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RESPONDING to the GLOBAL FINANCIAL CRISIS
What We Did and Why We Did It

The Legal Authorities Framing the Government's Response

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Note: The views expressed in this draft are strictly those of the author(s).

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Introduction: The Evolving Need for Emergency Tools

The Federal Reserve, the Treasury Department and the Federal Deposit Insurance Corporation (FDIC) each took strong and innovative action to mitigate the financial crisis. These actions were well-grounded in law and consistent with the direction of policymakers to do "everything possible" to address the crisis.

In some cases, the legal authority being applied was archaic or had not been used or interpreted for many years. In other cases, the law was being applied for the first time. In most cases, the legal authorities were built on the lessons of past crises involving "retail" panics and failures of depository institutions that were unlike the crisis that began in 2007.

Since these authorities were enacted, financial markets evolved and changed in significant ways. By 2007, important markets, such as the repo and the commercial paper markets, and new intermediaries, like money market mutual funds and asset-backed securitization vehicles, had developed and become critical sources of funding to businesses and consumers. Nonbanks rivaled depository institutions as intermediaries, and became critical credit conduits to businesses, consumers and investors.

Indeed, the 2007 crisis first manifested in the shadows of a financial system that did not exist during the years of the Great Depression or the 1980s and early 1990s, when the foundation for the emergency legal authorities of the federal agencies was built and last modified. The strong interconnections that had developed between nonbank financial firms and depository institutions increased both the scope and the depth of the impact that vulnerabilities in nonbank firms have on banks and the financial system as a whole.

The agencies responded to this new set of challenges by using the legal authorities available to them in ways that were contemplated by the authors of those authorities and in ways that, while clearly permissible, were new and innovative. And, as happened during past crises, Congress also responded by enacting new authorities to address these new problems.

An important lesson is that emergency authorities must evolve to reflect changes in the financial system. Because the system is dynamic and constantly evolving, every crisis is and will be different. The financial system that went into crisis in 2008 was different in very fundamental ways to the financial system in place when the depression-era emergency authorities were enacted, and even the system in place when authorities were enacted post the more recent savings and loan crisis.

Emergency authorities must evolve or be drawn broadly enough to accommodate the inevitable evolution of the financial system. Laws that are too narrow in scope or that handcuff policymakers in fashioning a measured response can dramatically reduce the ability of government to fashion an effective response, resulting in an increase in the costs and pain inflicted on citizens and the economy. Government may choose not to intervene in a particular crisis; but it should have available to it an effective arsenal of tools that gives it the option to intervene if it chooses to do so.

Although legal authorities and new emergency tools can be and have been added during a crisis, typically this is too late; it is more effective and less costly if the tools are in place before the crisis starts. Early and forceful action to address problems as they emerge allows policymakers to mitigate, and in some cases prevent, any destabilizing effects.

In the wake of the latest crisis, Washington strengthened some of the tools to enhance the resiliency of financial firms and the financial system to help prevent and limit the damage during another crisis and it added a new power that would allow the government to "resolve" (close or liquidate), rather than support, the biggest struggling financial firms using funding from the banking industry itself, not taxpayers.

At the same time, however, Congress took away from the agencies some of the legal tools that were essential in restoring stability in the last crisis, or diminished their scope, giving itself greater responsibility for addressing future emergencies.

In the Dodd-Frank Act (DFA), for example, it took away the Fed's power to lend to failing firms or to take assets off their balance sheets. In the future, the Fed may extend emergency credit only through broad-based facilities designed to help the financial system as a whole. Congress also took away Treasury's ability to use the Exchange Stabilization Fund to guarantee money market funds. And the FDIC no longer has the authority to provide assistance to the financial system, even if that assistance would prevent failures that pose systemic risk, without the concurrence of Congress.

This chapter first examines the legal authorities in place when the crisis started. It then focuses on three key areas—the Federal Reserve's lending authority, Treasury's emergency powers and the Fed's creation of broad-based lending vehicles—that were at the heart of the government's response. It discusses the major issues and obstacles encountered by the agencies, as well as the innovative steps they took to move quickly, and legally, to deal with the crisis.

A more complete version of this chapter will be available online in the future. Basic descriptions of the government's programs and policy decisions are outlined here and online to crystallize relevant legal issues and standards, but the details of these programs and actions are discussed elsewhere in this book.[2]

I. As the Crisis Unfolded: The Tools at Hand

The public often assumes that the government is subject to the same principle that applies to a private company—that which is not prohibited is permitted. But that is not correct: the government has the ability to do only what the law permits.

[2] This chapter also does not discuss the numerous legal issues attendant to the contracts and supporting agreements negotiated by the agencies in implementing their programs.

As the financial crisis began to unfold and deepen during the second half of 2007 and through September 2008, regulators looked closely at the tools available to address the situation. Some were antiquated and cumbersome, and taken together they amounted to a short list of narrowly circumscribed powers.

The President was authorized to declare a bank holiday that would close all banks but had no other special powers to deploy in a financial emergency. Treasury, unlike several foreign finance ministries, had no special emergency powers to address a financial crisis beyond controlling the Exchange Stabilization Fund worth about $50 billion. The Securities and Exchange Commission (SEC) could halt trading on the stock exchanges but couldn't provide emergency credit to a failing broker-dealer. And no one in the Federal government had the authority to resolve players in the shadow banking system that were in trouble. Nor did any agency have the power to acquire troubled assets or to inject capital into even *traditional* financial firms, in stark contrast to some other countries—like the United Kingdom, Switzerland and France—that were also being buffeted by the crisis.

The Federal Reserve's monetary policy tools were (and remain) powerful but they could not be narrowly tailored to address the specifics of the crisis. Rather, these powers are designed and intended to address weaknesses in the broad economy.

The most robust tools available to address particular problems involved depository institutions, perhaps because their failure played such a prominent role in the Great Depression.

The Fed is authorized to make secured loans to depository institutions at any time. And the FDIC provides a strong backstop with deposit insurance—a tool designed to protect consumers and maintain confidence in depository institutions.

The FDIC also is empowered to resolve failing depository institutions. The agency is authorized not only to marshal assets to pay depositors and other creditors but to manage the resolution in a way that minimizes the risk to the financial system. An important limitation requires the FDIC to resolve each institution in the manner least costly to the Deposit Insurance Fund. Congress wisely added a "systemic risk" exception to this limitation, permitting the FDIC, in extraordinary circumstances, to take other actions needed to address the potential effects on the system of depository institution failures. However, even this emergency exception did not extend to a nonbanking financial firm in distress, such as AIG, Bear Stearns or Lehman Brothers.

