

CARES Act \$454 billion Emergency Fund Could add up to Much More for Businesses, States and Municipalities

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Original post [here](#).

The [Coronavirus Aid, Relief, and Economic Security Act \(“CARES Act”\)](#) that President Trump signed into law on March 27th provides \$454 billion (the Emergency Fund) for the Secretary of the Treasury to make direct loans or to guarantee loans made by the Federal Reserve to assist business, states, and municipalities dealing with the pandemic. The Fed may do this through (i) purchasing obligations or other interests directly from issuers or other interests; (ii) purchasing obligations or other interests in secondary markets or otherwise; or (ii) making loans, including loans or other advances secured by collateral.

By providing the ability for the Treasury to guarantee or backstop Fed loans, the provisions create the possibility that the impact of the fund can be leveraged up significantly as stated by Secretary Mnuchin—“We can [lever up to \\$4 trillion](#) to help everything from small businesses to big businesses.” Fed Chairman Powell has echoed the Secretary—“[Effectively, \\$1 of loss-absorption is worth \\$10 worth of loans.](#)” Therefore the Emergency Fund could result in trillions of dollars being made available to the public. See [this YPFS blog post](#) for further discussion on the Treasury backstop.

The legislation creates great possibilities but also raises questions about limitations on the Fed’s authority. Section 4003(C)(3)(B) of the CARES Act explicitly provides “for the avoidance of doubt” that the requirements of Section 13(3) of the Federal Reserve Act would apply to any Fed program or facility relying on such funds “including requirements relating to loan collateralization, taxpayer protection, and borrower solvency.” We discuss herein the intersection of the Emergency Fund with Section 13(3).

Federal Reserve Act Section 13(3)

Section 13(3) of the Federal Reserve Act, often called the Fed’s emergency lending provision, provides the central bank with authority in “unusual and exigent” situations to broaden its permitted borrowers to include “any individual, partnership, or corporations.” The section was enacted during the 1930s and has been called a “broad and extraordinary authority.” ([Alvarez 05/26/2010](#)). The provision was used several times during the Depression, and although use was authorized twice during the 1960s, funds had not been lent under the provision in the 70 years prior to the 2007-09 global financial crisis (GFC). ([Alvarez 05/26/2010](#)).

Section 13(3) during the GFC

During the GFC, Section 13(3) authorized the Fed to extend credit to any individual, partnership or corporation if certain criteria were met:

- At least five members of the Board members determined that “unusual and exigent” circumstances exist
- The lending must be “indorsed or otherwise secured to the satisfaction of the [lending] Reserve Bank.”

- The borrower was “unable to secure adequate credit accommodations from other banking institutions”
- The credit complied with any limitations, restrictions and regulations prescribed by the Board. ([FRA Sec 13\(3\), 2008](#)).

During the GFC the Fed found that “unusual and exigent circumstances” existed and extensively used the provision, which became one of its most important tools to provide numerous broad-based programs aimed at providing liquidity to markets. The Fed has recently reintroduced versions of several of these programs to address the COVID-19 pandemic: the [Term Asset-Backed Securities Loan Facility \(TSLF\)](#), the [Commercial Paper Funding Facility \(CPFF\)](#), the [Primary Dealer Credit Facility](#), the [Money Market Mutual Fund Liquidity Facility \(MMIF\)](#).

Most recently, on March 23, the Fed and the Treasury reintroduced a modified version of another GFC-era program the [Term Asset-Backed Loan Facility \(TALF\)](#) to support credit flows to households and businesses by maintaining the flow of asset-backed securities markets. Pursuant to the TALF the Federal Reserve Bank of New York (FRBNY) will make loans to a SPV that will in turn make a total of \$100 billion three-year nonrecourse loans to U.S. companies that own eligible ABS. The SPV will be funded by a recourse loan from the FRBNY and an initial \$10 billion equity investment by the Treasury. The Fed again relies on the Section 13(3) authority and the Treasury uses the Exchange Stabilization Fund (ESF) to backstop the program. The TALF is thought to be a good candidate for use of the Emergency Fund to support lending by the Fed because of its demonstrated flexibility. See a YPFS blog on the 2020 TALF and Federal backstop [here](#).

During the GFC, the Fed also relied on its Section 13(3) authority to stabilize systemically important firms such as Bear Stearns and AIG, and to design ring-fencing programs like it did for Citigroup and Bank of America. The extensive use of Section 13(3) programs provided trillions of dollars of liquidity to the financial system and contributed greatly to the effort to quell the GFC. There has generally been little criticism of the Fed’s use and interpretation except for its Maiden Lane facilities in support of Bear Stearns and AIG.

