your testimony, you recommended a number of reforms to the Municipal Liquidity Facility, including establishing a permanent emergency program.

Would you mind just fleshing that out a little more?

Mr. WOODEN. Sure. With these programs, we always, in the first few weeks or months, discover in a moment of crisis how many deficiencies exist, and going through this experience—they say you should never let a good crisis go to waste, right?

In this case, we have a lot of learning from that, and I think standing it up—because we do need the speed with which Congress

moved last time. We just need a better product.

And if we take the time now to incorporate the lessons, improve on those deficiencies, and still leave it as an emergency use authorization, that will create a better product as well as going back to the State of Connecticut's experience, we would have had to—and I drafted legislation to allow municipalities to access the Federal program through the State of Connecticut.

We had to stand that up. So, we couldn't use it. But having an existing shelf-ready program will allow States and municipalities to put mechanisms in place in advance should that fiscal crisis

emerge.

Ms. DEAN. I thank you all for your thoughtful answers, and I yield back.

Chairman HIMES. Thank you.

The gentleman from Arkansas, Mr. Hill, is now recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. I appreciate Chairman Himes and Ranking Member Barr for holding this hearing, an opportunity to visit with all of you about your suggestions on the recent crisis and the Fed and the Treasury's response to it.

I spent the last—well, since April of last year, I have been on the Oversight Commission appointed by Mr. McCarthy to oversee the Fed and the Treasury's response, and it is down to just Pat Toomey and me because Leader Schumer and Leader Pelosi have not appointed any Democrats to that oversight responsibility.

So, I don't know how seriously they take overseeing the post-

CARES Act funding. But let me make a couple of points.

One, I agree with Mr. Russo and Ms. Rhee that this is an emergency facility, and the guardrails around that include all of the things that Mr. Russo pointed out, including a penalty rate, short term, abundant collateral, exigent circumstances, broad-based eligibility, so that the Fed isn't targeting and playing favorites and it is short term.

So the ability to, "have a permanent emergency," is, truly, the

oxymoron that that is. We can't do that. We won't do that.

And I would remind my friends on the other side of the aisle that these classic, ageless, timeless central bank rules about lending as the last resort in an emergency were codified by whom? Democrats, in the Dodd-Frank Act.

And I agree with that aspect of the Dodd-Frank Act. I think we should be very vigilant about not turning the Fed into, as Mr.

Russo says, a credit-allocating piggy bank.

Now, to my friend from New York saying that somehow these facilities benefited the oil and gas industry, certainly not in the TALF, which was trying to help short-term credit for borrowers, student loans, housing, credit cards, certainly, not in the corporate program that bought a broad section of corporate bonds and corporate ETFs, certainly not in the emergency facilities for airlines or for the defense industry.

So that leaves either the Municipal Liquidity Facility—I don't believe there were any energy companies in the two loans—or Main

Street.

Now, Main Street—I looked it up while we were sitting here—made 1,830 loans for \$17.5 billion on Main Street. Eight percent

was to anybody in an industry classification of oil and gas or min-

ing. Eight percent.

So, I don't think that is overwhelming. I don't know what oil and gas and mining are as a percentage of the GDP. But I will also tell you that at the moment this crisis hit, oil and gas prices collapsed. Reserve valuations in the oil and gas industry collapsed last March—please remember that—and people could not access the public markets.

So, I think the Fed and the Treasury, under the circumstances, did outstanding work, and I think this Congress responded to the emergency to benefit State and local governments.

So, Mr. Russo, on this aspect of Federal credit allocation, did that

work well with syn-fuels with Jimmy Carter?

Mr. RUSSO. I'm sorry, sir. I missed the very end of your question. Did it work well with—

Mr. HILL. With syn-fuels loan, with Jimmy Carter.

Mr. Russo. No.

Mr. HILL. You weren't born. But did it work well? Your answer is no. Thank you.

Mr. Russo. That is why I didn't understand the reference.

Mr. HILL. How about Solyndra in the recovery plan after 2009? Was Solyndra a good allocation of credit?

Mr. RUSSO. I don't have an opinion, but I don't believe the Wall Street Journal thought so.

Mr. HILL. Yes. Okay.

Let me say that when we get into the direct credit allocation business we get into trouble, and we compromise the Fed's credibility and independence.

And I will tell you, look at the national security loans in the CARES Act authorized by this Congress. We helped airlines. We

were to help the defense industry.

I would ask you to read the Oversight Commission reports on the defense industry. We loaned \$750 billion to Yellow Freight because it was essential, according to DOD, to national security, when all of the testimony before our Commission said it was not essential to national security.

Therefore, the largest loan there is, really, probably done not in accordance with the CARES Act statute, but it was made. It is an emergency. It is a crisis. But that is why credit allocation is so troubling.

Mr. Chairman, I don't know what this legislation was that was attached to the bill. We haven't talked about it today. So, I have concerns why that has been noticed for this hearing but never discussed.

So with that, let me yield back my time, and thank the sub-committee and the witnesses.

Chairman HIMES. Thank you.

The gentleman from Illinois, Mr. Garcia, is now recognized for 5 minutes.

Mr. Garcia of Illinois. Thank you, Chairman Himes and Ranking Member Barr, for holding this important discussion, and I want to thank our witnesses for joining us today.

When I first saw that the Federal Reserve was establishing a facility to help municipal bonds, I was relieved because I know first-

hand how challenging the municipal bond market can be.

I served in the Chicago City Council, in the Illinois Senate, and on the Cook County Board. Unfortunately, our bond ratings make national news. But what that means for us who live in working-class communities like mine is that schools, clinics, and libraries closed. It means that my neighbors worry about pay cuts and lay-offs every budget season, and you don't need an economist to see that makes our economy worse.

So, I had hoped that the Fed's Municipal Liquidity Facility would offer some relief, but I represent one of the very few communities that actually used the MLF and there is a reason many jurisdictions didn't sign up for the program. My State, Illinois, had to attest that we couldn't get financing in the private market before getting help from the MLF, and once we got help, the rates were bare-

ly better than the private bond market.

So, I would like to direct my first question to Mr. Wooden. When the Fed helped out the corporate bond market last year, did they have to deal with similar terms, and the same level of stigma?

Mr. WOODEN. With respect to—I did not follow the corporate bond market as I did with the municipal markets. But from my general knowledge, I think the answer is, of course not. There is always a different standard with respect to the corporate markets than the municipal markets.

Mr. GARCIA OF ILLINOIS. Okay. And do you think that the Municipal Lending Facility was designed fairly or did it stigmatize mu-

nicipal borrowers?

Mr. WOODEN. I will give you my, in the midst of the height of the pandemic response, which is that I thought it was unfair to State and local governments at the time—the penalty, the off-market rates, and the burdens associated with accessing it, and, certainly, the fact that it was designed so that not one municipality in the State of Connecticut was eligible for it.

With that said, given how our finances turned out in the State of Connecticut and our ability to access the traditional markets and how the facility stabilized the markets, more broadly, there was, certainly, a benefit to the State of Connecticut and to most States in the country as a result on that metric but not in our ability to actually half manifolding in the middle of the pandamic

actually help municipalities in the midst of the pandemic.

Mr. GARCIA OF ILLINOIS. Thank you.

Ms. Sahm, we are now going through a major crisis but, of course, that doesn't seem to be anything new. Every few years, municipal budgets get squeezed because of problems in Washington or on Wall Street.

After the last financial crisis, municipal defaults and bond rating cuts hurt cities across the country and cut our recovery short. The MLF was a good idea but it was too little and too limited.

How can we proactively address municipal bond issues in the future so that my neighbors don't worry about budget cuts and layoffs because of problems they didn't create?

Ms. SAHM. Right. I think one step forward would be to create more certainty, so to take this time to really structure those programs, make sure municipalities know how to access them—to the point, make sure more municipalities can access them if they need

I think we have heard a number of times this question of whether Emergency Lending Facilities are permanent or not. That power is in the Federal Reserve Act. Now, it has to be authorized by Treasury.

But Emergency Lending Facilities will be used in future crises, and I very much hope they will be used for State and local governments, and that means that we should do everything we can to make sure they work for State and local governments. And I agree there is a long way to go here.

Mr. GARCIA OF ILLINOIS. Thank you very much, Mr. Chairman.

I yield back.

Chairman HIMES. Thank you.

The gentleman from Ohio, Mr. Davidson, is now recognized for minutes.

Mr. Davidson. I thank the chairman, and I thank our witnesses

for participating in this hearing, and our colleagues.

But I really want to take a little bit of time to explain what happened, not a theory, but what happened, because there is really a range of things that I think have been misstated as part of today's hearing.

Perhaps, people just don't understand. I note that there aren't any actual market participants here. Municipal bonds—to the treasurer, thank you for coming—are a huge part of the market

and a big part of what we are talking about today.

But during the last half of March and, really, a lot of April of 2020, the Federal Reserve acted boldly and decisively in an unprecedented way. I think PhDs will be writing for decades about what went right and wrong there.

But for the action of the Federal Reserve, and 13(3) provisions, which were, frankly, stretched to the max of their statutory limit, we would have really had a massive collapse in our markets.

Markets work when there is equilibrium between buyers and sellers, and there was no buy side. I spoke to a hedge fund manager who had \$800 million in cash on his balance sheet at the time in a pretty conservatively managed fund, and in a period of 10 days, they burnt through over \$500 million in margin calls.

What are margin calls? Everyone in the room understands, but not everyone listening or watching does. So, if a company has a 50percent leverage, i.e., they have borrowed 50 percent and they put 50-percent equity in, and the value of, say, \$10 million worth of bonds goes down to \$4 million, well, now they have a \$3 million margin call. So call after call after call. The market was in freefall. It was true in municipal bonds. There was no buy side. So, why did the Municipal Liquidity Facility work? Well, it

wasn't because of the two loans they made, Mr. Torres. It was because of the hundreds of billions of dollars of loans that were facilitated because the market now knew there would be a buy side.

So, the freefall stopped. The margin call death spiral stopped. It literally bankrupted hedge funds, and no one is really sympathetic to hedge funds, but what happens when they fail? Well, the pension dollars that are in those funds go away.

So your teachers, firefighters, policemen, and whatnot are out money. The hardworking men and women of America who are counting on us to make this work are hurt.

And without decisive action, without these facilities, our market would not have worked.

Now, there are some people who don't actually want us to have a market economy, and when they say they want to fundamentally remake America, that is code for they don't actually want a market anymore. They want a centrally-planned, centrally-controlled financial system and, frankly, one of the features of our current monetary policy where we are no longer constrained by the amount of tax revenue we collect or even constrained by the amount of money we can borrow is that it threatens our financial system. It could actually collapse it.

Now, it is hard to believe that people will actually think that is a good thing, and very few will admit it publicly. But this is something that people who support modern monetary theory believe.

They believe-maybe some do-that it can continue to work because we have a currency, and this is where things have shifted. We went from good decisive action by the Fed in March and April to monetizing debt. The Fed's balance sheet has grown to \$8 trillion. They have continued to inject \$120 billion a month in a predictable way.

They have two roles. They are supposed to protect stable prices as the dollar as a store of value, and they are supposed to promote

full employment. They are not doing well on either metric.

And their last role is as a regulator. As a regulator, they have been schizophrenic. They have been encouraging all this liquidity in the marketplace. Lots of the cash has flowed to banks but then they are discouraging banks from making loans.

So because of that, they have acted as a lender of last resort, and Mr. Hill and others, and Treasurer Wooden, I think you highlighted some of the challenges that could be managed if there was

a predictable way 13(3) worked.

But, of course, it has to be known as an emergency, not a structural way to operate. So, I wish there was a market participant in the room.

I wish we could go into depth on all of the reasons why modern monetary theory is a fallacy and why Congress, this body, actually has to be responsible in setting parameters and providing oversight.

But I wanted to use my time differently than expected, just to correct the record. I yield back.

Chairman HIMES. Thank you.

The gentleman from Massachusetts, Mr. Auchincloss, who is also the Vice Chair of the Full Committee, is now recognized for 5 min-

Mr. AUCHINCLOSS. Thank you, Mr. Chairman.

Mr. Russo, in your written testimony you indicate your concern with monetary policy becoming credit policy and the threat to political insulation that comes from that. I think those are reasonable concerns

You also refer to six programs that were stood up under the Emergency Lending Facility that were designed to provide liquidity to the shadow banking system, which is not eligible for lending through the Fed's traditional lender of last resort tools.

Can you explain more what the shadow banking system was in this circumstance?

Mr. Russo. Yes. Thank you for that question, sir.

The shadow banking system is, effectively, financial institutions on Wall Street that act like banks but that don't fall under the

Fed's usual regulatory apparatus.

They don't have access to the discount window, which is the Fed's usual tool. These six programs I highlighted, these were things that we were going to try to solve with Dodd-Frank, but, in my opinion as an expert, were unsuccessful.

For example, lending to the primary dealers, making sure they have the liquidity to keep markets moving, something that we would hope had been solved by Dodd-Frank. But I think that was

incomplete.

So, I am uncomfortable with these programs. But in a crisis, given that it is an emergency, I understand that this is sort of an extension of lender of last resort to the shadow banking system.

Mr. AUCHINCLOSS. Would you recommend that we incorporate the shadow banking system into the rules that allow the Fed to be a lender of last resort or that we regulate the shadow banking system so that they are no longer banking?

Which one should we remove, the "shadow" or the "banking"

from the shadow banking system?

Mr. Russo. Sir, I think that is an excellent question.

I am a bit off my skis here. Let me refer to a colleague of mine who wrote a paper for the Mercatus Center on this topic and about COVID-19.

One of his recommendations was moving the shadow banking system under the umbrella of Fed regulation. Another thing that he mentioned specifically, for example, the swap lines that the Fed created to swap dollars with foreign currencies at other central banks.

He, instead, suggested that Congress end those, and that foreign banks that have liquidity problems in dollars, use their local branches in New York to borrow from the discount window as in-

Mr. AUCHINCLOSS. Understood. You also referenced 10 programs that were intended to assist Congress and the Treasury in allocating credit beyond the traditional lender of last resort doctrine. And I know, of course, that you are very concerned about these that these are really moving into credit policy with monetary pol-

Basic question here, why is it that Treasury itself couldn't give

loans? Why did the Fed have to backstop those loans?

Mr. Russo. If I understood the rationale correctly, when you were passing the CARES Act, you desired for the Fed to sort of act as a source of leverage. So, the Treasury committed X amount and the Fed tried to leverage that up by printing money, essentially.

And that was one of the views that was given. I think another and again, here, I am really speculating on your own intentions but it might be because the Fed as a central bank has people who are very smart and able to work in these incredibly difficult situations and have connections to market participants.

I don't want to judge what was done in the past. But looking ahead, let us get the system right so we don't have to do it through

the Fed again.

Mr. AUCHINCLOSS. Dr. Sahm had said in the last back and forth that these Emergency Lending Facilities are here to stay with the Fed, that they are statutory and that we should expect to use them again.

I saw that you were shaking your head as she was saying that. Are you disagreeing that they are permanent or are you disagreeing that they should be used again or—

Mr. Russo. Sir, thank you.

I hope they are not permanent. And I am not a lawyer. I can only read the plain language of the law. And so, when the Dodd-Frank Act amended 13(3) to say that the 13(3) lending must be broadbased in unusual and exigent circumstances, "unusual and exigent" doesn't mean every day. Again, for the Fed's independence, I would strongly urge Congress not to make these a permanent part of the Fed's arsenal.

Mr. AUCHINCLOSS. Would you—and Dr. Sahm, please jump in here—recommend that Congress provide more detail about what,

"unusual and exigent" means?

Ms. Sahm. Right. And to be clear, I wasn't saying that I think these should be standing facilities. I was just pointing out that 13(3) is in the Federal Reserve Act. It is absolutely the authority of Congress to amend that.

I think, in general, more broadly than your question, Congress should really lean into its role of defining what it wants the Fed

to do. The Fed is going to follow orders. It is good at that.

But guidance from Congress will help it achieve what you all want it to achieve. So, what are exigent circumstances can be defined. That language has been in there a long time.

Mr. AUCHINCLOSS. Ms. Rhee, in my last 30 seconds here, do you want take a crack at it, given that your expertise is in systemic risk? If you had to define unusual and exigent circumstances in 20 seconds, how would you do it?

Ms. RHEE. I don't know if anyone can actually define that. That is kind of prescribing what is going to happen in a financial crisis, trying to decide what the predicators are for a financial crisis. And I think that has been unsuccessful.

I think it is, really, you need to depend on the experience of the policymakers. You also have to look beyond the U.S. example and see what kind of creates a financial crisis and what indicates that we are in a systemic risk.

I think one of the challenges—

Mr. Auchincloss. Ms. Rhee—may I ask one more question?

Are you familiar at all with the work that the Santa Fe Institute has done on predicting systemic risk and—

Ms. Rhee. I have heard about that, yes.

Mr. AUCHINCLOSS. —do you think that that could be a tool used by policymakers to understand where risk is getting so correlated that it is becoming systemic and might be unusual and exigent? Ms. RHEE. I think there may be various factors, indicators, that you can use. IMF has some indicators also.

But be it all that, it is going to be hard to prescribe exactly what it means because the financial market is changing. There are different factors and products that are going to come out.

Mr. Auchincloss. Understood.

Mr. Chairman, thank you for the leniency. I yield back.

Chairman HIMES. Thank you.

Since there are no more Members asking questions, we will conclude this hearing now. I would like to thank our witnesses for

their testimony today.

The Chair notes that some Members may have additional questions for these witnesses, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

The hearing is now adjourned.

[Whereupon, at 11:46 a.m., the hearing was adjourned.]

APPENDIX

September 23, 2021

United States House of Representatives Committee on Financial Services Subcommittee on National Security, International Development, and Monetary Policy

September 23, 2021

"Lending in a Crisis: Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises"

Written Testimony of Mike Konczal
Director, Macroeconomic Analysis, Roosevelt Institute

Good morning and thank you for inviting me to testify at this hearing. My name is Mike Konczal, and I'm the director of Macroeconomic Analysis at the Roosevelt Institute. I've led our organization's research on full employment, fiscal and monetary policy, and the Federal Reserve's toolkit throughout both the Great Recession and the recession following the COVID-19 outbreak.¹

In response to the crisis in March of 2020, the Federal Reserve—using existing authority and in conjunction with powers and funding from the Coronavirus Aid, Relief, and Economic Security (CARES) Act—launched several emergency interventions in financial markets. I will discuss four of these interventions here. The first two involved direct lending to entities at a penalty rate—like section 13(3) emergency lending programs for financial firms, but for elements of the real economy. These included the Primary Market Corporate Credit Facility (PMCCF), which offered to purchase new corporate bonds, and the Municipal Liquidity Facility (MLF), which offered to purchase bonds from states and municipalities. The third intervention, called the Secondary Market Corporate Credit Facility (SMCCF), is a program to purchase a market index of already existing corporate bonds, and the fourth is the Main Street Lending Program (MSLP), which was designed to provide loans to small- and medium-sized businesses.

I will discuss three things about these programs today. First, the first three programs were more successful than people realize; we see dramatic effects if we look not just at their level of activity, but at their overall impact on interest rates. These efforts created lower borrowing costs at a time of severe budgetary stress, which helped ease pressure during the worst of the downturn. However, this is not a substitute for fiscal policy or direct support to states, municipalities, and people.

Second, these programs are an evolution of unconventional monetary policy at the zero lower bound and are likely to stay with us, just as they will likely stay with the other countries that used similar interventions throughout last year. There isn't just one interest rate in our economy that is administered by the Federal Reserve; there are many, and tools that allow the Fed to directly target them are critical in guiding the

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¹ Special thanks to Emily DiVito for research assistance, and to Sonya Gurwitt and Tayra Lucero for editorial and graphics support.

economy back to full employment.

Because these programs work by influencing interest rates, Black and brown communities suffered from punitive rates as a result of the delay in expanding the eligibility of the MLF. To prevent this from happening again, the Fed must make understanding the multiple ways it can improve these facilities a priority going forward. Moreover, the experiences of these programs can provide guideposts for ways in which unconventional monetary policy can drive other policy objectives in the future.

1) The Facilities Were Successful in Lowering Interest Rates Faced by the Real Economy

To understand the success of these programs, we need to look not just at the headline numbers of loans made, but instead at their overall impact on interest rates across all lending. The total amount of assets purchased and loans made was quite small, especially compared to the \$454 billion that was budgeted in the CARES Act for these programs, a number that was later leveraged to \$2.3 trillion.²

Nowhere near that amount of activity occurred through these programs. The PMCCF made no direct loans to corporations. The MLF made four direct loans to two entities, for a total of \$6.4 billion dollars.³ The SMCCF purchased \$14.1 billion worth of corporate bonds from the secondary market. By the end of 2020, the MSLP made a total of just \$16.5 billion in loans.⁴ If judged solely on the amount of loans and purchases, we would view these programs as a failure considering the scope of the crisis, or at least as not accomplishing any important economic objectives.

It was always likely that the direct lending programs wouldn't do much lending. Since the programs were created under 13(3) emergency lending authority, the Federal Reserve believed that they needed to be implemented with a penalty rate. As such, once the financial crisis had passed, there was the downside of a penalty rate, with no corresponding upside for participating. In contrast, the Payroll Protection Program (PPP) had the downside (from the point of view of businesses) of significant terms attached to lending but the upside of having loans turn into direct cash grants. The PPP saw substantial uptake by businesses; in 2020, because of the upside attached to its extra terms, the PPP approved 5,149,906 loans amounting to \$522,798,414,639.⁵ Adding any additional terms to the PMCCF or MLF facilities would have made uptake even less likely.

⁴ Board of Governors of the Federal Reserve System, "Uptake of the Main Street Lending Program," April 16, 2021, https://www.federalreserve.gov/econres/notes/feds-notes/uptake-of-the-main-street-lending-program-20210416.htm. ⁵ US Small Business Administration, "Paycheck Protection Program (PPP) Report: Approvals through 01/24/2021, January 24, 2021, https://www.sba.gov/sites/default/files/2021-01/PPP Report 10, 24-508.pdf.



² Joe Courtney, "H.R.748 - 116th Congress (2019-2020); CARES Act," Pub. L. No. H.R. 748 (2020), https://www.congress.gov/bill/116th-congress/house-bill/748/text; Board of Governors of the Federal Reserve System, "Federal Reserve Takes Additional Actions to Provide up to \$2.3 Trillion in Loans to Support the Economy," June 29, 2020, https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm.

³ Board of Governors of the Federal Reserve System, "Periodic Report: Update on Outstanding Lending Facilities," January 9, 2021, https://www.federalreserve.gov/publications/files/pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnlf-mself-msplf-nonlf-noelf-01-11-21.pdf#page=6.

However, if we look at how the announcements of the creation and later expansions of these programs affected interest rates, we see dramatic results. Table 1 summarizes several studies conducted on bond prices since the crisis. Though they all use different methodological tools and data sets to study the announcements and expansions as specific case studies, all of their results point in the same direction. This body of research finds that the mere existence of these programs, as well as their expansions, brought down the interest rates that municipalities and corporations faced.

This occurred during a period with a significant amount of lending, so these programs mattered. Total municipal issuances were above \$450 billion for 2020—significantly higher than in previous years. Lower rates ensured that this borrowing took place on more favorable terms to the public. There was reporting at the time of the crisis on corporations needing to turn to harsh terms from vulture funds and other distressed-debt funds in the immediate panic, but following the announcement of these programs, corporations were able to access funding at reasonable rates to survive the year. This resulted in a private sector that had less onerous debt and that was in a better position to expand and sustain the recovery.

The Municipal Liquidity Facility (MLF)

Take the MLF and municipal debt market as the first example. From March 2 to March 23, 2020, yields on AAA-rated municipalities dramatically increased by 1.8 percentage points. The ratio between the yields of municipal bonds and US Treasuries, normally below 100 percent, skyrocketed to levels of 365 and 252 percent (for 10- and 30-year bonds, respectively) by March 23. Yet this increase collapsed, and by June much of it had dissipated entirely.⁷

The MLF seemed poorly designed to do significant lending to address a crisis. Its original narrow terms meant it was very difficult for any subnational entity to qualify. When it was announced on April 9, 2020, it only applied to US counties with a population of at least 2 million residents and US cities with a population of at least 1 million residents. As was quickly pointed out, only 10 cities and 15 counties were eligible for direct access to the MLF under these criteria, and these requirements prevented all 35 cities with the highest concentration of Black residents from receiving direct assistance.⁸

On April 27, 2020, the Fed expanded the MLF by lowering the eligibility threshold for counties to 500,000 residents and for cities to 250,000. The Fed continued to expand eligibility, notably through a reduction in the penalty rate on August 11, 2020. But even with these expansions, only two borrowers—the state of Illinois and the Metropolitan Transportation Authority of New York—took advantage of the program, borrowing only \$6.4 billion out of the \$500 billion dollars available for lending through this program.

⁸ Aaron Klein and Camille Busette, "Improving the Equity Impact of the Fed's Municipal Lending Facility" (Brookings, April 14, 2020), https://www.brookings.edu/research/a-chance-to-improve-the-equity-impact-of-the-feds-municipal-lending-facility/.



⁶ Matt Wirz, "How Fed Intervention Saved Carnival," Wall Street Journal, April 26, 2020, sec. Markets, https://www.wsj.com/articles/how-fed-intervention-saved-carnival-11587920400.

Marco Cipriani et al., "Municipal Debt Markets and the COVID-19 Pandemic," Liberty Street Economics (blog), June 29, 2020, https://libertystreeteconomics.newyorkfed.org/2020/06/municipal-debt-markets-and-the-covid-19-pandemic/.

Yet as Table 1 shows, the interest rates municipalities faced dropped dramatically throughout April, and research has found this decrease in interest rates to be tied directly to the announcement of the MLF and its expansion. Research from the Federal Reserve Bank of New York found that lower-rated municipalities narrowly eligible for the MLF terms at the end of April saw a yield decline of roughly 72 basis points relative to those narrowly not eligible. Research from the Federal Reserve Bank of Dallas found that the MLF, as a result of its creation, kept rates from rising between an estimated 5 and 8 percent as the economy deteriorated. Reserve Bank of Chicago found an impact of roughly 110 basis points on a sample study of 20 US states, including a 220 basis point drop for Illinois.

Though the MLF made no loans during this period, the potential that it could was all it took to collapse private market spreads and to make sure that all the loans that did happen occurred on terms far more favorable to the public. This didn't just benefit municipalities with the best credit rating; New York Bank researchers found an option-like effect that disproportionately benefited municipalities with lower credit risk. The Chicago Fed researchers, looking at states, found that "the MLF might be more helpful to states with lower credit ratings," and it is reasonable to see this impact across entities. ¹²

The Secondary Market Corporate Credit Facility (SMCCF)

This same story played out in the corporate sector. Interest rates on corporate bonds started to spike in response to the panic in financial markets during March 2020. Spreads on investment grade bonds increased by 3.5 percentage points, while spreads on high-yield bonds were up 6.5 percent. The ratio of investment grade to high yield bonds had also increased, implying that this wasn't just about credit risk but a liquidity-driven panic.¹³

Though the purchases were only \$13.4 billion dollars, the impact was dramatic. One set of researchers found that eligible bonds had between a 51 and 85 basis point reduction in spreads.¹⁴ Other researchers, with a slightly different comparison group, found a 45 basis point reduction, noting that "the vast majority

¹⁴ Jessica S. Li and Rayhan Momin, "The Causal Effect of the Fed's Corporate Credit Facilities on Eligible Issuer Bonds," SSRN Scholarly Paper (Rochester, NY: Social Science Research Network, September 1, 2020), https://doi.org/10.2139/ssm.3684136.