In fact, the dearth of tools to address nonbank financial firms was consequential in determining the government's response to the threats to the financial system and economy that emerged from this critical part of the system.

Indeed, until October 2008—deep into the crisis—the only tool available to address issues at nonbank financial firms was the Fed's emergency authority to lend on a secured basis.

Congress added two critical powers during the crisis.

The first authorized the government to place the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), both government-sponsored enterprises (GSEs), into conservatorship, to avert their disruptive failure and liquidation in bankruptcy. (For more details, see Chapter XX.)

The second tool, the Troubled Assets Relief Program (TARP), authorized Treasury to acquire troubled financial assets and inject capital into financial firms. (See Chapter XX.) The powers conferred by TARP were used in the ways anticipated by the proponents and in other ways that were innovative and evidenced interpretive agility. TARP contained a sunset date and is no longer available. While not a new tool, as part of the TARP legislation Congress also increased deposit insurance, a tool created during the 1930s to decrease the likelihood of runs at depository institutions, to $250,000 from $100,000.

II. The Fed's Lending Authority: Providing Credit to Depository Institutions and Some Nonbanks

Credit for Depository Institutions

From its inception in 1913, the Federal Reserve has been authorized under a variety of statutes to provide credit to depository institutions. The authority most used for such lending is section 10B of the Federal Reserve Act (FRA), which permits lending during both normal and crisis times.[3]

One important requirement under section 10B is that the credit be "secured to the satisfaction of the [lending] Reserve Bank."[4] In their lending activities, Reserve Banks have traditionally relied on collateral pledged by the borrowing depository institution, typically a first-priority perfected security interest in collateral with a value equal to, or greater than, the amount of the credit.[5]

One of the first actions taken by the Fed in the late summer of 2007 was to encourage depository institutions to take advantage of its discount window to meet

[3] The provision that became section 10B was added to the FRA in 1932. The Fed has always viewed the language and purpose of section 10B as authorizing extensions of credit, not grants or capital injections. Section 10B refers to "advances," which are commonly defined as extensions of credit; establishes limitations on the duration of advances, which is characteristic of extensions of credit, but not grants or capital injections; and requires "security," a common feature of credit but not of grants or capital injections.

[4] 12 USC 347b. The Fed's Board of Governors may set parameters for Reserve Bank lending, including requirements regarding the types and minimum amount of collateral. 12 USC 347b(a). However, the Board has not set such requirements except at the recommendation of a Reserve Bank. It has generally left the Reserve Bank with discretion to determine when, whether and how it will become secured.

[5] Prior to making a loan to a depository institution, the Fed typically perfects its first priority by taking possession of the collateral or otherwise acting to perfect its security interest in the collateral (for example, by filing a financing statement).

liquidity stresses and to make credit available for extended periods—up to 30 days rather than overnight.[6]

However, seeking credit from the Fed carries with it a level of stigma that discourages borrowing even when it is in the bank's best interests. Depository institutions—which depend on appearing strong, especially during a crisis, to keep the confidence, and deposits, of their customers—develop a heightened sensitivity that such borrowing will be viewed by investors and counter-parties, in addition to customers, as a sign that the institution is desperate and unable to obtain funding from other sources.

To remove this stigma, in December 2007, the Fed's Board of Governors authorized the establishment of the Term Auction Facility (TAF), which created an auction system to determine the interest rate on credit it extended.

The Fed relies on section 14(d) of the FRA to set its rate. That section authorizes the Reserve Bank to establish a rate on a periodic basis, subject to review and determination of the Board.[7] Section 14(d) also sets a substantive requirement that the rate "be fixed with a view of accommodating commerce and business."[8]

Historically, the Fed set an interest rate for credit extensions using one of two methods—by establishing a specific numerical rate or by adopting a formula to calculate the rate.[9] The legal question raised by the TAF was whether the rate could be set by auction.

An auction provided an elegant way to meet the substantive requirement of accommodating business and commerce. TAF provided depository institutions with access to a specific amount of credit to help meet the liquidity demands of their operations, including providing credit to businesses that would facilitate commerce. An auction provided a mechanism for setting the precise rate that would make all of that credit available to institutions most in need.

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[6] www.federalreserve.gov/newsevents/pressreleases/monetary20070810a.htm; www.federalreserve.gov/newsevents/pressreleases/monetary20070817a.htm. An advance under section 10B may not have a term longer than four months unless it is secured by mortgages on one-to-four-family residences. 12 USC 347b. Advances under section 10B are typically made on an overnight basis and may be extended or renewed each day with the agreement of the lending Reserve Bank if the depository institution remains able to repay the credit.

[7] The Attorney General decided in 1919 that the requirement that the Reserve Bank establish a rate "subject to review and determination of the Board" meant that the Board had the ultimate authority to determine the rate under section 14(d). 32 Opinions of the United States Attorney General, no.81 (1919). This allows the Board to ensure that uniform national rates are charged on Federal Reserve credit. In practice, and certainly throughout the recent crisis, the Reserve Banks and the Board have agreed on the appropriate rate to charge at the discount window and, as discussed below, in the exercise of emergency lending authority.

[8] 12 USC 357.

[9] See, e.g., 12 CFR 201.51 (primary and secondary credit set at a specific rate; seasonal credit rate set using a formula that averages the Federal Open Market Committee's (FOMC) target interest rate and the rate paid on 3-month CDs).

To satisfy the procedural requirement that the Reserve Bank set the rate, subject to review and determination of the Board, the Fed analogized to its long-standing practice of setting rates for seasonal credit by formula.10 Seasonal credit from the Fed allows banks—typically community banks—to meet the fluctuating needs of farmers and vacation areas. Because seasonal credit was episodic, rather than overnight, the rate was determined by applying a set formula—recommended by the Reserve Banks and approved by the Board—to various inputs when the credit was extended. It thus dispensed with the need to have the Reserve Bank recommend, and the Board approve, a specific rate for each credit when it was requested.

The TAF auction was functionally and substantively the same—the Reserve Banks recommended that the rate be set at a specific minimum level subject to a higher rate set through an auction that had certain characteristics and inputs. Thus, the Reserve Banks recommended using a defined procedure that would lead to a specific rate at the time credit was extended. The Board approved this approach, fulfilling the procedural requirements of section 14(d).[11]

Emergency Credit for Nondepository Institutions

An important constraint in section 10B is that it authorizes the Reserve Banks to extend credit only to a certain kind of borrower, the depository institution. Other constraints in the FRA (most notably, section 23A) significantly limit the ability of a depository institution to pass on funds it borrows to its affiliates.[12] Thus, section 10B could not be used to lend to a depository institution affiliated with a nonbanking financial firm with the expectation that the depository institution would "on-lend" a significant amount of those funds to its affiliate. Consequently, lending by a Reserve Bank to a nonbanking firm (like Bear Stearns or AIG) or to a nonbank affiliate of a depository institution (such as the securities affiliate of Citibank or the nonbank holding company Bank of America) may be done effectively only by using the emergency lending authority provided in section 13(3).

