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Sue the Fed: The Case for Privately Enforceable Statutory Constraints on Federal Reserve Emergency Lending

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Abstract:

The federal government's economic response to the COVID-19 epidemic has principally been one in which the Federal Reserve has set up extraordinary lending facilities in partnership with the Treasury Department. These facilities were modeled on multi-trillion-dollar lending facilities set up by the Federal Reserve in 2008 in response to the prior economic crisis. These Federal Reserve lending facilities are extraordinary in size but also extraordinary because they involve lending to firms that are not banks. Federal Reserve lending over the first hundred years of its history was almost exclusively limited to banks. Congress put in place statutory limits on this extraordinary lending authority in the Dodd-Frank Act of 2010 to limit the Federal Reserve's discretion and minimize the risk that generous lending by the Federal Reserve would encourage excessive risk taking. Those limits prohibit the Fed from supporting insolvent firms, from propping up individual firms like it did with AIG in 2008, includes a number of other prescriptive measures to ensure the Federal Reserve takes reasonable risk management practices even in extraordinary times. This paper argues that those limits have not proven enforceable nor constraining on the Fed's discretion, and this paper instead argues that a private right of action to enforce them would better fulfill Congress' objective in the Dodd-Frank Act to limit Federal Reserve discretion in lending to non-banks.

Introduction:

The Federal Reserve has instituted a range of emergency support facilities pursuant to its authority under Section 13(3) of the Federal Reserve Act in 2020 in response to the economic crisis caused by the pandemic. The 13(3) emergency lending facilities set up by the Federal Reserve in 2020 were modeled on emergency lending facilities set up in response to the financial crisis of 2008. The 2020 facilities were sizeable, measured in mid-August of 2020 as supporting roughly $96 billion in

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outstanding loans.[1] While significant, is it considerably less than the trillions in liquidity support provided during the financial crisis of 2008.

While the Fed was engaging in monetary policy easing and setting up programs through its discount window, which were all part of normal central bank operations, the Fed also set up these extraordinary lending facilities that loan money and provided support to financial services firms who had never been given support by the Federal Reserve before. This activity represents a dramatic departure from traditional central bank jurisdiction.

This paper argues that 13(3) facilities are particularly costly from a moral hazard perspective, that the Federal Reserve often ignores legal and regulatory constraints on its emergency lending authority during a crisis, and therefore a private right of action for private parties to enforce these restrictions through private legal action is therefore advisable.

These facilities represent an extraordinary departure for the Fed, in that they involved lending to companies that are not banks. Over the first 90 years of the Fed's history, it made little use of 13(3), providing less than $2 million in liquidity support between 1913 and 2007. In 2008 the Fed vastly expanded its use of 13(3) and used it again in 2020. Legal constraints set up to govern this emergency lending program, including requirements for penalty rates, good collateral, and a prohibition on lending to insolvent firms among other restrictions, are designed to limit the moral hazard costs associated with emergency loans.

This paper first analyses the Fed's emergency lending in 2008, which many argue violated existing legal restrictions on its emergency lending authority, to lay the groundwork for how the Fed's more recent 13(3) emergency lending in 2020 violates some of the legal restrictions placed on its authority that were adopted in 2010 in response to the Fed's 2008 facilities.

The Federal Reserve serves multiple functions, one of which is to provide liquidity support (or, "bailouts") to financial institutions outside of normal monetary policy operations. This function of central banks is termed the lender of last resort (LOLR) function and has been studied by economic thinkers since Walter Bagehot and Henry Thornton first studied this function of the Bank of England in the mid-19th century.

If used excessively, the lender of last resort function can reward excessive risk taking and result in moral hazard costs, in essence encouraging future behavior that will lead to future crises. Professor John H. Cochrane sums up the problems created by excessive use of the lender of last resort function of central banks nicely:

[1] *See* Federal Reserve, Term Auction Facility (TAF) Background, *available at* https://www.federalreserve.gov/regreform/reform-taf.htm

> Institutions that can borrow at last resort don't set up backup lines of credit, don't watch the quality of their collateral, and don't buy expensive put options and other insurance, making crises worse. Investors who know that the Fed will stop "fire sales" don't keep some cash lying around for "buying opportunities," making fire sales worse. "Big banks are too complex to go through bankruptcy," the mantra repeats. But why do people lend to them, without the protections of bankruptcy? Because they know creditors, if not management and equity, will be protected….
>
> This isn't theory. When the Fed and Treasury bailed out Bear Stearns, and especially its creditors, markets learned…Lehman turned down capital offers, and the reserve fund put 40 percent of its assets in Lehman paper.[2]

Conventional wisdom among bank economists holds that in order to minimize these problems, central banks should follow Bagehot's dictum to lend freely during financial panics, but only to solvent institutions, at a penalty rate, and against good collateral. Former Chairman of the Federal Reserve Ben Bernanke continued to tout the importance of Bagehot's dictum even as the Federal Reserve ignored key aspects of it. It is not enough to argue that letting shareholders fail will eliminate moral hazard, as Professor Lawrence H. White argues that after the Federal Reserve's bailout of The Bear Stearns Companies, Inc. (Bear Stearns) (where shareholders incurred tremendous losses and creditors were bailed out), Lehman Brothers significantly increased its leverage.[3]

This paper explores the specific case of Federal Reserve extraordinary lending to non-banks, a special and rare power it is granted by Section 13(3) of the Federal Reserve Act. Bagehot's dictum was formulated with banking institutions in mind, but becomes even more important in the extraordinary case of lending to non-banks. The Federal Reserve utilized Section 13(3) to fund massive bailouts of American International Group (AIG) and Bear Stearns in 2008 and used 13(3) to set up extraordinary lending facilities to small businesses and municipalities in 2020.

Some of the prior limits on Section13(3) incorporated principles from Bagehot's dictum. The Federal Reserve stubbornly ignored those restrictions, and further violated explicit legal restrictions on 13(3), in its bailout of AIG and Bear Stearns. It was able to violate the law without any self-executing legal sanction.

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[2] John H. Cochrane, *Comments by John Cochrane*, *in* Paul Tucker, *How Can Central Banks Deliver Credible Commitment and Be "Emergency Institutions"?*, *in* CENTRAL BANK GOVERNANCE & OVERSIGHT REFORM 31-2 (John H. Cochrane & John B. Taylor eds., 2016).
[3] Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 458 (Fall 2010).

In response to the design of these 13(3) facilities, as part of the Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010 Congress adopted further restrictions on 13(3) to bring emergency lending facilities closer to Bagehot's dictum. This paper argues these restrictions will be, and in some cases in the 2020 facilities have already been, just as ineffective as the restrictions that preceded the 2008 financial crisis. This paper offers an alternative method to instead make restrictions on the Federal Reserve's authority under 13(3) self-executing by providing individuals and organizations with a private right of action to enforce the rule.

This paper explores a number of additional proposals to further restrict 13(3), including proposals drafted by the author that were contained in the Financial Choice Act which passed the House of Representatives in 2017, and links those proposals with debates about the lender of last resort function and with the benefits of strategic ambiguity in limiting moral hazard as they apply to non-banks.

The thesis of this paper is that the only way for the lender of last resort function to be restrained, and strategic ambiguity encouraged, would be to recognize a clear private right of action to allow private enforcement of 13(3) restrictions. Notably, this paper only references the Federal Reserve's lender of last resort role as it is implicated for non-banks and does not suggest a private right of action to police lending to chartered banking institutions.

This paper argues that if further, more meaningful, statutory restrictions are imposed on the Federal Reserve's extraordinary lending powers, and in the event those restrictions can be made binding on the Federal Reserve in some way (as through private actions to enforce them) then constructive ambiguity can serve as a meaningful tool to limit moral hazard costs in the future and thereby improve long-term financial stability.

I. Bagehot's Dictum: A Rule Intended to Constrain Moral Hazard in Central Bank Lending That Is Often Ignored

Calomiris and Khan observe that the final analysis of bailout policy should appropriately consider "the hard-to-measure moral-hazard costs in the future that come from such bailouts today."[4] This quote captures well the challenge facing government officials in their role as lender of last resort, in that they face the consequences of backlash from economic downturn but do not internalize the future costs of moral hazard created by their present day decision to provide support.[5]

[4] Charles W. Calomiris & Urook Khan, *An Assessment of TARP Assistance to Financial Institutions*, 29(2) J. ECON. PERSP. 53, 66 (Spring 2015).
[5] *See* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. (2010) and J.W. Verret, *The Bailout Through a Public Choice Lens: Government-Controlled Corporations as a Mechanism for Rent Transfer*, 40 SETON HALL L. REV. (2010).

Tucker argues that, to the extent a central bank develops a reputation for lending to insolvent institutions, it actually makes the stigma problem worse for future recipients of support.[6]

The literature on constraining the lender of last resort function of central banks has traditionally crystallized on observations from 19th century economic writer Walter Bagehot, who himself adopted much of it from Henry Thornton, suggesting that central bankers should lend freely, at a penalty rate, against sound collateral, to solvent institutions.[7] The idea behind Bagehot's dictum is that these constraints will allow central banks to provide liquidity widely to prevent a temporary panic from leading to a system wide bank crisis, while at the same time minimizing any moral hazard costs which would flow from subsidizing risky activities or rescuing fundamentally insolvent banks likely to otherwise remain insolvent once the temporary liquidity freeze up subsides.

Moral hazard costs are never eliminated in this system, but Bagehot's dictum provides a set of prescriptive measures to minimize moral hazard and balance it against the benefits of central bank liquidity provision during economic crisis.

Central bankers seem to have the most trouble with the penalty rate requirement of Bagehot's dictum.[8] Central bankers are reluctant to charge penalty rates during a crisis because they fear the penalty rates will further strain the financial system.[9] It should be noted that defining an appropriate penalty rate is by no means a simplistic exercise. At the height of a financial panic, from one perspective any rate may be considered a penalty rate because lending markets have frozen and the central bank's rate is effectively higher than the market clearing rate.

As the panic subsides, the benefit of hindsight may show that what appeared to be a penalty rate at the time later seems like a subsidy from the central bank to the recipient. This will be noted as the paper examines the various rates charged under Federal Reserve 13(3) programs initiated during the 2008 crisis.

The Federal Reserve would ideally provide clear guidance about how it sets the penalty rate to the market. For example, it could be defined as a set spread above

[6] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 20 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[7] *See* Walter Bagehot, Lombard Street: A Description of the Money Market. *See also* Brian F. Madigan, Dir., Div. of Monetary Affairs of the Fed. Reserve Bd., Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium in Jackson Hole, Wyoming, Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis (Aug. 21, 2009), *available at* https://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm.

[8] *See* Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 525 (2015).

[9] *See* Dietich Domanski & Vladyslav Sushko. Rethinking the lender of last resort: workshop summary, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 1, 7 (2014), *available at* https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

the immediately pre-panic rate for some type of similar lending product. In 2020, in some cases the Federal Reserve took this approach in setting a rate for emergency facilities. As will be explored below, the Federal Reserve gave up on a penalty rate entirely in setting up its 2020 Primary Dealer Facility program, and simply charged the same rate it was targeting in monetary policy operations. The Federal Reserve preserved as much flexibility as it could when it adopted guidance for how it would set the penalty rate, and simply listed a series of boilerplate factors it would consider in designing a penalty rate for 13(3) lending. Further, for some 13(3) facilities set up on 2020, the Fed abandoned any notion of a penalty rate altogether.

Bagehot viewed the collateral requirement as an effective proxy for institutional solvency, assuming that if a bank could provide valuable collateral for a loan before a panic began it might be fundamentally solvent despite being temporarily illiquid.[10] Some critics of the Bagehot approach note that determination of temporary illiquidity vs. insolvency is uncertain and subjective.[11]

Calomiris et al. argue that collateralized lending can serve as an inefficient limit on the LOLR function in some cases, as secured lending can contribute to the debt overhang problem and thereby discourage banks from making use of the LOLR facility.[12] In the ordinary course they note it serves a helpful screening function, much like borrower screening, to limit moral hazard.[13]

Tucker argues that collateral haircuts are a vital component to LOLR policy.[14] Though he remains skeptical of central banks using external parties to value collateral, he does not provide any reasoning why that cannot be helpful, particularly in avoiding bias on the part of the central bank to ignore collateral haircuts to encourage participation in facilities.[15] In the event that the Federal Reserve were required to obtain an opinion from an outside party attesting to the value of collateral, and were required to apply a minimum haircut to that collateral by statute, the prospects of central bank bias would be partially reduced.

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[10] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 46 (2014), *available at* https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[11] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 60 (2014), *available at* https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[12] *See* Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 59 (2016).

[13] *See* Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 59 (2016).