⁹ Andrew F. Haughwout, Benjamin Hyman, and Or Shachar, "The Option Value of Municipal Liquidity: Evidence from Federal Lending Cutoffs during COVID-19," SSRN Electronic Journal, June 28, 2021, https://doi.org/10.2139/ssrn.3785577.

https://doi.org/10.2139/ssrn.3785577.

¹⁰ Michael D. Bordo and John V. Duca, "How the New Fed Municipal Bond Facility Capped Muni-Treasury Yield Spreads in the Covid-19 Recession," *Federal Reserve Bank of Dallas, Working Papers* 2021, no. 2101 (January 2021), https://doi.org/10.24149/wp2101.

¹¹ Robert Bernhardt, Stefania D'Amico, and Santiago I. Sordo Palacios, "The Impact of the Pandemic and the Fed's Muni Program on Illinois Muni Yields," *Chicago Fed Letter* No. 449 (December 2020), https://doi.org/10.21033/cfl-2020-449. 12 Ibid

¹³ J. Nellie Liang, "Corporate Bond Market Dysfunction During COVID-19 and Lessons from the Fed's Response," Brookings Hutchins Center Working Paper, October 1, 2020, https://www.brookings.edu/wp-content/uploads/2020/10/WP69-Liang_1.pdf.

of the SMCCF's impact on the corporate bond market occurred before the Fed actually bought anything." ¹⁵ The SMCCF's impact mirrors that of the MLF, where even though the Federal Reserve purchased virtually nothing, the chance that it could was enough to drive down borrowing costs for the corporate sector.

2) These Facilities Are an Appropriate Evolution of Unconventional Monetary Policy in Our Era of Low Rates

These programs had a significant impact on interest rates just by being announced. One group of researchers with the Bank of International Settlement noted the irony of "the extraordinary power of modern central banks": That "when markets have trust in the central bank's ability to deliver on its promise" it "needs to do less (if anything) to deliver on its promise." They compare the SMCCF to Mario Draghi's 2012 statement that the European central bank would do "whatever it takes" to save the euro, a statement that had immediate and dramatic effects on interest rates though no additional action had taken place. ¹⁶ Here, we can see the impact of this kind of unconventional policy extended to real economy actors like municipalities and corporations.

We can also see how the MSLP disappointed in comparison to the other programs. The MSLP didn't start making loans until July 2020, and was therefore too slow to bring down rates in the immediate crisis. It was not able to take a broad exposure in the relevant lending market, and so couldn't credibly promise to bring down rates overall in the same way. It remained limited by bank underwriting in an environment where credit availability expanded. As such, the program would have likely benefited from an administrative structure with more experience and interest in executing it.

Yet it is through this lens, seeing asset purchase programs as an extension of unconventional monetary policy guiding long-term interest rates, that the impact and promise of these programs makes the most sense. Asset purchase programs viewed less as making actual loans and more as a mechanism for guiding and setting interest rates for users of funds in the economy aligns with this evidence. It also explains how these programs can work better in the future.

We will likely still need such programs in the future. Over the past several decades, interest rates have fallen across peer countries. The interest rate on 10-year US Treasury bonds was 8.55 percent in 1990. In 2000, it was 6.03 percent, and in 2019 it was 2.14 percent. Right now that rate is around 1.33 percent, which is below the rate before COVID and below any point in the six decades preceding the pandemic. Economists are engaged in significant debates over why interest rates are falling, with popular theories including increasing wealth inequality, the aging of the population, and more concentration in sectors across our economy. These trends are likely to stay with us.

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¹⁵ Simon Gilchrist et al., "The Fed Takes on Corporate Credit Risk: An Analysis of the Efficacy of the SMCCF," BIS Working Papers, September 9, 2021, https://www.bis.org/publ/work963.htm.
¹⁶ Ibid

¹⁷ On wealth inequality, see Atif R. Mian, Ludwig Straub, and Amir Sufi, "What Explains the Decline in R*? Rising Income Inequality Versus Demographic Shifts," SSRN Electronic Journal, Jackson Hole Economic Symposium, August 2021; on aging of the population, see Adrien Auclert, Hannes Malmberg, Frédéric Martenet, and Matthew Rognlie,

Low interest rates make conventional monetary policy, traditionally driven by changing short-term interest rates, more difficult, because the Federal Reserve has difficulty driving short-term interest rates into sufficiently negative values. In the two recessions preceding the Great Recession, interest rates were lowered 6 percent (in 1990) and 5.25 percent (in 2001); however, when the Federal Reserve lowered rates 5.25 percent to zero during the Great Recession, it was insufficient to bring about a rapid expansion. It was in this environment that the Federal Reserve turned to unconventional tools. The first several utilized during the Great Recession included purchasing longer-term assets like US Treasury bonds, known as quantitative easing (QE). Other unconventional interventions included making intentions on long-term goals more explicit, generally called forward guidance policy. The COVID crisis required yet another expansion of the unconventional monetary policy toolkit.

This expansion of unconventional monetary policy is also happening at other central banks. Even before COVID, other countries such as Japan and England had been experimenting with asset purchases as part of their unconventional monetary policy. The Bank of England announced a Corporate Bond Purchase Scheme (CBPS) in August 2016 to purchase corporate bonds to address the market chaos following the Brexit vote. A subsequent study found that being willing to purchase up to £10 billion of corporate bonds had the effect of reducing eligible bond spreads by 13–14 basis points, consistent with this unconventional monetary policy impact. ¹⁸

As summarized in Table 2, multiple central banks ran asset purchase facilities in 2020 in response to the COVID crisis. The Bank of England again expanded its CBPS. The European Central Bank did purchases under its Corporate Sector Purchase Programme (CSPP). The Bank of Japan expanded already-existing corporate bond purchasing facilities. The Bank of Canada launched its Corporate Bond Purchase Program (CBPP) and its Provincial Bond Purchase Program (PBPP) in May 2020. Notably, the PBPP purchased the secondary debt of Canada's provinces in an index based on outstanding debt, similar in structure to the Fed's SMCCF, which was also structured as an index of secondary debt.

The Importance of Unconventional Policy

As we examine this expansion of unconventional monetary policy, it is worth remembering two things. First, there isn't just one Federal Reserve-administered interest rate in our economy; there are multiple interest rates faced by different actors in our economy. As IMF Chief Economist Olivier Blanchard described in 2011, when it comes to monetary policy, "the fact is that there are many targets and there are

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[&]quot;Demographics, Wealth, and Global Imbalances in the Twenty-First Century," National Bureau of Economic Research, Jackson Hole Economic Symposium, August 2021; for a summary of both, see Matthew C. Klein, "Inequality, Interest Rates, Aging, and the Role of the Central Banks," Substack, The Overshoot (blog), August 31, 2021, https://theovershoot.co/p/inequality-interest-rates-aging-and; and on concentration and market power, see Emmanuel Farhi and François Gourio, "Accounting for Macro-Finance Trends: Market Power, Intangibles, and Risk Premia," Brookings Papers on Economic Activity, September 13, 2018.

¹⁸ Lena Boneva, Calebe de Roure, and Ben Morley, "The Impact of the Bank of England's Corporate Bond Purchase Scheme on Yield Spreads," *Bank of England Working Paper* No. 719 (March 23, 2018), https://doi.org/10.2139/ssm.3149766.

many instruments." ¹⁹ Lowering short-term interest rates should reduce the cost of funds to municipalities and corporations. But if it does not, or if it does not sufficiently to guide the economy to full employment, there's no reason the Federal Reserve shouldn't use other tools to drive down the rates that these entities face in financial markets.

Many economists and policymakers, both inside and outside the Fed, will feel uncomfortable that these kinds of large-scale asset purchases represent undesirable "distortions" of financial markets. Yet the goal of all monetary policy is to produce a pattern of asset prices, yields, and economic activity consistent with full employment. There is no such thing as "undistorted" values of interest rates, terms, risk premia, etc. These are always influenced by the policy choices of both the central bank and the elected government. There is not a single "interest rate," but many interest rates, many asset markets, and many kinds of institutions participating in them. The Fed will need multiple tools to be able to intervene in all of them.²⁰

Second, it's also worth remembering that so-called "unconventional" policy has been part of the monetary policy toolkit for much of the 20th-century. The Federal Reserve directly set long-term rates during World War II and intervened at multiple points of the yield curve throughout the mid-century period. As former Bank of England Monetary Policy Committee member Adam Posen noted in 2012, the history of monetary policy shows that "central banks have engaged in extended periods of administrative guidance, of doing very active directed lending in particular sectors, and especially of engaging in market operations on financial assets other than government securities."21 As monetary policy tools like the COVID facilities are developed, we should understand them as a rediscovery of tested practices just as much as a discovery of new ones.

3) There are Multiple Ways to Improve These Facilities

With the possible need for such programs in the future, it's important to improve these facilities and take additional steps to help ensure that any future actions are better prepared. Especially in a world where these programs work more through their impact on interest rates, rather than actual lending, program design is essential.

There are multiple ways to improve these facilities:

(1) There should be preparation for future municipal lending facilities designed with more broad-based eligibility that are credible enough to reduce rates yet can sufficiently reach smaller municipalities and Black and brown communities most at risk from lack of access to funding. The Federal Reserve should

https://rooseveltinstitute.org/publications/federal-reserve-expanding-monetary-policy-toolkit/.

21 Adam S. Posen, "Comments on 'Methods of Policy Accommodation at the Interest-Rate Lower Bound' by Michael Woodford," FRBKC Economic Policy Symposium on the Changing Policy Landscape, August 13, 2012.



¹⁹ Olivier Blanchard, "Monetary Policy in the Wake of the Crisis,"

https://www.imf.org/external/np/seminars/eng/2011/res/pdf/ob2presentation.pdf.

²⁰ Mike Konczal and J.W. Mason, "A New Direction for the Federal Reserve: Expanding the Monetary Policy Toolkit" (Roosevelt Institute, November 30, 2017).

research how expansive it can make eligibility requirements. It should consider the ability to build a broad-based basket, like the SMCCF, and how that could have changed the initial delivery. This is the approach Canada took with its PBPP. Given how disjointed and opaque the US municipal bond market is, this approach is likely to be difficult, but it is worth considering. A more expansive set of eligibility requirements would bypass the various "down-streaming" of benefits models, where entities borrowed on behalf of sub-entities, which turned out to not be a practical solution to the crisis.

(2) The Federal Reserve should remove its penalty rate for any future programs like these. The penalty rate makes perfect sense for times in which we want to guard against moral hazard, especially in the financial sector. But when programs are being used as part of a general toolkit of unconventional monetary policy and rate setting, the penalty rate makes less sense. There were multiple legal arguments discussed in 2020 for how the penalty rate could have been removed under existing 13(3) law for the MLF.²² Whether specific Congressional action would be needed or not, it's important that the Federal Reserve understand these programs as extensions of QE, and as such, direct its actions in terms of adjusting the rates end-users face, particularly in moments of market stress or downturns. This would take the pressure off of having to deal with specific terms of loans, and put more on the flow of credit in the system.

It is noteworthy that even though much of the rate reduction came from stopping the immediate financial panic by April 2020, studies also generally find impact from the later expansion of eligibility terms. Studies finding impact from the MLF in late April and even August 2020 show that these terms have important potential as a means of unconventional policy impacting interest rates in a recession. The delay in expansion of eligibility of the MLF meant that many communities ended up with too-high interest rates during the summer of 2020.

Beyond program design, there are general policy changes that should be considered by regulators and Congress to help deal with crises, both on the regulatory and stabilization side. Better regulations of openended mutual funds are necessary to prevent the kind of immediate seizing in corporate financial markets that we saw in March 2020. Better automatic stabilizers, both for people and for states and municipalities, would stabilize nominal income in a recession and take some of the pressure off credit policy to maintain spending. Though these measures are unlikely to fully eliminate the need for unconventional policy, they would reduce the full need for it.

There should also be efforts to take advantage of these programs to structure any large-scale investments and infrastructure needs the country faces. Dealing with climate change, for instance, will require

²² Steven Kelly, "Cruel and Unusual Circumstances: The Fed's Use and Misuse of Penalty Rates," Global Financial Markets Center at Duke University School of Law, *The FinReg Blog* (blog), June 21, 2021, <a href="https://sites.law.duke.edu/thefinregblog/2021/06/21/cruel-and-unusual-circumstances-the-feds-use-and-misuse-of-penalty-rates/s*, Skanda Amarnath, Alex Williams, and Arnab Datta, "How The Fed Jammed In A Penalty Rate Requirement For All Emergency 13(3) Lending When It Didn't...," *Medium* (blog), September 18, 2020, https://medium.com/@skanda_97974/how-the-fed-jammed-in-a-penalty-rate-requirement-for-all-emergency-13-3-lending-when-it-didnt-3c4f5ba6a417.



coordination of large-scale investments over time and directing significant credit policy toward greener energy sources. These facilities show that the Fed and lawmakers have tools to ensure that investment can be carried out on the financing side, to complement the actions of Congress.

Finally, these facilities are no substitute for fiscal policy. The goal in a recession should be to stabilize nominal incomes and spending, and while monetary policy can change the terms of lending, at the end of the day the best response in a crisis and prolonged recession is to directly support incomes. Though the CARES Act provided a significant amount of fiscal stimulus in terms of expanded unemployment insurance and direct checks to people, it did not include any sufficient level of aid to state and local governments, which had to wait until 2021 for the American Rescue Plan to receive direct relief. The MLF would not be able to substitute for that lack of funding, no matter how generous the loan terms became.

Thank you for your time, and I look forward to any questions you might have.



Table 1: Studies of the Federal Reserve's Emergency Lending Facilities

Title	Authors	Facility Studied	Impact from Facility	
The Option Value of Municipal Liquidity: Evidence from Federal Lending Cutoffs during COVID-19	Andrew Haughwout, Benjamin Hyman, Or Shachar	MLF	"Low-rated issuers that were narrowly eligible for emergency lending exhibited a yields decline (demand increase) of roughly 72 basis point"	
How the New Fed Municipal Bond Facility Capped Muni-Treasury Yield Spreads in the COVID-19 Recession	Michael D. Bordo, John V. Duca	MLF	"The MLF kept municipal bond rates from rising nearly 5 percentage points further for April 2020 [] 8 percentage points in mid-April"	
Municipal Markets and the Municipal Liquidity Facility	Nicholas Fritsch, John Bagley, Shawn Nee	MLF	"The MLF announcement is associated with a 21 to 29 basis point decrease in spreads"	
The Impact of the Pandemic and the Fed's Muni Program on Illinois Muni Yields	Robert Bernhardt, Stefania D'Amico, Santiago I. Sordo Palacios	MLF	"in a panel of 20 U.S. states while controlling for state fixed effects, the total average impact of the Fed announcements is about 110 bps"	
Flight to Liquidity or Safety? Recent Evidence from the Municipal Bond Market	Huixin Bi, W. Blake Marsh	MLF	"The announcement of the dedicated MLF facility on April 9 lowered yields by 17 basis points"	
The Causal Effect of the Fed's Corporate Credit Facilities on Eligible Issuer Bonds	Jessica S. Li, Rayhan Momin	SMCCF	"We estimate that eligible issuer bonds enjoy an additional 51 bps to 85 bps reduction in spreads, relative to ineligible issuer bonds"	

The Fed takes on corporate credit risk: an analysis of the efficacy of the SMCCF	Simon Gifehrist, Bin Wei, Vivian Z. Yue, Egon Zakrajšek	SMCCF	"Across the two announcements, our ten-day window estimates imply a total decline of 45 basis points in credit spreads and roughly a 25 basis point reduction in bid-ask spreads."
It's What You Say and What You Buy: A Holistic Evaluation of the Corporate Credit Facilities	Nina Boyarchenko, Anna Kovner, Or Shachar	SMCCF	"We document a dramatic improvement in average duration-matched spreads of 140 basis points in the three months after the initial announcement"
Anatomy of a Liquidity Crisis: Corporate Bonds in the COVID-19 Crisis	Maureen Maureen O'Hara, Xing (Alex) Zhou	SMCCF	"Most of the impact of SMCCF on bond liquidity seems to have materialized following its announcement"

Table 2: International Experience of Emergency Lending Facilities

Country	Name	Type	Maximum Amount Purchased Since Crisis	Most Recent Holding Amount
Bank of England	Corporate Bond Purchase Scheme	Corporate		£19.6 billion
Bank of Canada	Corporate Bond Purchase Program	Corporate	CAD 218 million	CAD 177 million
Bank of Canada	Provincial Bond Purchase Program	Municipal	CAD 19 billion	CAD 17.6 billion
European Central Bank	Corporate Sector Purchase Programme	Corporate	€296 billion	€296 billion

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"Lending in a Crisis: Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises"

June Rhee

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Testimony before the Subcommittee on National Security, International Development, and Monetary Policy Committee on Financial Services

U.S. House of Representatives

September 23, 2021

Chairman Himes, Ranking Member Barr, and members of the Subcommittee, thank you for inviting me to testify at this hearing. My name is June Rhee. For the past six years, I have been researching at the Yale Program on Financial Stability (YPFS) on interventions used by the government and central banks in response to financial crises around the world. The focus of my research has been on market liquidity and capital injection programs. I also instruct a course on financial regulations relating to financial stability and serve as a director for a specialized master's program at Yale School of Management focused on training junior and mid-level employees of central banks and other regulatory agencies with a financial stability mandate. The mission of YPFS is to create, disseminate and preserve knowledge about financial crises. YPFS commits to maintain neutrality and objectivity, and to make all its works, including data and research, publicly available.

In these remarks, I will focus on my research in market liquidity programs by the Federal Reserve (Fed) during the global financial crisis (GFC) and the COVID-19 pandemic based on the paper I co-authored and published in 2020¹ and a forthcoming working paper on post-GFC facilities. We define market liquidity programs as interventions for which the key motivation is to stabilize liquidity in a specific wholesale funding market that is under stress. These include various Fed facilities during the GFC, including the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF), Primary Dealer Credit Facility (PDCF), Term Asset-Backed Securities Loan Facility (TALF) and Term Securities Lending Facility (TSLF). The Fed relied on its emergency power under Section 13(3) of the Federal Reserve Act to construct these facilities.

¹ Rhee, June; Feldberg, Greg; Smith, Ariel; and Metrick, Andrew (2020) "Market Liquidity Programs: GFC and Before," *The Journal of Financial Crises*: Vol. 2: Iss. 3, 41-70. Available at: https://elischolar.library.yale.edu/journal-of-financial-crises/vol2/iss3/2.

I will start by highlighting some challenges the Fed faced during the GFC in constructing these lending facilities. Next, I will discuss post-GFC changes in the Fed's authorities to construct similar lending facilities and how this affected the Fed's response during the COVID-19 pandemic. Finally, I will discuss post-COVID 19 pandemic changes that may affect future efforts to introduce similar Fed lending facilities.

Fed's 13(3) Authority in GFC-era Market Liquidity Programs

The Fed is not allowed to extend loans to nonbanks in normal times, and its power to purchase market instruments is limited. Therefore, the Fed relied on its authority under Section 13(3) of the Federal Reserve Act to lend to nonbanks in "unusual and exigent circumstances." In some cases, the Fed lent to nonbanks to enable those organizations to purchase assets on the open market. For example, in the AMLF, the Fed lent cash to primary dealers so that they could purchase asset-backed commercial paper from money market mutual funds.

The Fed also created special-purpose vehicles, or SPVs, to purchase specific instruments and lent money to them using its emergency authority. The SPVs in turn purchased assets to help restore liquidity in troubled markets. These assets served as collateral for the Fed's loans to the SPVs. The Fed used SPVs to deal in securities that it did not normally handle and with entities that it did not normally lend to. For example, in the CPFF, the CPFF LLC, an SPV, purchased A-1/P-1/F-1-rated commercial paper directly from eligible issuers, including nonfinancial companies. The CPFF LLC received loans from the Federal Reserve Bank of New York for that purpose and these loans were secured by the commercial paper that the CPFF LLC acquired.

Lending under Section 13(3) requires the Fed to be secured to its satisfaction. The Fed has taken a variety of paths to make sure it is secured to its satisfaction. In the CPFF, the Fed secured itself to its satisfaction by requiring borrowers to pay fees, which, in aggregate, functioned as loss reserves. In the MMIFF, which the Fed established to support money market funds facing extraordinary redemptions, the Fed secured itself to its satisfaction by requiring money market funds or other investors that elected to sell assets to the SPV to then purchase subordinated debt issued by the SPV equivalent to 10% of the value of the assets they sold. This facility was never utilized, however.

It is relevant to note that, of all the Fed's lending facilities established under Section 13(3) during the GFC, only the TALF received credit protection from the Treasury to ensure that it was ensured to its satisfaction. In contrast, Treasury protection was a distinct feature of the lending facilities

² At the time of the GFC, the European Central Bank, Bank of Japan, and Bank of England faced few constraints limiting their market liquidity programs. They lent to a broad range of private actors and made outright purchases on the open market. After the crisis, the Financial Services Act 2012 clarified the Bank of England's responsibility for crisis management but required the Bank to seek cooperation from Her Majesty's Treasury if a liquidity program could put public funds at risk.

the Fed created in response to the COVID-19 pandemic, as I will discuss in more detail. None of the Fed facilities set up during the GFC or the pandemic crisis suffered losses.

In part because the Fed's indirect asset purchase programs were more complex than the direct asset-purchase programs implemented by other central banks, some of these programs (for example, the MMIFF, TALF, PPIP) took more than one month to get off the ground. The ability to roll out a program quickly can provide benefits in some cases, serving as a bridge as other programs are put together. For example, the AMLF and the Treasury's money market fund guarantee were both announced on September 19, 2008. The AMLF, in which the Federal Reserve Bank of Boston made loans to depository institutions to purchase certain asset-backed commercial paper from money market mutual funds, was rolled out the very next business day because it used existing arrangements through the discount window. But the Treasury guarantee did not go into effect until September 29. During the week of September 22, as some money market mutual funds continued to experience significant redemptions, AMLF usage jumped to more than \$150 billion. Fed economists concluded that the Fed's program had "provided substantial liquidity to MMFs at a critical moment." Similarly, banks that borrowed from the CPFF when it was launched on October 27—as much as \$15 billion by Bank of America Corporation alone—soon replaced those borrowings with longer-term debt, once the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program, which guaranteed newly issued debt at far longer maturities, was under way.4

Fed economists involved in constructing some of the Fed's market liquidity programs—including lending programs like TSLF and PDCF and the later indirect asset purchase programs—have said that, in hindsight, earlier rollout might would have made them more effective. "In retrospect ... we think that earlier introduction of broader programs and in some cases, in larger initial size could have been more effective. The programs were not approved and implemented until it was abundantly clear that runs were seriously impairing the ability of the financial institutions affected to meet the credit needs of the economy." 5

Ultimately, however, whether an intervention was indirect or direct does not seem to have had much influence on its effectiveness.

Post-GFC Reforms of Fed's 13(3) Authority

³ Logan, Lorie, William Nelson, and Patrick Parkinson. 2018. "Novel Lender of Last Resort Programs." Conference on Responding to the Global Financial Crisis: What We Did and Why We Did It, Brookings Institution, Washington, DC, September 11–12.

⁴ Anderson, Richard G., and Charles S. Gascon. 2009. "The Commercial Paper Market, the Fed, and the 2007-2009 Financial Crisis." Federal Reserve Bank of St. Louis Review 91, no. 6 (November/December): 589–612.

⁵ Logan, Lorie, William Nelson, and Patrick Parkinson. 2018. "Novel Lender of Last Resort Programs." Conference on Responding to the Global Financial Crisis: What We Did and Why We Did It, Brookings Institution, Washington, DC, September 11–12.

Following the GFC, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 added some restrictions to Section 13(3). Under the revised law, the Fed retains the ability to conduct market-wide liquidity programs, but it now must obtain the Treasury secretary's approval before establishing such a program. Also, it is required to report to Congress detailed transaction-level information on any loan extended under a Section 13(3) program within seven days. Some observers had raised the concern that this reporting requirement will disincentivize financial institutions from participating in future 13(3) programs because of the perceived stigma. Now that we have had a round of 13(3) facilities under this new regime, it may be worth surveying whether Congress released this information to anyone and the perception around these reports among participants of these facilities.

Brief Overview on Evaluating GFC-era Market Liquidity Programs

Post-GFC evaluations of market liquidity programs, typically conducted by central bank staff, have measured success in various ways: 1) Was the program used sufficiently? 2) Was the program introduced expeditiously? 3) Was price discovery restored? 4) Did market volumes recover relatively quickly? 5) Was credit restored to the real economy? To be sure, all of these criteria are not appropriate for evaluating all market liquidity programs. For example, recovery of market volumes is not necessarily a fair measure of the success of a program like the AMLF, which successfully helped money market funds dispose of their CP but could not address the market's aversion to CP during the crisis. It helped the funds, but not the issuers of CP. Policymakers then introduced the CPFF to temporarily create a market for commercial paper until market conditions recovered. Moreover, post-crisis studies emphasize the difficulty of isolating the independent effects of these facilities. They are often part of larger policy packages and, as their launches typically coincide with the worst of a crisis, the aftermath may coincide with a broader recovery. For example, a study suggests that it is hard to determine the role of PDCF in alleviating liquidity constraints for primary dealers as the Fed had TSLF running at the same time. ⁶

COVID-19 Pandemic and Market Liquidity Programs

Disruptions caused by the COVID-19 pandemic again drove the Fed to open market liquidity programs, some like GFC-era ones and some new ones, using Section 13(3) authority. Armed with know-how from the GFC, the Fed was able to quickly reintroduce four GFC-era market liquidity programs: the CPFF, PDCF, MMLF, and TALF. It also introduced new programs authorized by Congress with the passage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act: the Corporate Credit Facility (CCF), Main Street Lending Program (MSLP), Municipal Liquidity Facility (MLF), and Paycheck Protection Program Liquidity Facility (PPPLF). For the reopened

⁶ Yang, Karen (2020) "The Primary Dealer Credit Facility (PDCF) (U.S. GFC)," *The Journal of Financial Crises*: Vol. 2: Iss. 3, 152-173. Available at: https://elischolar.library.yale.edu/journal-of-financial-crises/vol2/iss3/6

facilities, much of the design was the same as their GFC-era counterparts. ⁷ However, unlike GFC-era facilities, most COVID-19-era facilities received Treasury's credit protection.