During the crisis, section 13(3) authorized the Fed to extend credit to any individual, partnership or corporation under certain specified conditions.[13] These included that at least five members of the seven-member Board determine that circumstances are "unusual and exigent," and approve the credit, and that the credit be "indorsed or otherwise secured to the satisfaction of the [lending] Reserve Bank."[14]

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[10] Id.

[11] www.federalreserve.gov/newsevents/pressreleases/monetary20071212a.htm; see also, www.federalreserve.gov/newsevents/pressreleases/files/monetary20080226a1.pdf.

[12] See 12 USC 371c-1.

[13] 12 USC 343. The Fed is also authorized to lend to non-depository borrowers under section 13(13) of the FRA, which allows an advance to any individual, partnership or corporation secured by U.S. government or agency securities. 12 USC 347c.

[14] 12 USC 343. In 2008, section 13(3) also required that the rate on the credit be set in accordance with section 14(d) of the FRA and that the lending Reserve Bank "obtain evidence" that the borrower was "unable to secure adequate credit accommodations from other banking institutions." Section 13(3) also provided that any credit extended under that section was subject to any limitations, restrictions and

Prior to 2008, the Fed extended credit using its emergency authority only during the Great Depression.[15] During that period, it made approximately $1.5 million in loans to individuals, partnerships and corporations secured by various types of assets. Among the borrowers were a vegetable farmer and a typewriter manufacturer.[16]

In 2008, the Fed started to extend emergency credit to a very different group of borrowers, and in amounts that would add up to hundreds of billions of dollars.

The Collapse of Bear Stearns and a Missing Board Governor

The first extension of section 13(3) emergency credit during the crisis came in March 2008, prompted by the rapid collapse of Bear Stearns, the smallest of Wall Street's Big Five investment firms.[17] There was no disagreement that the pressures experienced by the U.S. economy that month met the threshold requirement for invoking section 13(3) that circumstances be unusual and exigent, and Bear had failed to find another banking firm willing to provide a credit lifeline.[18]

The novel legal issue raised by the initial Bear Stearns credit, extended on Friday, March 14, involved the requirement of approval by at least five members of the seven-member Board. At the time, the Board had two vacancies and one of the five sitting members was traveling and unreachable.

When the Board met that Friday morning to ensure that Bear Stearns had sufficient liquidity to make it through the day and into the weekend, only four members were present in Washington or available by phone to vote. (The funding for Bear Stearns was

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regulations prescribed by the Board. Id. A fuller discussion of each of these requirements and how they were met will be available in the future.

[15] The Fed announced its willingness to use its emergency lending authority under section 13(3) during the 1960s, when savings associations came under severe pressure from high interest rates at a time when they were prohibited by statute from paying high rates to attract deposits. However, the crisis passed and no loans were in fact extended by the Fed.

[16] Hackley, Howard H., *Lending Function of the Federal Reserve Banks: A History*, p.130. Washington, D.C., Board of Governors of the Federal Reserve System, May 1973. (Hereinafter, Hackley)**.** See also Sastry, Parinitha, The Political Origins of Section 13(3) of the Federal Reserve Act, FRBNY Economic Policy Review, p. 27 (hereinafter Sastry) citing Banking and Monetary Statistics, Board of Governors (1943), Table 88, Bills Discounted by Class of Paper, p. 340.

[17] The Fed announced that it would open a broad-based lending vehicle, the Term Securities Lending Facility (TSLF), several days before extending the Bear Stearns credit. While the TSLF also relied on the authority provided in section 13(3), it did not become operational until several weeks later.

[18] The requirement of "unusual and exigent circumstances" was intended to ensure that this extraordinary lending authority was used only during emergencies. However, when section 13(3) was enacted in 1932, it was not expected that the Fed would make a specific finding that the circumstances surrounding *each borrower* were "unusual and exigent," only that general economic circumstances met those requirements. See Hackley, p. 128. Indeed, upon enactment in 1932, the congressional authors of the authority and the President publicly exclaimed that economic circumstances at the time were unusual and exigent, and the President urged the Fed to invoke its new authority immediately and begin extending credit widely. See Letter from President Herbert H. Hoover to Governor Eugene Meyer, quoted in Federal Reserve Board minutes, July 26, 1932; see also Sastry, footnote 199.

originally conceived as a discount window loan to JP Morgan Chase Bank (JPMC Bank), which was a significant counterparty of Bear Stearns and had agreed to on-lend the funds to the firm, but without recourse to itself. JPMC—the parent of JPMC Bank—ultimately acquired the firm.)[19]

To authorize the loan with just four votes, the Fed relied on a provision of law added after the terrorist attacks on September 11, 2001, that allowed the Board to invoke section 13(3) authority by unanimous vote in the event that fewer than five members were in service or available at the time and the Board took certain other steps, including finding that immediate action was necessary.[20] The Board then voted 4-0 to provide funds to a nondepository institution for the first time since 1934.

A Second Legal Issue: To "Discount" for Any Individual, Partnership or Corporation

A second legal issue in extending credit to a nonbank under section 13(3) was whether the borrower could provide its own promissory note to receive the credit or had to provide a note involving a third party. The distinction was crucial: a promissory note would facilitate the process enormously.

At the time, section 13(3) authorized the Reserve Banks to "discount for any individual, partnership, or corporation, notes, drafts and bills of exchange" (hereinafter, "notes") under certain circumstances. Section 10B, on the other hand, authorizes the Fed to "make advances" to depository institutions.

The Fed had long recognized that there was no legal distinction between an advance and a discount for purposes of section 13(3). Both are extensions of credit.

When originally enacted, section 13(3) authorized the Reserve Banks to "discount" only certain types of notes—specifically, notes "of the kinds…eligible for discount for member banks under other provisions of the [Federal Reserve] Act." In its initial authorization to Reserve Banks to exercise the lending authority under section 13(3)—issued just five days after Congress enacted that authority—the Board recognized that the reference to notes "of the kinds…eligible for discount" had a practical and legal difference when the issuer of the note was considered.