[14] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-Thinking the Lender of Last Resort 10, 26 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[15] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 26 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

The outside party's reputation may limit abuse. Moreover, any contractual liability the appraiser of that collateral may owe to the central bank would serve to limit incentives to overvalue the collateral. The Federal Reserve's implementing rule for the 2010 13(3) restrictions references that the Fed may utilize outside appraisers for collateral valuation. The release notes that "In connection with assigning a lendable value to other collateral, Reserve Banks readily take into account independent appraisals of the collateral that may be available."[16] It is unclear whether the Federal Reserve allows appraisers for collateral provided in emergency facilities to include liability opt-outs in engagement letters, a practice which is otherwise common in the valuation industry. That may have implications for the incidence of professional sanction in valuation of collateral.

One way to define the difference between insolvent firms and illiquid firms is that the former are likely to remain illiquid even without a financial panic. Temporarily illiquid firms, however, are unable to pay bills as they come due but otherwise would be able to do so if the markets for their asset portfolios were not temporarily frozen due to market panic.[17] These definitions require subjective assessment. The point however is not that the definition be perfect, but that it be objectively determined and that it be transparent. This serves to limit Federal Reserve discretion. Strategic ambiguity can also exist, potentially, above the minimum solvency requirements established by statute for recipients of 13(3) support.

The Federal Reserve's implementing language in the Regulation A amendment that puts Dodd-Frank's 13(3) restrictions in place takes a responsible approach to defining insolvency, and does not maintain maximum discretion for the Federal Reserve the way that its penalty rate language does.

The Fed goes beyond the specific language of Dodd-Frank to add restrictions suggested by commentors to ensure that lending is not provided to an intermediary firm used as a vehicle to indirectly provide support to an insolvent firm and also adds language suggesting that insolvent does not merely mean "currently in bankruptcy court" but instead means "unable to pay debts as they come due."[18] The latter language is commonly used in financial accounting and valuation to define a state of insolvency. The Fed should be commended to going beyond the base language of the statute it utilized in its initial proposal, focused only on whether a firm was already in bankruptcy, and provided a more holistic definition of insolvency.

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[16] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 4, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.

[17] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1534 (2017).

[18] *See* Extensions of Credit by Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 3, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.

The generous federal government safety net for financial institutions, including deposit insurance and access to the Fed's discount window, is justified by supporters as that banks have much higher levels of information about their borrowers and depositors that other financial counterparties, and therefore can generally operate under high degrees of leverage. Higher leverage, it is argued, allows banks to more efficiently intermediate capital, except in times of market panic during which their highly leveraged business model can lead them to magnify depressions.

That is not true, however, for the purposes of Federal Reserve lending to non-banks under 13(3). In this context, the Federal Reserve does not have this special insight into the health and inner working of the recipients from its regular bank examinations. Thus the information advantages the Fed may have when it fulfills a LOLR function for banks are not present when it does so for non-banks. Bagehot's dictum, and firm statutory constraints codifying it and private sanction to enforce it, become far more necessary in the context of 13(3).

The debate over the relevance of Bagehot's dictum in the LOLR function in banking may continue. This debate informs this paper's exploration of a means to implement Bagehot's dictum for 13(3) lending. A critical reminder for the reader is in order however, in that the focus of this paper, Section 13(3) of the Federal Reserve Act, deals with the very special case of that LOLR function as it applies to non-banks. The objective of this paper is not to resolve debates about the federal safety net for banking institutions. Moral hazard in the non-bank context is quite another matter.

This paper will show that the Federal Reserve largely ignored constraints on its 13(3) authority in 2008, and shows that the Federal Reserve further ignored principles of Bagehot's dictum that were later added via the Dodd-Frank Act as statutory constraints in 2010.

This paper will show that the Federal Reserve took seriously some of the constraints added by the Dodd-Frank Act to 13(3) when it implemented those reforms by way of amendment to its Regulation A.

In 2020, we will see that the Federal Reserve once again ignored key restrictions on its authority, or indeed was charged by Congress with ignoring some 13(3) restrictions in some cases. The Fed followed some limits in 13(3) in other cases. Ultimately the groundwork will be laid to demonstrate that one way to enforce those restrictions, or at least generate healthy strategic ambiguity about the availability of 13(3) to reduce moral hazard, is by way of a private right of action to enforce them.

II. The Case for Strategic Ambiguity in the Lender of Last Resort Function of Central Banks

One theory prevalent prior to the financial crisis was that constructive ambiguity about the likelihood of future liquidity support from the central bank could limit moral hazard, and thus it is helpful for central banks to remain ambiguous concerning the circumstances when they would or would not provide liquidity support to a failing financial firm. This section will review that literature to lay groundwork for how legal restrictions on the Fed's 13(3) lending authority enforced through private rights of action, even if imperfect in their application, can serve to foster precisely this strategic ambiguity.

Strategic ambiguity is helpful with respect to creating uncertainty about whether or not the central bank will provide liquidity in the future. Firm commitments about what will be required in the event liquidity will be provided, and about circumstances in which liquidity will not be provided, can also serve a useful market function and are not inconsistent with an approach that harnesses the benefits of strategic ambiguity. Uncertainty can remain with respect to whether institutions meeting the minimum requirements will in fact obtain liquidity.

One post-crisis workshop, hosted by the Bank for International Settlements (BIS), brought together central bankers to reflect on and assess the actions taken to address the crisis. Participants reached the consensus that constructive ambiguity can remain a useful tool with respect to central bank liquidity support to non-banks.[19] One dissenting paper argues that constructive ambiguity is no longer a helpful approach, arguing that it failed to minimize moral hazard in the lead up to the crisis of 2008.[20] The paper also argues that, in any event, the fact of the 2008 bailouts make it impossible to implement constructive ambiguity going forward.

The first argument against constructive ambiguity assumes, however, that constructive ambiguity was in effect at all prior to 2008. Actions taken by the Federal Reserve demonstrate just the opposite. The Federal Reserve's facilitation of liquidity support by large bank counterparties in winding down Long-Term Capital Management in 1999 (with the attendant assurance that Fed support might be available if needed) as well as a host of prior instances of support by the FDIC, including to Continental Illinois National Bank and Trust Company of Chicago in 1984, indicate that the market was not ambiguous about future Fed liquidity support at all.[21] The market simply assumed it would be there.

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[19] *See* Dietich Domanski & Vladyslav Sushko, Rethinking the lender of last resort: workshop summary, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 1, 5 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[20] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 44 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[21] *See* Volume 1, Chapter 7 of "History of the Eighties – Lessons for the Future" a study prepared by the FDIC's division of Research and Statistics, published in 1997 (https://www.fdic.gov/bank/historical/history/)

This generous use of discount window and 13(3) authority over the Federal Reserve's history cuts strongly against the argument that strategic ambiguity was the Federal Reserve's policy toward extraordinary lending. It instead suggests that the Federal Reserve was highly likely to support insolvent banks and institutions that served as large counterparties to insolvent banks, which is what it ultimately did.

One BIS paper argues that central banks did utilize constructive ambiguity simply by publishing policies or statements of how they intended to provide support in the future that were themselves vague documents.[22] If the market judges the propensity to provide liquidity support by prior actions of a central bank and other bank regulators similarly situated like the FDIC, rather than by non-binding statements of policy from the central bank, then true constructive ambiguity has not been achieved.

The same BIS retrospective on the LOLR function exercised by central banks notes that "[i]n all cases public communication remained consistent with a central bank's retention of full discretion as to how a policy would be implemented in practice."[23] In the end, this discretion also included the flexibility to flagrantly violate statutory restrictions on the Federal Reserve's authority to support non-banks. This paper argues that at this point, with the Federal Reserve's current track record on LOLR decisions, the only way to foster strategic ambiguity is through privately enforced statutory constraints that place boundaries around central bank discretion.

Supporters of the Federal Reserve's actions in 2008 and the Troubled Asset Relief Program (TARP) bailouts miss the mark when they focus on the exigencies of that particular crisis. The period when a future crisis is likely distant is the right time to plan for the next crisis. While the Fed and Congress missed an opportunity to sufficiently plan for the 2020 crisis over the prior ten years, as the economy returns to normal in the ensuing years another window for consideration of statutory and regulatory amendment to 13(3) will present itself once again. Furthermore, statutory changes limiting the potential for bailouts can themselves change institutional design and incentives within market structures to make them more resilient to future financial shocks.

Some may argue that the prospect of congressional appropriation, as in the TARP bailouts of 2008, may hinder the central bank's ability to inspire strategic ambiguity.

[22] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 47 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[23] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 48 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

The possibility of congressional appropriation can never be stopped by law (absent some unlikely constitutional amendment). And yet the political consequences of the last bailout appropriation may limit that fact. Going forward, a future congress will remember that the 2010 change in party control of the U.S. House of Representatives was fueled in part by popular anger at the TARP bailouts. That political cost to the congress that appropriated TARP may allow strategic ambiguity to persist. It is unclear to what extent those pressures were in place during 2020, as most of the emergency appropriation was efficiently directed to individuals in the form of direct stimulus.

This paper argues that if further, more meaningful, statutory restrictions are imposed on the Federal Reserve's extraordinary lending powers, and in the event those restrictions can be made binding on the Federal Reserve in some way (as through private actions to enforce them) then constructive ambiguity can serve as a meaningful tool to limit moral hazard in the future.

III. The Richmond Fed View of LOLR As Reflected in Some LOLR Reform Proposals

Goodfriend and King[24] elaborated on a theory posited by Friedman and Schwartz that has since become known colloquially as the Richmond Fed view, which suggests that banks and other firms do not need direct support at all during a crisis. Instead they argue that open market operations can more effectively get liquidity to the market, which private sector actors will then distribute to each other through loans priced for risk.[25] The Richmond Fed view of LOLR has been supported by a number of economists.[26]

[24] *See* Marvin Goodfriend & Robert G. King, Financial Deregulation, Monetary Policy, and Central Banking, 74 ECON. REV. 3, May/June 1988.

[25] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 46 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[26] *See* George Selgin, *L Street: Bagehotian Prescriptions for a 21st Century Money Market*, 32 (2) CATO J. 303 (2012). *See also* MILTON FRIEDMAN, A PROGRAM FOR MONETARY STABILITY 50-51 (Fordham Univ. Press 1960). Milton Friedman, *Monetary Policy: Theory and Practice*, 14 J. OF MONEY, CREDIT, AND BANKING 98-118 (1982). Thomas M. Humphrey, *The Real Bills Doctrine*, ECON. REV. 3-13 (Sept/Oct.1982). Marvin Goodfriend & Robert G, King, *Financial Deregulation, Monetary Policy, and Central Banking*, ECON. REV. 3-22 (May/June 1988). George G. Kaufman, *Lender of Last Resort: A Contemporary Perspective*, 5 (2) J. Fin. Services Res. 95-110 (1991). George G, Kaufman, Do Lender of Last Resort Operations Require Bank Regulation? Presented at a conference "Is Bank Regulation Necessary?" American Enterprise Institute (Oct. 27, 1999). Jeffrey M. Lacker, *Payment System Disruptions and the Federal Reserve Following September 11, 2001*, 51(5) J. MONETARY ECON. 935-965 (2004). Robert Hetzel, *Government Intervention in Financial Markets: Stabilizing or Destabilizing?*, *in* FINANCIAL MARKET REGULATION IN THE WAKE OF FINANCIAL CRISES: THE HISTORICAL EXPERIENCE 207 (Alfredo Gigliobianco & Gianni Toniolo eds., Banca D'Italia, November 2009).

Critics of that approach argue that the central bank has informational advantages about individual banks that other institutions do not.[27] On the other hand, supporters of the view that the central bank has superior information are too quick to discount the fact that central bank actors will have incentives to discount moral hazard concerns. Further, there is no indication that the central bank has any unique information advantage with respect to non-bank recipients of liquidity like AIG.