Among the COVID-19-era facilities, all except the PDCF and PPPLF received Treasury's support using the Exchange Stabilization Fund (ESF). CPFF and MMLF were each backed by \$10 billion in equity support that the Treasury agreed to provide prior to the passage of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. The rest, TALF, CCF, MSLP and MLF, were backed by \$195 billion committed by the Treasury under the CARES Act. On November 19, 2020, however, Treasury Secretary Steven Mnuchin sent a letter to Fed Chair Jerome Powell stating that he would not extend the four remaining lending facilities that used funds from the CARES Act after December 31, 2020. He asked the Fed to return the Treasury's unused funds for those facilities. On the same day, the Fed released a public response to Mnuchin stating it would "prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy." The next day, though, Chair Powell confirmed the Fed would return the unused portions of the funds allocated to the CARES Act facilities as Mnuchin had requested.

Post-COVID Reforms and Future

The <u>Consolidated Appropriations Act, 2021</u> signed into law on December 27, 2020, definitively closed the CARES Act Fed facilities and rescinded funds "not needed to meet the commitments, as of January 9, 2021, of the programs and facilities established." The Act preserved the Fed's authority under Section 13(3).

However, the Act removed the Treasury's authority to use ESF funds to support a Fed facility that is "the same as" the MLF, CCF, or MSLP. The Act made an exception for TALF. How broadly the Treasury will interpret the "same as" language in the future remains an open question. Therefore, if the Fed wanted to create a lending facility that falls within the scope of the Act in the future, it may have to find other ways to secure the loans to its satisfaction. The Treasury may not be able to assist the Fed in meeting that standard with ESF funds. As discussed above, the Fed has experience in constructing facilities where it deems itself sufficiently secured without receiving any credit protection from the Treasury and instead using other risk-management techniques. But there may be some need for the Treasury to support a future lending facilities. The MMLF accepted a much broader range of eligible collateral than the AMLF, its GFC-era counterpart—it included unsecured commercial paper and municipal securities, while the AMLF only accepted highly rated asset-backed commercial paper. Of course, all Fed lending facilities under Section 13(3) will continue to require the Treasury secretary's approval.

Under the Act, the Treasury can still provide equity protection to Section 13(3) lending facilities using non-CARES Act ESF funds, as it did for the CPFF and MMLF, as long as the facilities are

⁷ Fed Programs GFC & COVID-19, Yale Program on Financial Stability

not "the same as" the MLF, CCF, or MSLP. Approximately \$75 billion, as of December 2020, remained in the ESF that the Treasury can use for this purpose, providing some flexibility for the Treasury and the Fed to set up such structures as they deem necessary. This concludes my remarks. Thank you and I welcome all questions.



TESTIMONY

SAFEGUARDING THE FEDERAL RESERVE'S INDEPENDENCE

Christopher M. Russo

Postgraduate Research Fellow, Mercatus Center at George Mason University

Subcommittee on National Security, International Development, and Monetary Policy of the House Committee on Financial Services

Lending in a Crisis: Reviewing the Federal Reserve's Emergency Lending Powers during the Pandemic and Examining Proposals to Address Future Economic Crises

September 23, 2021

Chair Himes, Ranking Member Barr, and members of the subcommittee:

Thank you for inviting me to discuss the emergency lending powers of the Federal Reserve (Fed). My name is Christopher Russo. I am a postgraduate research fellow at the Mercatus Center at George Mason University, where my research focuses on central banking. Before joining the Mercatus Center, I held roles at the Federal Reserve Bank of Chicago and Federal Reserve Bank of New York, advising senior officials on a range of monetary policy decisions.

Today, I urge you to safeguard the Fed's political independence, which is the backbone of good monetary policy. My arguments can be boiled down to three points.

- The Fed's role as the lender of last resort (LOLR) is essential to achieving its dual mandate of
 maximum employmentand price stability. As the LOLR, the Fed provides liquidity to the entire
 financial system in times of crisis.
- Ten of the Fed's recent emergency lending programs crossed "red lines" from monetary policy into credit policy by directly or indirectly providing new credit to corporations, states, and municipalities.
- Credit policy is not the Fed's proper role. The Fed's independence is damaged when it is opened to intense lobbying by Congress and special interest groups alike, which occurs when the Fed is required to aid specific nonbank borrowers on Wall Street, K Street, or even Main Street.

In my comments, I do not wish to pass judgment on the actions that Chair Powell, the Federal Open Market Committee, or the Federal Reserve System took as they responded to the COVID-19 crisis.

For more information or to meet with the scholar, contact
Mercatus Outreach, 703-993-4930, mercatusoutreach@mercatusgmu.edu
Mercatus Center at George Mason University, 3434 Washingt on Blvd., 4th Floor, Arlington, Virginia 22201

The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.

Rather, I hope to assist Congress as it considers and designs a future for the Fed that preserves and protects its role as the LOLR.1

MAIN STREET REQUIRES AN EFFECTIVE LENDER OF LAST RESORT

As the LOLR, the Fed's job is to support the private creation of money by banks. Without a LOLR, banks pulling back on lending can shrink the overall supply of money. The shrinking money supply can cause sound banks to fail in a dash for cash. Those failures further reduce the money supply, triggering a chain reaction that could result in a recession or, worse — as history has shown — a depression.

The LOLR prevents such a chain of events. To avert a crisis, the Fed, as the LOLR, lends to banks without limit, in a timely manner, based on good collateral, at a penalty rate. These loans are not meant to finance new investment.

SOME FED EMERGENCY LENDING HAS CROSSED RED LINES INTO CREDIT POLICY

When the global economy was forced into a sharp contraction in March 2020 as the pandemic swept the world, the Fed unleashed a firehose of emergency lending. By one count, it set up about 16 programs (table 1). Six of these programs were designed to provide liquidity to the "shadow banking system," which is not eligible for lending through the Fed's traditional LOLR tools. These six programs extend the LOLR doctrine to meet recent institutional developments.

The other 10 programs were intended to assist Congress and the Treasury in allocating credit. These credit programs are beyond the traditional LOLR doctrine. For example, the Fed's municipal loan facility made direct loans—and only to the State of Illinois and New York City Metropolitan Transit Authority. As Chair Powell has described it, the Fed's response to the crisis "crossed a lot of red lines." 2 When I sought more information about the Fed's risk management practices, my requests were denied.3

TABLE 1. THE FED'S LIQUIDITY AND CREDIT PROGRAMS

Date	Program	Size	Eligible Borrowers or Beneficiaries	Collateral or Assets
3/12	Repurchase Operations*	\$1.5 tn	24 broker-dealers of US government securities	Treasuries, agency debt
3/15; 3/19	Swap Lines*	Various	European Central Bank and the central banks of Canada, Japan, Switzerland, and the United Kingdom; central banks of Australia, Brazil, Denmark, Mexico, New Zealand, Norway, Singapore, South Korea, and Sweden	Foreign currency
3/17	Commercial Paper Funding Facility*	No Limit	US issuers of commercial paperrated at least A-1, P-1, or F-1 by a major nationally recognized statistical ratings organization	Commercial paper

i. For recent work on the Fed's credit policy response, see Robert L. Hetzel, "COVID-19" and the Fed's Credit Policy" (Mercatus Working Paper, Mercatus Center at George Mason University, Arlington, VA. July 2020).

2. Jeanna Smialek, "Powell Says Federal Reserve Crossed Red Lines to Help Economy," New York Times, September 15, 2020.

3. Christopher M. Russo, "Is the Federal Reserve Taking Too Much Risk?," National Review, February 4, 2021.

TABLE 1 (CONTINUED)

Date	Program	Size	Eligible Borrowers or Beneficiaries	Collateral or Assets
3/17	Primary Dealer Credit Facility*	No Limit	24 broker-dealers of US government securities	Treasuries, agency debt, corporate bonds, equities
3/18	MMF Liquidity Facility*	No Limit	US depositories, US bank holding companies, US branches and agencies of foreign bankson-lending to prime money market mutual funds	Treasuries, agency debt, commercial paper
3/23	Term Asset-Backed Securities Loan Facility*†	\$100 bn	US companies with eligible collateral and account relationships with designated dealers	Asset-backed securities
3/23	Primary Market Corporate Credit Facility†	\$500 bn	US companies in the United States with material US operations and investment-grade ratings before March 22	Corporate bonds and commercial loans
3/23	Secondary Market Corporate Credit Facility†	\$250 bn	US companies in the United States with material US operations, including those with junk ratings	Corporate bonds and corporate bond exchange- traded funds
3/31	Foreign and International Monetary Authorities Repo Facility	No Limit	Foreign central banks and monetary authorities with accounts at the Federal Reserve Bank of New York	Treasuries
4/9	PPP Liquidity facility†	\$349 bn	Depository institutions that originate Paycheck Protection Program loans guaranteed by the Small Business Administration	Commercial loans
4/9	Municipal Liquidity Facility†	\$500 bn	States, cities with apopulation greater than 250,000, counties with a population greater than 500,000, and certain designees	Short-term municipal bonds
4/9; 4/30; 6/15	Main Street New Loan Facility;† Main Street Expanded Loan Facility;† Main Street Priority Loan Facility;† Nonprofit New Loan Facility;† Nonprofit Expanded Loan Facility†	\$600 bn	US depositories and holding companies on-lending to US businesses and nonprofit organizations with up to 15K employees or \$5 billion in annual revenues and a majority of its employees in the United States	Commercial loans

^{*}Denotes programs based on facilities that the Fed operated previously.
†Denotes credit facilities. The Term Asset-Backed's ecutilies Loan Facility, though a credit facility, has a liquidity component.
Source: Lev Menand, "The Federal Reserve and the Crisis of 2020" (CSAS Working Paper No. 21-20, Centerforthe Study of the Administrative State, Arlington, VA, March 15, 2021), 14.

CONGRESS SHOULD KEEP THE FED INDEPENDENT AND EFFECTIVE BY LIMITING ITS ROLE IN CREDIT POLICY

Congress last reformed the Fed's emergency lending powers with the 2010 Dodd-Frank act. Congress specified that emergency lending is for "unusual and exigent circumstances." It must be "broad-based" and only "for the purpose of providing liquidity to the financial system." 4 These restrictions insulate the Fed's decisions from direct political pressure.

However, seeing the Fed's success in the pandemic, some elected officials have argued for the Fed to take a permanent role in credit policy. Congress should resist this siren call of turning the Fed from a central bank into a piggy bank. Whether the Fed finances green energy or the construction of a border wall, the transformation of its role would subject the Fed to intense political pressure from policymakers and lobbyists. By damaging the Fed's independence, such pressure would harm its capacity to be the LOLR during the next crisis.

CONCLUSION

Congress has charged the Fed with the goals of maintaining stable prices and maximum employment. The Fed's independence is critical to achieving those goals. But that independence will be threatened by injecting the Fed into national credit policy.

Thank you again for inviting me to speak. I look forward to answering your questions.

 $^{4.\,}Federal\,Reserve\,A\,ct\,\S\,\,13(3),\,Pub.\,L.\,No.\,63-43,\,38\,Stat.\,251\,\,(1913)\,\,(amended\,2010).$

United States House of Representatives
Committee on Financial Services
Subcommittee on National Security, International Development, and Monetary Policy

September 23, 2021

"Creating a Municipal Liquidity Facility at the Federal Reserve that Works for Communities during Economic Crises"

Written Testimony of Claudia Sahm¹ Senior Fellow, Jain Family Institute Founder, Stay-At-Home Macro Consulting

I greatly appreciate this opportunity to testify on the Federal Reserve's Municipal Liquidity Facility. I will focus today on ways to strengthen this emergency lending program for State and local governments in the next crisis.

My proposals to improve the Municipal Liquidity Facility are the following:

- · Tailor eligibility and loan terms to State and local governments in financial distress.
- Use local economic conditions during the crisis to make those determinations.
- Improve the administrative systems before the next economic crisis.

Swift and effective relief from the Congress and Federal Reserve is crucial during crises. I began my career at the Fed in 2007 and saw firsthand the immense toll on families, businesses, and communities from the Global Financial Crisis and the Great Recession. The Fed stepped in immediately to save Wall Street with trillions of dollars in lending, but Main Street suffered. Stock prices bounced back quickly—as they have now—but millions of families did not.

During the Covid-19 crisis policymakers moved forcefully to support Main Street. Congress enacted about \$5 trillion in fiscal relief, including three rounds of stimulus checks, money for small businesses, and extra benefits for the unemployed. Even so, the recovery is incomplete. The S&P 500 is up over 30% since February 2020, but we are still missing more than 5 million workers. Encouragingly, we are living a sea change in fiscal and monetary policy.² And so it is imperative that we study the results from all the relief programs and improve them.

The Municipal Liquidity Facility at the Federal Reserve deserves careful review and improvement in order to better prepare for crises in the future. My critique of the program and my proposals to improve it draw on recent research on the program and data on the budgetary stress among State and local governments during the Covid-19 crisis.³

¹ I am grateful for the helpful comments from <u>Louise Sheiner</u>, Senior Fellow and Policy Director at the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, provided me in preparation for my testimony. The views here are my own.
² Claudia Sahm (2021). "COVID-19 Is <u>Transforming Economic Policy in the United States</u>" for an *Intereconomics* forum discusses the ongoing shift in monetary and fiscal policy during the Covid-19.

³ Examples are Alan Auerbach, William Gale, Byron Lutz, and Louise Sheiner in "Fiscal Effects of Covid-19" assessed State and local budgets as of fall 2020; and Sophia Campbell and David Wessel in August 2021 in "How well did the Fed's intervention in

Background on the Municipal Liquidity Facility

The broad goal of the lending program was, according to the Federal Reserve:

"to help state and local governments better manage the cash flow pressures they are facing as a result of the increase in state and local government expenditures related to the COVID-19 pandemic and the delay and decrease of certain tax and other revenues." ⁴

Its key features were:

- Authority to make up to \$500 billion in loans with \$35 billion allocated for losses.
- States, along with cities and counties above certain population sizes were eligible.
- Loan's maturity could not exceed three years and interest rates were above market.

The program began on April 9, 2021, and it ended on December 31, 2021. During that time, the municipal bond market stabilized, and the Fed made two loans for a total of \$6.56 billion.

Program Details

Congress gave the Fed the authority to make up to \$500 billion in loans directly to State and local governments, with \$35 billion set aside to cover any losses. The facility along with the \$300 billion for Main Street Lending program for medium-sized businesses was the Fed's first emergency program not aimed at Wall Street, large corporations, or foreign governments. Its innovative nature led to delays in its launch, disagreements between the Fed and Treasury about its exact structure, as well as subsequent debates about its effectiveness.

The Fed and the U.S. Treasury Department created the <u>guidelines</u> for the Municipal Liquidity Facility and Main Street Lending Program. The facilities launched in April, putting them among last of the <u>emergency facilities</u>. Most opened in March as soon as the financial market disruptions began. The delay occurred despite the fact that the interest rates on municipal bonds moved up sharply as soon as the crisis began.

The eligibility for the Municipal Liquidity Facility was largely determined by population size. States and the District of Columbia, as well as cities with populations larger than 250,000, counties with populations larger than 500,000, and some other select institutions were eligible for loans. The Fed would only purchase short-term loans such as tax anticipation notes (TANs) that are typically repaid within a year after tax season. No loan with a maturity of more than three years was eligible. In contrast, in the Primary Market Corporate Credit Facility for corporations, included bonds with a duration up to four years.

the municipal bond market work?" provide an excellent summary research on the Municipal Liquidity Facility, as well as the Commercial Paper Funding Facility and for the Money Market Mutual Fund Liquidity Facility which also supported the municipal bond market.

 ^{4 &}quot;The Municipal Liquidity Facility" webpage from the Federal Reserve provides the program details. See also the details in the Fed's fact sheet on the program. Information on all the emergency lending and liquidity programs are here.
 5 In August 2020, the Fed substantially lowered the population thresholds from the initial 1 million for cities and 2 million for

In August 2020, the red substantiany towered the population unrestories from the initial it limited its and 2 limited for counties. See Claudia Sahm, "The Money Machine That Can Save Cities" New York Times Opinion for a discussion of how the initial thresholds limited its ability to help the cities hit hardest by the pandemic. The updated terms in August also allowed for other non-government institutions to participate in the program, such as transit authorities.

In addition, the interest rates that the Fed offered were higher than the market rates—referred to "penalty rates"—with the intention that municipalities would turn to private lenders first and would have an incentive to pay back its Fed loans as soon as financial and economic conditions improved. The penalty rates depended on the long-term credit rating of the loan, ranging from 100 basis points (AAA, Aaa) to 330 (BBB-, Baa3) to 540 (below investment grade).

The Fed interpreted the Municipal Liquidity Facility's goal—as with its other emergency lending facilities—as the stabilization of municipal bond markets. In fact, soon after the announcement of the program, the interest rates offered on municipal loans, both short- and longer-term ones, which were not eligible for this program, began to decline. The interest rates on loans with high credit ratings were back to pre-pandemic levels by May, though that did not occur until September for low-rated loans.

However, the Fed made only two loans with this facility, which raised several concerns about the program's effectiveness. The State of Illinois and the New York Metropolitan Transit Authority borrowed \$3.2 billion and \$3.36 billion, respectively. That was about 1% of the authorized amount of loans. While the tax revenue shortfalls were less than expected when the program was enacted in spring 2020, as discussed below, more than two State and local governments and related institutions experienced budgetary distress due to the Covid-19 crisis.

Secretary Steve Mnuchin decided to end the Municipal Liquidity Facility on December 31, 2020. The Federal Reserve stated publicly that, in its opinion, the facility should be extended, but it complied with the Treasury's decision. Then the fiscal relief package than Congress enacted in December 2020 stated that the program would expire at year's end and could only be restarted by an act of Congress not the Treasury.

Altogether, the Municipal Liquidity Facility was an innovative program and served at least some of its purposes well. That said, the program should be improved before its future use. The remainder of my testimony proposes three changes to the program.

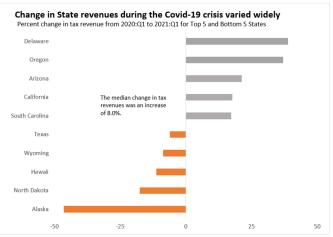
Proposal 1: Target Eligibility

So far, during the Covid-19 crisis, State governments received about \$400 billion in federal relief.⁷ Nearly three quarters of aid was enacted in the American Rescue Plan in March 2021. States and large cities also had access to the Fed's Municipal Lending Facility since May 2020. In both cases, the relief was poorly targeted.

The transfers from the federal government and eligibility for the Municipal Liquidity Facility were largely allocated by State population, despite the fact, that the budgetary strains varied considerably across the country. Lucy Dadayan, a Senior Research Associate at the Urban-Brookings Tax Policy Center estimates that the change in State tax revenues from first quarter

⁶ Initially, the penalty rates were 50 basis points higher for each rating and were <u>lowered</u> in August 2020.

2020 to first quarter 2021 ranged from a decline of 46% in Alaska to an increase of 39% in Delaware. 8



Source: Urban-Brookings Tax Policy Center. Taxes include sales, personal and corporate income, and fuel taxes.

Yet, Alaska, North Dakota, and Hawaii—the three hardest hit States—are fourth, fifth, and twelfth smallest, respectively by population. As a result, proportional aid did not serve the disproportionate stress in these areas. In contrast, tax revenues in California—the largest State in the country and recipient of the most aid—rose 18% during the crisis. To be clear, State tax revenues only offer a partial picture of economic stresses from Covid-19. As one example, most State and local governments had to spend more on public health due to the pandemic. Even so, in terms of tax revenue, the federal aid was not targeted to the greatest need. Moreover, some local governments within a State experienced larger shortfalls than the State overall.

The Fed's emergency lending facilities was only somewhat better in its targeting. All States, as well as some large cities, were eligible for loans from the Fed. But in practice, the above-market interest rates made the program of interest only to State governments in budgetary distress. In that way it was more targeted than the other federal to State and local governments, and the two loans from the Fed, in fact, went to institutions in financial distress. However, no loans from the Municipal Lending Facility went to areas with double-digit declines in State tax revenues, which is a sign that the program could be better targeted in the future.

⁸ Dadayan, Lucy. (2021). "Strong Tax Revenue Growth in the First Quarter of 2021, but Tax Volatility and Fiscal Uncertainties Continue." State Tax and Economic Review, 2021 Quarter 1." Urban-Brookings Tax Policy Center Research Report.

Proposal 2: Use Economic Conditions for Tailoring

Economic conditions, specifically in local labor markets, offer a good basis for decisions about eligibility, lending terms, and program duration for the Municipal Liquidity Facility. Effective targeting would offer more relief to the hardest hit communities while encouraging those experiencing less economic distress to use private markets. By narrowing the eligibility, the Fed could also lower the penalty rates and better support the smooth operating of public services and employment in those areas. Congress could allocate subsidies to borrowers to cover the penalty rates. Tying the duration of the program to economic conditions ahead of the crisis would free up policymakers' time to address problems unique to the crisis, and it would provide more certainty to State and local governments, as well as investors in municipal bond markets.

The employment estimates from the Bureau of Labor Statistics could be used to gauge economic conditions. The Bureau publishes high-quality, official statistics on the employment situation in States, metropolitan areas, and counties each month on conditions in the prior month. The official statistics are closely followed and cannot be influenced by any institutions or individuals. Moreover, decisions at the State and local level would have a limited influence on the overall payroll employment since the private sector accounts for the vast majority of jobs.

During the Covid-19 crisis, the decline in employment and the pace of recovery varied widely across the United States. The relative patterns in employment losses at the State level largely correspond to the budget shortfalls.

It is worth noting that large declines in employment during the current crisis occurred in States with large fossil-fuel and related sectors. An area of disagreement among policymakers on the Main Street Lending program was whether medium-sized businesses in those sectors should be eligible for loans. Tying eligibility to total employment regardless of industry would limit such debates about the Fed's emergency lending facilities relief during the crisis. That said, the programs are limited to the crisis and do not program long-term support to any particular industry. Each crisis has unique features, so it is impossible to predict which industries and by extension which local labor markets will be most affected.

Proposal 3: Improve and Prepare Administrative Systems

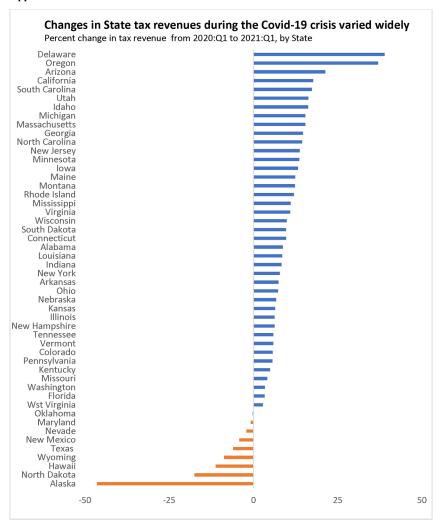
The Municipal Liquidity Facility was the Fed's first attempt at lending directly to municipalities during a financial crisis. The delay in the start of the program and changes to the eligibility criteria and loan terms mid-way underscore the need to improve the administrative systems ahead of time. Moreover, State and local officials would benefit from more streamlined application processes and guidance about the program prior to the crisis. Officials in the hardest hit areas during the Covid-19 crisis had the least time and resources to learn about new programs. Uncertainty about the program and changing program rules discouraged borrowing from the program. While the mere announcement of the program quickly helped to stabilize municipal bond markets, the most straightforward way to address budget shortfalls is to get money directly to those in distress. Finally, by establishing the systems ahead of time, Congress

could also ensure that other support programs for State and local government work well in tandem. In fact, some of the same targeting recommended for the Municipal Liquidity Facility could be used to target other aid to State and local government. A well-administered, well-targeted relief effort would be the most effective in supporting the recovery and in using federal government responsibly. It is difficult to achieve those two goals with policies crafted during the crisis

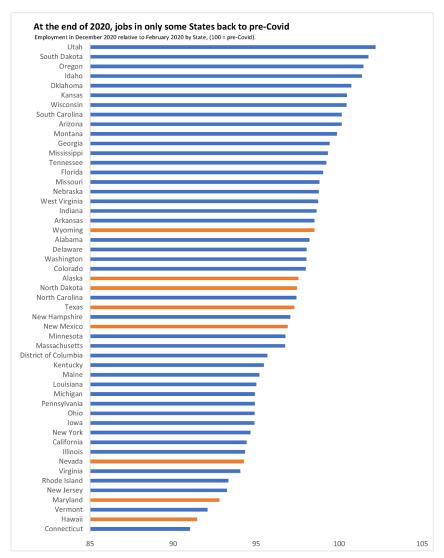
Conclusion

Improvements to the Municipal Liquidity Facility should consider that State and local governments operate under budget rules unlike any other private or public entity. Specifically, the vast majority are required by law not to run a deficit, that is, revenues must not be less than expenditures during a fiscal year. That limits expenditures and it creates more pressure on State and local government officials during times of economic uncertainty, as was the case during Covid, to accurately project their budgets. Given these additional constraints, the lending conditions should be more generous than in other programs, and the administrative processes as streamlined as possible. Such tailoring would allow an emergency lending facility at the Federal Reserve to better achieve its goal of supporting State and local governments in crisis.

Appendix Charts



Source: Urban-Brookings Tax Policy Center. Taxes include sales, personal and corporate income, and fuel taxes.



Note: Source: Bureau of Labor Statistics: Local Area Unemployment Statistics. Statistics are currently available through August 2021. The comparison here to December 2020 was chosen since that is when the Municipal Liquidity Facility expired. States shaded in orange are the ones with an estimated budget shortfall, according to the Urban-Brookings Tax Policy Center.



Connecticut State Treasurer Shawn T. Wooden

Testimony before the Subcommittee on National Security, International Development, and Monetary Policy

"Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises"

Chairman Himes, Ranking Member Barr, and distinguished members of the committee, I am Shawn Wooden, Treasurer of the State of Connecticut.

I appreciate the opportunity to testify before the House Financial Services Subcommittee on National Security, International Development, and Monetary Policy regarding the Federal Reserve's emergency lending powers and, specifically, Connecticut's experience with the Municipal Liquidity Facility (MLF), which was established in April of 2020.

As Treasurer of the State of Connecticut, I have three responsibilities related to today's hearing: investment of the State's pension and trust funds; management of the State's borrowing; and management of the State's cash including maintenance of its liquidity. For today's hearing, I am going to focus specifically on liquidity issues and not the more general COVID-19 response issues.

As President-elect of the National Association of State Treasurers (NAST), the bipartisan association of State Treasurers from across the country, and I have worked with my Democratic and Republican colleagues on this topic since the early days of the pandemic; thus, I will also refer you to our NAST recommendations included in letters dated March 20, 2020 and June 23, 2020 that are appended to my testimony.

Our experience in Connecticut, fortunately, was that the State and its municipalities were able to meet these unprecedented circumstances, adeptly drawing on talent, preparation, and prudent action. Those circumstances included prompt and effective federal action and assistance to states and municipalities.

Before the pandemic, the State's fiscal position was in the process of stabilizing after years of chronic budget deficits prior to Fiscal Year 2019. Certain fiscal controls put in place in 2017

were starting to bear fruit and contributed to the rebuilding of the State's Budget Reserve Fund, a strategic component of our liquidity.