The only notes that could be presented for discount under the other provisions of the FRA at the time section 13(3) was enacted were those that, put simply, were for

[19] This type of on-lending arrangement ordinarily might not require invoking section 13(3) because the credit being extended was to a bank, not a nonbank. However, in this case, all of the collateral posted as security was owned by Bear Stearns and the loan would be made without recourse to JPMC Bank or any of its assets. For that reason, the Board determined that the loan was in principle to Bear Stearns and decided it must invoke section 13(3).

[20] 12 USC 248(r).

agricultural, industrial or commercial purposes.[21] A bank could not present its own promissory note for discount because its activities were not considered to be agricultural, industrial or commercial. Thus, a bank could present for discount only the note of a third party that was engaged in agricultural, industrial or commercial transactions. However, the Board reasoned that because a bank could present a third-party note for discount that had the required purpose, then that same note was eligible for discount if presented by the third-party issuer itself under section 13(3) because the third-party note was "of the kind" eligible for discount if presented by a bank.[22]

This recognition would turn out to be of critical practical and legal significance in making section 13(3) a useful tool during emergencies. It made administration of lending under section 13(3) as straightforward as accepting a promissory note from the nonbank individual, partnership or corporation (IPC). It is a reading that was cemented with the repeal in 1991 of the requirement that notes be "of the kind" eligible for discount if presented by a bank. [23]

A Third Issue: Endorsed or Otherwise Secured, to the Satisfaction of the Reserve Bank

Another legal issue revolved around the provision that each loan extended under section 13(3) must be endorsed or otherwise secured to the satisfaction of the lending Reserve Bank.[24]

This provision imposes a limitation on Federal Reserve emergency credit, but with a fair degree of discretion. It authorizes credit that is both endorsed and secured—i.e., credit that is with legal recourse to the borrower or a third-party endorser, with collateral to back up repayment. It also authorizes credit that is endorsed but not collateralized—for example, credit that is backed by a third-party guarantee. And, importantly, it authorizes credit that is "otherwise secured" without an endorsement—that is, a secured

[21] This is often referred to as the "Real Bills Doctrine." For a thorough discussion of the history and purpose of the doctrine, see Hackley.

[22] See Federal Reserve Board circular dated July 26, 1932, Paragraph III, printed in 1932 Federal Reserve Bulletin 518, 519 (August 1932). See also Hackley, p. 129; and Sastry, p. 24.

[23] In 1991, the requirement in section 13(3) that notes be for an agricultural, industrial or commercial purpose was repealed. This change, made in response to the 1987 stock market crash, was designed to allow the Fed to lend under section 13(3) to securities broker-dealers and other IPCs that were not considered to be engaged in agricultural, industrial or commercial transactions. Pub. L. 102-242, Section 473 (December 19, 1991). See Remarks of Senator Chris Dodd, Congressional Record, 102nd Congress, 1st Session, p. S36131 (November 27, 1991) (This provision "give[s] the Federal Reserve flexibility to respond to instances in which the overall financial system threatens to collapse.")

[24] Originally, section 13(3) required that credit be *both* endorsed *and* secured to the satisfaction of the lending Reserve Bank. Pub. L. 72-302, Section 210 (July 21, 1932). Congress amended that requirement in 1935 so that the note could be *either* endorsed *or* secured. Pub. L. 74-305, Section 322 (August 23, 1935); 12 USC 343. An endorsement works as a guarantee by the signer, such that if the instrument is not paid by the primary obligor, the endorser will take it up. It is, therefore, similar to collateral—both provide forms of recourse if the party extended credit does not repay.

loan which, if the borrower does not pay, leaves recourse to the pledged collateral.[25] This type of secured lending became one of the most important tools in the Fed's emergency lending arsenal.

But that raises the question, what level of security is enough?

The statute sets no specific level that must be obtained, instead leaving the determination to the Reserve Bank.[26] Indeed, the precursor of section 13(3), which would have granted this emergency lending authority to the Reconstruction Finance Corporation, required that credit be "fully and adequately" secured, terms that do not appear in section 13(3).

How, then, should the Reserve Bank exercise its discretion? Could the Fed extend credit with a level of security that it understood at the time would not be sufficient to provide for full repayment? In other words, could the Fed extend credit under section 13(3) expecting to take a loss?

Every statute must be interpreted in harmony with its purpose, and the purpose of section 13(3) (as exhibited both in its wording and in its legislative history) was to authorize the Fed to extend credit, not to make grants or inject capital. Funds extended without the expectation of full repayment may be a credit in part, but they are a grant or capital injection to the extent repayment is not reasonably expected—and are not consistent with the language or purpose of the section.

Moreover, when Congress granted the Fed lending authority under section 13(3), it was empowered to act as a bank—the central bank and lender of last resort.[27] And at that time (and since), the Fed was a regulator of banks. As a regulator, it has long criticized bank lending as unsafe and unsound if the loan is made without the expectation and reasonable belief that it would be fully repaid with interest. In the case of lending to a troubled firm during a time of economic stress, repayment depends largely on the amount and quality of the security backing the credit.

To be consistent with the purpose of the statute, the security required to satisfy the lending Reserve Bank needed to be at a level sufficient for the bank to reasonably believe it would be fully repaid.

[25] Collateral-based lending has long been recognized as an authorized activity for a bank. See, e.g., OCC Letter from John E. Shockey, Deputy Chief Counsel, OCC (March 29, 1976); OCC Banking Circular 215; OCC Examining Circular 223; OCC Interpretive Letter 1117 (June 2009).

[26] Section 10B also requires that all credit extended by the Fed to depository institutions under that section be "secured to the satisfaction of the [lending] Reserve Bank."

[27] Indeed, the Reserve Banks are chartered as banks and are empowered to engage in "the business of banking." And section 13(3) provides that the Fed may extend credit under that section only if it is not available from "*other* banking institutions."

Two Complementary Key Innovations: Special Purpose Vehicles and Asset-Based Lending

In several cases, the Fed used special purpose vehicles (SPVs) to facilitate lending under section 13(3). An SPV is a corporate entity established to own assets funded by debt without that debt becoming an obligation of the owner of the SPV if the SPV enters bankruptcy. SPVs turned out to be one of the most innovative tools used during the crisis.[28]

The Fed created one SPV, called Maiden Lane, LLC, to facilitate the Bear Stearns loan and two more—Maiden Lane II LLC, and Maiden Lane III LLC—to facilitate credit to American International Group (AIG), the beleaguered finance and insurance giant.

In each case, JPMC and AIG provided independent capital to their respective SPV in the form of subordinated debt that functioned as the equity of the SPV, and the Fed provided senior funding.[29] Like an equity investor, the subordinated debt holder wouldn't receive any repayment until the Fed was fully repaid.

