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Pittsburgh, PA 15222-3779

April 18, 2023

The Honorable Gary Gensler, Chair
United States Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dear Chair Gensler:

Re: Supplemental Comment Letter II of Federated Hermes, Inc. (SEC File No. S7-22-21)

I am writing on behalf of Federated Hermes, Inc. to highlight regulatory implications of the Fed’s emerging model for providing liquidity to financial institutions during periods of market stress – particularly as they relate to money market funds (MMFs). The enclosed paper¹ chronicles the evolution of Federal Reserve lending facilities, leading to today: the restored use of the discount window and complementary steps to assist bank broker/dealers in performing their historic market-making role during liquidity events will significantly reduce systemic risk and dramatically reduce the need for emergency lending facilities that can falsely cast harsh light on their recipients.

Following the March 2020 shock to the financial system, the Fed engaged in large-scale quantitative easing that was quickly followed by the most rapid and dramatic rate-hiking cycle in 40 years, along with quantitative tightening. Thus, the Fed manufactured a more onerous market scenario than considered in typical bank stress tests.

To address the resulting March 2023 banking crisis, the Fed encouraged banks facing deposit redemption pressure to tap one or both of two lending facilities: the newly created Bank Term Funding Program (BTFP) and the discount window (DW). The DW was the original standing mechanism that the framers of the Federal Reserve Act of 1913 (“FRA” or the “Act”) envisioned for preventing contagion and supplying liquidity to the markets after the devastating panics of 1893 and 1907. The Fed has struggled to overcome the stigma associated with DW usage that, regrettably, the Fed itself created during the 20th century. But after a series of steps in 2003, 2020, and 2023, evidence suggests that the Fed has overcome this limitation to the point that the discount window is now positioned as a first line of defense.²

More relevant to the question of applicability in future systemic liquidity events, the BTFP is the most recent emergency lending facility provided under Section 13(3) of the FRA. These emergency programs have drawn increasing scrutiny from Congress subsequent to 2008, when the Fed exceeded its authority under Section 13(3): it indirectly purchased securities through special purpose vehicles it controlled, while the Act directly

¹ Granito, Michal R., *Liquidity Crises and the Fed: The Need for Standing Facilities as a First Line of Defense Against Market Liquidity Events* (Apr. 1, 2023). Available from Federated Hermes, Inc.

² See *id.* at 8; Federal Reserve, Press Release, *Federal Reserve Board announces it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors* (Mar. 12, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm>.

prohibits asset purchases.³ As a result, Congress curtailed the Fed’s Section 13(3) powers with the passage of the Dodd – Frank Act (“DFA”), Sections 1101 – 1103.

It is early in the process, but today’s collective action by the Fed, FDIC, and the Treasury to guarantee some uninsured depositors has set an unwanted precedent in expanding the federal safety net. And the BTFP itself has already drawn fresh Congressional attention. For instance, in a March 31, 2023 report, the Congressional Research Service (CRS) has identified several concerns:⁴

The creation of the BTFP raises several issues for Congress:

- **Moral Hazard.** The favorable BTFP terms, notably collateral valuation at par, reduces the incentive for banks to manage interest rate risk if they believe the Fed will lend them money regardless of the market value of the securities pledged.
- **ESF Backing.** The BTFP is being backed by ESF (Exchange Stabilization Fund) funds. This could be controversial given that it is not the originally intended use of the ESF and similar actions were prohibited in the past.
- **Inflation.** The BTFP increases the size of the Fed’s balance sheet, and could, therefore, increase inflationary pressures at a time when the Fed has been raising interest rates to reduce inflation.
- **Risk.** The BTFP requires high quality collateral and is backed by ESF funds, minimizing the risk of losses to the Fed.
- **Transparency.** The Fed is required to disclose participation with a one-year lag. The lagged release is meant to balance desires for transparency with the stigma that could be associated with an immediate release.

It is no surprise therefore that the Fed dislikes using emergency lending facilities; but has often done so historically, and today, out of concern that banks would be reluctant to use the discount window. This is true notwithstanding the fact that the Fed has wide latitude under Regulation A to set the terms of discount window lending to accommodate the nature of an emerging crisis.

But today’s banking crisis is a teaching moment: evidence suggests that the Fed has succeeded in restoring its most powerful standing lending facility to provide liquidity in a crisis. In fact, banks have shown a marked preference for the discount window over the BTFP.⁵ Thus, circumstances that previously required emergency lending programs can now be realistically handled using the discount window.

Why is this relevant to MMFs? The MMLF and other emergency programs created in March/April 2020 could have been addressed using the discount window, as history now shows. In this way, the alleged “vulnerabilities” of MMFs do not require special attention or vigilance by the Fed and should instead be

³ Maiden Lane I, II, and III, LLC.

⁴ Congressional Research Service, *Bank Term Funding Program (BTFP) and Other Federal Reserve Support to Banking System in Turmoil* (Mar. 31, 2023), available at <https://crsreports.congress.gov/product/pdf/IN/IN12134>.

⁵ S&P Global Market Intelligence, *Banks favor discount window lending over new Fed program amid liquidity crunch*, available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/banks-favor-discount-window-borrowing-over-new-fed-program-amid-liquidity-crunch-74845506>.

correctly viewed as a resilient cornerstone of the capital markets – one that sometimes may participate when the Fed must fulfill its original lender of last resort function to arrest a system-wide liquidity crisis.

Very truly yours,

A handwritten signature in blue ink that reads "Michael R. Granito". The signature is written in a cursive style with a horizontal line underneath it.

