Yale University
EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents (Series 1) Browse by Media Type

1-19-2009

The Legal Position of the Central Bank: The Case of the Federal Reserve Bank of New York

Thomas C. Baxter, Jr. Jr.

Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation
Baxter, Jr., Thomas C. Jr., "The Legal Position of the Central Bank: The Case of the Federal Reserve Bank of New York" (2009). *YPFS Documents (Series 1)*. 12620.
https://elischolar.library.yale.edu/ypfs-documents/12620

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents (Series 1) by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

The Legal Position of the Central Bank

The Case of the Federal Reserve Bank of New York

Thomas C. Baxter, Jr.*
General Counsel and Executive Vice President
Federal Reserve Bank of New York

Presentation Delivered to
Regulatory Response to the Financial Crisis
Monday, January 19, 2009, at LSE, Sheikh Zayed Theatre, 9:10 AM

---

* The views expressed in this article are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of New York or any other component of the Federal Reserve System. The author thanks David Gross, who is Counsel at the Federal Reserve Bank of New York, for his invaluable assistance in preparing this paper.

Thank you, London School of Economics and Political Science, for putting together such a wonderful program today. I am honored to be here with so many of my friends and esteemed colleagues in the banking community.

I will be discussing the legal position of the central bank in the United States. Specifically, I will provide my thoughts about the challenges the Federal Reserve has faced in the last 18 months, how we responded to those challenges, and most specifically, how the legal mandate of the Central Bank affected our decisions. I will only discuss information that is publicly available. Obviously, many decisions were made following privileged conversations, and I must be careful not to reveal any of the substance of those conversations. I am a lawyer, not a client, and ethical rules do not permit me to reveal privileged information. But within those constraints, I hope to sketch for you an outline of some of the legal challenges the Federal Reserve Bank of New York has faced in the last year and a half.

Let me start by saying that this is a remarkable time to be a central banker. In fact, 2008 was the most extraordinary year of my 29 years at the Federal Reserve Bank of New York. If you had told me a year ago that we at the Fed would create a special purpose vehicle to hold assets acquired to facilitate the merger of JPMorgan Chase and Bear Stearns, rescue AIG at the eleventh hour, and eliminate tail risk in a $300 billion portfolio of Citigroup assets, I would have thought you were mad. But of course, all those things have happened in just the last ten months.

After 9/11, the New York Fed realized that we had to prepare for crisis better than we had in the past. So we spent years on "contingency planning" and "emergency responses," trying to imagine all kinds of crises that might arise. And even against that backdrop, nothing could have prepared us for what happened in 2008.

Commentators differ as to how far along we are in the financial crisis. Often they analogize it to a game of American football, and try to guess what quarter we are in. There is very little consensus. Yet there is widespread agreement that the crisis began in the summer of 2007. Many will remember that on August 9, 2007, BNP Paribas froze redemptions for three investment funds. That same day, the European Central Bank injected $95 billion into the interbank market. A week later, the Federal Reserve announced the Term Discount Window Program, open to all primary credit-eligible depository institutions. But stability in the financial markets started to deteriorate.

In December 2007, the Federal Reserve began a series of measures intended to ease this credit crisis. In that month, we launched a new program, the Term Auction Facility ("TAF"). This facility changed the type of lending that we typically do at the discount window to depository institutions.

Under the Federal Reserve Act, the Federal Reserve Banks determine a discount rate. (Strictly speaking, the banks establish a rate that is not effective until confirmed by the Board of Governors of the Federal Reserve System.) Under this new TAF facility, the Reserve Banks and the Board of Governors

agreed to set this rate by auction. So depository institutions could now borrow from the Federal Reserve at a rate determined by auction.

Why was this done? By allowing the Federal Reserve to inject term funds through a broader range of counterparties and against a broader range of collateral than open market operations, this facility was designed to help promote the efficient dissemination of liquidity when the unsecured interbank markets were under stress.

There was great concern after observing the experience of Northern Rock about an institution being stigmatized by its use of the Central Bank's credit facilities. (In essence, stigma results from a perception that only the desperate go to the lender of last resort.) The theory was that the TAF would set the rate at which depository institutions could borrow in a competitive environment and thereby reduce the stigma. The auction process itself indicates that bidders for Central Bank credit are seeking credit at competitive rates because that is smart rather than desperate. From what we've seen, the returns seem to indicate that we have been successful in this effort to mitigate substantially this stigma associated with appearing to have no other options.