In general, the use of an SPV to hold the assets allowed the Fed, as the managing member of the SPV, to better manage the collateral securing its loan, and thereby better ensure full repayment.[30] Using SPVs avoided potential conflicts regarding the valuation of the assets and the timing of their sale that might have arisen had the collateral remained on the balance sheet of JPMC or AIG.

Importantly, the SPV also provided more transparency. SPVs allowed the Fed to make weekly reports on the collateral's value and the amount disposed during the previous week and to audit the collateral without interference. Indeed, financial statements for the SPVs used in the Fed's section 13(3) lending were all fully audited by an independent outside accounting firm and made public along with the annual audited financial statements of the Federal Reserve System.[31]

The SPVs also allowed the Fed to maximize the advantage of asset-based lending, which was a new type of lending for the agency. While the Fed believed at the time it extended credit to each SPV that the value of the collateral was sufficient to repay the loan, that expected value was less than the pre-crisis value of the collateral. The Fed, as

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[28] The Reserve Bank served the incidental role of establishing and administering the SPV. Conducting these duties was clearly a useful and valuable part of effectuating the lending transactions authorized under section 13(3) and reflected use of the incidental powers conferred on the Reserve Banks by section 4, undesignated paragraph Four(Seventh) of the FRA. 12 USC 341(Fourth).

[29] JPMC provided $1 billion in subordinated debt to Maiden Lane, LLC. Similarly, AIG provided $1 billion in subordinated funding to Maiden Lane II, LLC, and $5 billion in subordinated funding to Maiden Lane III, LLC, with the Fed extending senior credit of about $28.8 billion to Maiden Lane, LLC, $19.5 billion to Maiden Lane II, LLC, and $24.3 billion to Maiden Lane III, LLC.

[30] SPVs also facilitated the payment to the Fed of a portion of any increased value of the assets securing the loans as compensation for the increased risk of these loans (which relied on the realization of value from the sale of the collateral and were without recourse to either JPMC or AIG).

[31] See, e.g., Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet, June 2009, http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200906.pdf.

the central bank, could be patient and allow the collateral to recover its pre-crisis value. So, the Fed negotiated—as a term of its senior loan—to receive a portion of the amount actually collected on the sale of the collateral in the event that amount exceeded what was needed to repay the Fed's loan and the investor's subordinated debt. This potential value would help compensate the Fed—and the taxpayer—for the risk of the credit and allow the taxpayer to share in a portion of the borrower's profit made possible by the Fed's loan. Indeed, that potential was realized and the three SPVs collected several billion dollars in extra value for the taxpayer.

Although valuable innovations, SPVs and asset-based lending were not used in all of the Fed's emergency lending transactions. For example, as already noted, the Fed extended credit to depository institutions through its discount window and made other credit available to AIG and Bear Stearns directly, fully secured by collateral owned by the borrowers and retained on their balance sheets.

The availability of these different approaches adds flexibility that allows the Fed to "become secured" in various circumstances, and thereby protects the taxpayer in many types of emergencies.

The Exception to the Exception: Lehman

The security requirement in section 13(3) was central in every lending decision made by the Fed, but it was no more consequential than in the case of Lehman Brothers.

Going into the weekend of September 13-14, 2008, Barclays, a British banking organization, indicated an interest in acquiring Lehman, the fourth-largest U.S. investment firm. Had Barclays decided to acquire Lehman on that Sunday, it would have needed time to finalize documentation and obtain regulatory and shareholder approvals. To ensure that creditors did not continue their run on Lehman during that period, an open-ended guarantee of Lehman's obligations was needed, like the one provided by JPMC when it acquired Bear Stearns. But on that Sunday, Barclays said it could not issue that type of guarantee without a shareholder vote, which would produce a substantial delay.[32]

The question became whether the Fed could use its section 13(3) authority to provide an open-ended guarantee of Lehman's trading obligations in the interim or, in the alternative, provide a loan to Lehman of sufficient size to allow it to continue to operate.

The answer was "no." Lehman had no one willing to endorse credit extended by the Fed. Moreover, the unlimited nature of the guarantee to bridge the period until Barclays obtained the required approvals and the information from firms that had evaluated Lehman's financial statements during the weekend about the significant losses embedded in its assets raised strong doubt whether Lehman had sufficient collateral to

[32] Barclays ultimately acquired most of Lehman's securities broker-dealer through Lehman's bankruptcy. Prior to the bankruptcy, the broker-dealer represented only about 50% of Lehman's assets.

secure the full repayment of the size and type of credit it needed. Consequently, the Fed was not positioned to be secured to its satisfaction.

As a legal matter, this eliminated section 13(3) as a useful tool for rescuing Lehman, which declared bankruptcy on Monday, September 15. As noted, section 13(3) authorizes the Fed to extend credit, not to make grants or provide capital.

Lehman's broker-dealer subsidiary presented a different matter. While a major business of Lehman's, the broker dealer represented well less than half of Lehman's assets and held few of Lehman's troubled assets. Importantly, Lehman's broker dealer had sufficient valuable assets to support borrowing from the Federal Reserve. This allowed the Federal Reserve to use its section 13(3) authority to lend to Lehman's broker dealer during the week after Lehman announced its bankruptcy filing and prior to the acquisition of the broker dealer by Barclays out of the Lehman bankruptcy. [33]

AIG: A Legal Challenge

AIG required more attention and support from the Fed and Treasury than any other nonfinancial firm and the transaction with AIG was the only one that produced a legal challenge. Circumstances were clearly unusual and exigent and AIG faced collapse because other financial institutions and investors had determined, despite the encouragement of the Treasury and Federal Reserve, not to provide the funding AIG needed—two critical condition for invoking section 13(3). Importantly, unlike Lehman, AIG had substantial assets it could pledge against credit from the Federal Reserve, including shares of several large and viable insurance subsidiaries.

The Fed relied on section 13(3) initially to extend a revolving line of credit to AIG and to provide additional credit using two SPVs, modeled after the SPV used for Bear Stearns. After TARP was enacted, Treasury provided capital to AIG by acquiring securities that the firm issued. Together, these actions prevented the firm's collapse and the systemic consequences.

The novel legal issue in the rescue was whether the FRA permitted the Fed to establish some of the specific loan terms. In particular, some AIG shareholders challenged the Fed's right to require AIG to provide equity as consideration for receiving the emergency credit. The challenge was unsuccessful.

In previous cases, the Fed had required borrowers to pay non-interest compensation, in the form of fees and premiums, under both sections 13(3) and 10B of the FRA. These forms of consideration were imposed to cover the expenses in extending credit, including the costs associated with negotiating and documenting the credit and valuing collateral as well as the potential costs of litigation. Such consideration also helped compensate the Fed for the significant risk it assumed in extending credit to highly troubled debtors.