When I took office in 2019, I immediately took a number of steps to put Connecticut in a stronger fiscal position, one that could weather an economic downturn.

My first year in office, I worked with the Legislature and Governor to restructure the State's Teachers' pension system. In Connecticut, the State is wholly responsible for managing and funding the Teachers' Retirement System. Previous funding decisions resulted in an unaffordable increase in future state required contributions. Restructuring the Teachers' pension system avoided this spike and created a funding plan that was sustainable in the long term.

We also reduced the risk across our entire pension portfolio and identified and executed on investment opportunities across asset classes. All of these steps significantly reduced the future funding risk for our pension systems and contributed to our improved fiscal position.

In debt management, we consistently exercised conservative debt management practices including refinancing existing debt to lower interest rates, saving taxpayers \$190 million – that may not seem like a significant amount of savings at the Federal level, but for Connecticut and our residents and business, it is meaningful.

Additionally, I consistently advocated to protect our Budget Reserve Fund from being used for unintended purposes. I prioritized growing it, giving us greater liquidity and financial flexibility, which has allowed us to maintain a strong cash position and, in turn, has helped us manage through the ongoing pandemic.

Just before the pandemic, the State budget office predicted a modest \$58.6 million current year budget deficit and a \$2.77 billion Budget Reserve Fund balance for June 30, 2020, the highest in State history. (Source OPM March 20, 2020 letter)

After the pandemic began, the Governor's budget office made assessments of the possible fiscal impact of the pandemic and on April 30, 2020, revised its FY 2020 budget projections to a much larger \$934 million budget deficit and much lower \$1.9 billion Budget Reserve Fund balance. (Source OPM April 30, 2020 letter)

During this time in early Spring 2020, I participated in weekly calls with State Treasurers from across the country to discuss, in real time, the challenges different states were facing. At that point, all states were revising their budget projections and liquidity positions. Several states moved ahead and put in place lines-of-credit and other short-term borrowing facilities to address what was, at the time, an unknown impact from the quickly spreading COVID-19.

Several major and very timely actions by the federal government provided significant assistance to state and local government budgets and mitigated liquidity concerns. One was Congress's swift action in passing the Coronavirus Aid, Relief, and Economic Security Act, commonly referred to as the CARES Act. Another was the Federal Reserve's establishment of the Municipal Liquidity Facility (MLF) on April 9, 2020, just a few weeks into the pandemic.

Once the MLF program was established, I quickly convened a working group consisting of Treasury experts, bond attorneys, and the Governor's budget office. We considered the potential impact on the liquidity needs of Connecticut and our local governments resulting from policies enacted to mitigate the economic impact of the pandemic, as well as the potential use of the MLF and its effect on the municipal market.

Shortly after the declaration of the pandemic in mid-March 2020, the municipal market experienced tremendous volatility that prompted both base municipal bond index yields to rise by more than 225 basis points in just nine trading days, a rise not seen since the Great Depression. It also spurred dramatically wider credit spreads to the benchmark indices as mutual fund investors pulled over \$41 billion of assets out of the municipal market in less than three weeks.

Market function deteriorated to the point that buyers and sellers had difficulty determining price. Tax-exempt rates decoupled from Treasuries as investors were concerned about state and local governments' ability to withstand COVID-related liquidity and revenue shocks. The primary market was essentially shuttered for two weeks in mid-March, but municipal bond yields and credit spreads would remain elevated even as markets slowly reopened. Based on the strong positive correlation between the municipal spread and the weekly unemployment rate, it appeared that spreads would have continued rising in step with the unemployment rate absent intervention from the Federal Reserve.

The Federal Reserve's initial actions helped shore up market liquidity. The creation of the MLF provided critical support for issuers' solvency by standing ready to purchase short-term notes from state and local governments in an extremely uncertain environment, thereby helping states and local governments better manage the cash flow pressures associated with the pandemic. The MLF's \$500 billion of lending capacity exceeded estimated revenue shortfalls, which limited the perception of default risk in state and local governments and boosted investor confidence market wide. Municipal-Treasury spreads abruptly stopped rising in the week when the MLF was first announced, well before the facility actually opened in late May and despite a rising unemployment rate.

After the creation of the MLF, municipal markets began to stabilize for issuers in the higher rated "A" to "AAA" rating categories. Analysis by the Dallas Federal Reserve suggests that, particularly for more distressed municipal credits, the MLF had the impact of containing credit spreads in the months after the initial COVID liquidity crisis and helped stave off systemic risk to and collapse of the entire municipal market:

"That these effects occurred far in advance of the opening of the MLF and given the very modest borrowing by municipal entities at the MLF together imply that the announcement of this new facility had a pronounced and rapid backstop effect. These results along with others imply that there was systemic risk in the muni bond market in the Covid-19 pandemic, that was not the case for the isolated, but prominent, muni defaults in the prior half century."

There were some inquiries in Connecticut at the local level about this program for short-term borrowing as well as other programs. In another case, a bank that provides lending to local governments contacted the State with their concerns about local cash flow borrowing needs that may be coming and inquired how the State could assist its local governments.

Initially, no municipalities in the State would have been able to borrow directly from the MLF because of the 250,000 minimum population requirement for municipalities. Connecticut's largest municipality, Bridgeport, has about 144,000 people. Moreover, we do not have a county form of government. The Federal Reserve eventually allowed states to designate two municipalities or counties as additional direct borrowers on June 3rd. Because the MLF's potential use by Connecticut municipalities was so limited, we also developed proposed legislation to provide a mechanism for local governments to access the MLF or other liquidity funding indirectly through the State. Ultimately, we did not pursue any legislative changes as the impact on our municipalities were less than expected.

Following federal and State tax deferments, the Governor issued an executive order requiring cities and towns to either cap their low interest rate programs for tax delinquencies at 3% or offer residents a property tax deferral for 90-days. These relief measures obviously would have had a negative impact on the liquidity of cities and towns across the State. Despite our initial concerns, we did receive favorable reporting in August 2020 that property taxes in Connecticut were mostly being paid on time. One of the factors that contributed to this outcome is that homes with mortgages usually have a prefunding of property taxes through escrows and property taxes are paid directly by those mortgage providers.

The way the MLF was designed and implemented, it served as a "lender of last resort." The rates were above market and not significantly tied to market movements. Borrowers were required to certify that they were unable to secure adequate credit accommodations from other banking institutions. Despite the limited utilization of the program, the MLF provided a necessary backstop to a very large market without replacing the normal municipal market mechanisms for raising capital to alleviate liquidity concerns.

As we hopefully move out of this pandemic in the coming months, potential improvements to the structure of the MLF to be shelf-ready for the next financial crisis would include the following concrete changes based on our experience in Connecticut, many of which were officially communicated by NAST to the Treasury and the Federal Reserve.:

- Reduce Borrowing Rates and Index to Market Reduce the MLF's borrowing rates to
 more competitive market rates that move with the market. Due to current restriction on
 tax-exempt cash flow borrowing, most issuers would expect any borrowing from MLF to
 be taxable. The MLF would be more attractive to borrowers if the rates were set more at
 competitive taxable market levels and were indexed to track changes in the market.
- 2) Remove Required Certification Remove the requirement for certification that borrowers are unable to secure adequate credit accommodations from other banking institutions. The above market pricing model makes that certification redundant – an issuer would not need to access the MLF and its higher rates if other credit

- accommodations were available. Therefore, I recommend removing this requirement, especially if above market pricing is used again in the future.
- 3) More Flexibility for Form of State Guarantee Make the requirement that the state guarantee borrowings of local municipalities borrowing through the state more flexible. The Federal Reserve should not be wedded to state-level guarantees but be open to other forms of state level support. In Connecticut, we provide state-level credit support through contract assistance and special capital reserve funds. Another option is for the Federal Reserve to assume some of the credit risk.
- 4) Allow for Pooled Borrowings. The MLF should be available for pooled borrowings, not one-off guaranteed borrowings for particular municipalities. The costs of setting up such a borrowing would prohibit many smaller municipalities from being able to utilize the MLF. Liquidity challenges manifest differently from state-to-state and local government to local government be it unanticipated increases in expenditures, a shortfall in revenues, or a combination of the two. While federal aid should not be the vehicle for financial support to state and municipal governments, the Federal Reserve can be useful in bridging cash flow timing issues during times of crisis.
- 5) Longer Credit Terms and Creation of a Purchasing Special Purpose Vehicle (SPV) to Buy a Broad Range of Securities in the Secondary Municipal Market. The Federal Reserve could provide significant relief for issuers by extending the MLF credit facility to issue longer-term obligations and also create an SPV aimed at supporting issuer access to longer-term borrowing in the primary market and providing relief to the secondary market. Access to affordable lines of credit to state and local governments could also be further enhanced by creating an SPV to lend to banks at the Federal Funds Rate, provided they exclusively use such proceeds to make loans to or purchase securities from small municipal issuers.
- 6) Permanent Program- It would be valuable and forward thinking for the Federal Reserve to put in place a permanent emergency MLF program and set parameters that consider the variety of states' needs and circumstances. In Connecticut, we found that legislative changes to our statutes would have been required in order to enable our municipalities to borrow from the MLF through the State, as only two municipalities could have borrowed directly once eligibility was expanded. Having a permanent program in place would avoid this, and states could make any necessary changes in process, procedure, and statute, thereby setting the stage for ready access to the program if and when the next emergency occurs.
- 7) Possible Bank Managed Program Another idea to consider is allowing all local governments to borrow directly from the MLF with State supervision and approval, rather than requiring most to borrow through their state. While I appreciate the potential administrative burden of such a program, the Federal Reserve is better positioned to take on this lending function than states.

In order to mitigate this administrative burden, the banking community, which is structured for this function, could be tapped to administer the MLF cash flow borrowing on behalf of the Federal Reserve. This would be a similar model as the Payroll Protection Program (PPP) where banks administered the lending program for the federal government.

Overall, the MLF was a critical, historic, and necessary creation to support larger issuers with access to credit for cash flow needs, particularly as they faced the potential of delayed and lower income tax revenues. It was very important that there was a market back stop and the MLF provided comfort to investors that there was not going to be a market free fall. Through the MLF program, the Federal Reserve signaled municipal market support to investors, which ultimately resulted in credit spread improvements and market access. If state and local governments could not borrow, they would have been forced into more dramatic spending cuts and layoffs than occurred.

In Connecticut, the State's original projections of very large budget deficits for FY 2020 and FY 2021 at the start of the pandemic did not ultimately materialize, due to the help of the many federal programs including additional unemployment assistance and the payroll protection program, which assisted both businesses and their employees. These efforts, along with smart fiscal policies and budget management, contributed to Connecticut's fiscal year 2020 ending with a modest \$38.7 million surplus and is currently projected to end with a more robust \$514.6 million surplus for the 2021 fiscal year.

Despite the initial disruption, the municipal markets stabilized, and investors were reminded that municipal securities are a safe-haven in a storm that provide high credit quality. As a result, after a few months, in large part thanks to actions taken by the Federal Reserve in cutting interest rates and actions taken by Congress, the municipal market improved significantly. By June 2020, as a result of our strong and stable financial position, Connecticut was experiencing record high demand for our bond sales and record low borrowing costs.

Thank you again for the opportunity to submit this testimony today. I look forward to the continued discussion on how we can take the lessons learned during this pandemic and create a framework to support state and local governments in the event of a future major economic crisis.



March 20, 2020

VIA Electronic Mail

The Honorable Steven Mnuchin Secretary of the Treasury Main Treasury 1500 Pennsylvania Avenue, NW Washington, D.C. 20220 The Honorable Jerome Powell
Chair of the Board of Governors
The Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Secretary Mnuchin and Chairman Powell,

On behalf of the nation's State Treasurers and finance officials, we applaud your efforts to keep Americans safe from COVID-19 and to deliver needed assistance to financial markets during this time. We write to you today to request that the Federal Reserve and the Department of the Treasury jointly take emergency action to support the municipal bond market. We urge you to authorize the temporary purchase of a broad base of municipal securities to restore equilibrium to our markets.

The National Association of State Treasurers (NAST) serves as the nation's foremost authority on state finance issues and State Treasury programs, practices, and policies. NAST's nonpartisan membership comprises all State Treasurers or state finance officials with comparable responsibilities from the United States, its commonwealths, territories, and the District of Columbia, along with employees of these agencies.

The stability of the \$3.8 trillion municipal bond market is particularly important during this crisis as state and local governments and the municipal bond market provide critical support for the infrastructure, including hospitals, needed to care for and support our citizens. Issuance of municipal bonds precipitously declined from \$10-15 billion per week in early March to zero today. Before the start of this crisis, the market was on track for a record amount of municipal bond issuance, projecting over \$450 billion this year. Absent support for the municipal market, state and local government budgets will be further stressed at the most inopportune time, particularly as state revenues decline as a result of business closures and rising unemployment.

The Federal Reserve and Treasury should design a program with the flexibility to support all issuers and credits in the municipal bond market. In this period of economic uncertainty, the sudden rush for cash hampers issuers across the credit spectrum, impacting communities and critical projects and services throughout the country. We are already witnessing the immediate

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cost impact on states and localities of resetting floating rates. The closure of the primary market will have an even longer-term negative impact on states. Moreover, a significant percentage of municipal bonds are held by retail investors, either directly or via investments in mutual funds. Continued distress in this market will exacerbate the effect of this crisis on those investors as well.

Without timely and strong federal government support for the municipal bond market, our state governments and other issuers will be forced to take actions that will exacerbate the current economic contraction and offset the vital and unprecedented stimulus that Congress, the Federal Reserve, and the Administration have worked to provide.

We urge you to authorize the purchase of a broad base of municipal securities to counter the unprecedented impacts of these market conditions and thank you for your attention and continued support.

Sincerely,

Shaun Snyder Executive Director

National Association of State Treasurers

Shawn Smyder

CC: Members of the United States Congress





June 23, 2020

VIA Electronic Mail

The Honorable Steven Mnuchin Secretary of the Treasury Main Treasury 1500 Pennsylvania Avenue, NW Washington, D.C. 20220 The Honorable Jerome Powell
Chair of the Board of Governors
The Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Federal Reserve Actions to Support State and Local Finance through COVID-19

Dear Secretary Mnuchin and Chairman Powell,

On behalf of the state and local government finance officials that we collectively represent, we applaud the actions taken by the Administration, the Federal Reserve and Congress to stabilize our markets through this COVID-19 crisis. We, the undersigned members representing the National Association of State Treasurers (NAST) and the Government Finance Officers Association (GFOA), have formed a joint ad hoc committee on "Federal Reserve Interventions in the Municipal Market" to serve as an issuer-perspective resource as you seek to refine existing facilities and contemplate additional actions in the municipal marketplace.

We now write offering our collective responses to existing Federal Reserve actions to date to stabilize state and local government finances. We also wish to share our thoughts on additional actions the Federal Reserve can take to support our shared goal and Congress' intent to provide "liquidity to the financial system that supports lending to eligible businesses, States, or municipalities." Our comments reflect both our individual opinions and those of the organizations we collectively represent. Furthermore, we have kept our recommendations in line with the Federal Reserve actions we have seen in both the municipal markets as well as other sectors of the economy that have seen bold and unprecedented interventions.

States and local governments have been and will continue to serve on the frontlines of this national crisis. As you know, an historic cash event, prolonged paralysis in bond markets, and impending budget shocks stemming from the pandemic have all culminated at once, forcing many businesses and nearly every state and local government into a state of damage control. Our primary advocacy with our federal legislators based on current fiscal conditions is for additional direct, unencumbered direct funding to plug budget shortfalls and projected losses in revenues resulting from slowed commerce. Our advocacy extends to support the municipal debt market,

Page 1 of 5

¹ "Coronavirus Aid, Relief and Economic Security Act." H.R. 748. 116th U.S. Congress. § 4003(b)(4).

where state and local government access to credit and budgets will be further stressed at the most inopportune time, particularly as revenues decline as a result of business closures and rising unemployment. We remain particularly focused on programs to further support access to credit for smaller issuers across the country who represent the vast majority of issuers. Many of these jurisdictions were not included in prior congressional support through CARES, while at the same time smaller issuers, as frontline public service providers, will feel the fiscal impacts of this pandemic deeply.

Above all else, we wish to see the municipal credit markets quickly normalized. To that extent, we wish to serve as a resource for you as you seek to implement new policies and facilities (or to augment facilities already in place), but also offer ourselves as a resource in the future as you seek to ramp down these actions in a sustainable manner to protect the long term health and independence of our markets.

[Existing Action] Creation of the Municipal Liquidity Facility

On April 9, 2020, the Federal Reserve announced the "Municipal Liquidity Facility (MLF)," which will provide direct, short-term lending to eligible state and large local governments. The facility was greatly expanded, on April 27, to include a larger universe of eligible local issuers and multistate entities. The MLF is a critical, historic and necessary first step in supporting larger issuers access to credit for cash flow needs, particularly as they face delayed income tax revenues resulting from the IRS's decision to delay tax filing deadlines and the inevitable drop in revenues caused by the nationwide shutdown. We applaud the Federal Reserve's announcements regarding the MLF and appreciate its immediate positive impacts to issuers accessing credit markets over the past few weeks. We also commend the Federal Reserve's responsiveness and consideration to the issuer community's input as it has built upon and improved various iterations of the facility. However, we see great potential in the extension of the MLF to satisfy more present and intermediate term needs of issuers.

A number of questions regarding specifics of the MLF also remain unanswered. We ask that you respond to and provide further clarity on the specific questions set forth in Appendix A hereto in forthcoming guidance.

[Recommended Action] Extending Credit Term of MLF Paper and Creation of a Purchasing Facility to Buy a Broad Range of Securities from the Secondary Municipal Market

We believe the Federal Reserve can provide the most significant next step in relief for issuers by extending the MLF credit facility to issue longer-term paper and also develop an SPV aimed at supporting issuer access to longer term borrowing in the primary market and providing relief to the secondary market. The municipal bond market has recently improved, but it has done so largely based on expectations that the Federal Reserve will take additional actions to stabilize the market when needed. Issuers' access to credit remains fragile and volatile with many planned new money issues on hold waiting for improved market conditions and business decisions hinging on local market conditions. While the weekly outflows

have lowered from those seen in mid-March, even inflows of \$1 to \$1.5 B per week would take months to recover during a time when credit from our existing capital markets is most needed. Restoring stability to the municipal bond market through supporting primary market transactions and secondary market purchases when needed would provide significant support for state and local governments and their economies by facilitating continued access to credit to finance infrastructure investments.

Furthermore, uncertainty around the duration of the COVID-19 outbreak and the risk of a "second wave" of infections this fall continue to pose significant risks of a second cash-crunch and selloff in the municipal bond market. At a minimum, having such a facility developed in advance and at the ready to begin purchasing in the event of a second market selloff would provide much needed stability to our fragile markets. We believe such a facility is in line with the congressional intent of Title IV of the CARES Act (P.L. 116-136) and note congressional letters supporting the issue.^{2,3}

[Recommended Action] Easing Rules Around / Treatment of Municipal Securities in and Support for Lending to Small Municipal Issuers

While we believe the two aforementioned recommendations will aid access to credit, particularly for larger issuers, we also believe that targeted easing of capital requirements coupled with minor changes to the U.S. Tax Code would further strengthen access to bank loans and lines of credits for smaller issuers. Smaller regional and community banks have played an invaluable role in meeting small issuer needs through the purchase of bank qualified notes (26 USC 265). Often in smaller communities, the bank relationship between an issuer and the community bank is the primary source of capital. Limitations on the deductibility of carrying costs as well as stressed capital requirements and asset caps placed on banks constrain the abilities of banks to meet the credit needs of small issuers.

For these reasons we encourage Bank Regulators, including the Federal Reserve, to examine ways in which changes to asset caps and other rules could improve the capacity of regional and community banks to serve the credit needs of their local communities during these challenging times. With a general decline in economic activity leading to a decline in traditional retail lending, we believe these changes would have a double positive impact. Access to affordable lines of credits to state and local governments could be further enhanced by creating an SPV to lend to banks at the Federal Fund Rate, provided that they exclusively use such proceeds to make loans to or purchase securities from small municipal issuers.

We also encourage Congress to modernize provisions around the deductibility of carrying costs associated with municipal securities to further incentivize banks to engage in the municipal markets. Specifically, we support the inclusion of the "Municipal Bond Market Support Act of

 $^{^2}$ "Letter from Congressman Steve Stivers, Dutch Ruppersberger et. al. Calling for Support for the Secondary Municipal Bond Market." May 1, 2020. See attached.

^{3 &}quot;Letter from Senator Robert Menendez, Thom Tillis et. Al. Encouraging the Treasury and the Federal Reserve to Take Further Action to Stabilize the Municipal Bond Market." May 14, 2020. See attached.

2019" (H.R. 3967), which would greatly expand the number of small issuers eligible to issue "bank qualified debt" and provide an additional purchaser in our markets to further diversify sources of credit to state and local governments.

Conclusion

Without timely and strong federal government efforts to support the municipal bond market and compensate for delayed revenues, our state and local governments will be forced to take actions that will exacerbate economic contraction and offset the vital stimulus that Congress, the Federal Reserve, and the Administration have worked to provide. We urge you to consider using your authority provided in Title IV of the CARES Act and existing powers under Section 13 of the Federal Reserve Act to develop and refine facilities like those outlined above in order to counter the unprecedented impacts of current market uncertainty.

Please consider our organizations, staff and memberships as resources available to assist when and how you need during this process. We have asked Brian Egan (brian@statetreasurers.org | 202-630-1880) and Emily Brock (ebrock@gfoa.org | 540-589-0441) in our respective offices to address any additional questions you may have. Finally, we thank you for your attention and continued action to stabilize our economy.

Sincerely,

- Colleen Davis, NAST Rep, Treasurer, State of Delaware
- Kenton Tsoodle, GFOA Rep, Assistant City Manager, City of Oklahoma City
- Janet Aylor, NAST Rep, Director of Debt Management, Virginia Department of Treasury
- Dan Huge, GFOA Rep, Public Finance Director, Indiana Finance Authority
- Katherine Kardell, GFOA Rep, Senior Debt Administrator, Hennepin County, Minnesota
- Jessica Lamendola, GFOA Rep, Director of Administrative and Financial Services, City of Topeka, Kansas
- James MacDonald, NAST Rep, First Deputy Treasurer, Commonwealth of Massachusetts
- Sarah Sanders, NAST Rep, Assistant Treasurer for Debt Management, State of Connecticut
- Cindy Harris, GFOA Rep, Chief Financial Officer, Iowa Finance Authority
- Tim Schaefer, NAST Rep, Deputy Treasurer, State of California
- Ben Watkins, GFOA Rep, Director of Division of Bond Finance, State of Florida
- David Erdman, NAST and GFOA Rep, Capital Finance Director, State of Wisconsin

CC: Members of the Federal Reserve Board of Governors Federal Reserve Bank of New York Members of the House Committee on Ways and Means Members of the Senate Committee on Finance

Appendix A

Questions and requests for clarifications and amendments to the Municipal Liquidity Facility (MLF).

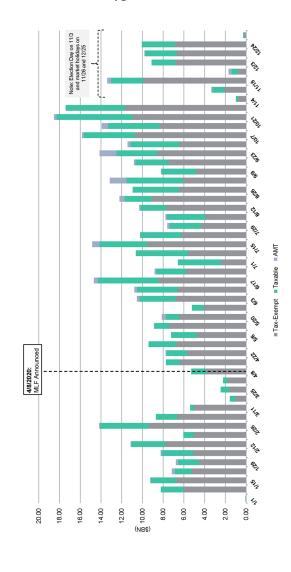
- Expansion of Universe of Eligible Issuers: We applaud the Federal Reserve's decision to update the MLF term sheet to more than triple the number of eligible issuers. We also recognize the updated facility still only provides direct lending to less than one percent of the total issuers of municipal bonds. Will the Federal Reserve further expand the universe of eligible issuers to include more smaller communities who are less prepared and have fewer resources and capability of managing the negative economic and fiscal impacts of the COVID-19 crisis and ensuing economic slowdown?
- Credit Risk Sharing of "Downstream" Lending: In keeping with our shared goal of ensuring access to credit for the largest number of issuers possible, would the Federal Reserve share at least a portion of the credit risk of eligible issuers lending to ineligible political subdivisions, municipalities, authorities or other governmental entities?
- Pricing and Taxability: Given that the Federal Reserve would have no federal tax liability for interest earned on MLF securities, we fail to understand why separate pricing matrices for taxable and tax-exempt securities are necessary or helpful. The overwhelming needs of eligible issuers are cash flow borrowings, which are largely prohibited from tax-exempt issuance. Therefore, we anticipate issuers would need, or at least strongly prefer, to issue taxable securities through the MLF and not be penalized with increased borrowing costs but also get the benefit of eliminating IRS compliance expense. We recommend that the MLF consider all securities taxable and priced at a fair rate similar to the matrix developed for tax-exempt securities.
- Certification Requirements: Under the current rules, an issuer must provide a "certification that it is unable to secure adequate credit accommodations from other banking institutions" as well as provide "evidence that participants in the MLF are unable to secure adequate credit accommodations from other banking institutions." We find the current penalty pricing model to make such a certification and demonstration redundant. No issuer would select the MLF as an option if other credit accommodations were available. For this reason, we request that the Federal Reserve reconsider and remove this added burden on issuers.



Municipal Bond Issuance - Weekly Reporting

January - December 2020

Morgan Stanley



Source: Morgan Stanley
IMPACT OF MLF



1901 West Carroll Avenue Chicago, Illinois 60612 (312) 329-6299

Lending in a Crisis: Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises.

Committee on Financial Services U.S. House of Representatives

September 23, 2021

Testimony Submitted by the Action Center on Race and the Economy (ACRE)

In the spring of 2020, state and local governments anticipated severe budget deficits, amid the COVID-19 public health crisis, that required intervention from both the federal government and the Federal Reserve. Without the injection of federal dollars, a cash flow crisis would have stymied state and local governments' ability to provide public services to communities in dire need. Immediate federal relief dollars helped to curb the worst of the public budget deficits, but comprehensive protections offered by the Federal Reserve for state and local governments fell short. This gap continues to have ongoing adverse impacts on struggling communities, especially in Black, Indigenous, and people of color (BIPOC) neighborhoods.

The Municipal Liquidity Facility Failed to Meet the Needs of Public Entities

In Spring 2020, the Federal Reserve created the Municipal Liquidity Facility (MLF), a tool that allowed the Fed to lend directly to state and local governments. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) granted the Federal Reserve the authority to make up to \$500 billion in loans to municipal borrowers. The creation of the facility signified an important step in the right direction for the Federal Reserve since, prior to the pandemic, the Fed had refused to lend directly to cities and states. The facility demonstrated the scope of the Fed's authority to support public entities, not just corporations.

Although some have argued that the mere existence of the MLF helped lower yields on municipal bonds, it is painfully clear that unnecessarily rigid parameters put in place by the Federal Reserve prevented municipal borrowers from effectively accessing the same low-cost financing with generous terms that the Federal Reserve made available to corporations through the Secondary Market Corporate Credit Facility (SMCCF). As a result, the MLF was severely underutilized and public sector borrowers were instead forced to seek higher-interest loans from the bond market. Any signaling effect that the MLF had in shoring up investor confidence in the municipal bond markets was insufficient to allow cities like Chicago to obtain affordable financing that would have allowed them to ensure communities' needs were met during the pandemic.