The Richmond Fed's view on LOLR originated with Milton Friedman and Anna Schwartz. Friedman argued in 1959 that the Federal Reserve's powers under both 13(3) and the discount window both be repealed as inconsistent with sound operation of monetary policy.[28] An analogy used to describe the Richmond Fed's view of LOLR is the "chancellor of the exchequer tossing the coins out the tower window without looking to see who catches them."[29]

Goodfriend and King articulate one advantage of the Richmond Fed view of LOLR. Where generous use of discount window lending provides liquidity support directly to banks, it requires a costly government regulatory structure to prevent abuse. Open market operations, however, which provide liquidity broadly to the system while still allowing individual institutions to fail, do not necessitate an accompanying costly supervisory system.[30]

The Richmond Fed view contemplates the private market doing a better job than the central bank of separating solvent from insolvent firms because the banks operating in that market have profit incentives that the central bank does not.[31] The Richmond Fed view also suggests that bilateral lending to specific institutions brings the central bank inappropriately into fiscal policy, or credit policy, in that it implicates distributional issues that should not be the province of the central bank and instead should be solely determined by the congress and the U.S. Department of the Treasury.[32]

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[27] That alternative view is described by Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, in Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 47 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.
[28] *See* Walker F. Todd, *Lessons of the Past and Prospects for the Future in Lender of Last Resort Theory*, 19-20 (Fed. Res. Bank of Cleveland, Working Paper 8805, 1988).
[29] *See* Walker F. Todd, *Lessons of the Past and Prospects for the Future in Lender of Last Resort Theory*, 21 (Fed. Res. Bank of Cleveland, Working Paper 8805, 1988).
[30] *See* Walker F. Todd, *Lessons of the Past and Prospects for the Future in Lender of Last Resort Theory*, 20 (Fed. Res. Bank of Cleveland, Working Paper 8805, 1988).
[31] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 18 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.
[32] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 18 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

Critics of the Richmond Fed view argue that markets are broken during a market panic, and therefore money markets and the interbank lending system can no longer be relied upon to separate insolvent from solvent firms.[33] Calomiris et al. argue that

> LOLR interventions can avoid disruptions to payments and credit intermediation that result from liquidity risk. Monetary policy…[is] not a substitute for LOLR lending in addressing liquidity risk problems because changes in the market rate of interest or the rate of inflation have limited and indirect effects on the insolvency risk of banks.[34]

Tucker describes the Richmond Fed view of the LOLR function of a central bank as "accommodat[ing] shocks to the aggregate demand for base money and plays no role in offsetting temporary problems in the distribution of reserves among banks."[35]

Central bankers admit that determinations of solvency in liquidity provision require subjective assessment, are subject to potential bias, and that determinations of illiquidity can quickly become insolvency the longer a crisis lasts.[36] The Richmond Fed view of the LOLR function relies instead on the price system to police solvency as money distributed through open market operations makes its way through the financial system in the form of interbank loans and commercial loans to bank counterparties.

The approach suggested in this article does not fully restrict the Federal Reserve to the Richmond Fed view. First this article does not address extraordinary support to banks via the discount window at all. This article works within the assumption that the political window to eliminate 13(3) will not be open in the near future and indeed assumes the political window to reform 13(3) is likely a narrow one. This article suggests reforms in statute that could reasonably constrain 13(3) to the approach outlined in Bagehot' dictum, which would also partially incorporate the logic of the Richmond Fed view of the LOLR function as well. Though the Richmond Fed view differs from Bagehot's dictum, they run in part toward parallel purposes and both help to inform recently proposed statutory constraints on the Federal Reserve's LOLR powers, particularly with respect to 13(3).

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[33] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 18 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[34] *See* Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 49 (2016).

[35] *See* Paul Tucker, *How Can Central Banks Deliver Credible Commitment and Be "Emergency Institutions"?*, *in* CENTRAL BANK GOVERNANCE & OVERSIGHT REFORM 4 (John H. Cochrane & John B. Taylor eds., 2016).

[36] Dietich Domanski & Vladyslav Sushko, Rethinking the lender of last resort: workshop summary, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 1, 4 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

The Federal Reserve's solution to mitigating the stigma problem in the discount window was to stop setting its own penalty rate, and instead proceed to auction off liquidity to a group of potential bidders.[37] This approach also set a market-based rate which left some strategic ambiguity as to which particular institutions participating in the auction would receive the loan. It appears that the effective rate on this facility was lower than the prevalent discount rate, which does leave one to wonder whether this Term Auction facility was operating at a penalty rate.[38]

It may have been preferable to set a firm floor on the auction, which is what the Fed at least suggested it will do in future iterations of 13(3) facilities in its amendments to Regulation A to implement the DFA's 13(3) reforms. Further penalty rates for institutions not successful at auction would occur as recipients of loans at auction charged a premium for passing the loan on at a risk based premium. In that sense, an auction-based liquidity programs incorporated some of the logic of the Richmond Fed view of the LOLR function.

An auction-based mechanism like that advocated by George Selgin in the final section of this paper would be consistent with the approaches suggested herein, and incorporates some of the thinking contained in the Richmond Fed argument. Auction based systems are one form of statutory restriction on 13(3) which could be enforced by the private right of action explored in the final section of this paper.

Thus far this paper has focused on the theoretical debates about the appropriate constraints on the lender of last resort function. At this point an exploration of Federal Reserve history is appropriate, with particular focus on the events of 2008, to demonstrate that the Federal Reserve has often ignored Bagehot's dictum in practice, and in 2008 was able to ignore legal restrictions on the LOLR function with impunity.

IV. The Federal Reserve Bails Out AIG and Bear Stearns Using Federal Reserve Act Section 13(3) in 2008. The Fed Violates the Law and Ignores Bagehot's Dictum. Moral Hazard Costs Ensue…

Section 13 originated in legislative amendment to the Federal Reserve Act just prior to adoption of the Glass Steagall Act in 1932, where it provided the Federal Reserve authority to lend to commercial firms in exigent circumstances.[39]

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[37] Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1544-45 (2017).
[38] *See* Federal Reserve, Term Auction Facility (TAF) Background, *available at* https://www.federalreserve.gov/regreform/reform-taf.htm
[39] *See* Norbert J. Michel, Dodd-Frank's Title XI Does Not End Federal Reserve Bailouts 4 (The Heritage Foundation, Backgrounder No. 3060, 2015), *available at* https://www.heritage.org/markets-and-finance/report/dodd-franks-title-xi-does-not-end-federal-reserve-bailouts.

At its origin, Section 13 involved Federal Reserve lending in a very direct way to commercial firms outside of the LOLR function of central banks, and the Federal Reserve spent a number of years fulfilling a similar function to the Reconstruction Finance Corporation during the New Deal era.[40] Section 13(3) was added to the Federal Reserve Act in 1932.[41] The Federal Reserve did not utilize its authority under 13(3) at all between 1936 and 2008.[42]

Though the Federal Reserve did little to use its authority under 13(3) for most of its history, some may point to other Section 13 facilities like these small business facilities as an indicator of its likelihood of using 13(3). The RCF portfolio was eventually transferred to a new Small Business Administration in 1958 with support from the Federal Reserve, as the then-Chairman of the Federal Reserve, William McChesney Martin, Jr., was uncomfortable with the Federal Reserve straying so far from it core monetary policy function to lend to individual firms and engage in credit policy traditionally reserved from the private market and the Treasury Department.[43]

The Federal Reserve retained general 13(3) powers however, as well as its discount window authority to lend to individual banks. The Federal Reserve provided large scale liquidity support to two insolvent banks in the twentieth century, Franklin National in 1974 and Continental Illinois in 1984, as well as a host of other troubled institutions via its discount window authority. Some of the latter were counterparties to the failed Penn Central railroad. The Long-Term Capital Management crisis further suggests the Federal Reserve would have provided liquidity to the LTCM counterparties if it had become necessary.

These actions with respect to banks and LTCM preceded the Federal Reserve's liquidity support under 13(3) in 2008. If the Federal Reserve was willing to bail out insolvent banks, and it was willing to provide support to an insolvent hedge fund, the actions taken under the auspices of 13(3) in 2008 were more predictable by the market. Moral hazard was baked into the market and may have been a contributing factor to the 2008 financial crisis.

The Federal Reserve utilized Section 13(3) of the Federal Reserve Act in 2007 to provide Bear Stearns a loan to facilitate its acquisition by J.P. Morgan Chase, the first

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[40] *See* Lender of More Than Last Resort: Recalling Section 13(b) and the years when the Federal Reserve opened its discount window to businesses 18 (David Fetting ed., Fed. Res. Bank of Minneapolis, REGION, Dec. 2002).

[41] *See generally* Parintha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, FRBNY ECONOMIC POLICY REVIEW (2018) available at https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_political-origins_sastry.pdf

[42] *See* Congressional Research Service, Federal Reserve: Emergency Lending, March 27, 2020, at page 7, *available at* https://fas.org/sgp/crs/misc/R44185.pdf.

[43] *See* Lender of More Than Last Resort: Recalling Section 13(b) and the years when the Federal Reserve opened its discount window to businesses 45-46 (David Fetting ed., Fed. Res. Bank of Minneapolis, REGION, Dec. 2002).

time the Federal Reserve had used that particular authority since 1930.[44] The Federal Reserve also provided an $85 billion line of credit to AIG in 2008 using Section 13(3).[45]

At the time, there were only a few requirements governing how and when the Federal Reserve could institute a 13(3) facility. First, it had to involve "unusual and exigent circumstances," a vague modifier with little operative significance.[46] Second, 5 of 7 Fed Governors had to approve of the facility.[47] Third, the borrower had to provide evidence that it was unable to secure credit from other banking institutions.[48] Fourth, the borrowing had to be secured to the satisfaction of the Federal Reserve Bank, the Federal Reserve Board could no longer dictate to Federal Reserve District Banks that they must lend to an institution.[49]

The Federal Reserve utilized Section 13(3) to take toxic assets off of Bear Stearns' balance sheet and thereby encourage J.P. Morgan to acquire Bear.[50] It did so by creating, and using 13(3) to fund, a Special Purpose Vehicle (SPV) to acquire those toxic assets.[51] The Federal Reserve similarly used 13(3) to create two SPVs to purchase toxic assets from AIG.[52] The Federal Reserve violated Bagehot's dictum in that it used this intermediary vehicle to provide support to an insolvent firm, actions which led to statutory reforms limiting the Fed from lending to insolvent firms included in the Dodd-Frank Act. The Fed further violated the law in that it used this intermediary vehicle to effectively take equity investments in the loan recipient as the form of collateral for the liquidity support.

Section 13(3) previously did not require the Federal Reserve to charge a penalty rate and left the Federal Reserve with the discretion to charge any rate it wished.

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[44] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 49 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[45] *See* Dietrich Domanski, Richhild Moessner and William Nelson, Central banks as lenders of last resort: experiences during the 2007-10 crisis and lessons for the future, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 43, 46 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[46] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 538 (2015-2016).

[47] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 538 (2015-2016).

[48] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 539 (2015-2016).

[49] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 539 (2015-2016).

[50] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 539 (2015-2016).

[51] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 536 (2015-2016).

[52] *See* Revisions to the Federal Reserve's Emergency Lending Rules, in Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 536 (2015-2016).

The macroeconomic conventional wisdom about Bagehot's dictum strongly suggested the Fed should charge a penalty rate. The Federal Reserve clearly did not however follow Bagehot's dictum under the Maiden Lane facilities set up to bail out AIG and Bear Stearns. The Maiden Lane facility ("Maiden Lane I") set up to facilitate J.P. Morgan's takeover of Bear Stearns charged the primary credit rate.

The loan was simply set at the primary rate and did not charge the type of substantial premium which would normally accompany merger financing. AIG paid an average of 1.34 percent interest on a $19.5 billion loan from the Federal Reserve ("Maiden Lane II") and an average of 1.29 percent on another $24.3 billion loan ("Maiden Lane III"). AIG also paid 2.36 percent interest on an additional credit facility of $37.8 billion set up to provide short-term financing. The terms of that Maiden Lane facility were the one-month LIBOR rate plus 100 basis points.[53]

The Federal Reserve further explicitly violated the law. The Federal Reserve has authority under 13(3) to "discount…notes, drafts, and bills of exchange" which on its face doesn't cover the AIG equity it took as part of the Maiden Lane II and Maiden Lane III facilities for AIG.[54] The original restrictive language in 13(3) was inserted to prevent the Federal Reserve from undertaking fiscal credit policies that subsidize individual firms at taxpayer expense.[55] The fact that the Fed set up an intermediary vehicle Treasury Trust Fund to hold the AIG securities, and then took notes in that trust as collateral, was a work around that frustrated the purpose of the statute. It was the sort of work around that the Fed would never permit regulated banks to use to evade restrictions on their ability to hold prohibited assets.

The Federal Reserve accepted a great deal of collateral generally deemed of low value.[56] Part of the reason collateral was difficult to value was that credit ratings became unreliable. In the absence of credit ratings, the Federal Reserve should at the very least adopt by statute a list of acceptable collateral that will bind it in the future.

Initially the Federal Reserve attempted to avoid using 13(3) in bailing out Bear Stearns by providing the liquidity directly to J.P. Morgan, and having J.P. Morgan then lend the funds to Bear Stearns.[57] The Federal Reserve's General Counsel

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[53] *See* L. RANDALL WRAY, LEVY ECON. INST. OF BARD COLL., THE LENDER OF LAST RESORT: A CRITICAL ANALYSIS OF THE FEDERAL RESERVE'S UNPRECEDENTED INTERVENTION AFTER 2007 47 (2013).
[54] *See* Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 456 (Fall 2010).
[55] *See* Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 456-7 (Fall 2010).
[56] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1539 (2017).
[57] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1548 (2017).

refused to sign off on that idea, and another workaround was established to evade restrictions contained in 13(3).[58]

The Federal Reserve lacked the authority to directly purchase the troubled assets it intended to purchase from Bear Stearns, so it created an intermediary called Maiden Lane ("Maiden Lane I") and the Federal Reserve then made a secured loan to that entity.[59] The two AIG Maiden Lane facilities similarly utilized pass through entities to evade 13(3), and further involved the Federal Reserve in accepting an equity interest in AIG which was later deemed to be outside of its statutory powers by a federal court.[60]

Under the Primary Dealer Credit Facility that the Federal Reserve created, it accepted as collateral assets that were thinly traded, equity interests, and assets with a low credit rating, despite statutory requirements that 13(3) lending be "secured to the satisfaction of the Fed" which presumably creates some reasonable floor of satisfactory collateral.[61] To some extent the Fed can implement this requirement through the process of taking "haircuts" on collateral that value them at an appropriate fractions of their face value, and the Federal Reserve has implemented changes to Regulation A in the Dodd-Frank Act which specify a process for application of haircuts to collateral.