[33] This collateralized lending was not sufficient, however, to prevent Lehman—the parent company of the broker-dealer—from entering bankruptcy.

The same rationale was behind the requirement that AIG provide convertible shares, amounting to approximately 79 percent of its outstanding common stock, as one of the conditions for the credit.[34] This consideration was negotiated to provide the American people with the upside potential that could result from the Fed's successful rescue of AIG—a potential that was, in fact, realized.[35]

Requiring a borrower to pay consideration in the form of equity—a so-called equity kicker—is a common feature of lending to a troubled debtor and postpones the lender's receipt of value until a more benign time. And it was a proper exercise of the authority granted to the Fed under the FRA.

Inherent in the authority to lend is the authority to receive compensation for the risks attendant to lending.[36]

In addition, section 13(3) specifically provides that Reserve Bank lending under that section must conform to any "limitations, restrictions, and regulations as the Board … may prescribe." The FRA does not curb the discretion of the Board in setting those limitations, restrictions and regulations. The Board was regularly apprised that the Reserve Bank sought authorization to receive fair and appropriate compensation for whatever credit it extended. In AIG's case, the Board made its authorization of the initial credit subject to the Reserve Bank obtaining a form of equity as compensation.[37]

Moreover, section 4 of the FRA authorizes the Reserve Banks "to exercise such incidental powers as shall be necessary to carry on the business of banking" in connection with any authority granted by the FRA.[38] National banks (and many state banks) have long been permitted to receive an equity kicker as supplementary compensation for the risks of extending credit.[39] Charging non-interest fees and other forms of compensation that are typically collected by a bank extending a similar type of credit is clearly part of the business of banking and within the incidental powers granted by section 4.

To interpret the FRA as permitting the Fed to receive only interest compensation for providing credit is to limit the central bank (and by extension, the taxpayer) to what is less than fair and adequate compensation for taking on the extra risks and expenses

[34] The Fed transferred these shares to the AIG Credit Facility Trust created for the benefit of Treasury. Treasury, which used TARP funds to provide capital to AIG, ultimately exchanged and sold these shares to receive repayment for those funds.

[35] It is noteworthy that the Fed reduced the original interest rate charged to AIG to help avoid a downgrade of AIG by the rating agencies based on their fear that AIG might not have the capacity to service its indebtedness to the Fed.

[36] See, e.g., 12 CFR 7.4002(a) (authorizing national banks to impose non-interest fees and other charges in connection with its business activities); see also OCC Interpretive Letter 932, footnote 2 (August 17, 2001) (charging non-interest fees and other premiums is inherent in the business of banking).

[37] http://www.federalreserve.gov/newsevents/pressreleases/other20080916a.htm.

[38] 12 USC 341(Seventh).

[39] See, e.g., 12 CFR 7.1006 (national banks are authorized by rule to accept warrants and other evidence of shares of profit, income or earnings of a business in connection with lending); OCC Interpretive Letter 620 (July 15, 1992); OCC Interpretive Letter 421 (March 14, 1988).

during the emergency.[40] This approach would also have the deleterious effect of rewarding the shareholders of the troubled debtor who did nothing to curtail the debtor's risk appetite.

Going Forward

The credits extended by the Fed using section 13(3) authority in the AIG case, like those extended in the case of Bear Stearns, were all fully repaid with interest. On the other hand, section 13(3) was unavailable for extending credit to Lehman because the firm could not meet the statutory requirement of providing sufficient security or endorsement to satisfy the Fed that its loans would be fully repaid.

The fact that Bear Stearns and AIG were rescued and Lehman filed for bankruptcy has fed a debate about whether the Fed should have done more to rescue Lehman, particularly in light of the damage to the financial system that its failure caused.

Although it is true that the outcome for Lehman was stark and singular, unlike that of Bear Stearns and AIG, it is simply untrue that the Fed did not try to fashion a durable rescue. But the rescue had to be accomplished within the parameters fixed by statute, and because Lehman failed in mid-September, the statutory powers had to be evaluated before TARP existed. For the Fed, this meant reliance on section 13(3).

Congress visited this debate in the Dodd-Frank Act and determined that the Fed should not take the risk of loss on credit to failing firms. To that end, Congress amended section 13(3) to prohibit the Fed from lending to failing firms to save them from insolvency or to take assets off their balance sheets. Rather, in future crises, it may extend emergency credit under section 13(3) only through broad-based lending facilities designed to provide liquidity to the system as a whole.[41]

These new restrictions will prevent the Fed from extending credit as it did in the cases of Bear Stearns and AIG (and from designing ring-fencing programs for Citigroup and Bank of America). Instead, Dodd-Frank provides emergency liquidation authority that allows the government to orchestrate and manage the resolution of troubled financial firms.

[40] See Starr International Company, Inc. v United States and AIG, No 2015-5103, 2015-5133 (Federal Cir. 2017).

[41] Congress also amended section 13(3) to require that collateral pledged to the Fed have a lendable value sufficient to protect taxpayers from losses, and that the Treasury approve of such lending. In effect, the changes codified two other aspects of the Fed's approach in extending credit during the crisis.

III. The Treasury's Emergency Authority: The Money Market Fund Guarantee Program and TARP

During the days following the failure of Lehman and the near failure of AIG, it became clear that policymakers needed additional tools to address the deepening crisis beyond the Fed's limited authority to extend credit.

Using the Exchange Stabilization Fund to Support Money Market Mutual Funds

In mid-September 2008, Treasury did not have any explicit power to address a financial crisis. But it did have control over the Exchange Stabilization Fund (ESF) and it used that authority in an extraordinary and innovative way to stem the runs on money market mutual funds that threatened the financial system following Lehman's failure.

On September 19, the department unveiled its temporary Money Market Fund Guarantee Program. With this program, Treasury agreed to purchase assets from qualifying money market mutual funds at the amortized cost of the asset, plus accrued but unpaid interest, to allow these funds to redeem shares held by their customers. Each fund was required to pay the Treasury an insurance premium to participate.

The program would not have been successful without a credible backstop of funding. The only source of funds that Treasury could call on was the ESF. Using it to guarantee money market mutual funds was certainly novel and creative. Importantly, it was also well within the discretion of the Secretary under section 10 of the Gold Reserve Act.

The Secretary reasoned that using the ESF to help stem runs on the money market industry was consistent with Congress' intent in creating it. The runs were threatening to spread the destabilizing stresses on the financial system beyond the United States. Forcing fire sales of assets by money funds to meet the demands of investors would cause a further deterioration of the U.S. economy and declines in the dollar's value.

