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From Fire Hose to Garden Hose: Section 13(3) of the Federal Reserve Act

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At the height of the Great Financial Crisis, the Federal Reserve employed a previously unused section of the Federal Reserve Act, Section 13(3), to engage in a level of lending unparalleled in global financial history. Section 13(3) provided a firehose of liquidity for the US financial system, and The Federal Reserve used it to successfully fight the Great Financial Crisis. However, once the worst of the crisis had passed, Congress quickly acted to limit the Federal Reserve's powers under Section 13(3) by passing Dodd-Frank and introducing the orderly liquidation authority.

These limitations have reduced the Federal Reserve's Section 13(3) power to that of a mere garden hose. One can only speculate whether the Great Financial Crisis would have continued and perhaps permanently crippled the US financial system had the Federal Reserve not been able to effectively utilize Section 13(3). The Federal Reserve's now-limited Section 13(3) power will undoubtedly hamper its ability to respond to crises in the future.

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INTRODUCTION

At the height of the Great Financial Crisis, Ben Bernanke, Chairman of the Federal Reserve, with the blessing of Timothy Geithner, President of the New York Federal Reserve Bank, and Hank Paulson, US Treasury Secretary, engaged in a level of lending unprecedented in global financial history. Utilizing an unused and untested section of the Federal Reserve Act, the Federal Reserve injected extraordinary levels of liquidity into a failing economic and financial system. In spite of the unparalleled success of these actions, however, Congress effectively ensured that the use of such raw economic power would be limited and constrained in the future.

Section 13(3) of the Federal Reserve Act[1] essentially provided the Federal Reserve, subject to certain conditions, with the ability to lend unlimited amounts to firms that were not subject to US federal financial regulation. This provided the Federal Reserve with a literal fire hose of liquidity. Through this authority, the Federal Reserve was able to open the hydrants of its lending authority and lend hundreds of billions of dollars to sustain Bear Stearns and AIG. Even more startling is the approximately $900 billion of credit that the Federal Reserve extended under a variety of liquidity programs put in place to preserve and bail out

1. Section 13(3) of the Federal Reserve Act is codified at 12 U.S.C. § 343(3) (2012).

a variety of financial sectors.[2] Unfortunately, recent amendments to Section 13(3) have transformed that source of liquidity from a fire hose into the proverbial garden hose.

Congress provided the Section 13(3) powers to the Federal Reserve to provide liquidity in the event of an unforeseen and extraordinary financial crisis. Although never aggressively employed until 2008, Section 13(3) was an extraordinarily powerful, but untested tool for the Federal Reserve. Paradoxically, almost because of its success, Congress has drastically reduced the reach of Section 13(3) and the Federal Reserve's independence to employ it.

This Article focuses initially on the Federal Reserve's use of Section 13(3) to battle the economic carnage of the Great Financial Crisis. It will then address the history and statutory provisions of Section 13(3), describing the statutory and regulatory changes made to Section 13(3). Finally, this Article will discuss the problematic consequences of these changes.

I. THE USE OF SECTION 13(3) OF THE FEDERAL RESERVE ACT

Prior to 2008, Section 13(3) was, for all intents and purposes, an untested and unused tool of the Federal Reserve. Although its use was considered from time to time, it was not until the Great Financial Crisis that its full potential was realized, resulting in the Federal Reserve lending hundreds of billions of dollars in an effort to provide liquidity to financial markets. Although used successfully, Congress quickly moved to ensure that the Federal Reserve could never utilize Section 13(3) in the same way again, in spite of its key role in fighting the crisis.

A. The Great Financial Crisis

The recession accompanying the US Financial Crisis officially began in December of 2007 and officially ended in June 2009.[3] However, that the Great Financial Crisis represented the worst financial crisis since the Great Depression is both beyond debate and well chronicled.[4] Financial

2. *See infra* notes 40–47 and accompanying text and table (summarizing the Federal Reserve's monetary lending to important non-depository institutions under Section 13(3) during the crisis).