Dodd-Frank Amendments

Following the GFC, in which some of the Fed lending was criticized, particularly assistance to individual companies, Congress enacted changes to Section 13(3) through the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#), which added several significant provisions including:

- the Fed can now only conduct emergency lending through a “program or facility with broad-based eligibility,”
- the purpose of the program must be “providing liquidity to the financial system, and not to aid a failing financial company”
- that the security for emergency loans is sufficient to protect taxpayers from losses
- that for any loan, a Federal Reserve bank must assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan under Section 13(3) in determining whether the loan is secured satisfactorily.

- That credit may not be given to any company that is insolvent.

Prior to introduction of the COVID-19 era programs, Section 13(3) had not been used since the GFC and thus, the Dodd-Frank amendments are untested.

Broad-based Eligibility. The amended provision seeks to prohibit the Fed from customizing assistance to individual firms and focuses on assisting the broad market and financial system. A program or facility has “broad-based eligibility” if it is (i) designed to provide liquidity to an identifiable market or sector of the financial system, not designed to aid one or more specific companies, and (ii) at least five companies would be eligible to participate in. ([FRA Reg. Sec. 201.3\(b\)](#)). Excluded from this definition is any program “structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy” or some other insolvency proceeding. ([Fed Website-Sec.13](#)) ([Fed Register vol 80, no. 243, 12/18/15](#)).

Collateral/Security and Protecting Taxpayers. Other Dodd-Frank amendments relate to the section’s requirement that any loan be indorsed or secured to the satisfaction of the lending reserve bank (the “indorsed or secured requirement”) which address issues of collateral/security and with the new amendments, protection of taxpayers’ interest. The Fed was required to establish regulations designed to ensure that (i) the “the security for emergency loans is sufficient to protect taxpayers from losses” and (ii) that require a reserve bank to “assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan.” ([Fed Register vol 80, no. 243, 12/18/15](#)). The regulation adopted by the Fed provides that in determining whether an extension of credit under any program or facility established under Section 13(3) is secured to its satisfaction, a Federal Reserve bank must, “prior to or at the time the credit is initially extended, assign a lendable value to all collateral for the program or facility... to ensure protection for the taxpayer.” ([Fed Register vol 80, no. 243, 12/18/15](#)).

Thus, it appears that through its new regulation the Fed retained much of its traditional discretion. Other than the new requirement to value collateral, it remains committed to its prior position and seems to have conflated the new valuation requirement into the traditional indorsed or secured requirement. By meeting this standard, it will presumably ensure “that the security for emergency loans is sufficient to protect taxpayers from losses.” This is consistent with the Fed’s long-held interpretation of its authority.

Administratively, the Dodd-Frank changes also require that:

- any such program must be established with the approval of the Secretary of the Treasury
- additional initial notification and ongoing reporting must be made to Congress
- any such program is terminated in a timely and orderly fashion. ([Fed Website-Sec13](#)).

How does Section 13(3) apply to the Emergency Fund?

Broad-based Eligibility. Under the amended Section 13(3), the individual assistance given to Bear Stearns and AIG, including their Maiden Lane facilities would not be permitted. However, it appears that the Dodd-Frank amendments leave intact many of the broad-based plans that the Fed employed in the GFC under Section 13(3) and which it has also chosen to redeploy to address the COVID-19 pandemic.

Collateral/Security and Protecting Taxpayers. It should be noted that the provisions of the original statute, nor the amendments provide guidance as to what constitutes sufficient satisfaction as to endorsement or collateral/security. The matter of what type and how much collateral, or what type of endorsement is sufficient is left to the Fed's broad discretion. ([Alvarez 2009](#)) ([Mehra 2010](#)). Courts generally have afforded great deference to the Fed's actions and its interpretations of its authority. ([Alvarez, Baxter, Hoyt 2018](#)).

Traditionally, as expressed by former Chairman Bernanke, the Fed has interpreted its Section 13(3) authority as only permitting it to make loans secured by collateral sufficient to provide [reasonable assurance that they will be repaid](#). This position was thrust into the spotlight during the GFC when the Fed did not lend to Lehman Brother because it concluded that Lehman did not have sufficient collateral to secure a loan of the size that it would need to save itself. The lack of a loan resulted in the investment bank's filing for bankruptcy. Under the amended section the Fed could reach the same conclusion but would have to assign values to the potential collateral and report on its decision to Congress.