By March 2008, however, the situation in financial markets had become more grave, and it became clear that the Central Bank had to do more. Liquidity conditions in the mortgage backed securities market had eroded considerably, almost to the point of stagnation. The Fed decided that the time had come to try to ease this liquidity crisis, felt primarily among the broker-dealer community. But how? Under normal conditions, the Federal Reserve can only lend at the

discount window to depository institutions. To provide liquidity to broker-dealers we needed to think about other legal authority. This authority, one that had not been used for many years, was Section 13(3) of the Federal Reserve Act.

The Fed has emergency lending powers in Section 13 of the Federal Reserve Act. Section 13(3) provides for "Discounts for Individuals, Partnerships, and Corporations." It reads:

> In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of Section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank: *Provided,* That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe.

This section was added to the Federal Reserve Act on July 21, 1932, with a minor amendment added in 1935. The original statutory language was somewhat ambiguous as to whether there were restrictions on the kinds of collateral that could be pledged by individuals, partnerships, and corporations to secure credit from a Reserve Bank. That uncertainty was resolved through an amendment in 1991 that eliminated any such restrictions, thereby broadening the application of Section 13(3) to a wider set of emergency situations.

I think a few words about how Section 13(3) has been used over the past 76 years will help put today's discussion in a useful context. The Board of Governors of the Federal Reserve System implemented the statute immediately after it was signed into law. Five days after its enactment, on July 26, 1932, the Board issued a circular granting permission to the Reserve Banks to make loans under the new authority for a period of six months, beginning August 1, 1932, and renewed such authorization from time to time until July 31, 1936. Prior to 2008, all loans under Section 13(3) were made during this period, with most occurring at the worst part of the Depression, from 1932-1933.

Examples of the kinds of loans made during that time include: (a) a loan of $300,000 to Smith-Corona Company, a manufacturer of typewriters; (b) a loan of $250,000 to Miller Cummings Company, a vegetable grower; and (c) a loan of $25,000 to L.N. Renault and Sons, Inc., secured by 5,000 shares of common stock of a brewing company and certificates representing ten barrels of brandy and 89 barrels of rum. (The purpose of the loan was to pay farmers for grapes.)

The total amount of credit extended from 1932-1936 was approximately $1.5 million. To give you an idea about the scope of the lending, this would be in the neighborhood of $23 million in today's dollars.

There were no new Section 13(3) authorizations until 1966, when mutual savings banks and savings and loan associations came under liquidity pressures as a result of substantial withdrawals of deposits over the midyear interest-crediting period. The Board authorized Section 13(3) loans again in 1969, when it appeared that savings institutions might experience massive deposit losses as

individual savers were attracted to higher-yielding investments available in the market. The 1966 authority was effective for about eight months. The 1969 authority was effective for about seven months. But no loans were made during either of those periods.

From 1970 until last year, there were several times when the Fed considered pursuing the use of Section 13(3) authority, and one time when it was briefly activated. (That was in 1980, when the authority was activated – but not used – to grant a loan to a Michigan nonmember bank to pay for cash letters presented to it.)

So that brings us to March 2008. Naturally, with a statute that had not been used to lend money in over 70 years, there was a great deal of reticence about activating this extraordinary authority. As someone who has spent almost 30 years working for the Federal Reserve, I can assure you that such steps are not taken lightly. Based on the statute, the first question that the Board of Governors had to confront (in a super-majority vote) was whether these were "unusual and exigent circumstances." But there was a corollary concern: even if the circumstances were unusual and exigent, what would the effect of such a finding by the Board of Governors of the Federal Reserve System have on confidence in the market? Keeping that in mind, you can understand why this authority was used in the Depression and activated (but not used) in the 1960's, but never at any other time. The determination that market circumstances are "unusual and exigent" could have been the catalyst for what would become a self-fulfilling prophesy. Happily, it was not.

The Board of Governors decided that circumstances were, in fact, so "unusual and exigent" that this extraordinary authorization was now needed. And in March 2008, specifically the weekend of March 8-9, the Federal Reserve began working on the Term Securities Lending Facility ("TSLF"). The thought was that we could alleviate the liquidity problem in broker dealers (actually a narrower population that we call "primary dealers") by lending them Treasury securities and in exchange taking as collateral their mortgage-backed securities ("MBS"). Because Treasuries were financeable but MBS were not, this would enable borrowing and stimulate market activity.[1]

On March 11, we announced the creation of the TSLF, and we announced that this facility was activated under Section 13(3) of the Federal Reserve Act, using our emergency lending powers. We expected the first lending would take place several weeks later. Of course, when relying on a statute that had not been used to lend since the Great Depression, the Fed could not know exactly how the market would react. Unfortunately, one unintended consequence was that certain members of the financial media wrongly concluded that the TSLF was created to save one particular investment bank, Bear Stearns ("Bear"). This was wrong. The TSLF was opened to add liquidity to the MBS market and not to aid any one institution. Nevertheless, the perception that the Fed was acting not to provide liquidity to the MBS market but to save Bear became the reality. Almost immediately, there was a run on Bear.