Michael R. Granito
Chief Risk Officer

Liquidity Crises and the Fed: The Need for Standing Facilities as a First Line of Defense Against Market Liquidity Events

Michael R. Granito

April 1, 2023

Abstract

We examine the lending facilities available to the Federal Reserve (Fed) to stem market liquidity crises: emergency lending, the discount window and the standing repo facility. Emergency lending can take time to implement, may require a Treasury backstop and can appear to be a “bailout.” The discount window is a standing facility that has historically been underutilized because of the associated stigma that the Fed itself created during the 20th century. The standing repo facility is hoped to have less stigma, but it can only be used to dampen illiquidity in the U.S. Treasury and Agency market because it is administered under Section 14 of the Federal Reserve Act that restricts activities to securities guaranteed by the U.S. Government. Legislation would be required to allow corporate securities, which is unlikely to be granted by a skeptical Congress.

When used to calm market liquidity stress, banks and broker-dealers could be encouraged to perform their historic role in intermediation that was sharply restricted by the imposition of increased capital and liquidity requirements in the wake of the Dodd – Frank Act (DFA) after the financial crisis of 2008. This would enable an expansion of bank balance sheets. However, post-DFA capital and leverage ratio requirements make it impossible for banks to engage in such activities without a waiver of these restrictions to allow increased intermediation, as was done in March 2020.

We argue that the discount window is the most realistic standing facility for providing funding to enable the banking system to perform its historic role in intermediation. This can be effective provided that federal banking regulators have a trigger by which liquidity crises are timely identified, a “Liquidity Event” is designated, and post-DFA capital and leverage ratios are temporarily suspended, which should be hard-coded in regulation upon Liquidity Event designation. These steps would enable bank balance sheet expansion pursuant to discount window lending to support market-making in stressed liquidity conditions – an original objective of the Federal Reserve Act.

I. The Origins of Declining Liquidity in the U.S. Capital Markets

The actions taken by the Fed after the financial crisis of 2008 are credited with ameliorating the depth of the ensuing Great Recession. The subsequent regulatory agenda was designed to impose new regulations on the banking sector with the goal of increasing resilience and reducing “too big to fail” risk. These included tougher capital and liquidity requirements as well as limits on the use of leverage.¹

However, there was overwhelming awareness among the Fed and other regulatory bodies that these regulations would impair the market-making ability of bank broker/dealers. Janet Yellen commented:

Large dealers appear to devote less of their balance sheets to holding inventories of securities to facilitate trades and instead increasingly facilitate trades by directly matching buyers and sellers. In addition, algorithmic traders and institutional investors are a larger presence in various markets than previously, and the willingness of these institutions to support liquidity in stressful conditions is uncertain. While no single factor appears to be the predominant cause of the evolution of market liquidity, some regulations may be affecting market liquidity somewhat. There may be benefits to simplifying aspects of the Volcker rule, which limits proprietary trading by banking firms, and to reviewing the interaction of the enhanced supplementary leverage ratio with risk-based capital requirements.²

Stanley Fischer, a former Fed vice chair, observed that:

¹ Janet Yellen summarized these as follows:

To strengthen banks' resilience, the Federal Reserve and the other banking agencies have substantially increased capital requirements. Regulatory minimums for capital relative to risk-weighted assets are significantly higher, and capital requirements now focus on the highest-quality capital, such as common equity. In addition to risk-based standards, bank holding companies and depositories face a leverage ratio requirement. Also, significantly higher capital standards--both risk-weighted and leverage ratios--are being applied to the most systemically important banking organizations. We are also employing annual stress tests to gauge large institutions' ability to weather a very severe downturn and distress of counterparties and, importantly, continue lending to households and businesses. Firms that do not meet these standards face restrictions on dividends and share buybacks. As a result of these changes, for the largest banks, Tier 1 common equity--the highest-quality form of capital--has more than doubled since the financial crisis.

Recently implemented regulations aim to strengthen liquidity. For example, a new liquidity coverage ratio requires internationally active banking organizations to hold sufficient high-quality liquid assets to meet their projected net cash outflows during a 30-day stress period. A new process--the Comprehensive Liquidity Analysis and Review--sets supervisory expectations for liquidity-risk management and evaluates institutions' practices against these benchmarks. A proposal for a net stable funding ratio would require better liquidity management at horizons beyond that covered by the liquidity coverage ratio. A proposed capital surcharge for the largest firms would discourage overreliance on short-term wholesale funding.

Janet L. Yellen, *Finance and Society* (May 6, 2015), available at <https://www.federalreserve.gov/newsevents/speech/yellen20150506a.htm>

² Janet L. Yellen, *Financial Stability a Decade after the Onset of the Crisis* (Aug. 25, 2017), available at <https://www.federalreserve.gov/newsevents/speech/yellen20170825a.htm>

Market participants have cited a decline in dealers' inventories as a possible source of decreased liquidity. ... The recent decline might be due in part to regulations, such as the Volcker rule and the Supplementary Leverage Ratio, aimed at making the financial system safer and sounder, as well as to changes firms may have made on their own, perhaps in reaction to the experience of the financial crisis. Regardless of the causes of the change, market participants have expressed a concern that the decline in inventories reflects in part a reduced willingness or capacity of the primary dealers to make markets -- which may in turn lead to lower liquidity.³

In the ensuing years, various organizations have observed the adverse impact on market liquidity resulting from banking reform. For instance, the Bank for International Settlements (BIS) found that:

Dealers have continued to lower their market-making capacity and willingness in many jurisdictions, focusing on activities that require less capital. Demand for market-making services, in turn, continues to grow given the expansion of primary bond markets and increased bond holdings by market participants who rely on dealers' immediacy services (eg asset managers).. For other markets, such as those for off-the-run sovereign bonds and corporate bonds, there is evidence of bifurcation, with liquidity deteriorating most in those market segments that have historically been less deep than others. In these segments, the reduction in dealers' market-making capacity seems to have had a greater impact on liquidity, given the limited availability of substitutes to their services.⁴

In December 2015, Congress directed the SEC's Division of Economic and Risk Analysis to report on the impacts of the Dodd-Frank Act, the Volker Rule, and other financial regulations on market liquidity in U.S. Treasury and corporate debt markets.