One [Fed legal memo from the GFC discussing the 2008 CPFF](#) and sheds light on how the Fed interprets Section 13(3), and in particular the indorsed or secured requirement. The [CPFF, which the Fed reintroduced on March 18th](#), is a broad-based program under which the FRBNY provides loans to a SPV that purchases eligible secured and unsecured commercial paper from eligible issuers. In discussing the CPFF, the Fed legal staff considered not only if the loan to the SPV would satisfy the indorsed or secured requirement, but also considered whether the requirement would be met if each purchase of commercial paper was considered an extension of credit to the issuer. The staff concluded that in both cases, the standard would be met in several ways:

1. by a third-party endorsement or guaranty (which did not apply to the CPFF)
2. by the commercial paper held by the borrower SPV,
3. by the pools of assets underlying ABCP held by the SPV, and
4. by paying a fee for an insurance premium, which applied to unsecured commercial paper under the CPFF ([Alvarez 2009](#)).

Thus, stated another way, the requirement can be met by a loan being secured by:

1. collateral with legal recourse to the borrower or a third-party guarantor,
2. an endorsement by a third-party guarantor without collateral, or
3. recourse to collateral without an endorsement. ([Alvarez 2009](#)).

In another context, Fed counsel have also considered whether the central bank could extend a loan not expecting to be fully repaid and concluded that it could not—"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." ([Alvarez, Baxter, Hoyt 2018](#).)

But there is a not an absolute prohibition on the Fed incurring losses. In providing assistance to Bear Stearns in March 2008 the Fed agreed to purchase a portfolio of Bear's assets to facilitate the merger of the troubled investment bank with JPMorgan Chase (JPMC), an

extraordinary transaction for the Fed that became known as Maiden Lane, the name of the special purchase vehicle created to hold the mortgage securities. The loan to the SPV was to be fully collateralized by the Bear portfolio (whose value had been determined to be able to support the loan) and would be non-recourse to JPMC. The lending Federal Reserve Bank of New York (FRBNY) determined that the indorsed and secured standard was met, yet, it also sought an indemnification from Treasury Secretary Paulson for any losses that might be incurred. Legally unable to grant an indemnification, Paulson issued the FRBNY a letter recognizing that there might be losses that would reduce the net earnings transferred by the FRBNY to the Treasury general fund. ([Paulson 3/2008](#)). Paulson issued a similar letter with respect to the Fed's assistance to AIG with respect to securities lending ([Paulson 10/2008](#)). These actions are consistent with the views of then FRBNY President Geithner that "a central bank should be prepared to take losses" and that it is "highly likely ... that the appropriate use of the lender of last resort authority might well result in some losses." ([Geithner 2019](#)).

Thus, a reasonable interpretation would conclude that as long as at the time of lending the Fed had a reasonable expectation of being repaid, either by the borrower, through access to collateral or insurance, or to a third-party guarantor, in this case the Treasury, the indorse or secured requirement would be satisfied. Further, satisfaction of this standard appears consistent with the current requirement under Section 13(3) to protect taxpayers from losses. In the event there was a loss that had to be absorbed by the Treasury's equity contribution or guarantee, these funds in effect had already been appropriated by Congress.

However, it would be prudent for the Fed to consider not only whether an individual default under a program would be covered by the Treasury backstop but also the likelihood that the total potential losses under a program could realistically be absorbed by the Treasury's guarantee. If they could, then it appears that Section 13(3) would have been complied with. The Fed recently reached a similar conclusion in its letter to Congress regarding the 2020 TALF—"the Board does not expect at this time that the TALF will result in losses in excess of the Department of the Treasury's equity investment. Accordingly, the TALF is not expected to result in losses to the Federal Reserve or the taxpayer (emphasis added)." ([TALF Report](#).)

Insolvency. The Dodd Frank amendments prohibit the Fed from directly or indirectly lending to any firm that is insolvent. Insolvent has been defined to mean (i) in bankruptcy, in a Dodd-Frank resolution proceeding, or in another insolvency proceeding, (ii) generally not paying its undisputed debts as they become due during the 90 days preceding the borrowing under the program or facility, or (iii) as otherwise determined by the Board or Federal Reserve Bank. ([Fed Register vol 80, no. 243, 12/18/15](#)).

Under the second definition above, a company that is generally not paying its undisputed debts as they become due during the 90 days preceding borrowing is considered insolvent and ineligible for a loan. ([Fed Register vol 80, no. 243, 12/18/15](#)). However, government COVID-19 assistance may provide forbearance relief to companies effected by the pandemic. One question in this situation is whether these missed payments, which may be legally excused, could be disregarded by the Fed for purposes of determining insolvency under Section 13(3). If they cannot be then a quirk in the law will constrain potential borrowers to choose which form of relief may be more valuable, a result which was perhaps unintended.