The program was successful in stopping the industry's erosion. In October, while the program was beginning and prior to its extension by the Secretary,[42] Congress enacted legislation allowing ESF to continue to support the money fund guarantee.

At the same time, it enacted legislation prohibiting the Secretary from using the ESF to provide a guarantee in the future. With this tool removed, and TARP now expired, Treasury is left with no emergency tools to address a future crisis.[43]

[42] The program was initially set to expire after three months but was extended for an additional four months, until April 30, 2009.

[43] 12 USC 5236; Pub. L. 110-343, section 131 (October 3, 2008); 122 Stat. 3797.

The Emergency Economic Stabilization Act and TARP

As delinquencies in residential mortgages increased, financial asset values continued to drop, and financial firms—both banks and nonbanks—had increasing difficulty raising capital to offset the losses from declining asset prices. It became apparent that the United States lacked certain emergency tools that were proving to be effective in other countries.

In particular, neither the Treasury nor the Federal Reserve had emergency authority to take action to stabilize asset prices or to inject capital into struggling but viable financial firms. Moreover, the resolution regime available for most nondepository institutions was bankruptcy, a court-administered process that focused on satisfying creditors without taking account of the systemic consequences of a firm's failure or the manner of its resolution.

To address these weaknesses, Congress, at the urging of the President, the Treasury and the Federal Reserve, enacted the Emergency Economic Stabilization Act (EESA) on October 3, 2008.[44] EESA, in turn, established the Troubled Assets Relief Program (TARP), with potentially $700 billion available to purchase troubled financial assets.[45]

Throughout TARP's existence, Treasury developed programs designed to stabilize the financial system and alleviate the housing crisis. The most successful TARP program injected much needed capital into financial firms by acquiring equity stakes in the firms.

Although the wisdom of this approach was criticized by some in Congress, its legal basis was never in doubt.

Securities issued by qualifying financial firms are financial instruments. After EESA's passage, the Treasury Secretary and the Fed Chairman determined that purchases of such securities would be the most effective way to quickly promote stability by providing viable firms with capital to offset the devaluation of other assets they held.[46]

TARP was critically important in addressing the vulnerabilities in the system, but it was also controversial because of the many policy issues it raised about the appropriate level of government involvement in distressed firms.

The authority to purchase troubled assets, including the capital of financial firms, to prevent disorderly failures and systemic shocks was one of the most effective tools during the crisis, and it remains in the arsenal of many foreign finance ministries and central banks. In the United States, that authority on October 3, 2010.

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[44] Public Law 110-343. 122 Stat. 3765 (October 3, 2008).

[45] 12 USC 5211(a)(1). Under section 3 of EESA, "troubled assets" includes "any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability..." 12 USC 5202(9)(B). For a complete discussion of TARP's terms and conditions, see Chapter XX.

[46] The purchase of securities issued by a financial institution is fully consistent with the factors the Secretary is required to consider in acquiring "troubled assets." See 12 USC 5213(1) through (9).

IV. The Federal Reserve's Creation of Broad-Based Lending Facilities and Other Actions

Prior to 2008, the Fed had provided emergency credit under section 13(3) strictly on a firm-by-firm basis, making only a small number of loans to nondepository institutions. During the crisis, it was evident that lending to specific firms would not be sufficient to address the liquidity needs of the overall economy, which had grown more complex and interconnected since the 1930s.

The Fed responded in an innovative way: it created broad-based lending facilities that were designed to relieve pressures on liquidity felt by entire markets, not just by specific firms.[47]

The basic purpose of these facilities was the same as the purpose of traditional emergency lending to specific borrowers—to provide liquidity to allow borrowers to conduct sound transactions involving good assets whose value was uncertain because of financial turmoil. The innovation was that each facility would allow borrowers to access central bank liquidity on the same terms and conditions so long as the funding was used to support a given market. In other words, the facility was not designed simply to provide liquidity to a single identified borrower to be used for the borrower's individual needs. Altogether, hundreds of borrowers participated in the broad-based facilities.

Because these facilities involved lending to nonbanks, they were based upon the powers in section 13(3).

The facilities raised a number of legal issues of first impression. Two related questions involved the finding of "unusual and exigent" circumstances[48] and the collection of evidence that borrowers were unable to secure adequate credit accommodations from other banking institutions.[49] In addition, as with the emergency loans to specific firms discussed above, careful attention was paid to ensure that the borrower's promise to repay was secured to the satisfaction of the lending Reserve Bank.

[47] These included the Primary Dealer Credit Facility (PDCF), Term Securities Lending Facility (TSLF), Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), Single-tranche Term Repurchase agreements, Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF) and Term Asset-Backed Securities Loan Facility (TALF).

[48] Each was authorized with the approval of a supermajority vote of the Board.

[49] The rate on credit extended under each broad-based lending facility was set in accordance with section 14(d) of the FRA, which, as noted above, requires that it be set "with a view to accommodating commerce and business." 12 USC 357. This approach resulted in different rates for different facilities. For example, the rate most helpful for "accommodating commerce and business" with a facility designed to provide liquidity to money market funds, such as the AMLF, was one that would encourage lending to funds under stress, and was not an appropriate rate to charge on a facility, like the TALF, that was intended to fund the asset-backed securities (ABS) market. Importantly, accommodating commerce and business during an emergency also allowed the Fed to establish rates that compensated it for the greater risks of lending in such a stressful economic period and were higher than would be the case during normal times, thereby discouraging borrowers from using the facilities as markets began to normalize.

The Fed approached the determination of when circumstances were "unusual and exigent" in the same way that Congress had in enacting section 13(3).[50] The required finding focused not on the borrower but on economic conditions and the role that a particular market played in the broader economy. The economy was experiencing unusual pressures and distress, greater than anything since the Depression, 75 years earlier. For each market targeted by a broad-based lending program, statistical evidence and observations of market conditions were gathered to show that it was contracting or experiencing extraordinary stresses.[51]

These statistics and anecdotes helped fulfill the requirement in section 13(3) that the Reserve Bank "obtain evidence that [the borrowing] individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions." That requirement was designed to ensure that the Fed did not supplant private-sector lenders and become the "lender of first resort."[52]

In the case of the broad-based facilities, evidence from participants in each targeted market indicated that credit was becoming increasingly difficult to obtain. Market data revealed that activity and liquidity were diminishing, rates and spreads were rising and credit was either not available or less available to consumers and businesses. The Reserve Banks continued to monitor the markets throughout the life of each facility. As evidence accumulated that a particular market was becoming active and could be sustained without Fed liquidity support, a termination date was set for its facility.