While there is little consensus in existing work concerning the direction, causal attribution, and mechanisms behind observed changes, evidence suggests that in recent years dealers have been less likely to engage in risky principal transactions. In addition, dealers generally decrease liquidity provision in times of severe market stress, such as during the financial crisis.

Evidence from the crisis [of 2008] suggests that during times of severe market stress, dealers may not lean into the wind, but instead make larger cuts in inventory of bonds that are aggressively sold by their customers. Such evidence supports a finding that dealers decrease liquidity provision in times of severe market stress.⁵

In 2020 Randal Quarles, then Fed vice chair for supervision and chair of the FSB, commented:

It may be that there is a simple macro fact that the Treasury market being ... much larger than it was a decade ago and now really much larger than it was even a few years ago, that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there⁶

³ Stanley Fischer, *Is There a Liquidity Problem Post Crisis?* (Nov. 16, 2016) available at <https://www.federalreserve.gov/newsevents/speech/fischer20161115a.htm>

⁴ Committee on the Global Financial System, *Fixed income market liquidity*, CGFS Papers No. 55 (Jan. 2016), available at <https://www.bis.org/publ/cgfs55.pdf>

⁵ SEC, *Access to Capital and Market Liquidity* (Aug. 2017) available at <https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-2017.pdf>, at 9

⁶ Benjamin Purvis and Catarina Saraiva, *The Treasury Market May Be So Big That the Fed Can't Step Away*, (Oct. 14, 2020 5:03 PM), available at <https://www.bloomberg.com/news/articles/2020-10-14/the-treasury-market-may-be-so-big-that-the-fed-can-t-step-away?sref=enGs3N51>

More recently, in a 2022 paper prepared for and presented at the Fed's 2022 Jackson Hole meetings, Acharya et. al. study the longer term effect of quantitative easing and find that the eventual quantitative tightening will place still larger liquidity strains on the market:

We document that banking deposits increase, and become more demandable when QE expands reserves. ... Banks also originate more corporate lines of credit. We observe little reversal of all this during quantitative tightening.

We argue that this asymmetric behavior makes the banking system dependent on the central bank for ever larger liquidity infusions during stress and can explain tightening liquidity conditions and occasional stress episodes when quantitative tightening is underway, despite the central bank balance-sheet being large relative to historical standards.⁷

II. The March 2020 Market Failure and other Recent Liquidity Events in the U.S. Capital Markets

It should be apparent to any neutral observer that the root cause of the March 2020 market failure was not the activities of financial firms. Rather, the root cause was a global economic shock to the system and orchestrated government action to stem the pandemic, which sharply reduced investor confidence, price discovery, and liquidity across all markets. Predictably, as governments around the world shut down their economies to prevent spread of the virus, a contagion then ensued as the prospect of the worst pandemic in 100 years shut-down economies across the globe. In these conditions, there was a dramatic increase in the VIX, a market indicator of fear, to a record high of 83%. Credit spreads for investment grade and high-yield bonds had already increased by approximately 150% from mid-February to March 18th.

Amid the growing crisis there was a general flight to safety. Large time deposits at banks, those without FDIC insurance, dropped sharply while smaller insured deposits surged. In the first weeks of March 2020, many corporations (often with high quality but, due to the crisis, temporarily illiquid direct commercial paper holdings), tapped bank credit lines. This placed liquidity strains on the banking system. The various new banking regulations limited the ability of dealers to take securities into inventory. As a result, dealers had less flexibility in intermediating fixed-income trades in any reasonable size irrespective of their credit quality.⁸ Thus, the pandemic conditions further eroded the market-making ability of bank broker/dealers, beyond the limitations created by the post-2008 crisis banking reforms.

But even before the Pandemic, declining liquidity began to be apparent even in the U.S. Treasury market. Like tremors before a severe earthquake, cracks in the system began to emerge:

On October 15, 2014 ("October 15"), the market for U.S. Treasury securities, futures, and other closely related financial markets experienced an unusually high level of volatility and a very rapid

⁷ Acharya,V., Chauhan,R., Rajan,R. and Steffen,S. (2022) *Liquidity Dependence: Why Shrinking Central Bank Balance Sheets is an Uphill Task*, Prepared for and presented at the Symposium of the Federal Reserve Bank of Kansas City on "Reassessing Constraints on the Economy and Policy," August 25-27, 2022, available at https://www.kansascityfed.org/Jackson%20Hole/documents/9040/JH_Paper_Acharya.pdf

⁸ Investment Company Institute, *Experiences of US Money Market Funds During the COVID-19 Crisis* (Nov. 2020) available at <https://www.sec.gov/comments/credit-market-interconnectedness/cll10-8026117-225527.pdf>

round-trip in prices. Although trading volumes were high and the market continued to function, liquidity conditions became significantly strained. The yield on the benchmark 10-year Treasury security, a useful gauge for the price moves in other, related instruments that day, experienced a 37-basis-point trading range, only to close 6 basis points below its opening level. Intraday changes of greater magnitude have been seen on only three occasions since 1998 and, unlike October 15, all were driven by significant policy announcements. Moreover, in the narrow window between 9:33 and 9:45 a.m. ET, yields exhibited a significant round-trip without a clear cause, with the 10-year Treasury yield experiencing a 16-basis-point drop and then rebound. *For such significant volatility and a large round-trip in prices to occur in so short a time with no obvious catalyst is unprecedented in the recent history of the Treasury market.* [emphasis added]⁹

A similar event took place in September 2019, as summarized in a federal joint agency report:

In September 2019, a confluence of factors disrupted the repo market and demonstrated that repo demand and supply can be very inelastic in the short run, creating the potential for repo interest rates to rise very rapidly and to very high levels in response to relatively small shocks.