[1] Note that there was no offsetting reserve impact. A loan increases the supply of money and requires the Federal Reserve to do an offsetting transaction to avoid the Fed Funds rate trading "soft." Securities swaps, like the ones taking place under the TSLF, do not.

Late in the day on March 13, at around 8:00 p.m., we learned that Bear would be filing for bankruptcy protection on March 14. Although we had been monitoring the situation at Bear, this was a surprise. We had not yet been lending to any investment bank.

Obviously, this was a very serious concern. Bear was ranked #1 in private-label mortgage-backed securities securitization. Bear was also a major derivatives dealer. And, of course, Bear was also a major source of interconnectedness with other market participants.

After meetings that began that Thursday night and lasted almost until the market opened on Friday morning, the Fed decided that we needed to finance Bear through the weekend. The weekend would provide us with two full days to analyze the issues and decide on a course of action. We decided that the lending would occur through a conduit loan, whereby the Fed would lend to JPMorgan Chase ("JPMC"), and JPMC would lend to Bear. The loan to JPMC was "non-recourse," meaning the Fed could look only to the collateral for payment. This legal feature essentially put all of the risk of Bear's non-payment to the Fed.

On Friday, March 14, the loan was made. The loan was for between $10-15 billion and it was fully secured by this collateral. Bear survived on a kind of "Federal Reserve life support" through the day.

Over the weekend, the Federal Reserve began to move on two fronts with two groups. The first group was trying to find a way to avoid Bear's filing a bankruptcy petition on Monday. The second group was analyzing the issues to

prepare for what might happen on Monday if the first group was not successful, and Bear had to file.

How big was Bear? It was $350-400 billion in size. In metaphorical terms, it was a badly wounded big Bear. It had a sizeable mortgage-backed securities portfolio. The Federal Reserve tried several different suitors for a possible merger with Bear, but there was only one real option: JPMC.

JPMC was Bear's clearing bank, so it knew Bear's business better than anyone else. If there was going to be a deal, it would have to involve JPMC. The Federal Reserve stood ready to assist, if necessary. Around midday on Sunday, it became clear that it *was* necessary. At that time, it was decided that the Fed would extend financing of approximately $30 billion.

Asian markets would open at 6:00 p.m. Sunday night. The uncertainty about whether Bear would survive had to be resolved by that time. So we had to have a deal in place with enough time so that an announcement could be made before then. We needed not just a merger, but for JPMC to stand behind Bear's short-term obligations – with a guarantee – by 6:00 p.m. Sunday evening.

On the second track, if Bear were to die, we were trying to come up with another facility. That was the Primary Dealer Credit Facility ("PDCF"). Using this facility, the primary dealers would pledge securities to borrow dollars (not securities, the objective of the TSLF). This, too, was done under Section 13(3). And by this time, we were a little more comfortable using this authority because we had done something similar the week before with the TSLF.

On Sunday evening, March 16, JPMC and Bear finalized their deal: Bear would be acquired by JPMC. The announcement went out before the Asian markets opened.

The PDCF opened on March 17, and primary dealers had access to a Federal Reserve credit facility when news about Bear rippled through the United States financial markets. The PDCF was hardly used until Lehman Bros.'s bankruptcy on September 15. Nevertheless, the facility provided stability from March until September, when the broker dealer community faced its next crisis.

What we hurried to do over that weekend in March was to outline, in the broadest terms, a term sheet. But now we needed to transform an outline into legal documentation. The market had concerns about JPMC's guarantee of Bear's short-term obligations, and wondered how good that guarantee really was. (Some practitioners were unkind with their criticism of the lawyers who drafted JPMC's guarantee, as you might have seen in the media reports.)

The Bear shareholders were upset about the share price: then set at $2/share. This threatened "deal certainty," as did the uncertainty relating to the guarantee. In addition, there was concern at the Federal Reserve over how the Fed would finance the $30 billion asset portfolio.

So there were two bilateral negotiations taking place, one between JPMC and Bear, and one between JPMC and the Federal Reserve. Both sets of negotiations took place over the course of the week between March 17-24.

At the end of that week, a deal was struck. JPMC would issue shares in the amount of 39.5 percent. This was done pursuant to a New York Stock

Exchange rule to give JPMC deal certainty. The infirmities in the guarantee were cured through an amended guarantee. And the share price changed from $2/share to $10/share. On the other front, the Federal Reserve negotiated more strongly the terms of the financial assistance that we would provide.

