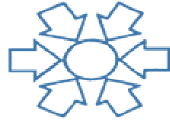

FedFin Client Report

Monday, November 30, 2015

FRB Sharply Curtails 13(3) Powers

Client Report: **RESCUE69**

Executive Summary

Reflecting an onslaught of criticism and pending legislation, the FRB today bowed and sharply constrained its emergency-lending powers. In contrast to the Board's initial proposal on its post Dodd-Frank 13(3) powers (see FSM Report **RESCUE67**), the final rule does not simply reiterate underlying statutory language to give the FRB the greatest amount of flexibility in a crisis. Instead, it now includes an array of conditions on any 13(3) powers reflecting language in the House language modifying 13(3) (see FSM Report **FEDERALRESERVE26**) and the Warren-Vitter bill (see FSM Report **FEDERALRESERVE21**) in areas such as the penalty rate, a minimum number of borrowers, and a clear definition of insolvent entities to which funds may not be advanced. During the board meeting analyzed in this report, governors emphasized the importance of putting 13(3) into the context of new resolution tools designed to end too big to fail, tools the Board lacked when it extended funds to AIG and others during the crisis. However, we doubt critics will be satisfied with these concessions, in part because many on the Hill believe that the Dodd-Frank resolution framework enhances rather than reduces TBTF institutions. Final deliberations between the House and Senate in the next few weeks on other changes to the FRB will in our view determine whether the Board's new rule defines its 13(3) powers or instead sets the floor above which Congress will still demand additional constraints. We will shortly provide clients with an in-depth analysis of the new standards.

Analysis

Opening the meeting this morning, Chair Yellen defended the vital importance of emergency lending power, noting that the FRB consulted with Treasury as significant changes were made to the proposal. Staff then described key provisions of the rule as follows:

- revisions to make it clear that companies can only receive funding also made available to the financial system, including a minimum of five loan recipients;

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- clarifications that funding cannot be used to avoid bankruptcy or resolution;
- a requirement that facilities be described;
- a definition of insolvency that makes clear any such firm cannot receive funding;
- a clear ban on lending to insolvent entities;
- penalty rates;
- tougher lending terms;
- tighter FRB-review considerations; and
- termination of programs (but not necessarily of outstanding loans) in one year absent Board-approved renewal.

Q&A proceeded as follows:

- Chair Yellen asked whether the facility could have had an even shorter term, with staff laying out why it believed the one-year term gives the FRB needed flexibility.
- Vice Chair Fisher praised the rule's clarity and suggested that an auction could be used to set the penalty rate. Staff said it could be used under the rule as long as the lowest rate determined by the auction was still a penalty rate.
- Gov. Tarullo had no time for questioning so outlined his policy views, stating that the post-crisis resolution framework makes it possible to constrain 13(3) powers as the final rule does far better than the NPR.
- Gov. Powell agreed that the final rule reflects a better understanding of the new framework but noted that the final rule still does not mandate restrictive collateral conditions as commenters recommended. Staff defended current collateral-valuation capabilities, noting that the final rules does require stringent collateral.

The Board unanimously approved the final rule.

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