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Small but important revisions to Section 13-3 of Federal Reserve Act

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The proposed changes to financial regulation require the Fed to obtain advance approval from the new Council before providing funds under Section 13-3 of the Federal Reserve Act. They also include a ban on the rescue of individual institutions. While these reflect doubts about some rescues during the current financial crisis, I fear they might prevent the Fed from fulfilling its role as lender of last resort (LOLR), for two reasons: (1) financial institutions other than banks could become a source of systemic risk, and (2) with fewer LCFIs in existence, measures targeting individual institutions are more likely to be necessary. Better changes to this section, in my view, would include strengthening the inspection system (e.g. third-party inspections, etc.) and establishing limits on the loan term.

Introduction

There are major moves afoot in the US, including the announcement of the so-called Volcker Rule, the Senate's confirmation of Chairman Bernanke for a second term, and the inspection of the FRBNY regarding the AIG bailout. These share a common issue: the revision of Section 13-3 of the Federal Reserve Act. In this report I would like to examine this small but important issue.

Section 13-3 and the proposed revisions

Section 13-3 of the Federal Reserve Act authorizes the FRS to extend credit to entities other than "banks" (deposit-taking institutions) via the Federal Reserve Banks. This provision was not utilized after the Great Depression, but has been widely used during the current crisis both to rescue individual financial institutions and to supply funds with a specific part of the financial sector in mind (Exhibit 1). In effect, the Fed has finally played its trump card.

Exhibit 1. Representative measures based on Section 13-3 Federal Reserve Act

Bear Sterns	March 08	Fed provided 10-year financing for Bear Sterns portfolio upon acquisition by JPMorgan	29 Bil USD
Funds supplied to AIG	Sep 08 (revised Nov 08)	2-year funds for AIG; later extended to 6 years to remove RMBS and CDS from AIG	85 Bil USD(later 52.5 Bil USD)
Primary Dealer Credit Facility (PDCF)	Mar 08 to Feb 10	Overnight funds for primary dealers	(no upper limit)
Term Asset-Backed Securities Loan Facility (TALF)	Nov 08 to Jun 10	Financing (up to 5 years) for SPV purchases of ABS	(1 tril USD limit)

Source: FRB

No one could object to the argument that the Fed's supply of funds helped stabilize the financial system in the crisis. Bringing non-bank entities such as investment banks and MMFs into the Fed's safety net was particularly significant, because these entities play a pivotal role in the US financial system. Although some of the facilities saw relatively little use, they effectively functioned as a backstop.

As the financial system stabilizes, however, assessments of the measures under Section 13-3 have turned negative. In particular, there has been criticism of rescues of specific financial institutions from those claiming that the decision goes beyond the functions entrusted to the Fed to maintain financial system stability—in other words, they claim it was a "back-door bailout." And inasmuch as exposing the Fed's assets to high risk could result in losses for taxpayers, it has been argued that the Fed should not be allowed to implement such measures on its own discretion. This debate appears to be heavily influenced by growing doubts among Congress and the public about the validity of the actions taken by the Fed.

The proposed changes to financial regulation contain a proposal to severely restrict measures based on Section 13-3. Under the bill approved by the House of Representatives last December, when implementing measures based on Section 13-3 the Fed must (1) gain advance approval (with a two-thirds majority) from the Financial Stability Oversight Council and (2) limit itself

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to facilities that can be accessed by a broad range of financial institutions, as opposed to measures targeting specific institutions. The bill now being considered by the Senate Banking Committee contains a provision similar to (2).

Examining the proposed revisions

I worry that the revisions will severely hamper the Fed's ability to serve as lender of last resort (LOLR) during a crisis.

First, if the proposed revisions become law, the Fed's role as LOLR will increasingly be limited to "banks" (deposit-taking institutions). This would be consistent with the philosophy in the Volcker Rule, which draws a clear line between banks and other financial institutions, with banks being supervised in exchange for strong protections.

But there is no guarantee that events will play out that cleanly. Conceptually it may be easy to draw a line between banks and other financial institutions. In reality, however, a variety of detours are likely to be taken. And then there is the question of whether the Fed would really refuse to supply funds to a large non-bank financial institution on the brink of failure if that institution were the dominant player in a specific market and had trades with numerous other players or had many retail investors among its customers. Even if the central bank ultimately decided not to rescue such an institution, could it refrain from acting as LOLR until an orderly workout could be conducted?

It would be irresponsible for the government to spend so much time devising measures to *prevent* a financial crisis that it neglects to prepare measures to *deal with* a crisis. Regardless of whether the revisions now being discussed are implemented, the Fed will doubtlessly be forced to serve as LOLR in the event of another financial crisis. In that case, it may once again have to depend on indirect financing via banks. This is hardly a healthy situation.