The final deal took place in June, and it was a remarkable marriage of the Section 13(3) authority and a relatively new feature of modern finance, the special purpose vehicle. Most special purpose vehicles are structured as limited liability companies, which trace their origin in the United States to the late 1970's. The Congress that enacted Section 13(3) in the 1930's envisioned the Federal Reserve lending to companies, but it surely did not envision the Fed lending to an LLC, because that legal form of organization would not be invented for another 40 years. And, there was a second issue – could the Federal Reserve cause the LLC to be created and then lend to the LLC? This issue was resolved with the Bear rescue.

The Federal Reserve created an SPV, which we called Maiden Lane, LLC, (later known as "Maiden Lane I") to which we lent approximately $29 billion and JPMC lent $1 billion. Under Section 13(3), the LLC used the loan proceeds to acquire Bear assets, transforming Bear into a merger target digestible to Chase. The Federal Reserve loan was secured by a pledge of the assets purchased from Bear by the LLC, and the term of the loan was for 10 years. The agreement stipulated that JPMC would take the first $1 billion of any loss.

The development of this structure was a crucial step in our management of the crisis, and it significantly augmented the Central Bank's alternatives. The

late Milton Friedman famously remarked upon the importance of liquidity during the Great Depression. In fact, Chairman Bernanke attracted considerable attention when he apologized, on behalf of the Fed, to Professor Friedman for the Fed's misguided reactive policy of contracting liquidity and contributing to the severity of the Great Depression. Now, with the marriage of Section 13(3) and the SPV, there is a powerful tool available to the Central Bank to inject liquidity and tailor the injection to a particular purpose. With proper Section 13(3) authorization from the Board of Governors, the Federal Reserve can create a limited liability company and then lend to it, in order to add liquidity or effect some other policy objective.

For example, the Fed formed two new SPVs in just the last few months to help stabilize American International Group ("AIG"). The first SPV acquired residential mortgage-backed securities from AIG. The New York Fed lent $22.5 billion to the SPV and AIG lent $1 billion and agreed (as JPMC did in the Bear rescue) to take the first loss. This SPV gets the Residential Mortgage-Backed Securities off AIG's balance sheet, helping to stabilize AIG and mitigate systemic risk.

The second SPV acquired AIG's collateralized debt obligations. Again, the New York Fed lent $30 billion to the SPV and AIG lent $5 billion and agreed to take the first loss. The SPV acquired the Collateralized Debt Obligations ("CDOs") from counterparties with whom AIG had written credit default swap contracts. Those credit default swap contracts are cancelled after the CDOs are purchased. The policy objective in this is twofold: the systemic effect of a default

by AIG to many counterparties is neutralized, and AIG's financial condition is bolstered.

The use of Section 13(3) and an SPV need not be limited to systemically important institutional aid. As I mentioned, it can also be effectively used for market liquidity. For example, on October 27, we opened the Commercial Paper Funding Facility, in which the SPV buys commercial paper using the proceeds of a Federal Reserve loan. And on November 24, we opened the Money Market Investors Funding Facility. In the near future, we will open the Term Asset-Backed Securities Lending Facility. If we have to consider other programs to assure financial stability, then we stand ready to do that. Obviously, the Federal Reserve must and will act within the bounds of the law, but we will interpret our legal mandate in a manner that facilitates our policy objectives, and sometimes this may require innovation, and a departure from the usual ways of doing business.

Let me conclude with a precautionary note about accounting, along with some balance sheet statistics to illustrate the importance of the Section 13(3)/SPV marriage. When we created Maiden Lane I to facilitate the JPMC-Bear merger, this lawyer was thinking the SPV would stand with its own balance sheet, independent of the Federal Reserve. The accounting professionals taught me that, because of post-Enron reforms directed toward SPV accounting, the SPV needed to be reflected on the Federal Reserve's balance sheet. And we have followed that professional advice. You can observe the results in our public financial disclosures. At the beginning of August 2007, the Fed had outstanding

lending through the discount window of around $1 million. Three months ago, that number was close to half a trillion dollars. Today, it is even higher. A year ago, we did not have any SPVs. Now we have nine and counting. At the end of 2007, the assets on our balance sheet totaled $330 billion. Today, because of all these liquidity facilities, our assets are well over $2 trillion.

The remarkable balance sheet increase bears witness to my concluding line: the Federal Reserve will continue to do whatever it takes, within the bounds of the law, to deal with this financial crisis. Thank you for giving me the opportunity to talk to you today.