Overnight repo rates began to rise on September 16, 2019, and accelerated on September 17. The Secured Overnight Financing Rate (SOFR), a broad measure of the cost of overnight Treasury repo borrowing, spiked to 5.25 percent, an increase of more than 300 basis points from the level two business days earlier. Overnight repo rates also became notably more dispersed. Some transactions on September 17 occurred at rates as high as 9 percent, and the spread between the 1st and 99th percentiles of rates on transactions used to compute SOFR was 675 basis points. By contrast, earlier in 2019, the daily spread between the 1st and 99th percentiles had averaged around 25 basis points. Other funding markets also experienced pressures, and the effective federal funds rate (EFFR) on September 17 printed at 2.30 percent, above the FOMC’s target range of 2 to 2.25 percent at the time.¹⁰

And subsequent to March 2020,

... on February 25, 2021, a large shift in investor sentiment triggered very high trading volumes that temporarily overwhelmed the intermediation capacity of the Treasury market. Yields jumped, market liquidity deteriorated, and trading volumes rose to record levels leading up to the Treasury Department’s auction of a 7-year note. After the yield realized in the auction exceeded market expectations by 4 basis points, with the lowest bid-to-cover ratio on record since the 7-year note was reintroduced in 2009, trading conditions deteriorated abruptly. The most notable decline in market liquidity occurred in on-the run securities in the interdealer market, especially longer-dated securities.¹¹

Moreover, a continuing general decline in market liquidity is chronicled by the Fed.

The bid-ask spread—the difference between the lowest ask price and the highest bid price for a security — is one of the most popular liquidity measures. ... bid-ask spreads have widened out in 2022... . Measures of the price impact of trades also suggest a notable deterioration of liquidity.

⁹ U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Reserve Bank of New York, U.S. Securities and Exchange Commission, and U.S. Commodity Futures Trading Commission, 2015, “Joint Staff Report: The U.S. Treasury Market on October 15, 2014,” available at <https://home.treasury.gov/system/files/276/joint-staff-report-the-us-treasury-market-on-10-15-2014.pdf>

¹⁰ Recent Disruptions and Potential Reforms in the U.S. Treasury Market: A Staff Progress Report (Nov. 8, 2021) available at <https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf> [hereinafter [Treasury Report](#)]

¹¹ Treasury Report, *supra* note 10

The market's capacity to smoothly handle large flows has been of ongoing concern since March 2020 ...as Treasury debt outstanding continues to grow. Moreover, lower-than-usual liquidity implies that a liquidity shock will have larger-than-usual effects on prices and perhaps be more likely to precipitate a negative feedback loop between security sales, volatility, and illiquidity. Close monitoring of Treasury market liquidity — and continued efforts to improve the market's resilience — remain important.¹²

III. The Fed's Stressed Market Lending Facilities

In response to crisis conditions such as March 2020, and the continuing risk of illiquidity in the U.S. Treasury market, the Fed has three primary lending tools: (i) emergency lending under Sections 13(3) and 13(13) of the Federal Reserve Act (FRA or the "Act")¹³; (ii) use of the Discount Window conducted under sections 10B and 13(2) of the FRA; and (iii) a Standing Repo facility for banks conducted under Section 14 of the FRA.

1. Emergency Lending Programs

Established in 1932 by the Emergency Relief and Reconstruction Act, and liberalized by various by acts including the 1935 Banking Act and the FDIC Improvement Act of 1991, FRA Section 13(3) defines the Fed's primary mechanism for emergency lending to the non-bank private sector.¹⁴ It was used sparingly from 1932 through 1936, making only 123 loans totaling approximately \$1.5 million.^{15,16} In fact the Fed even began to question whether it should be making loans to the private sector:

In the postwar period, Fed leaders began to question whether the central bank should be involved in making loans to businesses and individuals. In 1957, then-Fed Chair William McChesney Martin told Congress during testimony that while there might be a role for the government to address gaps in private sector lending, it was not one that the Fed should play. Rather, he said it was the preference of the Board of Governors for the Fed to "devote itself primarily to the objectives set for it by the

¹² Michael Fleming and Claire Nelson, *How Liquid Has the Treasury Market Been in 2022?* (Nov. 15, 2022), available at <https://libertystreeteconomics.newyorkfed.org/2022/11/how-liquid-has-the-treasury-market-been-in-2022/>

¹³ Tim Sablik, *The Fed's Emergency Lending Evolves* (2020), available at https://www.richmondfed.org/publications/research/econ_focus/2020/q2-3/federal_reserve

¹⁴ Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act* (Sept. 2018), available at https://www.newyorkfed.org/medialibrary/media/research/epr/2018/epr_2018_political-origins_sastry.pdf provides a detailed account the legislative history of the FRA Section 13(3).

¹⁵ Tim Sablik, *The Fed's Emergency Lending Evolves* (2020), available at https://www.richmondfed.org/publications/research/econ_focus/2020/q2-3/federal_reserve

¹⁶ An alternate form of direct lending, Section 13(b), was added to the Federal Reserve Act by the Industrial Advances Act of June 19, 1934. It authorized Federal Reserve Banks to "make loans to, or purchase obligations of" an "established industrial or commercial business" for "the purpose of providing it with working capital" when such business was otherwise unable to obtain funds from private markets. The authority was limited to "exceptional circumstances." Section 13(b) was utilized fairly extensively by the Federal Reserve System between 1934 and 1956; and loans between June of 1934 and May of 1935 totaled approximately \$44 million dollars to 961 entities. However, 13(b) was later repealed by the Small Business Investment Act of August 21, 1958, and the Fed was out of the direct lending business, in part because this had the effect of competing with commercial banks and it put the Fed in the role of allocating credit. See David Fetting, *How the Fed Made Section 13(b) Loans* (Dec. 1, 2002), <https://www.minneapolisfed.org/article/2002/how-the-fed-made-section-13b-loans>; David Fetting, *The History of a Powerful Paragraph* (June 1, 2008), <https://www.minneapolisfed.org/article/2008/the-history-of-a-powerful-paragraph>

Congress, namely, guiding monetary and credit policy so as to exert its influence toward maintaining the value of the dollar and fostering orderly economic progress."¹⁷

Section 13(3) was not again employed until the financial crisis of 2008 when a series of Fed emergency programs were put into place. These actions are well known and do not require further elaboration. However, it is noteworthy that the Fed was rebuked in its use of 13(3) powers.