3. *US Business Cycle Expansions and Contractions*, NAT'L BUREAU ECON. RES., http://www.nber.org/cycles.html (last visited Apr. 21, 2019).

4. The Federal Reserve Banks of Saint Louis and New York have each created a timeline chronicling the financial crisis. *See Financial Crisis Timeline*, FED. RES. BANK ST. LOUIS, https://www.stlouisfed.org/financial-crisis/full-timeline (last visited Apr. 21, 2019) [hereinafter *St. Louis Timeline*] (spanning from February 2007 to April 2011); *Timelines of Policy Responses to the Global Financial Crisis*, FED. RES. BANK N.Y., http://www.ny.frb.org/research/global_economy/policyresponses.html (last visited Apr. 21, 2019) (providing a domestic timeline, which focuses on the lead-up to and development of the crisis and the subsequent

sages will continue to add to the amount of technical and popular literature describing the crisis and actions to combat the financial collapse for decades.[5]

The economic carnage at the height of the crisis was breathtaking. The US DOW Industrial Average peaked on October 9, 2007 at 14,164,[6] but by March 9, 2009, it had reached its low point of the crisis at 6547.05,[7] representing a 55-percent decline from its peak.[8] Other stock markets across the world experienced similar declines.[9] During September of 2008, the US government nationalized Fannie Mae and Freddie Mac. Lehman Brothers filed for bankruptcy.[10] AIG was on the edge of insolvency.[11] Money market and commercial paper markets risked

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government responses, as well as an international timeline, which focuses on G-7 responses to the crisis). *See generally* DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC (2009) (detailing Ben Bernanke's actions as chairman of the Federal Reserve during the financial crisis).

5. *See, e.g.*, DIMITRIS N. CHORAFAS, FINANCIAL BOOM AND GLOOM: THE CREDIT AND BANKING CRISIS OF 2007–2009 AND BEYOND (2009); WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009); JOHN BELLAMY FOSTER & FRED MAGDOFF, THE GREAT FINANCIAL CRISIS: CAUSES AND CONSEQUENCES (2009); PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 (2009); LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS (2009); RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION (2009); ROBERT J. SHILLER, THE SUBPRIME SOLUTION: HOW TODAY'S GLOBAL FINANCIAL CRISIS HAPPENED, AND WHAT TO DO ABOUT IT (2012); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2018); GEORGE SOROS, THE NEW PARADIGM FOR FINANCIAL MARKETS: THE CREDIT CRISIS OF 2008 AND WHAT IT MEANS (2008); WESSEL, *supra* note 4.

6. Alexandra Twin, *Dow, S&P Break Records*, CNN MONEY (Oct. 9, 2007, 5:44 PM), https://money.cnn.com/2007/10/09/markets/markets_0500/index.htm.

7. Alexandra Twin, *For Dow, Another 12-Year Low*, CNN MONEY (Mar. 9, 2009, 6:18 PM), https://money.cnn.com/2009/03/09/markets/markets_newyork/.

8. To view how the Dow Jones Industrial Average fluctuated during this time, see *Dow Jones Industrial Average (DJIA)*, WALL ST. J., https://quotes.wsj.com/index/DJIA/historical-prices (last visited Apr. 21, 2019).

9. The various global stock exchanges all experienced extraordinary declines by March 9, 2009. The UK FTSE 100 fell to 3460 from a high of 6730 on October 12, 2007. The German DAX fell to 3588 from a high of 8076 on December 12, 2007. The Hong Kong Hang Seng fell to 11,344 from a high of 27,665 on November 12, 2007. The Australia S & P ASX 200 fell to 3135 from a high of 6,748 on October 12, 2007. *See International Stock Indexes*, WALL ST. J., http://www.wsj.com/mdc/public/page/2_3022-intlstkidx-20090309.html?mod=mdc_pastcalendar (last visited Apr. 21, 2019).

10. *St. Louis Timeline*, *supra* note 4.