As collateral for the loan to AIG, the Federal Reserve took assets, stock in AIG subsidiaries, and convertible preferred stock in AIG amounting to an ownership interest of 79.9% in AIG.[62] However, Section 13(3) does not permit the Federal Reserve to accept equity securities in a corporation as collateral for extraordinary lending.

Former AIG CEO Maurice "Hank" Greenberg sued the Federal Reserve in his capacity as a shareholder of AIG and challenged that the Federal Reserve did not have authority under 13(3) to become a shareholder in AIG through the bailout. His challenge was victorious, and the court ruled that "Section 13(3) did not authorize the Federal Reserve to acquire a borrower's equity as consideration for the loan."[63] He later lost on appeal on standing grounds, owing to his inability to assert a derivative action on behalf of AIG, but the lower court's determination that the Federal Reserve exceeded its authority under 13(3) remained intact. This ultimate

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[58] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1548 (2017).

[59] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1549 (2017).

[60] *See Starr Int'l Co., Inc. v. United States*, 121 Fed. Cl. 428, 468 (2015), *aff'd in part, vacated in part on other grounds*, 856 F.3d 953 (Fed. Cir. 2017).

[61] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1550 (2017).

[62] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 15 (July 2014).

[63] *See Starr Int'l Co., Inc. v. United States*, 121 Fed. Cl. 428, 468 (2015), *aff'd in part, vacated in part on other grounds*, 856 F.3d 953 (Fed. Cir. 2017).

conclusion by the court is consistent with contemporaneous observations from former Fed Chairman Paul Volcker and others that suggested the Fed was exceeding its authority and blatantly violating the law.[64]

There are important philosophical objections to the Federal Reserve's violation of the law in the bailouts of 2008. Lawrence White argues that the Federal Reserve's actions in 2008 violate what Hayek describes as:

> …the great principles known as the Rule of Law….this means that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and plan one's individual affairs on the basis of this knowledge.[65]

Another indication of the Federal Reserve's willingness to take a flexible approach to law in the event of an economic crisis was its behavior just after Bank of America purchased the failed brokerage house Merrill Lynch. Bank of America expressed an intent to utilize a Material Adverse Change clause in the purchase contract after additional diligence indicated that there may have been material adverse impacts on the value of the purchased entity. The Federal Reserve made threats to abuse its bank supervisory powers to punish Bank of America if it backed out of the deal using a MAC clause provision.[66] Bank supervisory power is intended to be used to maintain the safety of a regulated bank, here Bank of America. Regardless of whether Bank of America's potential use of the MAC clause was appropriate under the M&A agreement, it was an abuse regulatory discretion to instead use that bank supervisory power to force Bank of America to continue to proceed with the acquisition of Merrill.

Restrictions on liquidity provision to individual firms from both the Federal Reserve and the FDIC can serve the useful end of encouraging prompt resolution through bankruptcy of failing firms.[67] William Nelson, former Deputy Director of the

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[64] *See* Norbert J. Michel, Dodd-Frank's Title XI Does Not End Federal Reserve Bailouts (The Heritage Foundation, Backgrounder No. 3060, 2015), *available at* https://www.heritage.org/markets-and-finance/report/dodd-franks-title-xi-does-not-end-federal-reserve-bailouts *citing* Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 454-5 (Fall 2010). *Also see* Paul Volcker, Remarks by Paul Volcker at a Luncheon of the Economic Club of New York (Apr. 8, 2008).
[65] Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 452 (Fall 2010) (quoting F. A. HAYEK, THE ROAD TO SERFDOM 112 (Bruce Caldwell ed., Univ. of Chicago Press 2007)(1944)).
[66] *See* Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 455 (Fall 2010) *citing* Robert Kuttner, *Betting the Fed*, THE AMERICAN PROSPECT (May 20, 2009), http://prospect.org/article/betting-fed. See also Letter from Andrew Cuomo, Attorney Gen., N.Y., to Senator Christopher Dodd, Chairman, Senate Comm. On Banking, Housing and Urban Affairs (Apr. 23, 2009)(on file with author).
[67] *See* Lawrence H. White, *The Rule of Law or the Rule of Central Bankers?*, 30 CATO J. 451, 457 (Fall 2010)

Division of Monetary Affairs at the Federal Reserve, argues that the appropriate metric with which to gauge the Fed's liquidity facilities is the fact that the loans were all "repaid on time with interest."[68]

This perspective ignores the extent to which loans were made at submarket terms which will exacerbate moral hazard costs during the next financial crisis. The fact that loans were repaid on time, with interest, does not mean that at the time the loans were made they were to an insolvent borrower at sub-penalty rates. Avoiding the insolvency proceeding that would have otherwise occurred creates moral hazard whether or not the central bank ultimately gets paid back or makes a profit on the loan.

An otherwise insolvent borrower can become solvent solely by a loan from a creditor at generous terms, and eventually pay that loan back. The point is not for the central bank to recoup the loan, the point is that in a system where all firms get generous liquidity during a financial panic, moral hazard costs ensue, and lead firms to take risks that then result in the next financial disaster. Bagehot's dictum is intended to be a check on those moral hazard costs.

The Federal Reserve's use of 13(3) had immediate moral hazard consequences in 2008. Former Secretary of the Treasury, Henry "Hank" Paulson argues that after the Federal Reserve's extraordinary support to Bear Stearns, Lehman Brothers held out for similarly generous support from the Federal Reserve as it spurned opportunities to raise capital in other more expensive ways.[69]

The Bear Stearns rescue set the precedent that the Federal Reserve would act to rescue an investment bank using its non-bank extraordinary lending powers.[70] A House Financial Services Committee Report explains:

> The rescue of LTCM implied to market participants that the Federal Reserve *might* rescue the creditors of a non-bank firm, even if the Federal Reserve had no regulatory authority over the firm and did not supervise it. Ten years later, the Bear Stearns bailout confirmed that the Federal Reserve *would* rescue the creditors of a non-bank firm.[71]

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[68] *See* William Nelson, Lessons from lender of last resort actions during the crisis: the Federal Reserve experience, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 76 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[69] *See* Viral Acharya, *Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective* 11 (Hutchins Center on Fiscal & Monetary Policy, Brookings Institution, Working Paper No. 11, 2015).

[70] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 12 (July 2014).

[71] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 12 (July 2014).

This paper suggests statutory reforms to 13(3) that can significantly reduce the moral hazard costs associated with that troublesome provision in 13(3). First a focus back to more recent times regarding the Fed's 13(3) facilities from 2020 is appropriate.

V. Federal Reserve 13(3) Facilities Set Up in 2020 During Covid-19

In 2020 the Federal Reserve instituted a number of facilities set up pursuant to the Fed's 13(3) authority as a result of the economic recession cause by a massive economic shock experienced by the American economy during a national stay-at-home initiative. The Federal Reserve has utilized its authority under 13(3) during its response to Covid in 2020 by using 13(3) to stand up 6 different lending facilities.[72]

David Zaring described the situation succinctly that "the Fed and Treasury are doing absolutely everything they can think up to respond to the coronavirus crisis, and because of the still very flexible Depression era statutory language constraining them doesn't offer a whole lot of constraint, even after some amendment in Dodd-Frank, it is all just about legal."[73]

Some may argue that in the event of national emergency, the Federal Reserve's powers should be used liberally and should simply ignore statutory constraints on emergency lending facilities. Such a view in part ignores the dichotomy between Federal Reserve lending and congressional appropriation. To the extent the Federal Reserve is constrained, it adds pressure on congress to appropriate funds through a political process accountable to voters. Redirecting the situs of economic relief to a more appropriate and politically accountable venue like the Congress is another benefit of firm constraints on 13(3) authority.

One emergency lending facility the Fed using 13(3) to support is its Primary Dealer Credit Facility, which offers rates at the top of its federal funds target range (currently .25%) to the 24 financial institutions that are primary brokers with the Federal Reserve System.[74] The PDCF allows these institutions to use municipal bonds as collateral against the loans they accept.

[72] *See* Congressional Research Service, Federal Reserve: Emergency Lending, March 27, 2020, at page 7, *available at* https://fas.org/sgp/crs/misc/R44185.pdf.
[73] See David Zaring, *Four Questions About the Fed and Treasury's Response to the Coronavirus*, Notice and Comment, Y. J. REG., available at https://www.yalejreg.com/nc/four-questions-about-the-fed-treasurys-response-to-the-coronavirus-by-david-zaring/
[74] *See* Congressional Research Service, Federal Reserve: Emergency Lending, March 27, 2020, at page 8, *available at* https://fas.org/sgp/crs/misc/R44185.pdf.

The Fed is using 13(3) to backstop its support for money market funds.[75] The Fed is also using it to lend to companies through the commercial paper funding facility.[76] The Treasury Department used $10 billion from its ESF Fund to back up this facility.[77] The Fed is further using 13(3) to support its Main Street Lending Program, a program in which the Federal Reserve and the Treasury Department are jointly supporting. The Treasury Department is supporting the Federal Reserve's facility through an appropriation of funding in the Cares Act.

A number of provisions in these new facilities relate to restrictions on 13(3). There is a requirement that participants in the facility be investment grade, thus it appears the Federal Reserve is utilizing pre-Covid credit rating as a proxy for whether the recipient is insolvent. But the Federal Reserve is also at points ignoring either statutory or regulatory limits on its 13(3) powers in facilities set up during 2020.

The Primary Dealer Credit Facility was set up pursuant to the Fed's authority under 13(3).[78] The fact that the Primary Dealer Credit Facility is set at the same rate as the discount window rate, or .25%, leads one to question whether this facility is operating at a penalty rate.[79] The Federal Reserve has presently set the discount rate to the same federal funds rate that it targets in its open market operations, and the Federal Reserve described its decision to match the discount rate to the fed funds rate as: "Narrowing the spread of the primary credit rate relative to the general level of overnight interest rates to help encourage more active use of the window by depository institutions to meet unexpected funding needs." It is using a rate explicitly intended to encourage lending.

No matter how the concept of a penalty rate is defined, we can dispense with the fiction that the Federal Reserve has set a penalty rate for some of its current 13(3) lending programs by simply giving up and setting its lending rate to the discount rate. The fact that loans under the primary dealer credit facility are fully collateralized does nothing to remove the requirement in Regulation A that the Federal Reserve utilize a penalty rate for this 13(3)-supported facility. The rate utilized for the Term Asset-Backed Securities Loan Facility, another facility that the Fed used 13(3) to support in 2020, sets a rate at a 1-2 percentage point spread

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[75] *See* Jeffrey Cheng, Tyler Powell, David Skidmore, and David Wessel, What's the Fed Doing in response to the COVID-19 crisis? What more could it do? Brookings, *available at* https://www.brookings.edu/research/fed-response-to-covid19/

[76] *See* Jeffrey Cheng, Tyler Powell, David Skidmore, and David Wessel, What's the Fed Doing in response to the COVID-19 crisis? What more could it do? Brookings, *available at* https://www.brookings.edu/research/fed-response-to-covid19/

[77] *See* Congressional Research Service, Federal Reserve: Emergency Lending, March 27, 2020, at page 7, *available at* https://fas.org/sgp/crs/misc/R44185.pdf.

[78] *See* Federal Reserve, Term Auction Facility (TAF) Background, *available at* https://www.federalreserve.gov/regreform/reform-taf.htm

[79] *See* Federal Reserve, Term Sheet for Primary Dealer Credit Facility, available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20201130a3.pdf

above a swap rate, a rate more consistent with a penalty rate set above the market rate.[80]

Some of the 13(3) facilities are constructed within boundaries set for 13(3) lending. For example, the Commercial Paper Funding Facility limits investments in commercial paper to assets rated A1, or that are rated A2 but was rated A1 on March 17, 2020.[81] This represents an attempt to ensure that the Fed is not lending to an insolvent institution. It further sets a penalty rate of the three-month Overnight Index Swap Rate plus 110 bps for A1 rated issuers and OIS plus 200 bps for A2 rated issuers. There may be some questions about whether the penalty rate is sufficient, but at least it is designed to be a penalty rate. The Main Street Lending facility utilizes a rate of LIBOR plus 300 basis points, which may also represent an attempt at a penalty rate.[82]

One way in which the Federal Reserve has approached the solvency requirements in its lending has been to refer to solvency as of a pre-Covid date, like March 17 for the CCP or April 8, 2020 for the Municipal Liquidity Facility[83], and consider a prospective participant's financial health as of that date.