By April 2008, these developments provoked former Fed Chairman Paul Voleker to comment that the Federal Reserve had “taken actions that extend to the very edge of its lawful and implied powers, transcending certain long-embedded central banking principles and practices.”¹⁸

Other legal scholars have taken a more direct view. In a detailed review of the Fed’s actions, legal scholar Alexander Mehra writes:

In unusual and exigent circumstances, § 13(3) of the Federal Reserve Act empowers the Fed to provide an uncapped amount of liquidity to the financial system. It may, with the approval of the U.S. Treasury, establish programs of broad-based eligibility and lend freely against sufficient collateral. Before its amendment by the Dodd-Frank Wall Street Reform and Consumer Protection Act, § 13(3) also allowed the Fed, acting alone, to extend credit to particular individuals, partnerships, and corporations. From 2008 to 2009, the Fed invoked this authority repeatedly to purchase assets, lend money, and establish schemes that sought to restore market stability. However, [we] argue that § 13(3) was and remains a loan-making power of narrowly defined scope. On this view, the Fed’s asset purchases and certain of its lending activities raise great concerns. ... [We] argue that many of the Fed’s responses to the crisis exceeded the bounds of its statutory authority.¹⁹

Section 13(3) was definitive in that the Fed may make loans against sound collateral, but not purchase assets. The legal issues particularly relate to the creation of various special purpose vehicles (SPVs, in particular, Maiden Lane I, II, and III, LLC), controlled by the Fed, that purchased assets from the balance sheets of selected entities. This was facilitated through Fed loans to the SPVs, thus doing indirectly what 13(3) prohibited directly.²⁰ Moreover, the secrecy behind these transactions and the lack of oversight prompted a congressional backlash in the form of Sections 1101-3 of the Dodd-Frank Act (DFA).

DFA curtailed the Fed’s emergency lending authority by amending Section 13(3) with: (i) prohibitions against removing impaired assets from, or otherwise bailing out, an individual company; (ii) requiring that future lending be directed to providing liquidity to the market in programs with broad based eligibility; (iii) requiring that any such lending receive the prior permission from the Secretary of the Treasury; (iv) requiring formal and continuing reporting to Congress specifying details of any such program and the potential risks to taxpayers; (v) submitting to program audits by the Comptroller General; and (vi) public disclosure of audit findings. Lending programs that could entail losses to taxpayers would require capital allocated by

¹⁷ Tim Sablik, *The Fed’s Emergency Lending Evolves* (2020), available at

https://www.richmondfed.org/publications/research/econ_focus/2020/q2-3/federal_reserve

¹⁸ Frederic S. Mishkin and Eugene N. White, *Unprecedented Actions: The Federal Reserve’s Response to the Global Financial Crisis In the Historical Perspective*, NBER, Working Paper 20737 (Dec. 2014), available at https://www.nber.org/system/files/working_papers/w20737/w20737.pdf

¹⁹ Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 J. Bus. L. 221 (2010), available at <https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1375&context=jbl>

²⁰ Congressional Research Service, *Federal Reserve: Emergency Lending* (Mar. 27, 2020), available at <https://fas.org/sgp/crs/misc/R44185.pdf>

the Treasury.²¹ Guaranteeing the obligations of depositories is administered under Section 1105 of DFA. That section requires the determination by the Board of Governors of the Federal Reserve System and the FDIC that a “LIQUIDITY EVENT”²² has occurred, and the FDIC may then create a widely available program that guarantees the obligations of solvent insured depository institutions upon approval of the Congress and President, subject to the further requirements of Sections 1104-5.

During March and April 2020, the Fed again used its now restricted emergency lending powers to create eight separately approved and funded facilities with loss-absorbing capital (as necessary, including as a “backstop” despite the stated expectation of zero loss to taxpayers) by the U.S. Treasury. However, these programs were initiated after the market crisis had been raging for at least a month and significant damage to the economy had already been done. This fact brings us to a fundamental point: after witnessing the devastation caused by the panics of 1893 and 1907, the authors of the Federal Reserve Act of 1913 saw its objective as: (1) increasing the supply of money to support a growing economy; and (2), to prevent panics from occurring. As summarized by Senator Robert Owen, co-author of the Act,

It should always be kept in mind that it is not the welfare of the bank, nor the welfare of the depositor which is the main object to be attained, but it is the *prevention* of panic [emphasis added], the protection of our commerce, the stability of business conditions, and the maintenance in active operation of the productive energies of the nation which is the question of vital importance.²³

The Fed’s emergency facilities in 2020 were implemented to abate the crisis, not prevent it. As we will discuss further in consideration of a “standing repo” facility, the April 2021 Federal Open Market Committee (FOMC) minutes reveal the Fed’s awareness of the benefits of standing facilities in a crisis:

The April Federal Open Market Committee minutes showed that many officials were positive about a standing repo facility because it would be there all the time, ready to deal with stress and liquidity needs, and would save the central bank from making judgment calls about needing to use other market-calming interventions.^{24,25}

As a further illustration of the delays involved in implementing emergency facilities, in the case of the MMLF program announced on March 18th, and possibly other facilities administered through banks, the program could not become effective until the Fed, OCC, and FDIC jointly implemented and published in the Federal Register an interim final rule that neutralized the effect

²¹ This provision was specific to the CARES Act COVID facilities lending.

²² “LIQUIDITY EVENT. – the term “liquidity event” means – (A) an exceptional and broad reduction in the general ability of financial market participants— (i) to sell financial assets without an unusual and significant discount; or (ii) to borrow using financial assets as collateral without an unusual and significant increase in margin; or (B) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.” DFA Section 1105 (g)(3).