11. *See American International Group (AIG), Maiden Lane II and III*, FED. RES. (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-aig.htm [hereinafter *AIG Maiden Lane*] ("During the months prior to September 2008, short-term funding markets had come under severe stress, placing significant liquidity pressures on AIG that hindered its ability to obtain adequate funding from banking institutions or in the market, and threatened to prompt a default by the firm.").

failing. The list of economic crises appeared limitless.[12]

B. The Federal Reserve Response

The US government's actions to fight the Great Financial Crisis were extraordinary. In addition to the actions of the Federal Reserve, the US Treasury, the FDIC, and the SEC all made their own contributions.[13] One of the most unique efforts and actions, however, was the Federal Reserve's use of Section 13(3) to provide liquidity to the US financial system.

1. Section 13(3) of the Federal Reserve Act

The Federal Reserve had many different tools to deal with the financial crisis.[14] In dealing with a crisis, the Federal Reserve, by statute, is effectively limited to secured lending activities[15] and purchasing securities.[16] The Federal Reserve activities are directed by the Board of Governors of the Federal Reserve System (a US federal government agency) and are coordinated and funded through the Federal Reserve Bank of New York and the eleven other Federal Reserve Banks (collectively the "Federal Reserve").[17]

The most unique tool for the Federal Reserve is Section 13(3) of the Federal Reserve Act. Section 13(3), as codified prior to the statutory changes made by Dodd-Frank, permitted the Federal Reserve to lend to

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12. In addition, as explained in Christian A. Johnson, *Exigent and Unusual Circumstances: The Federal Reserve and the US Financial Crisis*, *in* LAW REFORM AND FINANCIAL MARKETS 269, 271 (Kern Alexander & Niamh Moloney eds., 2011), "the Reserve Primary Money Fund 'broke' the buck, Goldman Sachs and Morgan Stanley became bank holding companies, Washington Mutual Bank became insolvent, and Citigroup and Wells Fargo entered into a bidding war to purchase Wachovia Bank." For a complete breakdown of September 2008, see *St. Louis Timeline*, *supra* note 4.

13. For a discussion of the actions the US federal government took to fight the Great Financial Crisis, see generally Johnson, *supra* note 12.

14. *See* Johnson, *supra* note 12, at 274.

15. *Credit and Liquidity Programs and the Balance Sheet: Lending to Depository Institutions*, FED. RES. (July 24, 2017), https://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm.

16. *Credit and Liquidity Programs and the Balance Sheet: Open Market Operations*, FED. RES. (Apr. 4, 2018), https://www.federalreserve.gov/monetarypolicy/bst_openmarketops.htm.

17. For an overview of the Federal Reserve System, see FED. RESERVE, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS (10th ed. 2016), https://www.federalreserve.gov/aboutthefed/files/pf_complete.pdf. *See also About the Fed*, FED. RES. (Apr. 18, 2019), https://www.federalreserve.gov/aboutthefed.htm (listing current duties of the Federal Reserve, including conducting monetary policy, regulating banks, maintaining stability, containing systemic risk, and providing financial services). *See generally* ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE VOLUME 1: 1913–1951 (2003); ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE VOLUME 2, BOOK 1: 1951–1969 (2009); ALLAN H. MELTZER, A HISTORY OF THE FEDERAL RESERVE VOLUME 2, BOOK 2: 1970–1986 (2010).

non-depository institutions provided that the borrower and the situation met specific requirements.[18]

Section 13(3), prior to its amendment by Dodd-Frank, read as follows:

> 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 357 of this title, 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 or a 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.[19]

The language is anachronistic at best, employing terms and processes that were best understood in the early 1900s, but it still represents the power to lend to an "individual, partnership, or corporation" that is not a member bank of the Federal Reserve System.

In approving the emergency loan to The Bear Stearns Companies, Inc. under Section 13(3) in March of 2008, the Federal Reserve summarized the key Section 13(3) requirements in its approval of the transaction:

> As required by the Federal Reserve Act when fewer than five Board members were available to approve an extension of credit to any individual, partnership, or corporation under section 13(3) of the Federal Reserve Act, all available Board members then in office unanimously determined, in connection with the authorization of the extension of credit, that (1) unusual and exigent circumstances existed; (2) Bear Stearns, and possibly other primary securities dealers, were unable to secure adequate credit accommodations elsewhere; (3) this action was necessary to prevent, correct, or mitigate serious harm to the economy or financial stability . . . .[20]

The Federal Reserve effectively found in each of the instances that it exercised its powers under Section 13(3), that unusual and exigent

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18. For a general discussion of Section 13(3) prior to its amendment by Dodd-Frank, see Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221 (2010).