For the Municipal Facility, an eligible state, county, or municipal government participant must have been rated at least BBB- as of April 8, 2020 and must maintain a rating of at least BB- as of the date of purchase.[84] This restriction would make a city like Detroit, recently out of municipal bankruptcy with a pre-Covid rating of B, ineligible to participate. That may limit moral hazard to some extent, though political pressure on the Federal Reserve to lend to state and local governments with poor credit pre-Covid will no doubt continue.

The Federal Reserve extended its original terms on municipal lending by lowering the threshold of population required to participate, it remains to be seen whether they will cave on their requirement of a pre-Covid investment grade credit rating for participation in municipal facilities.[85]

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[80] *See* Congressional Research Service, Federal Reserve: Emergency Lending, March 27, 2020, at page 9, *available at* https://fas.org/sgp/crs/misc/R44185.pdf.

[81] *See* Federal Reserve Bank of New York, Commercial Paper Funding Facility: Program Terms and Conditions, November 30, 2020, available at https://www.newyorkfed.org/markets/commercial-paper-funding-facility/commercial-paper-funding-facility-terms-and-conditions

[82] *See* Federal Reserve, Main Street New Loan Facility, available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200608a1.pdf

[83] *See* Federal Reserve, Municipal Liquidity Facility, available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200511a1.pdf

[84] *See* Federal Reserve, Municipal Liquidity Facility, available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200511a1.pdf

[85] *See* Federal Reserve, Federal Reserve announces an expansion of the scope and duration of the Municipal Liquidity Facility, available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20200427a.htm

A recent working paper by Lev Menand argues that the Federal Reserve's lending facilities set up on response to the 2020 pandemic are "in tension" with a number of statutory constraints, including 13(3).[86] He argues that ten of the programs do not meet the new requirement in 13(3) that they must ensure the lending is "for the purpose of providing liquidity to the financial system" because the loans are not primarily to financial firms.[87] He argues that there is little enforcement of the provision added to 13(3) by Dodd-Frank requiring that the Fed "obtain evidence" that recipients are "unable to secure adequate accommodations " from another lender.[88]

One hiccup Zaring notes is that Dodd-Frank's amendments to 13(3) required institutions utilizing 13(3) to provide evidence to the Fed that they are unable to obtain credit accommodations from other financial institutions.[89] Another illegal aspect of the 2008 facilities that persists here is the Federal Reserve's acceptance of equity securities as collateral. For example, the term sheet for the Primary Dealer Credit Facility mentions that equity securities will be accepted as collateral.[90]

The joint Federal Reserve and Treasury response did not display systematic violations of statutory restrictions on the Fed to bail out individual firms like in 2008, but neither did the Federal Reserve strictly comply with the law either. Some of the liquidity provided for individual firms went through a congressional appropriation process whereby Congress imposed some dramatic strings. As of mid-May 2020 the restrictions attached to money appropriated for Boeing were so onerous that Boeing has thus far refused to accept it. This indicates that, to some extent, congressional bail-outs of individual firms may not risk eliminating the benefits of statutory 13(3) restrictions, at least as they relate to individual firms.

This is in many ways a vindication for the strong constraints contained in 13(3). They have not stopped the Federal Reserve's ability to provide massive liquidity broadly into the economy. Those constraints, and the reluctance of Congress to lift them, instead encouraged meaningful engagement in the political process and allowed the threat of political blowback to result in some strong constraints on any individual liquidity appropriated by Congress. Then again, another reasonable

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[86] *See* Lev Menand, Unappropriated Dollars: The Fed's Ad Hoc Lending Facilities and the Rules that Govern Them, available at https://ecgi.global/sites/default/files/working_papers/documents/menandfinal_1.pdf

[87] *See* Lev Menand, Unappropriated Dollars: The Fed's Ad Hoc Lending Facilities and the Rules that Govern Them, available at https://ecgi.global/sites/default/files/working_papers/documents/menandfinal_1.pdf

[88] *See* Lev Menand, Unappropriated Dollars: The Fed's Ad Hoc Lending Facilities and the Rules that Govern Them, available at https://ecgi.global/sites/default/files/working_papers/documents/menandfinal_1.pdf

[89] See David Zaring, *Four Questions About the Fed and Treasury's Response to the Coronavirus*, Notice and Comment, Y. J. REG., available at https://www.yalejreg.com/nc/four-questions-about-the-fed-treasurys-response-to-the-coronavirus-by-david-zaring/

[90] See Federal Reserve, Term Sheet for Primary Dealer Credit Facility, https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200317b1.pdf

interpretation is that the Federal Reserve did not feel that the constraints were meaningful enough to lobby against.

In Section 4008 of the Cares Act, Congress temporarily halted, through the end of 2020, limitations on the Federal Deposit Insurance Corporation's authority to guarantee bank debt. Those limits were put into place as part of the Dodd-Frank Act. Cares Act Section 4015 similarly suspended through the remainder of 2020 limits placed on the Treasury Department's authority with respect to the Exchange Stabilization Fund, a fund that the Treasury Department used to support the money market industry during the 2008 financial crisis and again in response to Covid in 2020.[91]

It is revealing that the Cares Act makes no amendment or even temporary halt to the restrictions that the Dodd-Frank Act placed on the Fed's 13(3) extraordinary lending authority. One reasonable conclusion is that the Federal Reserve did not lobby as an institution for any change to restrictions on its authority, unlike the FDIC or the Treasury, because it views those restrictions as toothless.

VI. The Case for Strong Statutory Restrictions on the Federal Reserve's Lender of Last Resort Function

Meltzer noted that the Federal Reserve has never announced a pre-committed strategy for its lender of last resort function.[92] Calomiris et al. point to an extensive prior literature linking generous federal government support to banks, including through LOLR lending, to a sharp increase in the severity and frequency of banking crises.[93]

They warn that LOLR activity is not without cost, and should be constrained by narrow rules, as the profligate bank bailouts of the twenty first century dramatically increased moral hazard and thereby the incidence of bank failure. They note:

> Worldwide, the costs of generous deposit insurance and bank bailouts have been very high since 1970; indeed, the frequency and severity of banking crises during this time period have been unprecedented, and the literature explaining these changes has identified the increasing

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[91] See Sage Belz and David Wessel, What is the Exchange Stabilization Fund Being Used For and Why? Brookings Institution, March 24, 2020, available at https://www.brookings.edu/blog/up-front/2020/03/24/what-is-the-exchange-stabilization-fund-and-how-is-it-being-used-in-the-coronavirus-covid-19-crisis/

[92] *See* L. RANDALL WRAY, LEVY ECON. INST. OF BARD COLL., THE LENDER OF LAST RESORT: A CRITICAL ANALYSIS OF THE FEDERAL RESERVE'S UNPRECEDENTED INTERVENTION AFTER 2007 22 (2013) *citing* Allan H. Meltzer, *Reflections on the Financial Crisis*, 29(1) CATO J. 25, 29 (winter 2009).

[93] *See* Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 60 (2016).

> protection of banks as the primary cause of the greater frequency and severity of banking crises.[94]

The case for strong rules to bind the LOLR function of central banks is that it will reduce moral hazard, it will further focus financial activity more efficiently on asset fundamentals rather than bets about whether support will be provided, and rules provide the financial system with guidance to plan for potential future liquidity shocks.[95]

One commenter further suggests that statutory constraints on a central bank's lender of last resort function can actually serve to preserve the operational independence of the central bank over the long run, as political actors would find it difficult to fault a bank for acting within the boundaries of clearly delineated statutes.[96] Walker Todd argued that:

> A solvency or capital rescue operation is better undertaken through the fiscal operations of the Treasury, in a manner that requires appropriations of funds on the public record and clear lines of political accountability for the actions taken.[97]

While there may be extensive debate about the LOLR function I the context of bank support, the case for restrictions becomes even stronger in the case of non-banks supported through 13(3) programs. Bagehot's dictum is one such rule to limit abuse of the LOLR function, but it is not self-executing unless adopted through some enforceable statute.

Kathryn Judge urges instead the virtue of soft constraints, and describes Bagehot's dictum as a form of soft constraint on the Federal Reserve, a normative principle that the club of central bankers try to meet even if they aren't always successful in hitting the target.[98] Judge describes these forms of soft constraints as where "deviation may lead to retribution or reputational damage" but "the degree of force backing the norm tends to be relatively soft…"[99] She describes both the Taylor Rule and Bagehot's dictum in this way.

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[94] Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 50 (2016).
[95] *See* Viral Acharya, *Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective* 14 (Hutchins Center on Fiscal & Monetary Policy, Brookings Institution, Working Paper No. 11, 2015).
[96] *See* Viral Acharya, *Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective* 15 (Hutchins Center on Fiscal & Monetary Policy, Brookings Institution, Working Paper No. 11, 2015).
[97] *See* Walker F. Todd, *Lessons of the Past and Prospects for the Future in Lender of Last Resort Theory*, 1 (Fed. Res. Bank of Cleveland, Working Paper 8805, 1988).
[98] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 66 (2015).
[99] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 69 (2015).

The problem with Bagehot's dictum as even a soft constraint is that by definition the dictum, and the lender of last resort function it constrains, only comes into play during emergency situations when the central bank is most willing to endure the soft sanction that comes with violating the principle.

This fact is evidenced by the central bankers' own postmortem writings on the Federal Reserve bailouts of 2008, where they all pay brief homage to Bagehot's dictum as they proceed to justify their near complete failure to abide by its prescriptions during 2008, particularly with respect to emergency loans to non-banks under FRA Section 13(3). Kathryn Judge counts 48 references to Bagehot's dictum during speeches at a 2009 Jackson Hole conference of Federal Reserve officials and other experts.[100]

Meltzer argued that the Federal Reserve has long ignored Bagehot's dictum, and indeed adopted policies that directly violated it, even while paying lip service to its admonitions.[101] Judge qualifies her argument noting that the dictum may simply serve as a means of justifying extraordinary action and to "deflect scrutiny."[102]

Judge argues that accountability for the Federal Reserve can go too far, citing empirical literature lending support to the idea of making central banks independent of elected officials.[103] Empirical arguments for central bank independence primarily focus on the central bank's role in monetary policy and the tendency of elected officials to encourage central banks to loosen monetary policy to support short term economic stimulus at the expense of inflation control.

The central bank's lender of last resort function remains fair game from this perspective for both congressional and judicial accountability argued for in this article. Judge suggests that congressional oversight of the Federal Reserve's LOLR function could result in congressional pressure to bail out individual firms.[104]

An oversight power like that added by Dodd-Frank to constrain the FDIC's bank debt guaranty powers works in precisely the opposite direction however, as a veto of individual lending programs proposed by the agency rather than a direction from congress to engage in specific lending. Further, the private right of action suggested

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[100] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 79 (2015).
[101] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 79 (2015) *citing* 1 ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE 20 (2003).
[102] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 81-2 (2015).
[103] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 92 (2015).
[104] *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 93 (2015).

in this article also does not implicate the issue of independence because the government would have a limited role in the private litigation.

Judge's work proposes more of a focus on judicial review of whether the central bank remains within the statutory constraints on its powers. Judge also argues that the agency may have a specialization advantage also urging in favor of increased independence.[105] This specialization advantage with respect to the banks the Fed regulates would not carry over to non-bank recipients of support under 13(3).

Any specialization advantage the Federal Reserve enjoys must be further balanced against its revealed bias toward moral hazard inducing bailouts, and against the alternative of liquidity provision more broadly through open market operations and widely available auction processes that harness the price system advantages of the Richmond Fed view of the lender of last resort function. Furthermore, insofar as this article primarily suggests added judicial review of the Fed's 13(3) power, interpretation of statutory constraints is squarely within the specialization of the judiciary.

The former Deputy Director of Monetary Affairs of the Federal Reserve Board, William Nelson acknowledges that limiting statutory authority to bail out non-banks works to create a useful form of constructive ambiguity to minimize moral hazard.[106] This article will proscribe a means to establish real strategic ambiguity.

A recent assessment of the Federal Reserve argues that the Fed should provide more guidance to the market about how it intends to operate Emergency Lending Facilities during periods of calm.[107] This presumes that the Federal Reserve is compelled by some form of legal or reputational sanction to follow its guidance, when the history of its use of the program suggests just the opposite. The Federal Reserve will ignore prior guidance, and even statutory limitation, when it perceived that the benefits of a facility that that violates limits on its authority exceed the costs.

V. Statutory Restrictions on 13(3) Contained in the Dodd-Frank Act Attempt to Constrain Fed Discretion Will Have Limited Success

In the Dodd-Frank Act, the Federal Reserve's authority to lend to non-banks was constrained in the following ways: emergency lending facilities are required to broad based, may not be used to provide support to insolvent firms, and must be

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105 *See* Kathryn Judge, *The Federal Reserve: A Study in Soft Constraints*, 78 LAW & CONTEMP. PROBS. 65, 93-4 (2015).