²³ Robert L. Owen, *The Federal Reserve Act(1919)*, available at https://fraser.stlouisfed.org/files/docs/publications/books/ra_owen_1919.pdf at 43

²⁴ Michael S. Derby, *Fed Officials Voice Support for New Tool to Smooth Market Stress*, MINUTES SHOW (May 19, 2021, 4:55 PM), available at <https://www.wsj.com/articles/fed-officials-voice-support-for-new-tool-to-smooth-market-stress-minutes-show-11621457740>

²⁵ The Fed also understood that the presence of a standing facility could also preemptively reduce strains in the market. For instance, the MMLF facility announced on March 18th, 2020 began to have effect even before it became effective on March 23rd.

on the capital and leverage ratios of banks participating in the MMLF program on behalf of MMFs. This occurred on March 23rd, when the MMLF also became effective.

2. The Discount Window

The discount window, provided in Section 13(2) of the FRA of 1913 and in Sections 10B and 13(2) today, was the mechanism that the authors of the Act intended to serve as the means of expanding the supply of money and credit for a growing economy; and for providing liquidity to avert panics.²⁶ It was envisioned that member banks could obtain loans from the discount window, based on sound collateral presented by commercial businesses, but not financial firms.²⁷ With the exception of U.S. Treasury securities, instruments that were the liabilities of financial companies, such as investment banks, could not be discounted so as not to promote the interests of Wall Street.²⁸ Precise definitions of the allowed paper would be determined through regulation by the Federal Reserve Board (the “Fed”) within the meaning of the Act.²⁹ Eligible paper could be issued by individuals, corporations, etc. with a maturity not greater than 90 days. Only bank members of the Federal Reserve System were allowed access to the discount window.³⁰

The essential difference between 13(2) and 13(3) is that 13(2) describes the discount window available to member banks. Section 13(3) provides for direct lending to individuals, partnerships, and corporations (often intermediated through a member bank) based on the same types of collateral required under Section 13(2) and requiring the same security. This limited availability of the Act to many because, for instance, individuals would typically not have the type of necessary collateral. The Banking Act of 1935 relaxed this requirement. However, loans against financial assets were still excluded. Section 473 of the FDIC Improvement Act of 1991 (“FDICIA”) struck the language “of the kinds and maturities made eligible for discount for member banks under other provisions of this Act.” Thus, the Fed could now lend to financial companies based on financial asset collateral. These amendments enabled the Fed to be a lender of last resort for both commercial and financial enterprises. Critically, all lending would be made against sound collateral. Thus, the statutory mandate was still limited to providing liquidity and not taking credit risk. Also of note, the language “unusual and exigent circumstances” was not defined in the Emergency Relief and Reconstruction Act, but it was presumed to imply emergency circumstances.³¹

While 13(2) or 10B were not intended to loan directly to businesses, in concept, business customers of a member bank could present eligible collateral for a loan from that bank. If the bank

²⁶ Today, the Discount Window is described primarily in Section 10B while retaining original Section 13(2).

²⁷ “Discounting” refers to providing a loan in an amount less than the fair market value of the collateral, the difference being the discount or “haircut”.

²⁸ This was a likely outcome of the fact that the “call loan” market, which was short term financing for security holdings, was a flash point for the panic of 1907. Accepting only collateral that arose from businesses engaged in commerce was the Real Bills Doctrine.

²⁹ Regulation A, which has been frequently amended, provides the mechanism and terms for discount window borrowing.

³⁰ Non-member banks (e.g. state chartered banks, thrifts, etc) were given access to the discount window in 1980 by the Monetary Control Act if they voluntarily held reserves against deposits.

³¹ Federal Reserve, Collateral Valuation, <https://www.frbdiscountwindow.org/pages/collateral/discount%20window%20margins%20and%20collateral%20guidelines>. Discounts to high quality short term paper are typically 2% for discount window borrowing. Loans or asset purchases made under FRA 13(3) can have varying provisions determined by the circumstances.

was not able to fund the loan, it could take it to the discount window, endorse the collateral, and receive a loan from the district Reserve bank, which it would then use to fund the customer's loan. This would correspond to Owen's concept of an elastic currency that could expand for the needs of business. Thus, the member bank could effectively serve as an intermediary between the customer and the Fed; and could determine the nature and type of customer for which such intermediation would be performed.^{32,33}

There was considerable use of the discount window in the early years after passage up to 1935, although it began to decline in the 1920s when the Fed began the use of open market operations to supply money and credit to the economy.³⁴ At the same time, the Fed became concerned that some banks could become overly reliant on the window, eventually weakening them. Consequently, the Fed began discouraging discount window borrowing, implying that it attracted troubled banks, and a stigma developed around its use. Notwithstanding this perception, the Fed maintained the borrowing rate below the market rate under the view that there should not be a penalty for banks in true need of the facility. However, the Fed did not want banks to take advantage of this rate and increasingly discouraged discount window use. Among other restrictions added over time on "appropriate" vs "inappropriate" uses, the Fed eventually added a surcharge for frequent borrowing and in 1973 added the requirement that the bank exhaust all other sources of funding before resorting to the window. The cumulative effect of these actions further entrenched the stigma of the discount window as the resort of troubled institutions.

This stance with respect to discount window borrowing remained until 2003 at which point the Fed introduced the concept of the Primary Credit Facility, which is the rate available to banks in strong financial condition; and the Secondary Credit Facility for banks not meeting that criteria. Now, the borrowing rates are at or above the top of the fed funds target range, with the excess over the top of the range representing a penalty rate. Loans for the Primary Credit Facility are advanced on a "no questions asked" basis. These steps were intended to eliminate the stigma for banks in strong financial condition, while aligning discount window policies with Walter Bagehot's famous dictum: lending freely against sound collateral but at a penalty to assure that lower cost alternatives are tapped first. Sadly, these steps did not eliminate the stigma and there was relatively little discount window borrowing during the financial crisis of 2008. Anticipating this limitation, in December 2007 the Fed introduced a temporary program, Term Auction Facility, which did see

³² See Tim Sablik, *Fed Credit Policy during the Great Depression* (Mar. 2013), available at https://fraser.stlouisfed.org/files/docs/historical/frbrich/econbrief/frbrich_eb_13-03.pdf for an historical account of Fed lending during the Great Depression years.