In its initial iteration, the MLF's eligibility requirements effectively locked out Black cities throughout the country from the facility. None of the thirty-five most Black cities met the Fed's

criteria for assistance. In response to criticism, the central bank expanded the eligibility criteria, but the rules remained so strict and pricing so high that the program functionally excluded most city, county, and state governments.² Although the Federal Reserve eventually lowered prices somewhat, in the program's final iteration, interest rates were still so high that most governments and public entities could not justify participating in the facility. As a result, throughout its existence, the MLF made loans to only two borrowers, neither of them cities.³

Without access to the affordable financing from the Federal Reserve, as Congress had intended, state and local governments were instead forced to turn to the bond markets for borrowing. The terms of the MLF were designed to discourage municipal borrowers from seeking loans from the Federal Reserve and this, ultimately, undermined pandemic relief and economic recovery efforts for public entities and subverted the will of Congress.

In contrast, the Federal Reserve offered the private sector more generous terms on corporate debt than it did to state and local governments on municipal debt. For example, through the SMCCF, the Federal Reserve offered to buy corporate bonds with terms of up to five years, compared to the three-year limit for the MLF. Even though the central bank's programs to purchase corporate debt were intended to "limit the losses of jobs and incomes," 4 the Federal Reserve failed to put in adequate oversight provisions to ensure corporations would actually use the money to keep workers employed. The facility also allowed exorbitant increases to CEO pay that exacerbated extreme wealth inequality during an unprecedented public health and economic crisis. The permitted use of funds from municipal debt financed by the MLF was far more restrictive by comparison. The corporate facility carved out much room for the ultra-wealthy to increase their wealth, while the MLF's exclusionary scope all but prohibited participation for state and local governments.

Without access to the extremely low, near-zero interest rates corporations were able to access from the Federal Reserve through the SMCCF, state and local governments were forced to take out more expensive loans in order to fund critical public services. Cities like Chicago are now trying to find ways to use funds from the 2021 American Rescue Plan Act (ARPA) to pay back the expensive loans they were forced to take in 2020 to deal with the economic impact of the pandemic because they were unable to access affordable financing from the MLF.

This vicious cycle traps state and local governments in Wall Street's chokehold. Several cities and states across the country have lobbied the Department of Treasury to allow them to use ARPA relief dollars to pay down their debt-diverting money away from public services and

¹ Busette, Camille and Aaron Klein. "Improving the Equity Impact of the Fed's Municipal Lending Facility." The Brookings Institution. 14 Apr 2020. https://www.brookings.edu/re

² Aiming to Underachieve. Fed Up. Jun 2020.

 $[\]frac{https://opulardemocracy.org/sites/default/files/A iming \%2010\%20Underachieve\%20-\%20Fed\%20Up\%20White\%20Paper\%20June\%202020.pdf}{\label{eq:files}}$

³ Albright, Amanda, Michelle Kaske, and Danielle Moran. "MTA Borrows \$2.9 Billion From Fed Before Window Closes." Bloomberg. 10 Dec 2020. https://www.bloomberg.com/news/articles/2020-12-

window-closes

4 "Federal Reserve announces extensive new measures to support the economy." Board of Governors of the Federal Reserve

System. 23 Mar 2020. https://www.federalreserve.gov/newsevents/pressreleases/monetary/20200323b.htm 5 Dayen, David. "Cities Want to Use Federal Rescue Funds to Pay Off Bank Debt." *The American Prospect*. 16 Aug 2021. $\underline{https://prospect.org/economy/cities-want-to-use-federal-rescue-funds-to-pay-off-bank-debt}$

into Wall Street investors' pockets. ⁶ This sort of wealth transfer highlights the immediate need for the Federal Reserve to employ its powers and reinstate an improved version of the MLF.

The Fed Should Reinstate and Improve the Municipal Liquidity Facility

Despite its flaws, the creation of the Municipal Liquidity Facility demonstrated a key tool that our central bank has at its disposal to repair significant flaws in our municipal finance system. The MLF failed because the Federal Reserve sought to be a lender of last resort to municipal borrowers rather than an active player in the rescue of the American economy during a time of historically unprecedented economic upheaval amidst a pandemic.

With the CARES Act, Congress recognized that making our communities pandemic-proof required a dramatic reimagining of our public finance system and gave the Federal Reserve the power to do that by giving it the authorization it needed to make long-term, zero-cost loans available to all municipal borrowers with very few restrictions on the use of proceeds. However, by severely limiting the eligibility criteria for borrowers, instituting penalty pricing, and insisting on relatively short-term loans for a limited set of uses, the Federal Reserve prevented the MLF from becoming effective.

The municipal finance system is supposed to exist to serve the public by providing funding for essential public services like replacing lead water pipes, providing universal broadband internet access, and building new public schools and hospitals. However, under the current system, cities and states get saddled with high interest rates and fees that drain billions out of public budgets every year. In fact, municipal borrowers typically pay a dollar in interest and fees to bondholders and banks for every dollar that they borrow—more than \$160 billion a year in total. This high cost of debt becomes a burden on the Black, Indigenous, Latinx, and poor communities that are forced to bear the cost. Moreover, governments that serve higher concentrations of people of color are more likely to be rated lower by ratings agencies, forcing them into higher interest rates than governments that serve whiter communities. Even though municipal borrowers in the US have a default rate of less than 0.1%, they are hit with lower credit ratings than corporations with similar credit profiles and they are forced to pay unreasonably high interest rates. The rules of the municipal bond market are currently set by Wall Street to maximize profits for banks.⁷

A significantly expanded and improved version of the MLF could allow the Federal Reserve to restructure the flawed municipal system. The Federal Reserve can use its authority under Section 14 of the Federal Reserve Act to make short-term, zero-cost loans directly to all state, territorial, tribal and local government borrowers in the United States. The Federal Reserve could agree to roll these short-term loans over every six months when they expire to mimic a long-term, 30-year loan. This could save government borrowers across the country more than \$160 billion annually. §

 $^{^6 \,} Coronavirus \, State \, and \, Local \, Fiscal \, Recovery \, Funds. \, 17 \, May \, 2021. \, \underline{https://www.regulations.gov/document/TREAS-DO-2021-0008-0002/comment}$

^{0008-0002/}comment
⁷ Baradaran, Mehrsa. The Neoliberal Looting of America. *New York Times*. 2 Jul 2020. https://www.nytimes.com/2020/07/02/opinion/private-equity-inequality.html

⁸ Alston, Brittany and Saqib Bhatti. Cancel Wall Street. Action Center on Race and the Economy. Sep 2020. https://acrecampaigns.org/wp-content/uploads/2020/09/CancelWallStreet 4-Sep2020.pdf

The less money cities pay toward debt service, the more they will be able to spend on rebuilding critical public services in the communities of color that have suffered from severe and targeted disinvestment over many decades. Our public infrastructure and services remain in crisis and an all-hands-on-deck approach is needed to undo the deep history of disinvestment. By lending directly to state and local governments, the Federal Reserve could reshape how our communities are funded and provide an avenue by which public dollars could remain in our public coffers.



September 22, 2021

The Honorable Jim A. Himes Chair Subcommittee on National Security, International Development and Monetary Policy Committee on Financial Services U. S. House of Representatives Washington, DC 20515 The Honorable Andy Barr Ranking Member Subcommittee on National Security, International Development and Monetary Policy Committee on Financial Services U. S. House of Representatives Washington, DC 20515

Dear Chair Himes, Ranking Member Barr, and Members of the Subcommittee:

My name is George Selgin, and I am a Senior Fellow at the Cato Institute, and Director Emeritus of its Center for Monetary and Financial Alternatives. On my own and the Center's behalf, I thank you for this opportunity to share my thoughts concerning the Federal Reserve's emergency lending during the pandemic. Although tomorrow's hearing, on "Lending in Crisis: Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises," concerns all facets of that lending, and I believe that all of the Federal Reserve's emergency lending programs warrant your scrutiny, my statement only concerns the Fed's Main Street Lending Program.

Main Street Lending: Expectations and Reality

Launched in mid-June 2020, the Federal Reserve's Main Street Lending Program (MSLP) was originally designed to enhance the supply of credit to businesses with less than \$2.5 billion in revenue and employing no more than 10,000 workers. Participating commercial banks would originate the program's loans, and would retain a 5 percent share in them, with the balance purchased by the Federal Reserve banks. Of \$454 billion in funding granted by the CARES Act to the U.S. Treasury for the purpose of supporting the Fed's emergency lending programs, \$75 billion were assigned to the MSLP.

Although the MSLP had a maximum lending capacity of \$600 billion, or 12.5 times its Treasury-supplied capital, the program initially proved far less popular with both banks and borrowers than its designers had hoped. In an effort to increase its popularity, Fed and Treasury officials relaxed those terms. Among other changes, firms with up to \$5 billion in revenue, or as many as 15,000 employees, were made eligible; loans terms were increased from four to five years; the minimum loan size was reduced from \$500,000 to \$250,000 and ultimately to just \$100,000; and the maximum loan amount was raised to \$35 million for new loans and \$300 million for expanded loans.

Even so, Main Street loan uptake remained disappointing: when lending under the program ceased in early January 2021, it had made 1,830 loans amounting to \$17.5 billion—just 2.9 percent of its capacity. Of the nation's 4,500-odd commercial banks, only some 300 took part in the program. Most were smaller banks, one of which—the City National Bank of Miami—alone accounted for \$4 billion, or 22.8 percent, of all Main Street loans! And instead of serving to finance firms' ongoing operations, 74 percent of the program's loans were used to pay-off their debts to other lenders.

To put these numbers in perspective, by its termination in May 2021, the Small Business Administration's (SBA's) Paycheck Protection Program had lent over \$780 billion, or more than twice its original \$349 billion CARE Act allocation, while between March and July 2020 alone, total commercial bank C&I (Commercial and Industrial) lending increased by about \$700 billion, or roughly 30 percent.

Although the statistics make it difficult to portray the Main Street Lending Program as a success, this hasn't kept its administrators from trying. Thus, a March 2021 Boston Fed study, after observing that "the volume of loans made under the Main Street program was about 60 percent of the volume of comparable loans made outside the program," concludes "that the program was a notable addition to the supply of credit to targeted borrowers." But the 60 percent figure only refers to commercial bank loans *originated* between August and December 2020, ignoring firms' extraordinary use of lines of credit iestablished before then, which many were allowed to draw upon on unusually favorable terms. Taking those lines of credit into account, the Fed's contribution to "Main Street" lending was trivial.

History Neglected, and Repeated

How could a program that Fed and Treasury officials spent many weeks designing have fallen so far short of expectations? The simple answer is that those expectations were never realistic, as Fed and Treasury officials might have known had they consulted the historical record.

Although the Fed's 13(3) emergency lending authority, allowing it to lend to non-bank businesses, was granted it as part of the 1932 Emergency Relief and Construction Act, the Fed interpreted the collateral requirements for 13(3) loans so strictly that throughout the Great Depression it only made 123 business loans, totaling just \$1.5 million, using that provision. To encourage further Fed lending to non-bank businesses, in 1934 a section 13(b) was added to the Federal Reserve Act, allowing the Fed to extend credit to businesses on terms not unlike those of its recent Main Street Facilities.

¹ Daniel Greenwald, John Krainer, and Pascal Paul, "The Credit Line Channel." Federal Reserve Bank of San Francisco Working Paper Series, June 2021. Available at https://www.frbsf.org/economic-research/files/wp2020-26.pdf
² Andrew DePietro, "Impact of COVID-19 On Lines of Credit." *Forbes*, March 30, 2020. Available at https://www.forbes.com/sites/andrewdepietro/2020/03/30/covid-19-business-lines-of-credit/?sh=2df26259493b

But that program also proved disappointing: despite \$280 million in Treasury backing, by the end of 1935 the Fed had granted just \$124.5 million in 13(b) credit to 1,993 businesses—a tiny fraction of total commercial bank loans, which exceeded \$16 billion at their 1933 nadir.³ In most subsequent years, the volume of 13(b) lending amounted to a mere trickle. It was partly for this reason (and as a replacement for the Reconstruction Finance Corporation) that the Small Business Administration, which administered the CARES Act's Paycheck Protection Program, was established in 1953.

The Fed's Reluctance to Lose Money

Why has the Fed proven so much less capable than the SBA of channeling credit to businesses? The simple answer is that, while it can make loans without the expectation of having them repaid—provided borrowers meet certain conditions, their Paycheck Protection Program (PPP) loans will be forgiven—the Fed cannot. Instead, it is generally supposed to confine itself to loans and investments that leave its capital intact, assuming they don't augment it. Dodd-Frank rules, in particular, require that the Fed's 13(3) lending arrangements "ensure … that the security for emergency loans is sufficient to protect taxpayers from losses."

With regard to the MSLP, the Dodd-Frank rule was understood to mean that it could afford to lose no more than \$75 billion—its Treasury backstop. In practice, owing in part to Fed officials' inability to anticipate MSLP loan losses with any degree of accuracy, but mainly to pressure from the Treasury, which seemed to look upon its Fed backstop as a loan rather than a grant, the terms of the MSLP ended up being made strict enough to keep its expected loan losses far below \$75 billion. 4 As of their September 10th emergency lending facilities report, Fed officials had recognized \$4 billion in MSLP loan losses—a figure implying a hefty loss rate of just under 23 percent, but only a small fraction of the MSLP's Treasury backstop. 5

No one knows just how many firms too large to qualify for PPP loans, and too small to issue their own commercial paper, might have been worthy targets of a more generous Main Street Lending Program. But there is little doubt that, by deciding to channel such support through the Federal Reserve System, the government in effect chose to make it available only on terms far stricter than those available to smaller firms only through the Small Business Administration's PPP program. It was rather as if a lifeguard decided that, while mouth-to-mouth resuscitation would be administered to all drowning victims, some would only receive it through a cocktail straw.

³ George Selgin, "When the Fed Tried to Save Main Street." *Alt-M*, March 30, 2020. Available at https://www.alt-m.org/2020/03/30/when-the-fed-tried-to-save-main-street/

⁴ Nick Timiraos and Kate Davidson, "Fed, Treasury Disagreements Slowed Start of Main Street Lending Program." Wall Street Journal, July 12, 2020. Available at https://www.wsj.com/articles/fed-treasury-disagreements-slowed-start-of-main-street-lending-program-11594558800

⁵ Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13 (3) of the Federal Reserve Act, September 10, 2021. Available at https://www.federalreserve.gov/publications/files/pdcf-mmlf-cpff-pmcf-smccf-talf-mlf-ppplf-msnlf-msplf-nonlf-noelf-09-13-21.pdf

The "Lever Up" Fallacy

Had there been clear advantages to relying on the Fed, those advantages might have made up for the constraints that went hand-in-hand with its involvement. But the advantage of Fed involvement most often cited by Fed and Treasury officials—that by relying on it, the government could "lever up" its \$454 billion in CARES Act funding to as much as \$4 trillion in total emergency business support, was entirely fictitious. It was so, not just because much of the supposed levering up never happened, but also because, if it had happened, it would not have made the programs any cheaper than if they'd been fully funded by Congress. The only differences would have been that, instead of the government borrowing more, the Fed would have done so; and interest, instead of being paid by the Treasury to holders of government securities, would have been paid by the Fed to banks holding reserve balances backed by the Fed's Main Street loans. Because the Fed's interest payments reduce its Treasury remittances, and the interest rate on reserves has generally been at least as high as the rate paid on most government securities, the ultimate burden born by taxpayers would have been roughly the same as that created by \$525 billion (\$600 billion - \$75 billion) in additional CARES Act funding.

The Lesson, and the Way Forward

What lesson should the Fed's Main Street lending experience teach us? What steps can Congress take to make sure that future emergency lending arrangements avoid the MSLP's shortcomings? The main lesson seems obvious: emergency business lending is not the Fed's forte. Nor is risky lending of any sort. But emergency business lending is essentially risky lending: unlike banks, which have only the Fed to turn to when they run short of liquidity, non-bank businesses can generally rely on commercial banks for credit. If they turn to the Fed for emergency loans, it is either because those loans are offered on especially lenient terms, or because they are denied credit elsewhere. It follows that a Fed determined not to become a business lender of *first* resort must either take on very risky loans or do very little business lending. As we've seen, in practice it tends to err on the conservative side.

What steps might Congress take to avoid this outcome? The answer here is also fairly obvious: keep the Fed out of the business of emergency lending to businesses, or at least avoid relying upon it as a source of funding for such lending: far from offering Congress a "free emergency lunch," in practice having the Fed fund emergency business lending means offering struggling businesses very little emergency support.

Instead of relying on the Fed as a source of emergency credit for Main Street, Congress should plan to fully fund any future emergency Main Street lending program. The might still involve the Fed in such efforts, but as a program administrator only rather than a source of funds.

⁶ Rosalind Z. Wiggins, "CARES Act \$454 Billion Emergency Fund Could Add Up to Much More for Businesses, States and Municipalities." Yale School of Management Program on Financial Stability, April 1, 2020. Available at https://som.yale.edu/blog/cares-act-454-billion-emergency-fund-could-add-up-to-much-more-for-businesses-states-and-municipalities
⁷ George Selgin, "A Real Lifeboat for Main Street." *National Review*, September 17, 2020. Available at

⁷ George Selgin, "A Real Lifeboat for Main Street." *National Review*, September 17, 2020. Available at https://www.nationalreview.com/2020/09/a-real-lifeboat-for-main-street/

Alternatively, some other existing agency, or an agency established for the purpose, could be made responsible for administering emergency business loans. So long as the Fed isn't relied upon for funding, there would be no need for strict lending terms aimed at ruling-out any risk of losses resulting in an unauthorized use of unappropriated public funds. Instead, the terms could be chosen with no aim save that of achieving the lending program's goal of avoiding wasteful business failures and consequent unemployment. Loans might then be forgiven, or even replaced by outright grants, whenever such concessions appeared worthwhile.

To avoid having Congress once again pass the buck to the Fed, Section 13(3) of the Federal Reserve Act should in turn be clarified to rule-out Fed lending to ordinary non-bank businesses. This can be done by replacing the vague requirement that the Fed "ensure ... that the security for emergency loans is sufficient to protect taxpayers from losses" with language stipulating that all of the Fed's 13(3) loans must either be fully secured by readily marketable collateral or financed using Treasury-supplied capital only.

The Wrong Way

I understand the temptation to address the challenge of emergency business lending by pursuing a course opposite the one I've suggested, that is, by amending section 13(3) of the Federal Reserve Act so as to further loosen the limits on such lending. I urge the committee to resist that temptation, and I hope it will convince Congress to do so. For what may seem like an "obvious" way to encourage more Fed emergency business lending is instead likely to result in yet another failed Main Street lending effort. The roots of Fed's unwillingness to make risky business loans, except on terms that must discourage most would-be borrowers, or bank participants, or both, do not reside in section 13(3) of the Federal Reserve Act. Instead, they can be traced to the Fed's basic constitution, with its privilege of being self-funding, though only within strictly-defined limits; and from there to Article 1 of the U.S. Constitution, which otherwise grants Congress alone the "power of the purse," meaning the power to dispose of public monies. Only by tampering with both of these constitutions might the Fed be turned into an effective source of emergency funding for struggling businesses. So long as other options are available, I hope that you will agree that such tampering can hardly be considered prudent; and I thank you again for considering my remarks.

Respectfully,

George Selgin

Senior Fellow and Director Emeritus

Center for Monetary and Financial Alternatives

The Cato Institute

⁸ George Selgin, "The Constitutional Case for the Fed's Treasury Backstops." Alt-M, April 13, 2020. Available at https://www.alt-m.org/2020/03/30/when-the-fed-tried-to-save-main-street/

REVISING THE LEGAL FRAMEWORK FOR NON-BANK EMERGENCY LENDING



SEPTEMBER 2021

COMMITTEE ON CAPITAL MARKETS REGULATION

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COMMITTEE ON CAPITAL MARKETS REGULATION

The Committee on Capital Markets Regulation (the "Committee") is an independent 501(e)(3) research organization, financed by contributions from individuals, foundations, and corporations. The Committee's membership includes thirty-eight leaders drawn from the finance, business, law, accounting, and academic communities. The Committee Co-Chairs are R. Glenn Hubbard, Dean Emeritus of Columbia Business School, and John L. Thornton, Former Chairman of the Brookings Institution. The Committee's President is Hal S. Scott, Emeritus Nomura Professor of International Financial Systems at Harvard Law School and President of the Program on International Financial Systems. Founded in 2006, the Committee undertook its first major report at the request of the incoming U.S. Secretary of the Treasury, Henry M. Paulson. Over ten years later, the Committee's research continues to provide policymakers with an empirical and non-partisan foundation for public policy. This report was prepared by the Committee's staff.

Staff Report:

Revising the Legal Framework for Non-Bank Emergency Lending

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Executive Summary

This Report examines the Federal Reserve's (the "Fed's") role in emergency lending to non-banks in light of its response to the COVID-19 pandemic. During the pandemic, the Fed took on novel responsibilities, establishing lending facilities not only to support liquidity in the financial system but also to support the flow of credit to the real economy and to state and local governments. These facilities raise critical questions about the appropriate role of the Federal Reserve in emergency lending to non-bank financial institutions and non-financial companies as authorized by Section 13(3) of the Federal Reserve Act.

This report proposes a new framework for emergency lending to non-banks. It does not suggest reforms to the Fed's exercise of monetary policy, as the Fed's monetary policy authority does not derive from Section 13(3) of the Federal Reserve Act and does not involve credit risk as the Fed only purchases government or government guaranteed securities when exercising its monetary policy authority.

The report proceeds in four parts. Part I outlines the current framework governing emergency lending to non-banks, with a focus on the restrictions adopted in the Dodd-Frank Act following the global financial crisis. These restrictions include requiring Treasury approval of any Fed lending program or facility for non-banks; requiring that loans be collateralized in a manner that is sufficient to protect taxpayers from losses; and limiting the Fed's ability to lend to insolvent borrowers

Part II describes the Federal Reserve's assumption of a novel role as part of its response to the COVID-19 pandemic: the credit provider, not just liquidity provider, of last resort. Because of restrictions imposed on the Fed by the Dodd-Frank Act, however, the Fed could not assume this role on its own. Instead, it needed the approval of and financial backing from Treasury due to the Dodd-Frank framework.

Part III focuses on issues with the non-bank emergency lending framework that were high-lighted by the Fed's pandemic response role. First, the current framework allows the Fed to operate lending programs that are essentially fiscal programs, which should properly be the responsibility of elected authorities. This was particularly an issue during the pandemic response for Fed lending programs to non-financial companies. Second, the Fed is put in the position of picking winners and losers when determining to whom it will lend. Finally, the lack of transparency regarding the design of the joint Treasury-Fed lending programs makes it difficult to determine who is responsible for success and failure. If the Fed bears the blame for failures that are the responsibility of Treasury, it could threaten the Fed's independence and its ability to exercise its more traditional functions

Part IV proposes a revised framework for emergency lending that would address the concerns raised in Part III. Under this framework, for all emergency loans to non-banks, the Treasury must first determine whether such lending poses significant credit risk—meaning that borrowers have a substantial likelihood of being unable to repay the loans. Lending that poses significant credit risk should be viewed as implicating fiscal policy and thus outside the Fed's purview. In our view, lending to non-financial companies, such as lending programs to main street businesses, always involves significant credit risk and thus should be the sole purview of the Treasury. The Treasury should have sole responsibility for the structure and terms of emergency lending facilities that pose significant credit risk. And these programs should be identified as Treasury and not Fed

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programs. However, the Fed would still have an important role to play in advising Treasury on economic conditions and serve to operate the programs as an agent of Treasury.

If the Treasury determines that the lending facilities to non-banks would *not* pose significant credit risk, then the Fed would have sole responsibility for the structure and terms of emergency lending facilities that would be identified as Fed programs. Part IV also considers whether the revised framework should be extended, in whole or in part, to the Fed's emergency lending authority for banks and concludes that there is no compelling reason to alter the longstanding framework for emergency bank lending.

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The Threshold for Non-Bank Emergency Lending

The Fed's authority to lend to non-banks is governed by Section 13(3) of the Federal Reserve Act, which has long provided that the Fed can lend to non-banks in "unusual and exigent circumstances." This standard was not changed by the Dodd-Frank Act of 2010. Historical context would suggest that this phrase was intended to have a broad meaning. When Section 13(3) was first enacted in July 1932, Congress's primary concern was that the Fed needed direct lending authority to circumvent banks, which were not extending new credit to businesses.² Once President Hoover and the Fed turned to implementing Section 13(3), Hoover argued that the "unusual and exigent circumstances" existed because of the number of borrowers who reported being refused for loans by banks. He noted that "the unwillingness of eligible banks to take advantage of the facilities provided by the government"-referring to the Fed's discount window-gave rise to the kind of situation envisioned by Section 13(3).3

The Fed periodically authorized Section 13(3) lending to nonmember banks, which at the time were not eligible for discount window loans, between 1936 and 2008, even though no systemic collapse was anticipated. In the summer of 1966, the Fed Board authorized Reserve Banks to lend to nonmember banks because of "the possibility that during the period ahead some nonmember depositary-type institutions ... might be subjected to unusual withdrawals of funds,"4 a far cry from a systemic threat to the financial system. The Board authorized lending to nonmember banks again in December 1969, on the ground that "the sharp further advance in market yields ... unusually large net savings withdrawals at depositary institutions ... and preliminary reports of rather poor savings experience in some areas ... had all created some concern about the possibility of substantially enlarged savings attrition at such institutions." In 1980, Section 13(3) was activated again, but not actually used, to grant a loan to a Michigan nonmember bank to pay for cash letters presented to it.6 The Fed did not authorize Section 13(3) lending again until the global financial crisis of 2007 to 2009.7

During the financial crisis, the Federal Reserve undertook aggressive measures to stabilize financial markets. 8 These emergency actions prevented the spread of the worst liquidity crisis since

¹ Federal Reserve Act, § 13(3)(A). The threshold requirement of "unusual and exigent circumstances" is discussed at greater

length in Part 0.

Partinitha Sastry, The Political Origins of Section 13(3) of the Federal Reserve Act, FRBNY Economic Policy Review 19–23 (Sep. 2018), available at https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_political-oricosp. 2019), aramaore at maps://www.newyorktea.org/medialibrary/media/research/epr/2018/epr_2018_political-ori-gins asstry.pdf.

3 Id at 23-24. See also Hal S. Scott, Connectedness and Contagion: Protecting the Financial System from Panics 91-92 (MIT Press 2016)

⁴ Board of Governors of the Federal Reserve System, Fifty-Third Annual Report: Covering Operations for the Year 1966 92

⁽Federal Reserve 1967).

Solven of Governors of the Federal Reserve System, Fifty-Sixth Annual Report: Covering Operations for the Year 1969 92. (Federal Reserve 1970).