106 *See* William Nelson, Lessons from lender of last resort actions during the crisis: the Federal Reserve experience, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 76 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

107 *See* Peter Conti-Brown et. al., *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REG. 1, 81 (2021)

approved by the Secretary of the Treasury.[108] The FDIC's powers to guarantee bank debt by contrast were strongly curtailed by Dodd-Frank, as they include a 2/3 vote of the FDIC Board, approval by the Federal Reserve, and require a resolution of approval passed through the congress. The Federal Reserve's 13(3) lending authority was not as strongly curtailed as it does not include a requirement for congressional approval.

The Dodd-Frank Act purported to constrain the Federal Reserve's authority under 13(3) by adding a number of requirements to use extraordinary lending facilities. The statute required that new facilities must be broad based, must be designed to provide liquidity to the entire financial system rather than assist a particular failing firm, may not be provided to insolvent borrowers, and that security for loans must be sufficient to protect taxpayers from any losses.[109] The President of the Federal Reserve Bank of Richmond testified that these new requirements were vague enough that the Federal Reserve could lend to individual companies in the future just as it did under the Maiden Lane facilities.[110]

The Dodd-Frank Act also called upon the Federal Reserve to issue rules outlining how it would implement the new statutory restrictions. It took three years before the Federal Reserve released a proposal, and then only under significant pressure from congress to do so.[111] The initial proposal defined "insolvent" to simply mean a firm currently in bankruptcy.[112] This proposed definition would have allowed the Federal Reserve to lend to insolvent firms whose creditors had not yet filed for bankruptcy.[113] The initial rule proposal did not define "broad based," and further did not specify a minimum number of participants in a loan facility which would qualify as broad based.[114]

The Federal Reserve's final rule implementing Dodd-Frank's restrictions on 13(3) was in some ways designed to maximize the Federal Reserve's discretion and minimize any restrictions on its ability to bail out entities. For example, the final rule only requires that five entities must *be able* to participate in a program for it to

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[108] *See* Revisions to the Federal Reserve's Emergency Lending Rules, *in* Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 532 (2015-2016).
[109] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 82-3 (July 2014).
[110] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 82-3 (July 2014) *citing Examining How the Dodd-Frank Act Could Result in More Taxpayer Funded Bailouts: Hearing Before the H. Comm. on Fin. Servs.*, 113th Cong. 18 (2013).
[111] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 84-5 (July 2014).
[112] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 85 (July 2014).
[113] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 85 (July 2014).
[114] *See* REPUBLICAN STAFF OF H.R. COMM. ON FIN. SERVS., FAILING TO END "TOO BIG TO FAIL": AN ASSESSMENT OF THE DODD-FRANK ACT FOUR YEARS LATER 85-6 (July 2014).

be deemed broad based, while still allowing only one entity to participate.[115] The final rule also states that a program or facility will not be in compliance if intended for one specific entity.[116]

And yet such an aspirational, intent based definition will not bind the Federal Reserve in any way. Given that the Federal Reserve explicitly ignored a much more specific restriction in the creation of the Maiden Lane facilities, and explicitly violated legal restrictions with impunity, the vague aspirations contained in the new broad-based restrictions will similarly be ineffective.

The Federal Reserve's rules implementing the insolvency restriction require that CEO's provide written certification that they are not presently insolvent, defined as a failure to pay debts as they come due in the previous 90 days.[117] Material misrepresentations will result in debts immediately coming due.[118] This does not however cover borrowing to prevent the threat of future insolvency, and further would require the same Federal Reserve that has institutional incentives to lend in excess to enforce the provision. Private action enforcing insolvency restrictions would operate free of the operational conflicts faced by the Federal Reserve.

The Federal Reserve's final rule implementing the new 13(3) restrictions explicitly states that it is intended to ensure that the Federal Reserve could not replicate the type of lending it undertook to support both AIG and the acquisition of Bear Stearns.[119] And yet given that the original lending itself was in violation of statutory restrictions on the Federal Reserve's authority, it is unlikely these hortatory aspirations will have any meaningful weight during the next financial crisis.

The Federal Reserve's final rule adopting the Dodd-Frank amendments to its 13(3) authority clarified that loan programs would need to available to at least five borrowers to be considered "broad-based," cannot be designed to prevent the bankruptcy of any firms, and cannot be designed to provide liquidity to a particular borrower.[120] The final 13(3) rule constructively expanded the basic definition of insolvency contained in the Dodd-Frank text (borrowers currently in an insolvency proceeding) to also include borrowers who were previously unable to meet their debts in the preceding 90 days or borrowers otherwise deemed to be insolvent by

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[115] *See* Revisions to the Federal Reserve's Emergency Lending Rules, *in* Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 540 (2015-2016).
[116] *See* Revisions to the Federal Reserve's Emergency Lending Rules, *in* Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 540 (2015-2016).
[117] *See* Revisions to the Federal Reserve's Emergency Lending Rules, *in* Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 541 (2015-2016).
[118] *See* Revisions to the Federal Reserve's Emergency Lending Rules, *in* Developments in Banking and Financial Law: 2015, 35 REV. BANKING & FIN. L. 530, 541 (2015-2016).
[119] Extensions of Credit by Federal Reserve Banks, 80 Fed. Reg. 78961 (Dec. 18, 2015).
[120] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.

the Federal Reserve.[121] The final 13(3) rule provides that loans may not be made to firms that intend to use them to support another firm that is insolvent.[122]

The final rule provides that 13(3) lending must be accomplished via a penalty rate.[123] The final 13(3) rule also provides that in the event a company is found to have made a material misrepresentation regarding its solvency, that matter will be referred to law enforcement and all loan proceeds with be immediately due.[124]

Though the final rule purports to set a penalty rate for 13(3) lending, the language in the rule is sufficiently vague that it does not constrain the Fed's discretion to lend at whatever rate it chooses. In some ways it was a constructive development for the Fed to add language to Regulation A suggesting it would use a penalty rate, as the Dodd-Frank changes to 13(3) did not require the Fed to utilize a penalty rate in 13(3) support. The text of the implementing however rule simply lists a broad range of factors that the Fed would take into account when setting a penalty rate, including the condition of the financial system, the historical rate for similar loans, the purpose of the facility, the risk of repayment, and any other relevant factors.[125] The only contours contained in the rule are that the penalty rate should be a rate that "is a premium to the market rate under normal circumstances, [a]ffords liquidity in unusual and exigent circumstances, and [e]ncourages repayment of the credit and discourages use of the program or facility as the unusual and exigent circumstances that motivated the program or facility recede and economic conditions normalize."[126]

Partially consistent with arguments advanced by Selgin, the final rule permits the Federal Reserve to set the penalty rate via auction procedure.[127] Yet the penalty rate language also hedges by allowing the Federal Reserve to set a rate "at a level that is a premium to the market rate in normal circumstances, affords liquidity in

[121] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[122] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[123] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[124] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[125] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 2, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[126] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, at page 8, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.
[127] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.).

unusual and exigent circumstances, and encourages repayment…"[128] This list of mutually contradictory goals will generally afford the Federal Reserve discretion to set any rate it desires.

The Federal Reserve also maintains the discretion under the rule to independently determine that a firm is insolvent, but language in the rule focuses that determination to a review of the financial statements.[129] Since this review will focus only on historical accounting estimates in previously audited financial statements, it will not take into account the present value of balance sheet assets with current market values which may be negligible as a result of fire sale panics in those asset markets.

This section has demonstrated that the attempted restrictions on Federal Reserve 13(3) lending contained in the Dodd-Frank Act will be of limited effect to the extent that the Federal Reserve is determined to evade them. To some extent the Fed has followed their direction its more recent 13(3) facilities set up in 2020, to some extent the Fed has not followed these prescriptions. This backdrop suggests there is work left to be done to constrain central bank discretion under 13(3), create constructive ambiguity, and thereby limit the costs of moral hazard.

VI. Proposed Alternative Restrictions on 13(3), including those contained in the Financial Choice Act of 2017, and a novel proposal for a private right of action enforcing statutory restrictions

A. The Financial Choice Act, previously the FORM Act

The author served as the principal staffer drafting the Fed Oversight Reform and Modernization Act of 2015 (FORM Act), which passed the House on November 19, 2015 on a vote of 241-185. The FORM Act included new restrictions on the Federal Reserve's authority under 13(3), restrictions which were modeled in part on Bagehot's dictum. Those provisions were inserted into a subsequent bill, the Financial Choice Act, which passed the House in 2017.

The restrictions included a requirement that 13(3) support be provided only to entities predominantly engaged in financial activities. This restriction would prohibit the Federal Reserve from accepting equity in exchange for liquidity support. The restrictions required a certification by the relevant federal regulator that the recipient was solvent, and required a minimum penalty rate apply, calculated as the average Federal Reserve discount rate over the preceding 90 days plus a ninety-day trailing average of the difference between a corporate bond index

[128] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.).
[129] *See* Extensions of Credit By Federal Reserve Banks, 12 CFR Part 201, Regulation A; Docket No. R-1476, *available at* https://www.govinfo.gov/content/pkg/FR-2015-12-18/pdf/2015-30584.pdf.).

yield and a relevant treasury bond index yield.[130] The FORM Act further required that a supermajority of Federal Reserve regional presidents approve of the extraordinary lending, in addition to the supermajority of Federal Reserve Board members presently required by the statute.

These new restrictions were intended to breathe new life into the existing statutory constraints on 13(3). And yet, like the attempted constraints that preceded them, they also suffer from the drawback that there is no penalty if the Federal Reserve decides to ignore them. This section argues that in order to be meaningful, the restrictions must be accompanied by a clearly recognized private right of action to enforce them by a class of parties who can both obtain proper standing under existing standing doctrine and who are likely to make use of them in the aftermath of a crisis.

B. Auction Processes, Primary Dealer Reform, and Dividend Restrictions

Before exploring the efficacy of private party standing to enforce statutory restrictions, this subsection will explore additional ideas that have been advanced to limit the Federal Reserve's LOLR function which are consistent with Bagehot's dictum, the Richmond Fed view, and strategic ambiguity ideas explored in this paper.

Central bankers post-crisis have been generally supportive of auction based mechanisms to govern discount window lending, as they observe it tends to resolve stigma limitations that discourage banks from accepting discount window support.[131] Discount window lending is a close cousin of 13(3) extraordinary liquidity support. One way that auction-based liquidity programs can solve the stigma problem is by establishing a pooling equilibrium effect in which outside parties are not able to infer insolvency from a firm's mere participation in a liquidity facility.[132]

This suggests that any non-bank support pursuant to 13(3) also be conducted via an auction mechanism which is widely open to the general public. In a sense, the auction-based facilities partially utilized some of the logic behind the Richmond Fed view on lender of last resort, albeit incompletely in so far as only banks or other subsets of market actors were allowed to participate in particular discount window auctions.

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[130] *See* John L. Walker, *Emergency Tools to Contain a Financial Crisis*, 35 REV. BANKING & FIN. L. 669, 701-2 (2016).
[131] *See* Andrew Hauser, Lender of last resort operations during the financial crisis: seven practical lessons from the United Kingdom, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 76 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.
[132] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 21 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

Selgin argues that a revived term-auction facility may be a way to provide liquidity to the market during financial crises while abiding by Bagehot's dictum.[133] He suggests that while the rate on lending should generally be set by auction, it should have a minimum penalty rate floor.[134] A minimum floor was utilized in some of the Federal Reserve's facilities, like the Term Auction Facility.

One argument the Federal Reserve uses to justify the extraordinary liquidity support it provided during 2008 was that many of the participants in those programs were primary dealers, a small number of institutions serving as counterparties to the Federal Reserve as it participated in open market operations.

Norbert Michel argues that opening up the primary dealer system to allow a much larger group of financial players to become eligible, as is the case in the European Union, would limit this incentive for the Fed to support primary brokers during a crisis.[135] Selgin also points to the small primary dealer system as one of the overriding precipitants to the bailouts of 2008.[136] Tucker also argues against the US approach to primary dealers, arguing that relying on a small group of dealers as the conduits for monetary policy forces the central banks hand and encourages it to bail them out in times of financial stress.[137]

Michel's suggestion would also make open market operations a more effective means to provide liquidity to the market during a downturn. This would enhance the effectiveness of the Richmond Fed view of the lender of last resort function, straightforward open market operations, which would provide liquidity while minimizing moral hazard.

In the event a future government liquidity facility is structured in a similar way to TARP, it is likely the Treasury Department will again be tempted to accept equity investments in recipients rather than engage in collateralized lending. This is a common tendency of governments engaged in bailouts, motivated by a concern that issuing new debt to the government will result in a "debt overhang" problem that will lead creditors, subordinate to the government's bailout loan, to panic.[138]

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[133] *See* George Selgin, *L Street: Bagehotian Prescriptions for a 21st Century Money Market*, 32 (2) CATO J. 303, 324 (2012).