³³ An alternate form of direct lending, Section 13(b) was added to the Federal Reserve Act in the Industrial Advances Act of June 19, 1934. It authorized Federal Reserve Banks to "make loans to, or purchase obligations of" an "established industrial or commercial business" for "the purpose of providing it with working capital" when such business was otherwise unable to obtain funds from private markets. The authority was limited to "exceptional circumstances." Section 13(b) was utilized fairly extensively by the Federal Reserve System between 1934 and 1956; and loans between June of 1934 and May of 1935 totaled approximately \$44 million dollars to 961 entities. However, 13(b) was later repealed by the Small Business Investment Act of August 21, 1958 and the Fed was out of the direct lending business, in part because this had the effect of competing with commercial banks. See David Fettig, *How the Fed Made Section 13(b) Loans* (Dec. 1, 2002), available at <https://www.minneapolisfed.org/article/2002/how-the-fed-made-section-13b-loans>

³⁴ Olivier Armantier et al., *History of Discount Window Stigma* (Aug. 2015), available at <https://libertystreeteconomics.newyorkfed.org/2015/08/history-of-discount-window-stigma.html>

considerable use.³⁵ In a further effort to stimulate use, in March 2020 the Fed again encouraged banks to access the window and set the Primary Credit rate equal to the top of the fed funds range set by the FOMC, which is where it stands today.

3. The Fed Standing Repo Facility

Interest in a standing repo facility emerged as a way to address the dislocations or liquidity disruptions in the U.S. Treasury market seen in recent years. In the event of an aberration in Treasury yields, a bank could purchase securities with abnormally high yields, while simultaneously posting them as collateral for repos with (loans received from) the System Open Market Account (SOMA) that are used to purchase the securities.³⁶

In concept, such a facility performs a similar function as traditional discount window loans, but with a key difference. Repo operations are conducted under Section 14 of the FRA which governs open market operations. They are therefore subject to the same limitations with respect to the types of securities that can be transacted. In particular, open market transactions are only authorized for securities guaranteed by the U.S. Government; and standing repo transactions are similarly limited. However, the Fed anticipates that such transactions will have less stigma attached and will, therefore, more likely be used to support liquidity in the Treasury market without the need for emergency facilities under Section 13(3). On July 28th, 2021 the Fed announced the creation of this facility for U.S. Treasury securities.^{37,38}

The most recent notable development in the use of repo facilities for more general emergencies occurred when the Bank of England calmed market disruption in the Fall of 2022 by temporary expansion of its repo line to include corporate securities as collateral.³⁹ It is widely believed that if such a facility was available in the U.S. in March of 2020, the disruption to financial markets would have been much less severe and the Fed would not have had to create the MMLF and other facilities under Section 13(3). One distinction in considering this alternative is that the Fed cannot make this amendment to accept non-Treasury collateral under Section 14 of the FRA through regulation. Legislation would be required to amend the scope of open market operations and the powers of the SOMA.

IV. Conforming Amendments to Capital and Leverage Ratios During Liquidity Events

One feature that is common to any of the stressed market facilities – emergency lending, the discount window or a standing repo facility – is the fact that, even as they may be intended to provide liquidity to market participants such as MMFs, they are often facilitated through a member

³⁵ Olivier Armandier et al., *Discount Window Stigma during the 2007-2008 Financial Crisis*, Federal Reserve Bank of New York Staff Reports, No. 483, available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr483.pdf

³⁶ In this way, the transactions represent repo from the standpoint of the SOMA, but reverse repo from the standpoint of the bank engaged in the transaction.

³⁷ *Statement Regarding Repurchase Agreements* (July 28, 2021), https://www.newyorkfed.org/markets/opolicy/operating_policy_210728

³⁸ Gara Afonso et al., *The Fed's Latest Tool: A Standing Repo Facility* (Jan. 13, 2022), <https://libertystreeteconomics.newyorkfed.org/2022/01/the-feds-latest-tool-a-standing-repo-facility/>

³⁹ Temporary Expanded Collateral Repo Facility Market Notice (Oct. 10, 2022), <https://www.bankofengland.co.uk/markets/market-notice/2022/october/temporary-expanded-collateral-repo-facility-market-notice-10-october-2022>

bank that directly accesses the Fed. In this way, the balance sheet of the member bank is the conduit through which liquidity flows to the end market participant. To stem crises such as March 2020, large broker/dealers and banks could be encouraged to perform their historic role as market makers and take high-quality short-term but illiquid securities onto their balance sheets. They would then profit from the higher yields that these securities could provide during such market conditions compared with their funding costs through borrowing from the Fed.

However, this poses a challenge to banks and broker-dealers that are part of bank holding companies because the regulatory capital and leverage rules continue to apply to any balance sheet expansion resulting from use of the facility. Therefore, even if the facility would work to calm the markets and assist end market participants in obtaining access to liquidity, the entity may be unwilling to engage as a lending conduit because of the adverse impact on regulatory capital requirements or leverage ratios. For the MMLF and PPPLF programs, the Fed, FDIC, and OCC enacted interim final rules on March 23rd, April 13th, and May 6th of 2020 to neutralize the balance sheet impact of member banks participating in these programs.⁴⁰ Similarly, use of the discount window or standing repo facility (expanded to non-Treasury collateral or not) would also require relief from regulatory capital and leverage rules in order to enable member bank participation.