19. 12 U.S.C. § 343(3)(A) (2006) (current version at 12 U.S.C. § 343(3)(A) (2012)).

20. Minutes of the Board of Governors of the Federal Reserve System (Mar. 14, 2008), https://www.federalreserve.gov/newsevents/pressreleases/files/other20080627a1.pdf [hereinafter Board Minutes].

circumstances existed, the borrowers were unable to secure liquidity elsewhere, and the action was needed to deal with the Great Financial Crisis.

2. Section 13(3) Lending to Systemically Important Non-depository Institutions

The Federal Reserve has been sharply criticized for its Section 13(3) lending, and it has faced the most criticism for its direct loans to "what is often euphemistically referred to as systemically important non-depository institutions."[21] These loans include those that it directly provided to Bear Stearns and AIG "because their financial difficulties threatened entire financial markets."[22] The Federal Reserve also provided aid to Citigroup and Bank of America Corporation through "guarantees" provided under Section 13(3).[23]

The Federal Reserve's first ever utilization of Section 13(3) was its USD $12.9 billion loan to The Bear Stearns Companies Inc. in March of 2008.[24] After this amount was repaid, the Federal Reserve, in a complicated structure, lent USD $29 billion to facilitate the acquisition of Bear Stearns by JP Morgan Chase.[25] All of the facilities and amounts lent pursuant to the Bear Stearns "bailout" have been repaid and terminated.[26]

The failure of Lehman Brothers was also a pivotal event in the

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21. Johnson, *supra* note 12, at 282. When the crisis began to calm in January 2010, US Treasury Secretary Geithner and other Fed and Treasury officials testified before Congress regarding the Fed's treatment of AIG. To watch Secretary Geithner's testimony, see *Secretary Geithner on Government Assistance for AIG*, C-SPAN (Jan. 27, 2010), https://www.c-span.org/video/?291680-1/secretary-geithner-government-assistance-aig.

22. Johnson, *supra* note 12, at 282. *See infra* notes 40, 42–43 and accompanying text and table.

23. *See infra* notes 46–47 and accompanying text and table.

24. Board Minutes, *supra* note 20. *See also* John De Vito, Comment, *Discretion to Act: How the Federal Reserve's Decisions Whether to Provide Emergency Loans During the Financial Crisis Were Discretionary and Why Dodd-Frank Falls Short of Preventing Future Bailouts*, 10 J. BUS., ENTREPRENEURSHIP & L. 295, 301 (2017). For specifics regarding the loan, see *Bear Stearns, JPMorgan Chase, and Maiden Lane LLC*, FED. RES. (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-bearstearns.htm.

25. *See infra* note 26 and accompanying text.

26. *Maiden Lane Transactions: Milestones*, FED. RES. BANK N.Y., http://www.newyorkfed.org/markets/maidenlane.html (last visited Apr. 21, 2019) ("ML LLC [Maiden Lane] was created to facilitate the merger of JP Morgan Chase & Co. (JPMC) and Bear Stearns Companies, Inc. (Bear Stearns) by purchasing approximately $30 billion in assets from the mortgage desk at Bear Stearns."); *see also* Press Release, Fed. Reserve Bank of N.Y., Statement on Fin. Arrangement of JPMorgan Chase's Acquisition of Bear Stearns (Mar. 24, 2008), http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324.html ("This action is being taken by the Federal Reserve, with the support of the Treasury Department, to bolster market liquidity and promote orderly market functioning.").

financial crisis.[27] As will be discussed below, based on technical reasons, the Federal Reserve did not step into the void to bail out Lehman Brothers.[28] The failure to do so probably increased the severity of the Great Financial Crisis,[29] and has been subject to great examination.[30]