[134] *See* George Selgin, *L Street: Bagehotian Prescriptions for a 21st Century Money Market*, 32 (2) CATO J. 303, 324-5 (2012).

[135] *See* Norbert J. Michel, Dodd-Frank's Title XI Does Not End Federal Reserve Bailouts 7 (The Heritage Foundation, Backgrounder No. 3060, 2015), *available at* https://www.heritage.org/markets-and-finance/report/dodd-franks-title-xi-does-not-end-federal-reserve-bailouts.

[136] *See* George Selgin, *L Street: Bagehotian Prescriptions for a 21st Century Money Market*, 32 (2) CATO J. 303, 304 (2012).

[137] *See* Paul Tucker, The lender of last resort and modern central banking: principles and reconstruction, *in* Bank for Int'l Settlements, BIS Papers No. 79: Re-thinking the lender of last resort 10, 27 (2014), https://www.bis.org/publ/bppdf/bispap79a_rh.pdf.

[138] *See* Charles W. Calomiris & Urook Khan, *An Assessment of TARP Assistance to Financial Institutions*, 29(2) J. ECON. PERSP. 53, 66 (Spring 2015), citing Charles W. Calomiris & Jason R. Mason, *How to*

Equity investments by the Treasury Department present their own problems, as equity ownership discourages the Treasury Department from subsequently allowing a firm in which it owns an equity investment to fail.[139] Equity investments also result in a number of other distortions to the market in which government-controlled firms operate.[140]

To the extent that Federal Reserve support under Section 13(3) is contemplated to support firms also receiving a government bailout run by the Treasury Department in the future, provisions could be added to Section 13(3) to limit abuse. Indeed, the Federal Reserve could be prohibited from providing liquidity support to a firm obtaining support from the Treasury Department or in which the Treasury Department has an equity interest.

One approach utilized to regulate recipients of government liquidity is to limit their dividends,[141] which can also serve a secondary function of minimizing moral hazard through discouraging banks from accepting support.[142] Calomiris and Khan argue that recipients of government support through the Treasury Department should be prohibited from paying dividends. From the perspective of bank safety, they should be encouraged to build up capital by retaining their earnings rather than paying them out, and from the government's perspective payments of dividends diminishes the security of their position as lender.[143] This prohibition should be applied to 13(3) extraordinary support to non-banks for the same reasons.

<u>C. Private Right of Action to Enforce Statutory Restrictions on the Federal Reserve's Lender of Last Resort Function</u>

Statutory limits on central bank liquidity provision, when coupled with judicial means to enforce those limits, can engender meaningful constructive ambiguity. This is particularly true if the expected outcome of litigation challenging a particular exercise of the Federal Reserve's 13(3) powers is itself uncertain. Generally uncertainty in the law is something code drafters attempt to avoid, but when it

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Restructure Failed Banking Systems: Lessons from the United States in the 1930s and Japan in the 1990s, *in* Governance, Regulation, and Privatization in the Asia-Pacific Region, Volume 12, 375-420 (Takatoshi Ito & Anne O. Krueger eds., Univ. Chi. Press 2004) and Armen Hovakimian, Edward J. Kane & Luc Laeven, Variation in Systemic Risk at US Banks During 1974-2010.

[139] *See* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. (2010). Verret, Treasury Inc.

[140] *See* J.W. Verret, *Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice*, 27 YALE J. ON REG. 316, 349 (2010). Verret, Treasury Inc.

[141] *See* Charles W. Calomiris & Urook Khan, *An Assessment of TARP Assistance to Financial Institutions*, 29(2) J. ECON. PERSP. 53, 58 (Spring 2015).

[142] *See* Charles W. Calomiris & Urook Khan, *An Assessment of TARP Assistance to Financial Institutions*, 29(2) J. ECON. PERSP. 53, 58 (Spring 2015).

[143] *See* Charles W. Calomiris & Urook Khan, *An Assessment of TARP Assistance to Financial Institutions*, 29(2) J. ECON. PERSP. 53, 73 (Spring 2015).

comes to statutory reforms intended to minimize moral hazard that uncertainty can be helpful.

In the related context of congressionally appropriated bailouts, Eric Posner suggests "a statute could create a specific cause of action for challenging a bailout" but that to "allow for the discretion necessary for implementing bailouts, the challenge would have to be after the fact and provide for damages rather than injunction relief."[144]

This would depend on whether the entity sued was the Federal Reserve or the recipient of the award. If the Federal Reserve was the target of litigation, damages awarded will not be paid by the Federal Reserve, but would instead be paid by the Treasury via the Court of Federal Claims. A damages award by the Fed would do little to constrain the Fed in that case, and injunctive relief would be far more useful.

If on the other hand the defendant was the recipient of the support, and the recipient had to repay the loan as a result of the Fed's failure to abide by statutory constraints contained in 13(3), then post-hoc damages (in the form of disgorgement) may serve as a meaningful constraint on Fed discretion. Recipients of extraordinary support would then have their own incentive to ensure that any emergency facilities they intended to utilize complied with the requirements of the statute. The recipients would also internalize any risk of uncertainty in their application, which would be a means of inserting just the form of strategic ambiguity that central bankers say they want to see in extraordinary lending programs.

Furthermore, it is likely that judges will be more willing to award damages after the fact than to issue an injunction against emergency lending at the height of the crisis. In at least one example a Delaware judge seemed reluctant to enjoin JP Morgan's acquisition of Bear Stearns during the height of the crisis.[145]

The Court in *Starr International Co. v. United States* held that without the Federal Reserve's loan, AIG would have gone bankrupt, and therefore found that plaintiff was unable to demonstrate damages.[146] This difficulty in damages determinations may recur in future instances of damages awards. If instead the damages award is a form of disgorgement, like that utilized in qui tam actions, then this complication is avoided. That seems to be the case with the recent Wells Fargo opinion permitting a qui tam action to proceed against Wells for violation of the terms of 13(3) emergency lending.

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[144] *See* Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 535 (2015).
[145] *See* Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 Emory L.J. 713, 760 (2009).
[146] *See Fifth Amendment - Illegal Exaction - Court of Federal Claims Holds That Government Acquisition of Equity Share in AIG Effected in Illegal Exaction*, 129 Harv. L. Rev. 859, 866 (2016).

Posner argues that judicial review overturning government emergency actions are unlikely, and that in any event judges lack expertise to do so effectively.[147] And yet judges have sufficient expertise to read the face of a statute, here 13(3) and determine whether the Federal Reserve is acting consistently with constraints determined appropriate by the congress.

Further, even if judges ultimately turn out to be risk averse, and simply ignore the law in the face of perceived financial instability,[148] the prospect that a judge might stop a future program adopted under 13(3) could create helpful strategic ambiguity. This is particularly likely given that judicial precedent of a determination that the Federal Reserve exceeded its authority under 13(3) already exists. It would be difficult for a judge to ignore the existing interpretation of 13(3) in Starr v. U.S that determined the Federal Reserve exceeded its authority.

This article argues that statutory reform to 13(3) contained in the Financial Choice Act provides helpful restrictions on the Federal Reserve to reduce moral hazard concerns. This article also argues however that one vital change is missing from that statutory reform, namely a provision expressly proving standing for parties harmed by a 13(3) lending program to challenge the program and either stop it before liquidity support is provided in a prohibited manner or mandate that the support be subsequently returned via some form or disgorgement or qui tam remedy.

It appears that parties do already have private standing to challenge 13(3) lending that violates the False Claims Act pursuant to the Second Circuit's decision in *Wells Fargo*. This would apply with respect to 13(3) restrictions that require the recipient to make certain representations to the Federal Reserve, but are fraudulent in those representations. The False Claims Act would not apply in the event the Fed ignores a statutory constraint where no false claim was made to the Fed by the recipient. This article suggests building on the finding in *Wells Fargo* to further permit private plaintiffs to challenge 13(3) support that violates

Zaring suggests that standing requirements have discouraged the financial industry from bringing challenges to the government's actions under the congressionally appropriated TARP bailout.[149] In this context, statutory recognition within the text of Section 13(3) could help encourage private party enforcement of statutory constraints on the Federal Reserve's emergency lending powers.

Generalized taxpayer standing won't be available to challenge Federal Reserve liquidity programs, as that generally only permits taxpayers to challenge spending

[147] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1572 (2017).
[148] *See* Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 Emory L.J. 713, 760 (2009).
[149] David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1432 (2014).

authorized by congress pursuant to its taxing and spending power.[150] Standing requires a plaintiff demonstrate that a particular "injury in fact" can be traced to the actions of a particular defendant, and that a favorable judicial decision can redress that injury.[151]

The Supreme Court has held that statutory grants of standing can eliminate prudential standing requirements, but still cannot eliminate the "case or controversy" requirement contained in Article III of the Constitution.[152]
One way to establish statutory standing and stay within jurisprudential standing requirements would be to specify in statute that standing shall be afforded to shareholders in the recipient, traders taking a short position in the recipient of the 13(3) support, to competitors of the recipient, to banks that are members of the Federal Reserve system, and any other parties expected to experience a direct impact from the provision of liquidity in violation of 13(3).

The Federal Reserve Act could also be amended to explicitly permit banks that are members of the Federal Reserve System to bring actions challenging Federal Reserve Bank or Federal Reserve Board actions as ultra vires and thereby stop disbursal of funds by the bank pursuant to illegal actions not authorized by the text of 13(3).

Lujan v. Defenders of Wildlife holds that statutorily conferred citizen taxpayer standing still requires some particularized harm. The statutory reform to 13(3) could recognize that commercial harm, and harm to a short sale interest betting against a failing company, could both meet the particularized harm requirement for purposes of a challenge to 13(3). Similarly, a bank's interest as a member of the Federal Reserve System could be recognized within the Federal Reserve Act as establishing the requisite harm to show proper standing.

The standing cases also seem to focus on making sure the plaintiff with the most particularized harm brings the action, and so courts may be reluctant to let a mere taxpayer control the case if some competitor more directly affected by the bailout would do a better job of directing the litigation. Such an issue might be resolved by mentioning in the statute that the court will select the lead plaintiff. This, of course, would require the court to also consider whether the plaintiffs will face competitive commercial harm as a result of the government support.

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[150] Meredith L. Edwards, *Constitutional Law - Taxpayer Standing to Challenge Executive Spending - Discretionary Spending versus Spending Pursuant to Congressional Authority* , 77 Miss. L.J. 695, 701 (2007).
[151] Bryan Dearinger, *The Future of Taxpayer Standing in Establishment Clause Tax Credit Cases*, 92 OR. L. REV. 263, 272 (2013).
[152] Bryan Dearinger, *The Future of Taxpayer Standing in Establishment Clause Tax Credit Cases*, 92 OR. L. REV. 263, 323 (2013) *citing* Bennett v. Spear, 520 U.S. 154, 163 (1997). A13 at 324 and the cases it cites.

A form of qui tam lawsuit to enforce 13(3)'s statutory prescriptions could also be contemplated, to the extent that a recipient of 13(3) support provided false information to the government concerning the value of its collateral or the availability of alternative financing. This approach was vindicated in an action that challenged representations by Wells Fargo in its application for emergency support during 2008.[153]

In a recent 2019 opinion, the Second Circuit considered this precise question, and found that emergency lending facilities implemented in 2008 were subject to False Claims Act jurisdiction. The Court reasoned:

> Although we agree that FRB personnel are not "officer[s]" or "employee[s] ... of the United States" within the meaning of 31 U.S.C. § 3729(b)(2)(A)(i), we conclude that loan requests presented to the FRBs under the Discount Window and Term Auction Facility are nonetheless "claims" under the FCA because the FRBs are "agents of the United States" within the meaning of § 3729(b)(2)(A)(i), and also because the "money ... requested" by Fed borrowers is "provided" by the United States to advance a Government program or interest within the meaning of § 3729(b)(2)(A)(ii). "The FRBs are instrumentalities of the federal government and the operating arms of its central bank. *See Starr Int'l Co. v. Fed. Reserve Bank of N.Y.*, 742 F.3d 37, 40 (2d Cir. 2014). The Federal Reserve Act ("FRA") empowers the FRBs, in conjunction with the Board of Governors of the Federal Reserve System (the "Board"), to issue legal tender and to finance the Fed's activities by purchasing public and private debts. The FRA also authorizes the FRBs to administer the Fed's emergency lending facilities. Requests for loans made to these facilities are requests for loans from the United States. And as the FRBs are required to remit all their excess earnings to the United States Treasury, a borrower's failure to pay the appropriate amount of interest on a loan from an FRB injures the public fisc, not merely the FRBs' nominal shareholders."[154]

That case was filed on the basis of the plaintiff's allegation that the recipient of assistance from a 13(3) facility falsely represented to the Federal Reserve that it was solvent when it was not and alleged to have falsely certified their compliance with the terms of the Federal Reserve borrowing facility.[155]

Thus at least one of the restrictions placed on the Federal Reserve's emergency lending authority by the Dodd-Frank Act are already enforceable under the False Claims Act. To the extent that recipients provide fraudulent statements in their

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[153] See *United States v. Wells Fargo & Co.,* 943 F.3d 588, 592 (2d Cir. 2019).
[154] See *United States v. Wells Fargo & Co.,* 943 F.3d 588, 592 (2d Cir. 2019).
[155] See *U.S. v Wells Fargo & Co.* at 594.

applications about their eligibility for participation in the emergency program, such as their certification that they have been able to pay their debts as they come due for the prior 90 days, or representations about the value of collateral provided to secure lending from the facility, private plaintiffs can already bring a qui tam action under the FCA to recover.