In order to justify and trigger such regulatory relief, the Fed, OCC, and FDIC would likely require an event, such as the distressed market conditions that led to the creation of the specific MMLF or PPPLF programs in 2020. In the case of a standing facility such as the discount window or repo, a new program is not being created – in fact, that is a key objective of using standing facilities. In this circumstance, we recommend that federal banking regulators borrow the concept of a “Liquidity Event” from Section 1104 of DFA.⁴¹ This term fits the circumstances in February and March of 2020 and, we believe, other potential future stressed market conditions warranting Fed intervention. Designation of a Liquidity Event could represent the condition that would warrant a similar temporary relief from regulatory capital and leverage ratio requirements as were implemented in March of 2020 and would enable eligible entities, including banks and broker dealers within bank holding companies, to use the standing facilities available to them under Sections 10B and 14 of the FRA, as well as any emergency facilities created under Section 13(3). Specifically then, the regulatory agencies should hard-code into regulation a Liquidity Event concept to provide for standing capital relief when a similar market condition obtains.

⁴⁰ “The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation are adopting as final the revisions to the regulatory capital rule and the liquidity coverage ratio (LCR) rule made under three interim final rules published in the Federal Register on March 23, April 13, and May 6, 2020. The agencies are adopting these interim final rules as final with no changes. Under this final rule, banking organizations may continue to neutralize the regulatory capital effects of participating in the Money Market Mutual Fund Liquidity Facility (MMLF) and the Paycheck Protection Program Liquidity Facility (PPPLF), and are required to continue to neutralize the LCR effects of participating in the MMLF and the PPPLF. In addition, Paycheck Protection Program loans will receive a zero percent risk weight under the agencies’ regulatory capital rules.” *Treatment of Certain Emergency Facilities in the Regulatory Capital Rule and the Liquidity Coverage Ratio Rule*, 85 Fed. Reg. 68243 (Oct. 28, 2020).

⁴¹ “LIQUIDITY EVENT. – the term “liquidity event” means – (A) an exceptional and broad reduction in the general ability of financial market participants— (i) to sell financial assets without an unusual and significant discount; or (ii) to borrow using financial assets as collateral without an unusual and significant increase in margin; or (B) an unusual and significant reduction in the ability of financial market participants to obtain unsecured credit.” DFA Section 1105 (g)(3).

V. Conclusions

The Fed has various means at its disposal to address liquidity crises, which, if not timely addressed, can also lead to insolvencies and a full-blown financial crisis. However, each of the tools available to the Fed – emergency lending under FRA 13(3), the discount window under FRA 10B and 13(2), and standing bank repo facilities under FRA 14 – have limitations that hamper their effectiveness. Arguably, the limitations of emergency lending and the discount window derive primarily from the Fed’s own management of these facilities – with either a political or financial stigma associated with their use. And the standing repo facility cannot be employed for private market securities without further legislation, which Congress may be in no mood to approve.

The only broadly available standby facility that federal banking regulators can freely use by regulation (Regulation A) is the discount window. It enables a wide range of borrowers and a wide range of collateral (security types). By establishing the extent of the “discount” for differing collateral and the term of the loan, the Fed can assure that it is not taking credit risk that, under our regulatory regime, would require a Treasury backstop. The practical limitation of the discount window is the ability of banks and bank holding companies to satisfy the stringent capital and leverage requirements associated with a significant expansion of bank balance sheets, as may occur if major banks were encouraged to provide liquidity to the system in a crisis. However, this can be addressed using something along the lines of the interim final rule such as the Fed, the OCC, and the FDIC employed in March 2020 to temporarily waive these requirements. The remaining challenge is to have a clearly defined trigger to set this programmatic strategy in motion. It is our recommendation that the Fed hard-code the concept of a “Liquidity Event” such as defined in Section 1104 of the Dodd-Frank Act. If for instance, relying on input from the open market desk of the Federal Reserve Bank of NY or the FOMC, the Board declared such an event, then pre-established rulemaking and discount window directives could be timely set in motion to respond to emerging liquidity crises. This would enable a modern-day solution to Owen’s original problem – preventing panics. The problem of stigma can be overcome in these circumstances when, at the urging of the Fed, multiple bank broker/dealers are enlisted to participate.

VI. Addendum

As these pages are written a new banking crisis is emerging. While still in its early stages, a few observations can be made. Thus far, the crisis does not stem from the market illiquidity that is addressed in this paper. The stresses are resulting from a rapid growth of deposits driven by QE, followed by a rapid Fed rate-hiking cycle and quantitative tightening. Banks typically provide deposit rates substantially below market rates. When there are deposit outflows, often in search of higher yields, bank assets available for sale to meet withdrawals are potentially sold at losses because they were purchased during the period of lower rates and deposit inflows. This exposes the bank to capital shortfalls requiring new equity funding. The bank is then subject to a run, particularly when deposit holders are institutions with uninsured deposits. Since this general circumstance may be a characteristic of many banks and there can be little transparency, contagion can ensue and the entire banking system can be subject to runs. While the Fed promptly implemented the Bank Term Funding Program (BTFP), this Section 13(3) emergency measure is limited because it can only lend against FRA Section 14 collateral (i.e., is guaranteed by the U.S. Government) in order to avoid subjecting the taxpayer to losses. Even so, the Treasury still had to backstop the facility with \$25 billion drawn for the Exchange Stabilization Fund. These events are

subjecting the Fed to further political scrutiny because it appears to be a “bailout” of the banking system that has arisen from the Fed’s own monetary policies and that bank supervision apparently failed to adequately anticipate (although it was seemingly anticipated in Acharya et. al.).

Notwithstanding the fact that the current crisis did not stem from illiquidity in the markets, an emerging observation that supports the conclusions of the present paper is that, thus far, banks are currently borrowing more from the discount window than the BTFP – a further endorsement of the utility of the discount window to stem crisis conditions.⁴²

⁴² See S&P Global Market Intelligence, *Banks favor discount window lending over new Fed program amid liquidity crunch*, available at <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/banks-favor-discount-window-borrowing-over-new-fed-program-amid-liquidity-crunch-74845506>.