Thomas C. Baxter, Jr., The Legal Position of the Central Bank, The Case of the Federal Reserve Bank of New York 6 (Jan. 19, 2009), available at https://web.archive.org/web/20130511222423/http://lse.ac.uk/fing/documents/events/conferences/2009/regulatoryResponse/1160_Baxter.pdf.

Id.

Scott, Connectedness and Contagion at 76 (cited in note 3). A detailed description of these measures is available from U.S.

Scott, Connectedness and Contagion at 76 (cited in note 3). A detailed description of these measures is available from U.S. Gov't Accountability Office, Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance (2011), https://www.gao.gov/assets/gao-11-696.pdf.

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the Great Depression. However, in the aftermath of the crisis, Congress concluded that the Fed had overstepped its already-broad bounds, and it imposed new restrictions on the Fed's emergency lending authority to non-banks.9 These limits, adopted in the Dodd-Frank Act, 10 constrain the Fed's ability to exercise its emergency lending powers independently and restricted the scope of any potential lending program or facility.

Dodd-Frank Restrictions on Emergency Lending

The Dodd-Frank Act included significant revisions to Section 13(3) of the Federal Reserve Act, 11 which governs the Fed's authority to lend to non-banks "in unusual and exigent circumstances." The most important of these revisions were that: (i) the Fed cannot establish any such program or facility for non-banks without the Treasury Secretary's approval; (ii) any emergency lending program or facility for non-banks must have broad-based eligibility; (iii) the Fed must have policies and procedures in place to ensure that the security for emergency loans is sufficient to protect taxpayers from losses; and (iv) the Fed must establish procedures to prohibit the participation of insolvent borrowers in any emergency lending program or facility

A more detailed description of each of these new requirements follows.

1. Treasury approval

The Dodd-Frank amendments to Section 13(3) specify that the Fed may not establish any program or facility for emergency lending to non-banks without the prior approval of the Secretary of the Treasury. ¹² The Fed's implementing regulations clarify that this approval is necessary both for the establishment and the renewal of any such emergency lending program or facility. 13 As a practical matter, because the Secretary can withhold approval if he or she objects to any aspect of a Fed emergency lending proposal, and because the Fed is unlikely to abandon a proposal in a crisis merely because it disagrees with the Treasury's desired terms, this requirement effectively empowers the Treasury Secretary to dictate the design, terms or duration of any such emergency lending program or facility.

2. Broad-based eligibility

The Dodd-Frank amendments to Section 13(3) provide that the Fed may only authorize a facility with broad-based eligibility. 14 They also clarify that a "program or facility that is structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid" an insolvency proceeding is not

⁹ For a more detailed description of these limitations, see Scott, Connectedness and Contagion at 93–104 (cited in note 3). Congress also contemplated significantly curtailing the Fed's supervisory responsibilities. Senator Dodd introduced a bill in Congress and contemphated significantly culturaling the Feb suspervisory responsionines. Scientific Doublind Induced a 10th in 2009 that would have removed the Fed's supervisory authority over state-member banks and limited its supervisory responsibilities to systemically important non-bank financial firms and holding companies with assets over \$50 billion. See Walter W. Eubanks, Federal Financial Services Regulatory Consolidation: Structural Response to the 2007-2009 Financial Crisis, Congressional Research Service Report 7-5700 (April 12, 2010).

19 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. 111–203, 124 Stat. 1376 (2010).

11 Federal Reserve Act, § 13(3)(B)(iv).

^{12 12} C.F.R. § 201.4(d)(9)(ii).

¹³ The Dodd-Frank amendments to Section 13(3) also build in congressional oversight, by requiring the Fed Board to provide to committees of the House of Representatives and the Senate a report and periodic updates regarding its emergency lending activities. Federal Reserve Act, § 13(3)(C).

14 Federal Reserve Act, § 13(3)(A).

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considered to have broad-based eligibility. 15 These revisions to Section 13(3) were aimed at loans extended by the Federal Reserve during the 2008 crisis to individual non-bank financial institutions like AIG 16

Under implementing regulations finalized by the Fed in 2015, a program or facility is only considered to have broad-based eligibility if it is designed "to provide liquidity to an identifiable market or sector of the financial system." ¹⁷ In addition, a program or facility is treated as not having broad-based eligibility if: (i) it is designed for the purpose of assisting one or more specific companies avoid bankruptcy, resolution or another insolvency proceeding; (ii) it is designed for the purpose of aiding one or more failing financial companies; or (iii) fewer than five persons or entities would be eligible to participate in the program or facility. ¹⁸ It is not clear, for purposes of the last condition, *when* there must be at least five eligible participants: at the time a program or facility begins to extend credit, or over the entire course of its operation. If it is the latter, then the fewerthan-five restriction could have little practical impact.

3. Collateral and Security

The revisions to Section 13(3) also include provisions to protect the Fed against credit loss. In particular, Section 13(3)(B)(i) mandates that the Fed establish policies and procedures governing emergency lending that are "designed to ensure that ... the security for emergency loans is sufficient to protect taxpayers from losses." ¹⁹ These policies and procedures must require that "a Federal reserve bank assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank ... in determining whether the loan is secured satisfactorily." ²⁰ These amendments indicate that the Fed cannot make loans under Section 13(3) that are not backed by sufficient collateral or a third-party guarantee or other form of protection against loss.

4. Solvency

Another bulwark against credit loss is the requirement that only solvent borrowers may participate in an emergency lending program or facility. Under Section 13(3), a borrower is considered insolvent if it is currently subject to a bankruptcy, resolution or other insolvency proceeding. Section 13(3)(B)(ii) also requires the Fed to establish procedures to "prohibit borrowing from programs and facilities by borrowers that are insolvent." The statute specifies that those procedures may include a certification by the borrower that it is not insolvent. The Fed's implementing regulations incorporate the certification option, allowing borrowers to self-certify that they are solvent based on their reasonable belief. However, the implementing regulations go farther than the statute when it comes to the definition of insolvency by providing that a borrower

¹⁵ Federal Reserve Act, § 13(3)(B)(iii).

Federal Keserve Act, § 15(3,D),(III).

In Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, U.S. to Take Over AIG in 885 Billion Bailout;
Central Banks Inject Cash as Credit Dries Up, Wall Street Journal, Sep. 16, 2008, available at https://www.wsj.com/articles/SB121256561931242905. See also U.S. Gov't Accountability Office, Federal Reserve System: Opportunities Exist to
Strengthen Policies and Processes for Managing Emergency Assistance at 162–177 (cited in note 8).

^{17 12} C.F.R § 201.4(d)(4)(ii). 18 12 C.F.R § 201.4(d)(4)(iii).

¹⁹ Federal Reserve Act, § 13(3)(B)(i).

²⁰ Id

²¹ Federal Reserve Act, § 13(3)(B)(ii)

²² Federal Reserve Act, § 13(3)(B)(ii) ²³ 12 C.F.R. § 201.4(d)(5)(iv)(A).

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is considered insolvent if it is "generally not paying its undisputed debts as they become due during the 90 days preceding the date of borrowing under the program or facility."24

Emergency Lending During the COVID-19 Pandemic

The framework described in the prior section governed the Fed's emergency lending during the COVID-19 pandemic. In response to pandemic-induced economic disruption, the Fed invoked its Section 13(3) authority to establish several emergency lending facilities for non-banks. Pursuant to the Dodd-Frank amendments to Section 13(3), all of the Fed's emergency facilities required approval by the Treasury Secretary. Some of these facilities involved the Fed's traditional liquidity provision function, such as lending to primary dealers against good collateral to provide liquidity to financial markets. Others went beyond that traditional role; the Main Street Lending Program, for example, was designed to provide credit to struggling small- and mid-size enterprises. Because of Dodd-Frank's collateral requirements and the inability of many borrowers from the COVID facilities to provide collateral, the facilities were supported by financial backing by Treasury as a substitute for borrower collateral. This section describes the initial lending facilities established by the Fed at the outset of the COVID-19 pandemic; the facilities set up after the passage of the CARES Act; and the closure of the CARES Act facilities.

a. The Original Facilities

On March 17 and 18, 2020, prior to the enactment of the Coronavirus Aid, Relief and Economic Security Act (the "CARES Act"), the Fed announced its first three facilities to deal with the pandemic-the Commercial Paper Funding Facility (the "CPFF") to buy highly-rated commercial paper, the Primary Dealer Credit Facility (the "PDCF") to make loans to primary dealers, and the Money Market Mutual Fund Liquidity Facility (the "MMLF") to make loans to banks to buy money market fund assets. Each of these facilities was approved by the Treasury Secretary²⁵ and they were modeled after similar facilities used in 2008.

Unlike their 2008 counterparts, in 2020 both the CPFF and MMLF were backed by the Treasury's Exchange Stabilization Fund (the "ESF") to satisfy the Dodd-Frank collateral requirement. The CPFF was backed with a \$10 billion equity contribution and the MMLF was backed with \$10 billion of credit protection.²⁶ The legality of using the ESF in this way was not straightforward. Before it was amended by the CARES Act, the ESF's establishing statute described the purpose of the ESF as stabilizing exchange rates. 27 The statute authorizes the Treasury Secretary to deal in Treasury securities, gold, foreign exchange, "and other instruments of credit and

^{24 12} C.F.R. § 201.4(d)(5)(iii).

¹² C.F.R. § 201.4(d/S/km).
25 Federal Reserve Board announces establishment of a Commercial Paper Funding Facility (CPFF) to support the flow of credit to households and businesses (Mar. 17, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary.20200317a.htm; Federal Reserve, Federal Reserve Board announces establishment of a Primary Dealer Credit Facility (PDCF) to support the credit needs of households and businesses (Mar. 17, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary.20200317b.htm; Federal Reserve, 2020), available at https://www.leadraireserve.gov/newseventisspressreleases/monetary/2020031/6.htm; Federial Reserve,
Federial Reserve Board broadens program of support for the flow of credit to households and businesses by establishing a
Money Market Mutual Fund Liquidity Facility (MMLF) (Mar. 18, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary/2020031/8a.htm.

26 Federal Reserve, Commercial Paper Funding Facility: Program Terms and Conditions (Nov. 30, 2020),
https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-terms-andconditions; Federal Reserve, Money Market Mutual Fund Liquidity Facility FAQs (March 21, 2020, amended May 26,
2020). https://www.federapressrena/facility-facility-facility-faQs (March 21, 2020, amended May 26,

^{2020.),} https://www.federalreserve.gov/monetarypolicy/files/mmlf-faqs.pdf. $^{\rm 27}$ 31 USC 5302(a)(1).

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securities the Secretary considers necessary." While this language is open-ended, in context it appears to mean that Treasury can buy or sell other securities to maintain the value of the dollar.

Treasury backing of the CPFF was necessary because the Fed purchased unsecured commercial paper. It was also necessary for the MMLF where loans to banks could be backed by unsecured commercial paper and where the Fed had no recourse back to the banks in case the paper issuers defaulted.28

Treasury backing was thus a substitute for the lack of collateral. If Treasury took a firstloss position in these facilities, it could be persuasively argued that the security for the loans extended through the facilities was "sufficient to protect taxpayers from losses." But, of course, that would only be true to the extent that the Fed's losses were less than the Treasury backing. Backing was not needed for the PDCF, however, because in that facility, while collateral included a range of equity securities and investment-grade debt securities, such securities were generally high quality and margin-adjusted, and there was recourse back to dealers in the case of default. 25

None of these pre-CARES Act facilities had a fixed cap on the amount of lending they could extend or assets that they could purchase, which suggests that the Fed would have to modulate the amount of its lending itself in order to protect against the prospect of losses in excess of Treasury backing

b. The CARES Act Facilities

The relationship between the Treasury and the Fed evolved significantly with the enactment of the CARES Act on March 27, 2020. Section 4003 of the Act appropriated at least \$454 billion to the Treasury's ESF to make loans, investments or guarantees to the Fed to support Fed lending to eligible businesses, states or municipalities by purchasing obligations or making loans. The bill specifically ordered the Treasury to seek Fed programs for such borrowers. 31 The legislation further stated that if there was any doubt, the provisions of Section 13(3) should apply to any Fed facilities created under the CARES Act. 32 The lending envisioned by the CARES Act went well beyond the Fed's traditional lender-of-last-resort function; instead, the CARES Act appeared to anticipate that the Fed would serve as a credit provider of last resort for broad sectors of the economy by establishing programs or facilities to purchase debt or make new loans, with Treasury backing to protect the Fed from credit risk.33

The authorization for the Fed to purchase existing non-bank debt, in addition to making new loans, was also novel. By statute, the Fed is only authorized to buy U.S. Treasury securities or government guaranteed debt, like mortgage-backed securities issued by government-sponsored enterprises.³⁴ During the global financial crisis, the Fed used its Section 13(3) authority to circumvent these restrictions on direct purchases by lending to Fed-created special purpose vehicles

Rederal Reserve, Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility Terms and Conditions (February 5, 2010): https://www.frbdiscountwindow.org/Archive/Asset-Backed-Commercial-Paper-ABCP-Money-Market-Mutual-Fund-MMMF-Liquidity-Facility-Terms-and-Conditions.
29 Federal Reserve, Term Sheet for Primary Dealer Credit Facility (PDCF) (March 17, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20200317b1.pdf
30 Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. 116–136, § 4003 (2020).

³¹ CARES Act, § 4003(a). 32 CARES Act, § 4003(c)(3)(B).

¹³ CARES Act. 8 4003(b)

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(SPVs) that in turn purchased assets, like commercial paper, that the Fed could not purchase directly. 35 As described in further detail below, the Fed repurposed this SPV structure for its pandemic lending facilities. This time, however, the structure was authorized by the CARES Act, which explicitly recognized that funds appropriated to the Treasury's ESF would be used to support Fed facilities that were engaged in "purchasing obligations or other interests directly from issuers of such obligations or other interests" or "purchasing obligations or other interests in sec-

Over the next few months, the Fed established, with the required Treasury approval, four emergency lending facilities: (i) the Term Asset-Backed Securities Loan Facility (the "TALF") to purchase asset-backed securities;³⁷ (ii) the Primary Market and Secondary Market Corporate Credit Facilities (the "PMCCF" and "SMCCF") to purchase corporate bonds and ETFs in the primary and secondary markets, respectively,³⁸ (iii) the Main Street Lending Program (the "MSLP"), comprising five separate facilities to purchase bank loans to small- and medium-sized businesses (the Main Street New Loan Facility, Priority Loan Facility and Expanded Loan Facility) and nonprofits (the Nonprofit Organization New Loan Facility and Expanded Loan Facility); 39 and (4) the Municipal Liquidity Facility to purchase newly-issued state and municipal obligations (the

Each of these facilities had a similar structure: an SPV capitalized with a Treasury equity investment. For example, the two corporate credit facilities operated through the same SPV, which was capitalized with a Treasury investment of up to \$75 billion (the Treasury ultimately contributed only \$37.5 billion). 41 The Main Street facilities operated through a joint SPV capitalized with a Treasury investment of up to \$75 billion (as with the corporate credit facilities, the Treasury ultimately only contributed \$37.5 billion to this SPV). ⁴² Since the vast majority of borrowers targeted by Congress did not have sufficient collateral to back lending on the scale envisioned by the CARES Act, the backing by the Treasury with funds appropriated by Congress served as a substitute to protect the Fed from losses.

³⁵ See Federal Reserve, Commercial Paper Funding Facility: Frequently Asked Questions (October 27, 2008), https://www.newyorkfed.org/markets/cpff_faq_081027.html; Eric A. Posner, What Legal Authority Does the Fed Need During a Financial Crisis?, 101 Minn. L. Rev. 1529, 1551-52 (2017); Alexander Mehra, Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis, 13 U. Penn. J. Bus. L. 221, 235-36 (2011). 6 CARES Act, § 4003(b)(4).

TARIS ACI, § 400510/41.

37 Federal Reserve, Federal Reserve announces extensive new measures to support the economy (Mar. 23, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

38 Id.

³⁹ Federal Reserve, Main Street Lending Program, available at https://www.federalreserve.gov/monetarypolicy/main-streetlending.htm (last visited Dec. 7, 2020).

40 Federal Reserve, Federal Reserve takes additional actions to provide up to \$2.3 trillion in loans to support the economy

[&]quot;Federal Reserve, Pederal Reserve takes additional actions to provide up to \$2.3 trillion in toans to support the economy (Apr. 9,2020), available at https://www.federalreserve.gov/newsvents/pressreleases/monetary/20200409a.htm.

4 Federal Reserve, Primary Market Corporate Credit Facility (July 28, 2020), https://www.federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a9.pdf.; Federal Reserve, Secondary/20200728a1.pdf; Federal Reserve, Facility (July 28, 2020), https://www.federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a1.pdf; Federal Reserve, Facility (July 28, 2020), https://www.federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a1.pdf; Federal Reserve, Facility (July 28, 2020), https://www.federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a1.pdf; Federal Reserve Facility (July 28, 2020), https://www.federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a1.pdf; Federalreserve.gov/newsvents/pressreleases/files/monetary/20200728a1.p

⁴² Federal Reserve Bank of Boston, Main Street Lending Program For-Profit Businesses: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, Main Street for Nonprofit Organizations Part of the Main Street Lending Program: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/-/media/Documents/special-lending-facilities/mslp/fegal/frequently-asked-questions-faqs-nonprofit.pdf.; Federal Reserve, Factors Affecting Reserve Balances, Federal Reserve Statistical Release H.4.1 (Dec. 28, 2020).

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Each of the CARES Act facilities also featured a fixed cap on the amount it could lend or purchase. The two corporate credit facilities had a \$750 billion cap on combined primary and secondary market purchases. 43 The Main Street facilities had a cap of \$600 billion on aggregate loan purchases. 44 The ratio of the fixed cap to Treasury's equity investment represents the leverage of the facility: 10 times for the corporate credit facilities (\$750 billion divided by \$75 billion), and 8 times for the Main Street facilities (\$600 billion divided by \$75 billion). 45 The existence of these caps indicates an intent to limit potential losses incurred by each of the facilities-not just on the Fed's investment, but on Treasury's equity investment as well.

In addition, the CARES Act facilities had detailed requirements with respect to the qualifications and riskiness of the assets purchased or eligible borrowers. These requirements were not mandated by Congress in the CARES Act; they were determined either by the Treasury or the Fed or both. 46 The effect of these requirements, like the effect of the fixed caps on aggregate loan purchases, was to limit each facility's potential losses. Thus, for example, the corporate credit facilities specified that issuers had to have been rated at least BBB-/Baa3 as of March 22, 2020, and issuers that were subsequently downgraded had to be rated at least BB-/Ba3 as of the date of purchase. 47 Detailed requirements regarding creditworthiness were also included in the term sheets for Main Street's three for-profit business facilities. 48

The Main Street New Loan Facility (the MSNLF), which was meant to facilitate new lending by banks to for-profit small and medium-sized businesses, can serve as a representative example of how the terms of the Main Street facilities operated to reduce credit risk. The MSNLF allowed a business borrower with up to 15,000 employees or revenue of \$5 billion or less in 2019 to borrow a minimum of \$100,000 (\$250,000 prior to October 30, 2020) and a maximum of the lesser of: (i) \$35 million or (ii) an amount that, together with the borrower's existing debt, did not exceed four times the borrower's 2019 EBITDA. 49

The lender was specifically required to do a credit assessment of the borrower's financial condition. 50 In addition, if the borrower had an existing loan from the bank, it must have received

⁴⁸ Federal Reserve, Primary Market Corporate Credit Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a9.pdf.; Federal Reserve, Secondary Market Corporate Credit Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

⁴⁴ Federal Reserve Bank of Boston, Main Street Lending Program For-Profit Businesses: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, Main Street for Nonprofit Organizations Part of the Main Street Lending Program: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/-/me-

Part of the Main Street Lenang Program: Prequently Asked Questions (Nov. 25, 2020), https://www.bostonied.org/-media/Documents/Special-lenang-Facilities/mspl/egalf/requently-asked-questions-fags-nonprofit.pdf.

4 Federal Reserve, Primary Market Corporate Credit Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20200728a9.pdf.; Federal Reserve Bank of Boston, Main Street Lending Program For-Profit Businesses: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/mslp-fags;

4 See Part e for a discussion of the problems raised by the absence of clear responsibility.

4 Federal Reserve, Primary Market Corporate Credit Facility, https://www.federalreserve.gov/monetarypolicy/pmcf.htm

⁽last visited Oct. 4, 2020); Federal Reserve, Secondary Market Corporate Credit Facility, https://www.federalre-serve.gov/monetarypolicy/smccf.htm (last visited Oct. 4, 2020).

48 Federal Reserve Bank of Boston, Main Street Lending Program For-Profit Businesses: Frequently Asked Questions (Nov.

^{25, 2020),} https://www.bostonfed.org/mslp-faqs; Federal Reserve Bank of Boston, Main Street for Nonprofit Organizations
Part of the Main Street Lending Program: Frequently Asked Questions (Nov. 25, 2020), https://www.bostonfed.org/-/media/Documents/special-lending-facilities/mslp/legal/frequently-asked-questions-faqs-nonprofit.pdf.

⁴⁰ Federal Reserve, Federal Reserve Board adjusts terms of Main Street Lending Program to better target support to smaller businesses that employ millions of workers and are facing continued revenue shortfalls due to the pandemic (Oct. 30, 2020), available a fltps://www.federalreserve.gov/newsevents/pressreleases/monetary/2020/1030a.htm.
⁵⁰ Federal Reserve, Main Street New Loan Facility (October 30, 2020), https://www.federalreserve.gov/newsevents/pressre-

leases/files/monetary20201030a1.pdf

an internal risk rating equivalent to a "pass" (the highest rating) in the supervisory rating system as of the end of 2019 (or upon origination or purchase, if the loan was originated or purchased in Moreover, the borrower had to certify that it had the ability (with the loan) to meet its financial obligations and did not anticipate going into bankruptcy in the next 90 days. 52 These creditworthiness requirements precluded many needy borrowers from using the facility.

The terms of the loans issued through the MSNLF were also demanding and thus unattractive to many needier borrowers. The interest rate on loans was adjustable LIBOR plus 300 basis points, and the loans were relatively short-term with a maturity of 5 years. 53 The new loans could also include up to 200 basis points of origination and transaction fees. 54 The borrower could not use the proceeds of the new tranche of the loan to repay or reduce existing debt (but could use them to make mandatory principal and interest payments).⁵⁵

Finally, the requirement that banks continue to hold a portion of eligible loans also reduced the uptake of the MSNLF, thus reducing the risk of potential losses that would be borne by the facility. Under the MSNLF, the shared Main Street SPV bought 95 percent of new program loans, and banks continued to hold the remaining 5 percent with no protection from the Fed for this exposure. 56 A large amount of 5 percent stakes adds up to significant exposure

Critics attacked the design of the CARES Act facilities—the Main Street facilities in particular-for prioritizing loss minimization at the expense of getting funds to needy but risky borrowers. 57 Specifically, they noted that the terms of the Main Street facilities—too onerous for borrowers and insufficiently attractive to lenders—would hamper their ability to channel credit to needy small and mid-size businesses. 58 Treasury Secretary Mnuchin appeared to confirm this prioritization when he told reporters in late April that "[i]f Congress wanted me to lose all the money, that money would have been designed as subsidies and grants as opposed to credit support," and affirmed that "[w]e're looking at it in a base case scenario that we recover our money.

When the CARES Act facilities stopped purchasing assets on January 8, 2021, Treasury had only invested \$102.5 billion of the CARES Act appropriation (although it had committed more than this, \$195 billion), together with its investment of \$11.5 billion from the Exchange Stabilization Fund before passage of the CARES Act. 60 Moreover, lending or purchases under the CARES Act facilities fell far short of the scale provided by Congress: when they were shut down, the

⁵¹ Id. ⁵² Id.

⁵³ Id. 54 Id. 55 Id.

See, e.g., Glenn Hubbard & Hal Scott, Main Street Needs More Fed Help, Wall Street Journal (Apr. 16, 2020), available see, e.g., Glein Hubbard & Hal Scott, Whan Street Feeds-more-fed-help-1158755459; Editorial Board, The Main Street Fedecout, Wall Street Journal (Apr. 30, 2020), available at https://www.wsj.com/articles/the-main-street-fakeout-11588288799; Glenn Hubbard & Hal Scott, Who's Looking Out for Main Street? Wall Street Journal (May 17, 2020), available at https://www.wsj.com/articles/whos-looking-out-for-main-street-11589741411.

See, e.g., Glenn Hubbard & Hal Scott, Wain Street? Program Is Too Stingy to Banks and Borrowers, Wall Street Journal (July 20, 2020), available at https://www.wsj.com/articles/main-street-program-is-too-stingy-to-banks-and-borrowers-

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⁵⁹ Kate Davidson & Richard Rubin, Steven Mnuchin Says U.S. Aims to Get Back Its Money From Fed Programs, Wall Street Journal, Apr. 29, 2020, available at https://www.wsj.com/articles/mnuchin-says-u-s-not-aiming-to-lose-money-on-fed-

lending-facilities-11588178749.

⁶⁰ Federal Reserve, Factors Affecting Reserve Balances, Federal Reserve Statistical Release H.4.1 (Jan. 14, 2021).

facilities had only purchased \$40.5 billion worth of loans (the maximum amount outstanding over time) approximately 2 percent of the \$2 trillion cap on aggregate lending through all of the facili-

Despite their lack of uptake, several of the facilities do appear to have stabilized financial markets, allowing private sector lending to resume and preventing a full-blown financial crisis. The existence of these facilities, rather than the amount of credit that they extended, stabilized the market. 62 By contrast, the minimal uptake on the Main Street facilities—aggregate purchases of \$16.5 billion, supporting just over \$17 billion in loans, compared to a total cap of \$600 billion occurred against the backdrop of deteriorating credit conditions for small and medium-sized businesses throughout the pandemic. 63 The market-based facilities, like the corporate credit facilities, could backstop specific markets by ensuring access to credit for borrowers, thus reducing rollover risk and risk spreads in those markets without issuers actually accessing the facilities. Because small and medium-sized businesses do not borrow in capital markets, the Main Street facilities could not aid them without actually extending credit.⁶⁴ And such credit did not otherwise come from banks. The Federal Reserve reports that, leaving out \$525 billion in forgivable loans extended as part of the Small Business Administration's Paycheck Protection Program, commercial and industrial loans extended by banks declined in 2020.65

c. Closing the CARES Act Facilities

On November 19, Secretary Mnuchin sent a letter to the Chairman of the Federal Reserve ordering the Fed to close, at the end of the year, all the facilities that had received Treasury backing with funds appropriated under the CARES Act. 66 As noted above, under the Dodd-Frank amendments to Section 13(3), the approval of the Treasury Secretary is necessary for any Fed non-bank lending facilities or programs, and the CARES Act explicitly reinforced this authority. ⁶⁷ Moreover, the CARES Act facilities were due to expire at year end; under Fed regulations the Treasury Secretary's approval would have been necessary to renew the facilities.⁶⁸ As the power to approve includes the power to disapprove, Secretary Mnuchin was effectively authorized to terminate any and all of the CARES Act facilities. However, the fact that he undertook unilateral action through a letter, ordering the Fed to comply, was an extraordinary and historic economic confrontation, given repeated statements by Fed officials that the facilities should remain in place past the end of

⁶¹ Id.