Though the *Wells* case is directly on point for the private right of action suggested in this article, it is important to remain cautious, however, about whether this holding regarding application of the Tort Claims Act will hold up in other circuits. Important distinctions between the Federal Reserve Board and Federal Reserve Banks need to be kept in mind, at times other federal laws have been deemed not to apply to local Federal Reserve Banks.

In *United States v. Hollingshead*[156], the Ninth Circuit held that a Federal Reserve Bank employee whose authority included making recommendations about expenditure of appropriated federal money was a "public official" under the Federal Bribery Statute. Federal Reserve Banks have been deemed federal agencies for purposes of exemption from state taxation.[157]

In *Lewis v. U.S.,* the 9th Circuit held that, for purposes of interpreting the Federal Tort Claims Act, a Federal Reserve Bank was not a federal instrumentality, but instead was a privately owned and locally controlled corporation.[158] This analysis may seem to carve Federal Reserve Banks out of the qui tam arena. On the other hand, the Federal Reserve Board sets the terms of 13(3) facilities, and the Board is close to the federal government than the local banks. Furthermore, that analysis will be complicated by the fact that under the recent CARES Act, the Treasury Department has appropriated government funding it is using to bolster the Fed's 13(3) programs. The outcome in Wells makes clear that, at least for 13(3) lending, the False Claims Act applies.

One Court has considered whether a local Federal Reserve Bank is covered by the False Claims Act for other purposes outside of extraordinary 13(3) lending and determined that the bank is not covered by the FCA. In the Court's reasoning, it drew a sharp distinction between local Federal Reserve Banks and the Federal Reserve Board, noting: "The Court begins its analysis with a word on the structure of the Federal Reserve: under the Federal Reserve Act, the Board of Governors of the Federal Reserve is comprised of seven members, who are appointed by the President with the advice and consent of the Senate….contrast, the RFRBs are

[156] 672 F.2d 751 (9th Cir. 1982),
[157] *Fed. Reserve Bank of Bos. v. Comm'r of Corps. & Taxation of Com. of Mass.,* 520 F.2d 221, 223 (1st Cir. 1975)

[158] *See Lewis v. United States*, 680 F.2d 1239, 1241 (9th Cir. 1982)

"private corporations whose stock is owned by the member commercial banks within their districts.""[159]

Still, the Wells Fargo case makes clear that the type of 13(3) programs recently set up, involving as they do the Federal Reserve Board (which is required to approve the lending) and in some cases even the Treasury Department, are clearly covered by the False Claims Act. Other Federal Statutes that permit private party rights of action against the government may or may not apply to local Federal Reserve Banks absent statutory reform to create them.

For other limitations that have been placed on emergency lending, like the requirement that lending be at a penalty rate, the FCA would not apply. If the reasoning in Justice Stevens' concurrence in Lujan holds up however, and Congress were to delineate a class of plaintiffs directly harmed by violations of the restrictions on emergency facilities, then private party enforcement of these additional constraints could be facilitated.

In Lujan, the Supreme Court rejected a claim against the government, citing the need for a demonstrated particularized injury.[160] Lujan holds that Congress lacks the authority to authorize private suits against the government unless particularized action is demonstrated.

Beck argues that Lujan's holding is misguided, and that the history of qui tam actions in the United States and English legal traditions is one involving qui tam actions by private citizens against corrupt government actors, including agents of the Treasury Department.[161] He notes that the first Congress adopted legislation authorizing qui tam suits against federal revenue officers, census officials, and Treasury Department employees.[162] This legislation was designed in part to counter executive branch resistance to legislative mandates in previously adopted legislation.[163]

Though Lujan did not consider the constitutionality of qui tam actions, Beck argues that the bounty provision of qui tam statutes provides the particular interest necessary to meet the threshold for action that Lujan requires.[164] In a subsequent ruling in *Spokeo Inc. v. Robins*, the Supreme Court found that standing under Lujan also requires a determination that the plaintiff's injury is not only particularized, but

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[159] *See United States ex rel. Holbrook v. Brink's Co.,* 336 F. Supp. 3d 860, 868 (S.D. Ohio 2018)
[160] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1238 (2018).
[161] *See generally* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235 (2018).
[162] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1240 (2018).
[163] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1240 (2018).
[164] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1240 (2018).

also concrete.[165] He argues that the Supreme Court got the history of qui tam actions wrong in *Lujan* by assuming that qui tams actions traditionally involve only suits against private parties.[166]

The Supreme Court considered in *Vermont Agency of Natural Resources v. U.S. ex rel Stevens* whether a private litigant could bring a qui tam action against a state agency for harm caused to the United States.[167] The case concludes that private parties have standing to bring suits on behalf of the government, but that states are not "persons" who may be sued under the law.

Justice Kennedy's concurring opinion in Lujan urges that "Congress has the power to define injuries and articulate claims of causation that will give rise to a case or controversy where none was before…Congress must at the very least identify the injury it seeks to vindicate and relate the injury to the class of persons entitled to bring suit."[168] Congress could fulfill Justice Kennedy's framework by clarifying that the class of plaintiffs entitled to bring suit to enforce the prescriptions in FRA 13(3) include entities that obtain assistance under 13(3), shareholders firms listed as primary dealers with the Federal Reserve, firms that can demonstrate they are in competition with a recipient for customers or for investment funding, or any individual or entity owning an equity, debt or derivative interest in the above listed class of firms.

Beck notes that the Lujan opinion reads the "take care" clause of the Constitution to limit suits by private citizens, because it would take away executive power intended to remain in the executive branch.[169] The Federal Reserve's odd relationship with the executive branch may complicate that facet of Lujan. In any event, it appears that the Congress could design an explicit private right of action that builds on the model of the False Claims Act to provide private parties with a cause of action to challenge emergency liquidity support that violates the terms of 13(3).

A simple design for this would be to explicitly establish a private right of action in Section 13(3) of the Federal Reserve Act. It would provide that funds expended in violation of these restrictions would be returned to the Federal Reserve, and it may also provide for a percentage recovery for the plaintiff much as whistleblower provisions in the federal securities laws provide.

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[165] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1253 (2018).
[166] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1239 (2018).
[167] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1257 (2018).
[168] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1310 (2018).
[169] *See* Randy Beck, *Qui Tam Litigation Against Government Officials: Constitutional Implications of a Neglected History*, 93 NOTRE DAME L. REV. 1235, 1311 (2018).

One of the strongest criticisms of the reform suggested in this article is that, pragmatically, judges would be disinclined to rule against the Federal Reserve's emergency borrowing during a pandemic. As one example, Ed Rock argues that the Delaware Court of Chancery declined to review a challenge to the Federal Reserve's rescue of Bear Stearns on dubious grounds.

That argument may hold true with respect to a plaintiff's seeking an injunction against an emergency program or a particular participant's participation in it. In the event of litigation more resembling the approach under the FCA, that critique would not hold up. Indeed, in the *Wells Fargo* case it did not hold up. Even if a judge may be unwilling to take the risk of major economic impact in permitting challenge to a Fed facility during the crisis, they may be willing to do so ten years later as was the case in Wells Fargo. The precedent of this case, and the prospect of future ex-post determinations of violation, would still provide the deterrence value and the strategic ambiguity benefits to minimize moral hazard costs.

The private right of action suggested in this paper should be coupled with a legislative provision to limit the Federal Reserve's discretion to interpret Section 13(3) of the Federal Reserve Act. In the Dodd-Frank Act, Congress limited the deference afforded the Comptroller of the Currency to interpret statutory provisions governing OCC preemption of state law, now codified at 12 U.S.C. 25b. The statute essentially eliminated court deference under *Chevron* to agency interpretations of their own statute. In this instance, a statutory constraint on Federal Reserve authority policed by a private right of action would make little sense if the Federal Reserve were granted wide authority under *Chevron* to interpret the constraints placed on its discretion.

The pre-Dodd Frank requirements for 13(3) lending included that institutions establish that they were unable to obtain support from other financial institutions.[170] This representation could be subject to qui tam liability for false representations, and it may prove helpful to explicitly recognize this in the statute. Further, the Federal Reserve could notify prospective 13(3) recipients that they may be subject to qui tam liability for false representations about the availability of alternative support (even if that support has prohibitively high costs or involves a deep discounted price on a new issue of share equity).

To some extent it might remain unclear whether and to what extent courts will respect the express grant of standing suggested in this article. To some extent it may also remain unclear whether parties will bring challenges to Federal Reserve abuse of 13(3) powers and whether courts will uphold legitimate challenges in any event. In the end, the point is merely to reduce the certainty that the central bank will be able to provide unlimited liquidity support to insolvent non-banks and to reduce moral hazard. Thus even an imperfect statutory reform, subject to

[170] *See* Eric A. Posner, *What Legal Authority Does the Fed Need during a Financial Crisis?*, 101 MINN. L. REV. 1529, 1541 (2017).

uncertainty in application or constitutional legitimacy, could still nevertheless work to provide much needed strategic ambiguity to the central bank's lender of last resort function, particularly with respect to non-bank lending where it is most needed.

Statutory changes to increase opportunities for private party legal challenge under 13(3) could serve to minimize moral hazard and could introduce a measure of real strategic ambiguity to this aspect of the lender of last resort function. The statutory reforms may not be perfect and litigants may be reluctant to bring challenge or judges wary of intervening in a financial crisis may refuse to enforce them. A private right of action on the books nevertheless introduces a measure of true uncertainty to the prospects of future liquidity support to non-banks.

Some argue that stigma attached to the discount window discourages banks from accessing it during financial crisis when discount window lending would otherwise serve to reduce financial strain.[171] The stigma calculus should be distinguished in the context of non-banks, as they are not central to the Fed's monetary policy transmission mechanism. In order for statutory constraints to work, including private actions enforcing 13(3) and through congressional oversight, full transparency of 13(3) lending will be a vital prerequisite.

Central bankers would be wary of such a reform, likely preferring to retain discretion to respond to future crises. But it is precisely that discretion which obviates any benefits they hope strategic ambiguity will achieve, as their statements about the lender of last resort function are dismissed by the market as merely hortatory aspirations and the long history of Federal Reserve support to insolvent institutions, including in 2008, dominates market assumptions about how the LOLR function will be liberally exercised to provide liquidity support to insolvent institutions in the future.

Conclusion:

Many scholars like George Selgin, including Bagehot himself, support a more competitive banking system free from domination by a central bank as a more effective alternative to central banking lending subject to Bagehot's dictum.[172] This paper offers policy reform suggestions given the existing operating framework of a central bank generally inclined to generously provide liquidity support during financial panics.

[171] *See* Oliver Armantier, Eric Ghysels, Asani Sarkarm & Jeffret Shrader, *Discount Window Stigma During the 2007-2008 Financial Crisis*, 118 J. FIN. ECON. 317, 318 (2015).
[172] *See* George Selgin, *L Street: Bagehotian Prescriptions for a 21st Century Money Market*, 32 (2) CATO J. 303 (2012).

Alternative constructs may be optimal. For example, before the Federal Reserve was created, clearinghouses provided liquidity to their members banks.[173] Some have argued in favor of abolishing Section 13(3) of the Federal Reserve Act and closing the Fed's discount window.[174]

This paper argues that, if the Federal Reserve's role is expected to continue, and its power under 13(3) remains, some statutory constraint on that power can reduce moral hazard and market distortions by way of a combination of firm commitments and strategic ambiguity with respect to lending to non-banks.

This paper further argues that neither firm commitments nor strategic ambiguity are possible without enforceable statutory constraints on the Federal Reserve's power to lend to non-banks. The restrictions on 13(3) added by the Dodd-Frank Act do not provide such enforceable statutory constraints. One way to create a strong enforcement mechanism would be through establish private rights of action for financial actors who could have the incentive to bring them and sufficient constitutional standing to bring a challenge.

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[173] *See* Charles W. Calomiris, Marc Flandreau & Luc Laeven, *Political Foundations of the Lender of Last Resort: A Global Historical Narrative*, 28 J. FIN. INTERMEDIATION 48, 56 (2016).

[174] *See e.g.* Norbert J. Michel, Dodd-Frank's Title XI Does Not End Federal Reserve Bailouts 12 (The Heritage Foundation, Backgrounder No. 3060, 2015), *available at* https://www.heritage.org/markets-and-finance/report/dodd-franks-title-xi-does-not-end-federal-reserve-bailouts.