Another cause for concern is that both the Senate and House bills prohibit the Fed from rescuing individual institutions, allowing only facilities that can be accessed by a broad range of financial institutions. As noted above, there are growing questions about the justification for the AIG rescue, and some argue that to the extent the Fed's LOLR function is designed to address systemic risk, any measures should apply to broad-based institutions.

But a review of the recent financial crises shows that systemic risk is more likely to be triggered by a business crisis at a large and complex financial institution (LCFI).

Together with the declining number of LCFIs in the global financial system, this suggests there are likely to be more cases in which the Fed is forced to act as LOLR to individual LCFIs to ease systemic risk during a crisis.

It may also be possible to take the approach underlying the Volcker Rule to the extreme and argue that strict limits on LCFI assets will keep the Fed from having to act as LOLR for individual institutions. But when systemic risk is a concern, the Fed must act as LOLR for specific financial institutions not only because those institutions have many assets but also because they have trades and (via positions) relationships with numerous other players and customers. A failure of such an institution would be a systemic risk in the sense that it could have a destructive impact on the financial system.

In light of these two points, revising Section 13-3 of the Federal Reserve Act in line with the bills risks significantly impairing the ability of the Fed to address systemic risk. At the climax of every financial crisis, characterized by falling net asset value and general unease, all players are exposed to severe liquidity risk. I think few would object to the argument that only the supply of funds by the central bank can achieve a breakthrough under such conditions and avert a broad-based loss of financial system functions. In addition, it is unrealistic to expect government entities to be able to supply funds as flexibly as the central bank can.

As for the opinion that the Fed should not become involved in dangerous operations like serving as LOLR, I offer the P/L of measures implemented for Bear Stearns and AIG in 2008 based on the Federal Reserve Act (Exhibit 2). The cumulative balance of these operations through the first three quarters of 2009 was non-negligibly positive. While that may not be sufficient reason to approve all

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such actions, successful LOLR operations could generate profits after the fact.

Exhibit 2. P/L on funds for measures for Bear Sterns and AIG based on Section 13-3 (Cumulative)

Item	Bil USD
Income on Assets	46.68
Valuation Losses	31.82
Interest Expense	2.00
Administrative Costs	0.61
Net Profit (incl. interest paid to Fed)	12.25

Source: FRB

Preferred revisions to Section 13-3

Finally, I would like to consider what sorts of changes should be made to Section 13-3 of the Federal Reserve Act in light of the political situation in the US today.

If we hope to maintain the Fed's role as LOLR while preventing its misuse, one realistic option would be to establish a system for after-the-fact reviews. Tax payers may like to have an advance check in place. But as the case of TARP clearly showed, this is simply not practical. In the current crisis, the decline in house prices was initially quite gradual, and it was only the mortgage bankers and mortgage insurers that experienced problems. Subsequently, however, by the time the problems had reached the GSEs, investment banks, and a large insurer, the situation was literally deteriorating from hour to hour. We cannot ignore the risk that the needs for advance checks under such conditions would expose the financial system to even greater danger.

Also, after-the-fact reviews should not be seen simply as a post-mortem, for they have the potential to enforce discipline over the Fed's role. And we must first clarify precisely who is responsible for the LOLR function. Even if the Financial Stability Oversight Board is established to oversee systemic risk, it would be desirable to delegate the decision of LOLR to the Fed with mandatory consultation with members of this board.

A sensible review would require the Fed and other supervisory authorities to keep records of all data used in the decision-making process along with the content of any investigations, including discussions. Financial institution inspections are prone to the loss of information and data as well as misunderstandings and differences of opinion between the involved parties (and this is not limited to the US). It would also be equitable to make the reviewing body a "third-party committee" made up of independent experts. Their reviews should include discussion of such factors as (1) the appropriateness of alternative methods (other than LOLR) and (2) estimates of the cost of LOLR operations.

In addition to establishing a review system, the term of credit extended under Section 13-3 should be limited to one year or less. Given the Act's requirement that such loans be limited to "unusual and exigent" circumstances, it would clearly be reasonable to limit its use to short-term credit. Eliminating medium- and long-term credit would prevent "back-door bailouts" by making it clear that the government or supervisory authorities would decide the fate of the institution in question while the Fed acted as LOLR to prevent a disorderly failure in the meantime. If it is decided that longer-term credit is necessary, it should be provided by the government or supervisory authorities using other measures. The Fed's extension of long-term credit in the cases of Bear Stearns and AIG could not be helped given the lack of a framework for the workout of failed institutions and should not be made into a precedent.

Conclusion

It appears that the Volcker Rule is being discussed as one with the Senate bill on financial regulation reform. With its fairly controversial content, including restrictions on bank operations and asset size, it is likely to provoke heated debate, not only in Congress but also among a wide range of parties in both the public and private sectors. It is my hope that the issue of revisions to Section 13-3 of the Federal Reserve Act, which is small but has important implications, will receive proper consideration. I also hope that the current proposals will be revised appropriately in the course of future debate.

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