As noted earlier, a central element of section 13(3) is that credit is endorsed or otherwise secured to the satisfaction of the lending Reserve Bank.

In the case of the broad-based facilities, this requirement was generally met by having the borrower post collateral. The type of collateral was market-specific. For example, collateral pledged under TALF consisted of securities backed by consumer credit-card receivables, student loans or small business loans.

Credit extended under CPFF, targeted to the commercial paper market, was secured in an entirely new manner.

This market involves the issuance of highly-rated short-term debt, known as commercial paper, by financial and nonfinancial companies to underwrite their lending activities or commercial operations.

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[50] See footnote 17, supra.

[51] For example, the AMLF and MMIFF were created to help stem runs on money market funds. Market evidence showed that these runs were threatening to destabilize the value of assets held by the funds, reduce confidence in financial markets generally and reduce the liquidity available to businesses and consumers that relied on the funds. TALF was created to provide liquidity to the ABS market, which had virtually ceased to function, resulting in sizable reductions in the availability of auto loans, student loans, small business loans and similar securitized credits. CPFF was created because the commercial paper market was failing to supply credit to corporations and the PDCF was a response to a dramatic reduction in the funding available in the tri-party repo market. See Chapter XX.

[52] Citation of statements by Senator Glass still to come.

CPFF was originally conceived as a vehicle that would be owned and funded by private investors. The investors would hold an equity or subordinated position and obtain credit from the Fed secured by the commercial paper held by the vehicle. However, it soon became apparent that the same stresses that were reducing liquidity in the commercial paper market were discouraging investors from funding a commercial paper vehicle, even with Fed liquidity.

The challenging question for CPFF was how to fulfill the "indorsed or otherwise secured" requirement. Attorneys at the Fed focused on the fact that a guarantee in the form of an endorsement was in substance a kind of insurance. Indeed, credit insurance providing that the insurer will repay a debt in the event of the borrower's death, disability or other specified event is a kind of guarantee or endorsement. This concept led Fed lawyers and economists to explore the novel idea that CPFF could include a pool of assets and funds—an insurance pool—that would be available to cover losses on commercial paper that might default.

CPFF required all participants to pay fees to obtain funding for commercial paper. To create a pool of funds to protect against losses from defaults on unsecured paper, issuers of uncollateralized paper would be required to pay a special premium to CPFF. The size of the premium was tied to the amounts expected to be needed to cover any losses. The combined pool of fees paid by all participants that issued commercial paper and the special fees paid by issuers of unsecured paper would be available to absorb losses on the unsecured paper, mutualizing those losses much as an insurance fund would.[53]

Thus, the commercial paper acquired by CPFF was supported by the obligation of the commercial firm to repay, and the credit of the borrower was enhanced by the funds in the pool of premiums collected by CPFF. This enabled the lending Reserve Bank to conclude that the credit extended through CPFF was secured to its satisfaction.

CPFF and the other broad-based lending facilities were successful in restoring the functioning of their respective markets. When Congress repealed the Fed's authority to lend to specific IPCs under section 13(3), it specifically retained the authority in that section to create this type of broad-based lending vehicle.

Other Actions

A number of other actions were taken by the Fed, Treasury and FDIC to mitigate the crisis.

These included the Temporary Liquidity Guarantee Program (TLGP) implemented by the FDIC; swap lines with foreign central banks and Single-tranche Term Repurchase agreements established by the Fed; a number of TARP investment

[53] Commercial paper may be either secured or unsecured. Secured commercial paper was already supported by assets of the issuing corporation. This provided an alternate justification for its acquisition, which was arguably permitted as the discount of a secured note, backed by the collateral pledged by the issuer.

programs undertaken by the Treasury; and the ring-fencing facilities announced for Citigroup and Bank of America.

Although each of these programs represented an important effort by the sponsoring agency, all of them (with the exception of TLGP) relied on relatively straightforward interpretations of the underlying legal authority. That authority will be discussed in more detail in a Legal Appendix to be published online in the future.

TLGP relied on a novel review of the FDIC Act, and merits its own discussion in Chapter XX.

The FDIC's authority to reinstitute a TLGP program in a future crisis was significantly inhibited by Dodd-Frank, which prohibits the agency from establishing a debt guarantee program like TLGP without Congress' consent. The change essentially requires enactment of a new authorizing law.[54]

V. Conclusion

The legal authorities available to the Fed, Treasury and FDIC during the financial crisis shaped and constrained their responses. They allowed the government to take some actions that had worked in the past. They also allowed the agencies to act in innovative ways that may not have been imagined by the authors of the empowering laws.

Policymakers were united in a view that everything "possible" should be done within the bounds of the law to mitigate the crisis (and their lawyers explored every avenue). Yet in certain situations, such as the collapse of Lehman, the law did not permit the government to take actions that it wanted to take.[55]

The initial response to the crisis was to add some tools to prevent another crisis. In particular, the banking agencies, the SEC and the Commodity Futures Trading Commission (CFTC) all have greater prudential powers than they did prior to the crisis.

And the government also now has authority to resolve systemically important financial firms in a manner that provides funding backed by the banking industry (and not the taxpayer) and that empowers policymakers to maintain financial stability and limit damage to the economy. This authority, while untested and undoubtedly imperfect, puts a new tool in the crisis management toolbox that is an alternative to government lending or capital support.

[54] See sections 1104, 1105, 1106 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L 111-203 (July 21, 2010). 124 Stat. 1376.

[55] For example, the government did not have authority to close or liquidate a nondepository institution in a manner that, unlike bankruptcy, allowed consideration of the impact on financial stability.

At the same time, though, Congress has reserved much more authority to itself in crafting a response to the next crisis. The next time, Congress will decide whether to make available some of the emergency tools employed the last time, such as providing emergency credit to nondepository institutions outside of a broad-based market facility (as was done by the Fed), providing capital to the banking system on an emergency basis or supporting the money market fund industry (as was done by Treasury), and establishing an industry-backed debt guarantee program (as was done by the FDIC).

This reservation of power may limit moral hazard and impose market discipline if Congress ensures that both large and small entities are exposed to failure during the next crisis. Still, narrow or limited emergency authority could prevent policymakers from acting quickly and effectively to help the broader economy, and result in more damage to a wider range of consumers and businesses.

An alternative approach would be to provide a wide and mighty arsenal of emergency powers, subject to strong, workable governance requirements ensuring that these tools are used only during an emergency and only to the extent necessary.

Limiting the authority to act during a financial crisis will not prevent the next crisis. But it will shape the government's response to that crisis—and fundamentally determine its cost to the nation.