⁶² Committee on Capital Markets Regulation, Treasury and Fed Lending Programs: An Assessment and Call for Continued Support for SMEs 11–19 (Dec. 30, 2020), https://www.capmktsreg.org/2020/12/30/treasury-and-fed-lending-programs-anassessment-and-call-for-continued-support-for-smes/ (discussing TALF and the corporate credit facilities); Nicholas Fritsch, John Bagley & Shawn Nee, Municipal Markets and the Municipal Liquidity Facility, Working Paper 21-07 (March 22, 2021), https://www.clevelandfed.org/en/newsroom-and-events/publications/working-papers/2021-working-papers/wp-

^{2021).} https://www.elevelandred.org/enriewstroni-mane-verins-participal-markets-and-the-municipal-liquidity-facility aspx (discussing the Municipal Liquidity Facility).

207 Committee on Capital Markets Regulation, Treasury and Fed Lending Programs at 23–27 (cited in note 62).

308 William B. English & J. Nellie Liang, Designing the Main Street Lending Program: Challenges and Options, Hutchins and Committee on Capital Markets Regulation (Programs of April 2020). Center Working Paper #64 (June 2020), https://www.brookings.edu/wp-content/uploads/2020/06/WP64_Liang-English_FI-

Federal Reserve, Supervision and Regulation Report 8-9 (April 2021), https://www.federalreserve.gov/publica-

tions/files/202104-supervision-and-regulation-report.pdf.

66 Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized under Section 13(3) of the Federal Reserve Act (Nov. 19, 2020), available at https://home.treasury.gov/system/files/136/letter11192020.pdf. Federal Reserve Act, § 13(3)(B)(iv).

^{68 12} C.F.R. § 201.4(d)(9)(ii).

the year. 69 Although the Fed immediately objected to the closure of the facilities, 70 without the Treasury Secretary's approval to extend the facilities it could not unilaterally continue their operation and was thus forced to comply.

The Treasury Secretary's letter went further than just terminating new lending or purchases under the CARES Act facilities. It also requested that the Fed return any "unused" Treasury funds.⁷¹ On the next day, November 20, 2020, the Fed acceded to the Treasury's requests, noting that the Fed would work with Treasury to return the unused portion of the CARES Act funds in connection with the facilities' year-end termination. The Fed's agreement was not a foregone conclusion, since the authority of the Treasury Secretary under the CARES Act to order the return of Treasury's equity investments was unclear. 73 The CARES Act provided that "remaining funds" appropriated to back Fed lending could not be used for new loans or investments after December 31, 2020, but that restriction was best read to refer to funds made available to but not used by the Treasury. Funds that had already been invested in Fed lending facilities were already used and therefore would most likely not have qualified as "remaining funds.

While the Treasury Secretary closed the CARES Act facilities, the CARES Act left open the possibility that a new Treasury Secretary could restart them, albeit without the funds that had already been returned by the Fed. 75 Coronavirus relief legislation passed in late December as part of the omnibus Consolidated Appropriations Act of 2021, however, forbade the CARES Act facilities from making any new loans or purchasing new assets after December 31, 2020 (except for the Main Street facilities, which were allowed to continue to purchase certain loan participations until January 8, 2021).76

The legislation also prohibited the use of funds from the Treasury's ESF to back any new Fed program or facility, except for the TALF, "that is the same as any such program or facility in which the [Treasury] Secretary made an investment pursuant to" the CARES Act. 77 Although that provision forbids Treasury from using the ESF to back a facility that is the "same" as one of the CARES Act facilities, it leaves open the possibility that Treasury could in the future use the ESF's remaining "core funds"—which stood at approximately \$95 billion as of December 31, 2020—to

⁶⁹ See, e.g., Colby Smith & James Politi, Political divisions put Fed's pandemic emergency measures in doubt, Financial Times (Nov. 19, 2020) (citing Fed Chair Powell's statement that "[w]hen the right time comes, and I don't think that time

is yet or very soon, we will put those tools away").

70 James Politi & Colby Smith, US Treasury refuses to extend some of Fed's crisis-fighting tools, Financial Times (Nov. 19, 2020), https://www.ft.com/content/e4b3a063-db44-4e6c-b998-74a29d70b136 ("The Federal Reserve would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy.").

The Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized under Section 13(3) of the Federal Reserve

Act (cited in note 66).

⁷² Letter from Chair Powell to Secretary Mnuchin regarding emergency lending facilities (Nov. 20, 2020), https://www.federalreserve.gov/foia/files/mnuchin-letter-20201120.pdf.

⁷³ Jay B. Sykes, Section 4029 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Extension of the Federal Reserve's Emergency-Lending Programs 6–7 (Dec. 17, 2020), available at https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov/files/Memo%20re%20CARES%20Act%20Section%204029.pdf.

⁷⁴ Id.

⁷⁵ Id.

¹d. Or Social Appropriations Act, 2021, H.R. 133, 116th Cong., Division N, § 1005 (December 27, 2020), available at https://rules.house.gov/sites/democrats.rules.house.gov/files/BILLS-116HR133SA-RCP-116-68.pdf.
77 Id., § 1005.

back Fed emergency lending facilities that were similar but not the "same" as the CARES Act facilities.78

The Problems with the Section 13(3) Framework

The experience of the CARES Act facilities illustrates three problems with the current Section 13(3) framework for emergency lending to non-banks. The first is that it allows the Fed to operate lending programs that, like the Main Street Lending Program, are essentially fiscal programs, which arguably should properly be the responsibility of elected authorities, not independent agencies. Second, the current framework vests the Fed with considerable discretion to pick winners and losers. Finally, shared Treasury-Fed responsibility for emergency lending and a lack of transparency makes it difficult to determine who should be held responsible for success or failure.

a. The Fed's Exercise of Fiscal Authority

The CARES Act facilities—especially the Main Street facilities—gave the Fed a central role in supporting the flow of credit to certain non-financial firms. Although actual lending on the scale anticipated by Congress did not materialize, risky extensions of credit could have exposed the Fed to potential losses if losses had exceeded Treasury backing. Of course, credit loss would not bankrupt the Fed since it can create money. Nonetheless, Fed losses would impact the taxpayer by reducing the amount of profit the Fed annually remits to the Treasury. 79 Moreover, if the losses were severe enough, they might tarnish the Fed's credibility and reputation. 80 Congress and the Treasury would likely feel compelled to recapitalize the Fed, so the losses would be passed on to the American taxpayer.

The more fundamental concern raised by the Fed's potential assumption of significant credit risk, however, is that by engaging in risky lending the Fed would wrongly cross the line into making fiscal decisions which, in a democracy, rightly belong to elected government officials the Congress and the Administration—not an independent agency like the Fed. In a democracy, fiscal authority should lie with actors that are directly accountable to voters. 81 The exercise of fiscal policy by the Fed clearly raises concerns about political accountability

At the same time, there is widespread recognition that the Fed can, and should, act independently as the lender of last resort to prevent financial crises. So then what is the line between the Fed's legitimate role as lender of last resort and the exercise of fiscal authority? Basically, the line is between liquidity provision and high-risk credit provision. If firms with strong balance sheets need to borrow from the Fed simply because the financial system has withdrawn private liquidity, even from solvent borrowers, then that is a liquidity problem that the Fed can and should

The See Hal Scott, Here's how the Fed can do more to support US small business, Financial Times (Jan. 11, 2021), available at https://www.ft.com/content/0d0b0f48-d13c-4b2f-97b8-d2da0415d8d6.

At their high in 2015, remittances constituted \$117 billion, including a one-time capital surplus transfer of more than \$19 billion, 3.6% of U.S. general revenue. Internal Revenue Service, Gross collections, by type of tax and state, fiscal year 2015.

^{(2016),} available at https://www.irs.gov/pub/irs-soi/15db05co.xls.

80 See Martin Hellwig, Financial Stability and Monetary Policy, MPI Collective Goods Preprint, No. 2015/10, 12-13 (Aug. 2015), available at http://ssrn.com/abstract=2639532.

81 For an elaboration of a similar view, see Paul M.W. Tucker, Solvency as a Fundamental Constraint on LOLR Policy for

Independent Central Banks: Principles, History, Law, 2 J Fin. Cris. 1, 9-11 (2020).

address independently. However, if firms are substantially likely to become insolvent absent some intervention, then that is a credit problem.82

Concern over the Fed's assumption of fiscal authority, and exposure to potential financial losses, in its capacity as a lender of last resort is not self-evident. After all, there is a broad consensus that the Fed's independence from the executive branch, and politics more generally, is important for sound monetary policy, and monetary policy has a profound influence on fiscal policy. 83 It is also the case that the Fed's exercise of monetary policy could, in theory, incur significant risk of loss, in the form of interest rate risk through its holdings of government obligations, principally Treasury securities.

There are, however, significant differences between the Fed's exercise of credit policy and its exercise of monetary policy. For one, there is a broad and longstanding consensus of Fed independence when it comes to monetary policy. Further, there is an important distinction between interest rate risk and credit risk. Credit risk deals with the risk of borrower default, of which there is virtually none with respect to the Fed's traditional portfolio-holding U.S. government and government-backed obligations. Also, the Fed is protected against the full impact of interest rate risk since it does not mark-to-market its portfolio and only incurs gains or losses when its sells portfolio holdings.85

In fact, the interest rate risk on monetary policy is rather small. A 2011 note published by the Federal Reserve Bank of San Francisco concludes that the short-term interest rate would need to be around 7% for the Fed's interest expenses to surpass its interest income. 86 And the Fed's balance sheet has substantially increased since then. Treasury, agency and government-backed securities as of August 25, 2021, were \$7.787 trillion, and bank reserves were \$4.2 trillion. 87 Continuing to assume, as did the Fed note, that the average coupon yield on the bundle of assets is 4 percent, this would generate \$311 billion in interest income. The short-term interest rate would then need to be above 7.4% for the Fed's interest expenses to surpass its interest income. According to this calculation, the Fed has even lower interest rate risk in 2021 than in 2011. However, the current Fed balance sheet also includes significant reverse repo liabilities, approximately \$1.4 trillion, while the 2011 balance sheet only included less than \$60 billion of reverse repos. 88 Adding the potential interest rate expense associated with the reverse repo liabilities, the short-term interest right would need to rise above 5.5% for the Fed's total interest expense to surpass its interest income. But since the reverse repo rate has historically been below the Fed Funds rate, the shortterm rate that would equate interest expense with interest income likely falls somewhere between 5.5% and 7.4%. Therefore, under this alternative calculation that includes reverse repos, the interest rate risk is still relatively low, although not necessarily lower than in 2011.

⁸² See Tucker, Solvency as a Fundamental Constraint on LOLR Policy at 13-15 (cited in note 81) (noting that distinguishing

between liquidity problems and solvency problems involves inherently forward-looking, probabilistic judgments).

83 Christopher J. Waller, Independence + Accountability: Why the Fed Is a Well-Designed Central Bank. Federal Reserve

Bank of St. Louis Review, 292-301 (September/October 2011), https://doi.org/10.20955/r.93.293-302.

Review, 292-301 (September/October 2011), https://doi.org/10.20955/r.93.293-302.

Review, 292-301 (September 2011), https://www.wsj.com/articles/SB10001424052748704358904575477580959771188#U3012412216331wH. 85 Board of Governors of the Federal Reserve System (Federal Reserve), Financial Accounting Manual for Federal Reserve

Banks 104 (January 2020).

86 Glenn D. Rudebusch, The Fed's Interest Rate Risk, FRBSF Economic Letter 2011-11 (April 11, 2011).

Federal Reserve, Factors Affecting Reserve Balances, Federal Reserve Statistical Release H.4.1 (August 26, 2021)

If the Federal Reserve shrinks its holdings of Treasury, agency and government-backed assets and bank reserve liabilities in the same proportion, then the short-term interest rate needed for interest expenses to surpass interest income would remain unchanged. Otherwise, if the Federal Reserve only sells off longer-term assets and bank reserve liabilities remain the same, the shortterm interest rate needed for interest expenses to surpass interest income will decrease. But in any event, interest rate risk is minimal compared with credit risk

The current Section 13(3) framework allowed the Fed to take a central role in credit provision. In the case of the CARES Act facilities for non-bank financial institutions, the Fed took steps to limit its role to liquidity provision without significant credit risk by lending to mostly investment grade or near-investment grade borrowers and keeping the duration of most of its lending relatively short-term. ⁸⁹ However, the Main Street facilities (for non-financial companies) were examples of credit facilities—designed to support firms struggling with weak balance sheets—rather than liquidity facilities. And emergency lending that involves significant credit risk should be the exclusive domain of elected authorities that are accountable to the public—not an independent agency like the Fed. Admittedly, the Fed's exposure to excessive Main Street losses was mitigated by Treasury backing of the facilities. The facilities, however, were still nominally Fed facilities, and thus the Fed rather than the Treasury would still be deemed responsible for their success or failure.

We note the separate argument that, when the Fed exercises fiscal authority, this could raise constitutional concerns. The Constitution provides that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law." 90 By assigning the "power of the purse" to Congress, the Constitution forbids any federal agency or official, including the Fed, from engaging in public spending without legislative authorization. 91 Of course, Congress has explicitly authorized the Federal Reserve to act as a lender of last resort, including by lending to non-banks in specified circumstances. So the argument would be that the Constitution limits Congress's ability to delegate its fiscal authority to another federal agency, including the Fed. 92 That said, although there is no case law on point, courts have applied the nondelegation doctrine sparingly and, in particular, appear to have rejected the notion that Congress's appropriations power is categorically nondelegable. 93 So the issue of whether the Treasury or the Fed should take on credit risk is ultimately a matter of policy rather than constitutional concern.

b. Picking Winners and Losers

A related problem with the current Section 13(3) framework arises in connection with programs that vest the Fed with significant discretion to choose which specific borrowers or assets,

⁸⁹ Jerome H. Powell, Statement before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (Dec. 1, 2020), https://www.federalreserve.gov/newsevents/testimony/files/powell20201201a.pdf ("The SMCCF supports market liquidity by purchasing, in the secondary market, corporate bonds issued by investment-grade U.S. companies, by U.S. companies of partitioning in westment grade before the onset of the pandemic and remain near investment grade.") For a concise description of each facility's terms, see Andrew P. Scott, Rachel Y. Tang, Marc Labonte & Ben Wilhelm, Treasury and Federal Reserve Financial Assistance in Title IV of the CARES Act, CRS Report R46329 9-11 (Jan. 6, 2021). https://crsreports.congress gov/product/pdt/R/R46329.

Outs. Constitution, art. I, § 9, cl. 7.

See Kate Stith, Congress' Power of the Purse, 97 Yale L.J. 1343, 1356–60 (1988).

⁹² Id. at 1381-86.

¹ Ld. at 1581-80.

³ See, e.g., Synar v. United States, 626 F. Supp. 1374, 1385-86 (D.D.C. 1986) (noting in obiter dicta that "[t]he appropriations power is not functionally distinguishable from other powers successfully delegated by Congress."). See generally Eric A. Posner & Adrian Vermeule, Interring the Nondelegation Doctrine, 69 U. Chi. L. Rev. 1721 (2002) (critiquing the non-

or categories of borrowers or assets, are eligible for participation: the risk of picking winners and losers. Although the Fed will always exercise some discretion when determining program eligibility, the more it does so, the greater the concern that it has favored some prospective borrowers over others.

This problem was, to some extent, a problem with all of the pandemic lending facilities. Most of those facilities involved the Fed setting generally applicable terms for all willing borrowers. Thus, each of the PDCF, MMLF and TALF involved the Fed (or SPVs controlled by the Fed) lending to private entities—banks, primary dealers, and other financial institutions—that used the proceeds of those loans to purchase eligible assets.²⁴ In the case of the CPFF, PMCCF and MMLF, eligible issuers could only sell commercial paper or newly issued corporate or municipal debt to the Fed on general terms set by the Fed, rather than based on the Fed's exercise of discretion. Whenever the Fed sets generally applicable terms, it must decide which borrowers or assets are eligible for participation and which are not. Wherever the Fed decides to draw the line, it can create the perception that the Fed is helping or penalizing certain sectors or industries.

Another potential issue of picking winners and losers arose in connection with the operation of the Fed's Secondary Market Corporate Credit Facility (the SMCCF), since the Fed exercised its discretion to determine which ETFs and bonds the SMCCF would buy and at what price. 97 The Fed attempted to minimize this problem by initially only purchasing highly diversified ETFs, but it still had to decide which ones to buy. And when it later bought bonds directly, it did so by constructing its own broad bond index composed of all secondary market issues that met the SMCCF's eligibility criteria. 98 A similar winners-and-losers concern would have arisen if demand for any of the CARES Act facilities would have exceeded capped supply, and the Fed were forced to choose between different eligible participants. Because of the limited take-up of the pandemic facilities, this particular concern did not actually arise.

The "winners and losers" problem is an inherent issue with any Fed lending program and can pose a political threat to the independence of the Fed, particularly if the Fed is picking "winners and losers" among borrowers that pose significant credit risk rather than the Fed's more appropriate role of providing liquidity to solvent borrowers during a market-wide liquidity crisis.

⁹⁴ TALF also limited this problem by excluding single-asset, single-borrower commercial mortgage-backed securities as eligible collateral. See Board of Governors of the Federal Reserve System, Term Sheet for Term Asset-Backed Securities Loan Facility (July 28, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/mone-25. 20-20, triangle in high with the control of the

https://www.newyorkfed.org/markets/commercial-paper-funding-facility/comme quidity Facility (Nov. 30, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20201130a2.pdf.

8 See, e.g., Victoria Guida & Zack Colman, Fed's expansion of lending program sparks oil bailout worries, Politico (April 30, 2020), https://www.politico.com/news/2020/04/30/feds-expansion-of-lending-program-sparks-oil-bailout-worries-227545 (Fed's relaxation of Main Street terms raises concerns about lobbying by oil-and-gas companies); Robert Schmidt, Jesse Hamilton, & Sally Bakewell, *Private Equity to Get Squeezed Out of Another Stimulus Program*, Bloomberg News (April 23, 2020) (private equity owned companies concerned that they would not qualify for Main Street facilities), https://www.otoomberg.com/news/articles/2020-04-23/private-equity-to-get-squeezed-out-of-another-stimulus-program?sref=2lCQoM0A.

Fooderal Reserve, Secondary Market Corporate Credit Facility (July 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200728a1.pdf.

c. The Problem of Joint Responsibility

The current Section 13(3) framework gives Treasury the final say on any non-bank emergency lending by the Fed. But this arrangement makes it unclear where the responsibility for the design of any such facility actually lies, as between the Treasury and the Fed. Did the Treasury dictate the terms, or did it merely accede to terms proposed by the Fed? The current framework blurs the lines of political accountability, rendering it impossible to determine who should be responsible for the success and failure of lending programs. If the Fed shoulders the blame for failures that are properly the responsibility of Treasury, it could threaten the Fed's longstanding independence and its ability to exercise its traditional functions

Treasury's role in the design of the emergency lending facilities was particularly evident in the case of the CARES Act facilities. A major driving force behind their structure and terms appears to have been Treasury's desire to minimize losses on its investments in the facilities. As noted above, Secretary Mnuchin emphasized that he did not expect Treasury to incur losses in connection with the CARES Act facilities.⁹⁹ Each of the CARES Act facilities featured a fixed cap on lending, with a leverage ratio set based on the perceived riskiness of the facility's loans. Specific terms governing participation in the CARES Act facilities also appear to have been designed to protect against credit risk. For example, as noted above, the Main Street facilities directed banks to make creditworthiness judgements about potential borrowers and required that eligible borrowers have a "pass" rating requirement for existing loans. 100 Perhaps the most direct evidence of Treasury's concern with incurring losses in connection with the CARES Act facilities was Treasury's reluctance to use the entire \$454 billion Congress appropriated in the CARES Act. When the facilities were closed, \$351.5 billion of that CARES Act funding had never been put at risk. 101

Despite Treasury's apparent role in setting the terms of the pandemic emergency lending facilities, responsibility for the success and failure of the facilities remains murky. On the one hand, the Fed may have agreed with the program design, or even suggested it, being unwilling to step into fiscal territory. Vice-Chair Quarles testified before the Senate Banking Committee:

We are required by law that we structure these facilities so that they are loans to entities that we expect to be repaid and that the various measures and metrics that we have included in the Main Street facility are designed to try to balance as broad a reach as we can while maintaining fidelity to the statutory requirements. 102

In addition, the Congressional Budget Office (the CBO) estimated, "[b]ased in part on information from the [Fed] Board of Governors," that the budgetary impact of the appropriation to Treasury under the CARES Act would be zero, since income from the facilities would basically

⁹⁹ Kate Davidson & Richard Rubin, Steven Mnuchin Says U.S. Aims to Get Back Its Money From Fed Programs, Wall Street Journal, Apr. 29, 2020, available at https://www.wsj.com/articles/mnuchin-says-u-s-not-aiming-to-lose-money-on-fed-

lending-facilities-11588178749.

100 Federal Reserve, Term Sheet for Main Street New Loan Facility (Apr. 9, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200409a7.pdf; Federal Reserve, Term Sheet for Main Street Expanded Loan Facility (Apr. 9, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/mone-

Federal Reserve, Factors Affecting Reserve Balances, Federal Reserve Statistical Release H.4.1 (Jan. 14, 2021).

[&]quot;Federal Reserve, ractors Affecting Reserve Dutantes, recein a Reserve Statustian Research 11.7.1 (2011. 17, 2021). The States Committee on Banking, Housing, and Urban Affairs, Oversight of Financial Regulators (May 12, 2020), https://www.banking.senate.gov/hearings/05/12/2020/oversight-of-financial-regulators

offset any losses. ¹⁰³ On the other hand, reports indicate that the Fed sought to soften the terms of the Main Street facilities and take more credit risk. ¹⁰⁴ While some of the terms were, in fact, relaxed in subsequent revisions of the facilities' terms, they were not softened enough to make them attractive to borrowers.

Further challenges of joint responsibility were raised in connection with the closing of the CARES Act facilities. The Treasury ordered the Fed to close the facilities and return the Treasury's investments. Although the Fed was reluctant to do so, it ultimately did not resist. Under the existing Section 13(3) framework, both the Fed and Treasury are needed to approve any emergency lending facility at the outset and its continued operation. Thus, one of them—Treasury in this case—can shut it down unilaterally by refusing to extend it.

The question of responsibility is more acute when one considers what would have happened if the emergency lending facilities had failed entirely and the U.S. had been plunged into a depression. Who would have been held responsible, the Fed or Treasury? And who will be held responsible for future programs (or future failures)? Since the emergency lending facilities are nominally "Federal Reserve" programs, it is possible under the current framework that the Fed could unfairly take the blame for terms that are actually dictated by the Treasury, with the result that the Fed's future independence, even for traditionally independent functions like monetary policy and liquidity provision, could be threatened.

IV. A Revised Framework for Non-Bank Emergency Lending

To mitigate the problems highlighted in the existing framework, this section proposes, in the short term, increased disclosure in connection with the creation and operation of emergency lending facilities. Going forward, however, structural reform is needed. Under that framework, the Fed would continue to serve in its traditional function as the lender of last resort by providing emergency liquidity to non-bank financial institutions without significant credit risk and against good collateral. Treasury, on the other hand, should be solely responsible for emergency lending to non-banks that pose significant credit risk and thus implicate fiscal policy.

This section outlines what that division of authority would look like in practice. Treasury—not the Fed—would be the ultimate arbiter of whether emergency lending to non-bank financial institutions poses significant credit risk, based on factors including overall market conditions and the presence or absence of good collateral. If the Treasury determines that an emergency lending program would pose "significant credit risk," then the Treasury would determine whether to lend and the terms of such loans. If the Treasury determines that an emergency lending program would not pose significant credit risk, then the Fed would have the sole authority to determine whether to lend and the terms of such lending. In order to serve this novel emergency lending function, Congress should provide the Treasury with standing emergency lending authority, either in the form of an emergency lending fund—on the model of the current Exchange Stabilization Fund—or authority to guarantee loans made by the Fed acting in its capacity as the agent of Treasury.

¹⁰³ See Congressional Budget Office, Preliminary Estimate of the Effects of H.R. 748, the CARES Act, Public Law 116-136,

⁽Apr. 27, 2020), available at https://www.cbo.gov/system/files/2020-04/hr/148.pdf.

104 Victoria Guida & Aubree Eliza Weaver, Marning Money: We're in a recession, by the way, Politico (June 9, 2020), available at https://www.politico.com/newsletters/morming-money/2020/06/09/were-in-a-recession-by-the-way-788358 ("People familiar with the matter tell [Morning Money] that the Treasury Department has been more cautious on taking risk than the Fed. They're the ones ponying up taxpayer dollars, so this makes some sense.").

a. Disclosure as a Short-Term Solution

A significant motivation for the revised framework is that responsibility for the structure and terms of emergency lending should be made clear. Responsibility for the design choices made with respect to the CARES Act facilities was unclear. The approach proposed here is structural: define in law the relative responsibility of the Treasury and Fed. Where the Treasury establishes the program, Treasury would be responsible; the Fed could only be charged with execution failures. Where the Fed lends to non-banks without significant credit risk, the Fed would be entirely responsible.

As an initial matter, there should be full disclosure under the existing framework as to whom, as between the Treasury and the Fed, is responsible for the design of the facilities. This would be difficult to do during the actual crisis but could be done after the crisis has subsided. At that time, the Treasury and Fed could be required to issue a joint statement, laying out responsibility for major decisions about the structure and terms of the facility. Such disclosure might still not adequately assign responsibility when decisions were the product of compromises between the Fed and Treasury. Accordingly, disclosure is an important but limited step in dealing with accountability. Structural solutions would still be necessary.

b. Structural Change in the Longer Term

1. The Threshold for Lending

A threshold question that arises in connection with the use of any lending facility, whether established by the Fed or the Treasury, is the standard for when it can be used. Under current law, the Fed (upon the vote of at least five of the seven Fed Board members) is only permitted to establish a Section 13(3) facility for non-banks in "unusual and exigent circumstances." 105 The term "unusual and exigent circumstances" is not defined by statute or regulation, and there is virtually no legal authority interpreting what market conditions might meet that standard. But the history of the Fed's invocation of Section 13(3) indicates that it was never understood to require a potential threat to the stability of the financial system as a whole. When the Fed invoked Section 13(3) after it was first given that authority, its concern was not systemic risk; rather the Fed acted based on evidence that a significant number of potential borrowers were being turned away by banks. Likewise, when the Fed authorized Section 13(3) lending again in the 1960s, its concern was not systemic risk, but a market disruption affecting the liquidity of nonmember banks (to which the Fed could not lend through the discount window).

Under the proposed framework, the appropriate threshold governing when emergency lending facilities can be established should be lower than the possibility of a systemic collapse, consistent with the Fed's historical interpretation of the "unusual and exigent circumstances" threshold. 107 In particular, the threshold governing lending with significant credit risk by Treasury should not require a credit crisis that threatens the stability of the U.S. financial system for Treasury to intervene. Rather, Treasury should be empowered to act in the event that disruptions in

¹⁰⁵ Federal Reserve Act, §13(3)(A).
106 See text accompanying notes 1–6. Adam J. Levitin, In Defense of Bailouts, 99 Georgetown L.J. 435, 496 (2011) ("[E]ven the "unusual and exigent circumstances" requirement does not necessarily indicate systemic risk, just market disruption.").

107 Under current Section 13(13), the Fed can extend short-term loans to non-banks provided those loans are backed by Treasury securities or other debt that is fully guaranteed by the federal government. Federal Reserve Act, § 13(13). Although the Fed's Section 13(13) authority is not limited by statute to "unusual and exigent circumstances", the Fed has, by regulation, mandated that it can only exercise that authority in "unusual and exigent circumstances". 12 C.F.R. § 201.4(d)(13)

lending markets severely impair access to credit by borrowers in general or by borrowers in a broad-based sector of the economy, even if short of an emergency. That standard is consistent with the Fed's historical interpretation of the "unusual and exigent circumstances" threshold. 108

2. Treasury's Responsibility for Lending with Significant Credit Risk

Loans to insolvent institutions and loans to institutions that have a substantial likelihood of becoming insolvent bear significant credit risk and should be regarded as implicating fiscal policy. Accordingly, under the proposed framework, the entire establishment and design of any such lending facility would lie with the fiscal authorities—the Congress and Treasury—and the facility should be identified as a "Treasury" facility. Of course, the Treasury should fully utilize the Fed's expertise in implementing any emergency lending program that poses significant credit risk. The Fed would continue to inform Treasury of market conditions and the need for action. But the responsibility for the design of the program and the lending terms would be with Treasury.

A key question is who should ultimately be responsible for making the determination whether lending poses significant credit risk. Since this determination could implicate the exercise of fiscal authority, Treasury should be the ultimate arbiter. Note that this differs from the United Kingdom's current arrangement, which—similar to the framework outlined here—distinguishes between emergency lending to "at-risk" firms (which requires Treasury approval) and normal lending (which does not). ¹⁰⁹ The U.K.'s framework formally leaves the judgment as to whether firms are at risk to the Bank of England (the "BoE"). ¹¹⁰ If the BoE determines that the borrower is not at risk, then it is free to lend without the approval of the HM Treasury. However, it is unclear in practice whether the BoE or HM Treasury would prevail under the U.K.'s framework in the event of a disagreement between the BoE and Treasury about whether a firm is at risk.

3. The Fed's Responsibility for Lending without Significant Credit Risk

To be clear, under the proposed framework, the Treasury would not be required to design and take responsibility for *all* facilities in which it determines there could be *any* credit risk. It might well decide, after consultation with the Fed about the anticipated design and terms of a potential facility, that the credit risk is not significant and let the Fed establish its own facility. If the Treasury determines a Fed facility does not pose significant credit risk, even in the absence of real collateral—for example, because it would only buy highly rated commercial paper issued by financial companies—then the Treasury could permit the Fed to establish its own facility. When Treasury permits the Fed to do so, it should disclose its reasons for doing so.

Ultimately, the decision about whether or not a proposed facility poses significant credit risk should be Treasury's to make. Where Treasury believes that a proposed facility poses significant credit risk—as was clearly the case with the Main Street facilities—Treasury would establish its own facility, identified as belonging to, and designed and controlled by, the Treasury.

¹⁰⁸ Under current Section 13(13), the Fed can extend short-term loans to non-banks provided those loans are backed by Treasury securities or other debt that is fully guaranteed by the federal government. Federal Reserve Act, § 13(13). Although the Fed's Section 13(13) authority is not limited by statute to "unusual and exigent circumstances", the Fed has, by regulation, mandated that it can only exercise that authority in "unusual and exigent circumstances". 12 C.F.R. § 201.4(d)(13).

¹⁰⁹ For a more detailed discussion of the U.K.'s emergency lending framework, see below text accompanying notes 122–123 and 133–137.

¹²³ and 133–137.

110 Scott, Connectedness and Contagion at 112–114 (cited in note 3).

4. Does Lending Pose Significant Credit Risk?

On what basis should Treasury determine whether a lending program or facility involves significant risk of loss and thus, if so, should be the sole responsibility of the Treasury?

This is a difficult line to draw. A first criterion should be whether the lending takes place in an economic downturn or financial crisis where there are serious questions about the ability of borrowers to repay. Possible objective criteria can be used to determine whether this is the case. A second consideration is whether borrowers can provide adequate security, while recognizing that the existence of collateral does not by itself necessarily ensure lack of credit risk.

In all of the pandemic emergency lending facilities, only one—the Primary Dealer Credit Facility (the PDCF)—met the security requirement without any Treasury backing, since the dealers being financed were required to post high quality collateral. In fact, the collateral standards for the PDCF were equivalent to those used by the Fed for discount window lending. ¹¹¹ Moreover, the Fed had recourse back against dealer participants in the event the collateral was insufficient to cover Fed losses. ¹¹² The lack of significant credit risk in this facility was also underscored by the fact that institutions must meet high standards to qualify as primary dealers. ¹¹³ That there was no Treasury backing of this facility indicates that the Fed and Treasury believed that the dealer collateral and full recourse were adequate to protect against significant credit risk.

Unlike the PDCF, the other pandemic facilities lacked real security. In the case of the CPFF and the CARES Act facilities, Fed loans to the relevant SPV were merely backed by the assets purchased by the SPV, including unsecured debt, and the Fed only had recourse back to the SPV (which held the purchased assets), but no recourse back to the actual issuers whose debt the SPV purchased. 114 In the case of the MMLF, where no SPV was involved, and the Fed made loans directly to banks to purchase money market assets, including unsecured commercial paper, there was also effectively no security. The underlying assets that served as collateral were potentially unsecured and the Fed had no recourse back to the banks in the event the banks defaulted on their loans. 115

We also recommend the prohibition outright of Fed lending to non-financial companies (as under Main Street) or purchasing the securities of non-financials (as under the CPFF, the

¹¹¹ See. e.g., Term Sheet for Primary Dealer Credit Facility (PDCF) (Nov. 30, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201130a3.pdf ("The pledged collateral will be valued by Bank of New York Mellon according to a schedule designed to be similar to the margin schedule for lending by the discount window, to the extent possible ").

the extent possible.").

112 Federal Reserve, Term Sheet for Primary Dealer Credit Facility (Jul. 28, 2020), available at https://www.federalre-serve.gov/possystelasses/files/manetary/2020072888 ndf

serve_gov/newsevents/pressreleases/files/monetary/20200728a8.pdf.

113 Federal Reserve Bank of New York, Primary Dealers, Expectations and Requirements, https://www.newyork-fed.org/markets/primary-dealers#:~:text=Be%20either%20(1)%20a%20broker,2)%20a%20state%200r%20federally (last visited Oct. 4, 2020).

114 See: Federal Reserve, Commercial Paper Funding Facility: Program Terms and Conditions (Nov. 30. 2020),

¹¹⁴ See: Federal Reserve, Commercial Paper Funding Facility: Program Terms and Conditions (Nov. 30. 2020), https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-commercial-paper-funding-facility-commercial-paper-funding-facility-commercial-paper-funding-facility-commercial-paper-funding-facility https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20200728a6.pdf; Federal Reserve, Primary Market Corporate Credit Facility (Iuly 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20200728a1.pdf.
175 Federal Reserve, More Medital Market Corporate Credit Facility (Iuly 28, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary/20200728a1.pdf.
175 Federal Reserve, More Medital Market Description (International Conditions)

Til- Federal Reserve, Money Market Mutual Fund Liquidity Facility (Nov. 30, 2020), https://www.federalre-serve.gov/newsevents/pressreleases/files/monetary20201130a2.pdf.

Secondary Market Corporate Credit Facility, and the Municipal Liquidity Facility). The assets of non-financial companies tend to be less liquid than those of non-financial companies; they are also less diversified than financial companies. As a result, they are more likely than financial companies to pose credit, rather than liquidity risk. The kind of lending the Fed engaged in through TALF would be more difficult to classify. On the one hand, the asset-backed securities to which the Fed was exposed through TALF included non-financial debt such as student and equipment loans; on the other hand, the loans made by TALF were to financial companies that were independent of the

c. Leverage and Funding

Under the proposed framework, Treasury's facilities could be implemented either through direct Treasury lending or through a Treasury guarantee of lending by another party, either the Fed or even private lenders. Importantly, any funds or guarantees provided by Treasury would have to be authorized by Congress. The Congress would, therefore, be able to limit the appropriation or guarantee however it sees fit. From a budgetary perspective, there is little difference between either approach. Under the Federal Credit Reform Act of 1990, both direct loans and loan guarantees by the federal government must be accounted for in the budget on an accrual, net-present-value basis. 116 That is how the \$454 billion appropriation under the CARES Act was scored. 117 The treatment of a loan guarantee that, in the view of the CBO, exposed Treasury to an equivalent level of credit risk would receive the same treatment.

Since a crisis can materialize quickly and require immediate action, Congress should act in advance to give Treasury standing authority. If Congress takes action in advance, then it is far more likely that it would be in the form of a guarantee, likely with a cap, rather than an appropriation that might never be used. To the extent Congress caps the Treasury's ability to guarantee losses at a specific dollar figure, then the Treasury must be careful to limit guaranteed lending to its best conservative estimate of losses that would be within the limits set by Congress. If the losses still exceeded the guaranteed limit, then there would likely still be an implicit guarantee, as there currently is under the deposit insurance system, to cover excess losses, with the clear expectation that Congress would cover the overrun.

d. The Fed's Role as Treasury's Agent

The Treasury may need the Fed to execute Treasury programs as its agent, due to its connection to the bank distribution channels. If the Fed were involved in this capacity, it would only be responsible for its failure to execute in accord with Treasury directions. If tapped to administer a Treasury emergency lending program, however, the Fed should rightly insist that it be operationally equipped to run any emergency lending program that it is being required to administer. Lack of operational capacity was a problem for the Small Business Administration (the SBA) in administering the Paycheck Protection Program, the forgivable loan program for the smallest businesses authorized by the CARES Act. Technical problems hampered the SBA's ability to process loan applications efficiently, and its systems were quickly overwhelmed by the number of applications

¹¹⁶ Federal Credit Reform Act of 1990, P.L. 101-508, § 504 (1990). Previously, they were accounted for on a cash-flow basis. See Mindy R. Levil, Budgetary Treatment of Federal Credit (Direct Loans and Loan Guarantees): Concepts, History and Issues for Congress, Congressional Research Service 4–5 (June 24, 2014).

117 Congressional Budget Office, Preliminary Estimate of the Effects of H.R. 748, the CARES Act, Public Law 116-136 (cited

for emergency loans, though the SBA was ultimately able to process more than 5 million firstround PPP loan applications. 118

If the Treasury calls on the Fed to act in this capacity, the Treasury should have the authority to require the Fed to engage in emergency lending. Section 15 of the Federal Reserve Act gives the Treasury the authority to deposit "moneys held in the general fund of the Treasury" with the Federal Reserve Banks, "which banks, when required by the Secretary of the Treasury, shall act as fiscal agents of the United States." ¹¹⁹ Historically, the Federal Reserve Banks' role as fiscal agents has involved the provision of various financial services for the Treasury, such as redeeming government securities, processing payments to and from the federal government, monitoring collateral for Treasury funds, and maintaining the Treasury's bank account. 120 The Treasury could also invoke this authority to require Federal Reserve Banks to extend loans, using Treasury funds, to risky borrowers. 121

The current U.K. framework gives HM Treasury the authority, in exceptional circumstances, with parliamentary oversight, to direct the BoE to make risky loans to entities that the BoE does not judge to be solvent, on terms that HM Treasury dictates. 122 In the event of such direction, the BoE is considered to be acting as the Treasury's agent. The funds are placed in a special purpose vehicle ("SPV") that is segmented from the BoE balance sheet, and the SPV and the BoE are indemnified by the Treasury for losses. This authority was invoked during the COVID-19 pandemic. The COVID Corporate Financing Facility, established by the BoE at the behest of HM Treasury, directed the BoE to purchase eligible commercial paper in the primary and secondary market, including from middle-market firms that had not previously issued commercial paper, on terms comparable to those prior to the crisis. 123

Under our proposed framework, the U.S. Treasury should similarly be empowered, through an amendment to Section 13(3) to direct the Fed, acting solely as the Treasury's agent, to open an emergency lending facility for risky borrowers on terms that the Treasury dictates, provided that any losses are borne by the Treasury. Since a lending facility of this sort would pose significant credit risk, it would involve the exercise of fiscal power. The Fed should not have the power to block such fiscal measures because it disagrees with the need for them or their specific design or

¹¹⁸ Stephanie Ruhle & Ben Popken, Thousands of applicants, zero loans: Trump's small businesses lending program is a failure to launch, NBC News, Apr. 4, 2020, available at https://www.nbcnews.com/business/business-news/thousands-applicants-zero-loans-trump-s-small-businesses-lending-program-n1176766; Lauren Fox, Glitches hamper second round of small business loan finding, CNN, Apr. 27, 2020, available at https://www.cnn.com/2020/04/27/politics/state-of-play-paycheck-protection-program-small-business-administration/index.html. Federal Reserve Act, § 15.

¹²⁰ Donna A. DeCorleto & Theresa A. Trimble, Federal Reserve Banks as Fiscal Agents and Depositories of the United States in a Changing Financial Environment, 2004 Fed. Res. Bulletin 435, 436–37 (Autumn 2004).
121 Operations of the Treasury's Exchange Stabilization Fund, which typically include buying and selling foreign currency and self-united buying the Endoral Pagency Bank of the Computer Stabilization Fund.

but have also included short term loans to emerging market countries, are conducted through the Federal Reserve Bank of New York in its capacity as Treasury's fiscal agent. Exchange Stabilization Fund, Fedpoint (May 2007), https://www.newyorkfed.org/aboutthefed/fedpoint/fed14.html.

122 HM Treasury, Bank of England, and Prudential Regulation Authority, Memorandum of understanding on financial crisis management §25 (2012), available at https://www.bankofengland.co.uk/-/media/boe/files/memoranda-of-understanding/resolution-planning-and-financial-crisis-management.pdf?la=en&hash=57D8302D2AE09F004E67BEF19A554547CA

D2D47B.

12 See Letter from Rishi Sunak, Chancellor of the Exchequer HM Treasury, to Andrew Bailey, Governor of the Bank of England (Mar. 17, 2020), available at https://assets.publishing.service.gov.uk/governmen/uploads/system/upl nancing Facility, https://www.bankofengland.co.uk/markets/covid-corporate-financing-facility (last visited Oct. 4, 2020).

terms. But the Fed should still be able to object on the ground that it does not have the operational capacity to carry them out. Granting the Treasury this authority, however, would require a revision of the current emergency lending framework. Section 15 is probably not sufficient authority, since it would not cover the case where the Treasury provides an indemnity as opposed to supplying the

To the extent that a Treasury lending program enlists the Fed as the Treasury's agent, it again raises the concern with the Fed, an independent agency, picking winners and losers. To address that concern, Treasury programs should generally avoid delegating the Fed significant discretion to determine program eligibility, and any Treasury program that does so should make its terms clear and transparent. The Fed should then seek to operate the program to reduce the need to pick winners and losers by delegating authority to do so to a third party or operating on a strict first-come, first-serve basis.

e. Loans vs. Purchases

Pursuant to the revised framework proposed here, Congress should also clarify that the Fed's ability to provide emergency liquidity to non-bank financial institutions—either when doing so does not involve significant credit risk or when the Fed is acting as Treasury's agent for a fiscal program—is not limited to lending but also extends to the purchase of debt or other interests directly from issuers or on the secondary market. In other words, the Fed's ability to provide emergency support to non-bank financial institutions should depend on the substance of that support, not its form.

f. The Fed as Bank Regulator

In addition to its role conducting monetary policy and acting as a lender of last resort, the Fed is the most important bank regulator. In order to incentivize banks to use some of its facilities, such as the MMLF and its financing of bank loans to small businesses through the Paycheck Protection Program Liquidity Facility, the Fed (in its capacity as a bank regulator) specified that banks need not hold capital against assets acquired pursuant to these programs. 124 In addition, it exempted these assets from the Liquidity Coverage Ratio. 125

Theoretically, the relaxation of these requirements increases the Fed's exposure to losses from riskier banks. While this may be unlikely in present circumstances, given what appears to be the strong capital and liquidity positions of the banks, together with the relatively small share of bank assets generated by these programs, there remains the conceptual concern that such actions do increase Fed credit risk. However, these are actions clearly within the Fed's regulatory authority. While one could argue that the Treasury should call the shots on regulatory relief to accompany

¹²⁴ Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System & Federal ¹²³ Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Regulatory Capital Rule: Money Market Mutual Fund Liquidity Facility, 85 Fed. Reg. 16232 (March 23, 2020); Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Regulatory Capital Rule: Paycheck Protection Program Lending Facility and Paycheck Protection Program Lending Facility and Paycheck Protection Program Lending Facility and Paycheck Protection, Special Reserve System, Federal Deposit Insurance Corporation & Office of the Comptroller of the Currency, Federal bank regulatory agencies modify liquidity coverage ratio for banks participating in Money Market Mutual Fund Liquidity Facility and Paycheck Protection Program Liquidity Facility (May 5, 2020), available at https://www.federalreserve.ox/newsevents/fornessreleases/herep 2070/05/05/a btm

https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200505a.htm.

its own programs, the proposed framework would leave regulatory decisions where they normally lie, with the Fed.

g. Should the Revised Framework be Extended in Whole or in Part to Banks?

The proposed revision of the framework for non-bank emergency lending invites the question whether the revised framework should be extended to banks. On the one hand, the Fed's current authority allows it to engage in bank lending that poses significant credit risk, which might argue that the reform should be extended to emergency bank lending as well. On the other hand, in practice the Fed has not used its bank lending authority this broadly, and in fact has constrained it through its own regulation. That belies the necessity of significant changes to the Fed's existing authority to lend to banks.

Currently, emergency lending to banks is governed not by Section 13(3) of the Federal Reserve Act, but by Section 10B, the so-called "discount window". That statute only requires that emergency lending to banks be secured "to the satisfaction" of the Fed. This discretionary standard was the same one used in Section 13(3) before Congress amended that provision in the Dodd-Frank Act to require collateral that is sufficient to protect taxpayers from losses and is assigned a lendable value. 126 Section 10B currently allows the Fed—on its own, without Treasury approval to make loans to at-risk (and even insolvent) banks at a premium rate, if it considers the collateral sufficient (although it rarely does so). 127 The Fed has imposed limitations on its discount window authority: under applicable regulations the Fed can only extend credit to undercapitalized banks if doing so is "consistent with a timely return to a reliance on market funding sources" or "would facilitate the orderly resolution of serious financial difficulties" of the bank.

In addition, Section 10B sets time periods beyond which the Fed cannot lend to undercapitalized banks without incurring a potential liability to the Federal Deposit Insurance Corporation (the "FDIC"). Specifically, subject to certain exceptions, the Fed is required to make the FDIC whole for losses incurred as a result of the Fed lending to: (i) any undercapitalized bank for more than 60 days in any 120-day period; or (ii) any critically undercapitalized bank beyond the fifth day after the institution becomes critically undercapitalized. 129 The Fed's liability to the FDIC is capped at the lesser of: (i) the loss the Fed would have incurred if the increased lending beyond the specified time period had been unsecured; and (ii) the interest earned by the Fed on the increased lending beyond the specified time period. ¹³⁰ The Fed is required to report to Congress any liability it incurs to the FDIC as a result of lending to an undercapitalized bank within six months

¹²⁶ Scott, Connectedness and Contagion at 91-92 (cited in note 3).

¹²⁶ Scott, Connectedness and Contagion at 91–92 (cited in note 3).
127 12 C.F.R. § 201.4(a) ("A Federal Reserve Bank may extend primary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is in generally sound financial condition in the judgment of the Reserve Bank."); § 201.4(b) ("A Federal Reserve Bank may extend secondary credit on a very short-term basis, usually overnight, as a backup source of funding to a depository institution that is not eligible for primary credit."); § § 201.104–110 (describing eligible collateral for discount window loans). In nearly two decades, the highest average weekly usage of the Fed's secondary credit facility was less than \$1 billion. See Board of Governors of the Federal Reserve System (US), Accept 1 Jimithity and Credit Pacilities: Lanes: Secondary Credit: Week Average, retrieved from FRED, Federal Reserve Assets: Liquidity and Credit Facilities: Loans: Secondary Credit: Week Average, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WSC, February 5, 2021.

128 12 C.F.R. § 201.4(b).

¹²⁹ Federal Reserve Act, § 10B(b). These limitations were added by Section 142 of the Federal Deposit Insurance Corporation Improvement Act of 1991, in response to concerns that the Fed's discount lending would impose losses on the FDIC by keeping banks afloat long enough for uninsured depositors to withdraw their money from insolvent banks. See Frederic S. Mishkin, Evaluating FDICIA 17 (Dec. 1996), https://www0.gsb.columbia.edu/faculty/finishkin/PDFpapers/FDICIA96.pdf. 130 Federal Reserve Act, § 10B(b)(3)(B).

of incurring it. ¹³¹ These consequences reflect Congress' past concerns with the Fed making risky loans to banks. It appears that the Fed may design its lending to banks to avoid being penalized and disclosing that they have done so. ¹³²

It is worth noting that the U.K. restricts emergency lending to banks and non-banks in the same way. The U.K. approach emerged out of a confusion of roles between the BoE and HM Treasury in the 2008 financial crisis, particularly as it concerned the rescue of Northern Rock. ¹³³ Under the current arrangement, the U.K. divides emergency lending authority into two parts. First, there is *normal* lending to banks and other borrowers specified by the BoE, a list which now includes primary dealers, broker-dealers, and central counterparties. It appears that BoE, on its own, can further expand this category at its discretion. Second, there is *emergency lending* to banks and non-banks. ¹³⁴ In the U.K., emergency lending is governed by a Memorandum of Understanding between BoE and the Treasury. ¹³⁵ which permits the BoE to make loans to solvent but "at risk" firms with the approval of the Treasury. It appears, despite the absence of published guidance on the point, that Treasury approval would come with a Treasury indemnity of BoE losses. ¹³⁶ (As noted above, the current U.K. framework also gives HM Treasury the further authority, in exceptional circumstances, to direct the BoE to make loans to entities that the BoE does not judge to be solvent on terms dictated by HM Treasury. ¹³⁷)

That said, there does not appear to be any compelling reason to extend our proposed revised emergency lending framework to banks. The Fed has used its discount window authority appropriately, constrained by its regulations and historical practice, to engage in liquidity provision by lending against good collateral. Moreover, extending the revised framework to banks would require involving Treasury in bank lending, historically an area where the Fed has had broad autonomy. Accordingly, the Fed should continue to remain independent and able to make any loans to banks without the approval of the Treasury.

V. Conclusion

In response to the COVID-19 pandemic, the Federal Reserve assumed a novel role: engaging in *credit* provision rather than *liquidity* provision, particularly with respect to lending to non-

¹³¹ Federal Reserve Act, § 10B(b)(3)(D).

^{**} Federal Reserve Act, § 103(b)(3)(D).
**3.5 See R. Alton Gilbert, Kevin L. Kliesen, Andrew P. Meyer, & David C. Wheelock, Federal Reserve Lending to Troubled Banks During the Financial Crisis, 2007-2010, 94 Federal Reserve Bank of St. Louis Review 221 (May/June 2012) (the Fed limited lending to undercapitalized and critically undercapitalized banks during the financial crisis).
**3.5 See Ian Plenderleith, Review of the Bank of England's provision of emergency liquidity assistance in 2008-09 51 (Oct. 2012), available at https://www.bankofengland.co.uk/-/media/boe/files/news/2012/november/the-provision-of-emergency-

¹³⁸ See Ian Plenderleith, Review of the Bank of England's provision of emergency liquidity assistance in 2008–09 51 (Oct. 2012), available at https://www.bankofengland.co.uk/-media/boe/files/news/2012/november/fibe-provision-of-emergency-liquidity-assistance-in-2008-9. "The purpose of this review is to learn lessons to inform the way the Bank conducts ELA operations for individual financial institutions. Such support operations will, in due course, be conducted under the new Crisis Management Memorandum of Understanding, which was published in January 2012. The review will build on the lessons learned in relation to the ELA provided to Northern Rock in 2007, as set out in the Treasury Committee's report "The Run on the Rock"; See also Bank of England, Court of the Bank of England commissions a set of reviews to learn lessons (May 21, 2012), available at https://www.bankofengland.co.uk/-/media/boe/files/news/2012/may/court-of-the-boe-commissions a set of reviews to learn lessons.

commissions-a-set-of-reviews-to-learn-lessons.

Definancial Services Act of 2012, c. 21, Part 4, available at http://www.legislation.gov.uk/ukpga/2012/21/part/4/enacted;
HM Treasury, Bank of England and Prudential Regulation Authority, Memorandum of understanding on financial crisis management at §1 (cited in note 122).

¹³⁶ Scott, Connectedness and Contagion at 112-114 (cited in note 3).

¹³⁷ HM Treasury, Bank of England, and Prudential Regulation Authority, Memorandum of understanding on financial crisis management at §25 (cited in note 122).

financial companies. This unprecedented intervention has raised the concern that the Fed was engaged in fiscal policy, which is properly the sphere of elected authorities. Because of limits placed on the Fed's non-bank lending authority by the Dodd-Frank Act, when the Fed assumed the role of the credit provider of last resort, it did not do so on its own; it needed the approval of and financial backing from the Treasury, with funds appropriated by Congress in the CARES Act. Collaboration between the Fed and Treasury blurred the lines of political accountability, raising concerns that the Fed might bear the blame for failures that are the responsibility of the Treasury. In the short run, absent legislative change, there needs to be much more transparency about the relative responsibility for Section 13(3) facilities as between the Fed and the Treasury.

In the longer run, this report proposes a revised framework for emergency lending to nonbanks, including purchases of non-bank debt and lending to non-financial companies. Within this framework, emergency non-bank lending that presents significant credit risk should be viewed as constituting fiscal policy and be the sole purview of the Treasury. The arbiter of whether significant credit risk is present would be the Treasury.

The Treasury would manage lending facilities that pose significant credit risk, with the Fed serving only in an advisory and operational role. In our view, lending to non-financial companies should be regarded per se as involving significant credit risk and be the sole purview of the Treasury. The Treasury would also have the power to direct the Fed, acting solely in its capacity as the Treasury's agent, to make loans, purchase assets or even operate an emergency lending facility, provided the Fed is operationally equipped to carry out the Treasury's direction. The Fed, on the other hand, would continue to be responsible for emergency non-bank lending and asset purchases that *do not* pose significant credit risk. Finally, the report considers whether the proposed framework should be extended to emergency lending to banks and concludes that there is no compelling reason to alter the current framework for bank lending.

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