To deal with the worldwide liquidity crisis that occurred because of the failure of Lehman Brothers, the Federal Reserve believed it was necessary to intervene in the AIG failure.[31] The Federal Reserve found itself providing increasing financial support for AIG as the global financial crisis worsened.[32] Through a variety of loans and facilities, the Federal Reserve lent over USD $125 billion to AIG under its Section 13(3) powers. All of the amounts lent pursuant to the AIG "bailout" have been repaid and terminated.[33]

Because of concerns about the effects that the collapse of Citigroup and Bank of America Corporation could have on the financial recovery, the Federal Reserve also provided financial assistance to Citigroup[34] and

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27. *See generally* Michael J. Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, FRBNY ECON. POL'Y REV., December 2014, at 175.

28. De Vito, *supra* note 24, at 303–04; James B. Stewart & Peter Eavis, *Lehman Revisited: The Bailout That Never Was*, N.Y. TIMES, Sept. 30, 2014, at A1. *See also* Mark Thoma, *Letting Lehman Fail "Was a Genuine Error"*, ECONOMIST'S VIEW (Oct. 23, 2008, 2:07 AM), https://economistsview.typepad.com/economistsview/2008/10/letting-lehman.html (arguing that the Federal Reserve's decision to let Lehman fail was a mistake that made the financial crisis worse).

29. Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J. (Dec. 29, 2008, 12:01 AM), https://www.wsj.com/articles/SB123050916770038267.

30. Report of Anton R. Valukas, Examiner, *In re* Lehman Brothers Holdings Inc., 445 B.R. 143 (Bankr. S.D.N.Y. 2011) (No. 08-13555). For a full report of the proceeding, see *Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner*, JENNER & BLOCK, https://jenner.com/lehman (last visited Apr. 21, 2019).

31. For a discussion of the Federal Reserve's lending to AIG, see *AIG Maiden Lane*, *supra* note 11; CONG. OVERSIGHT PANEL, 111TH CONG., JUNE OVERSIGHT REPORT, THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY (2010).

32. For a discussion of AIG's actions, see FED. RESERVE, REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: RESTRUCTURING OF THE GOVERNMENT'S FINANCIAL SUPPORT TO THE AMERICAN INTERNATIONAL GROUP, INC. ON NOVEMBER 10, 2008, https://www.federalreserve.gov/monetarypolicy/files/129aigrestructure.pdf; *American International Group's Impact on the Global Economy: Before, During, and After Federal Intervention: Hearing Before the Subcomm. on Capital Mkts., Ins., & Gov't Sponsored Enters. of the H. Comm. on Fin. Servs.*, 111th Cong. 231 (2009) (statement of Orice M. Williams, Director, Financial Markets and Community Investment), *available at* http://www.gao.gov/new.items/d09490t.pdf.

33. Javier E. David, *AIG Makes Final Repayment to Government for Bailout*, CNBC (Mar. 1, 2013, 1:37 PM), http://www.cnbc.com/id/100397698.

34. FED. RESERVE, REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: AUTHORIZATION TO PROVIDE RESIDUAL FINANCING TO CITIGROUP, INC. FOR A DESIGNATED ASSET POOL, https://www.federalreserve.gov/monetarypolicy/files/129citigroup.pdf; *see also* Joint Press Release, Joint Statement by Treasury, Fed. Reserve, and the FDIC on Citigroup (Nov. 23, 2008),

Bank of America Corporation[35] under its Section 13(3) authority. This included loss sharing guarantees in conjunction with the Treasury and the FDIC that subjected the Federal Reserve to potential liability if the guarantees were necessary.[36] As the companies have stabilized, both Citigroup[37] and Bank of America Corporation[38] paid exit fees and terminated the loss sharing guarantees.

The following chart[39] summarizes the loans the Federal Reserve made to systemically important non-depository institutions under Section 13(3):

http://www.federalreserve.gov/newsevents/press/bcreg/20081123a.htm [hereinafter November 2008, Joint Press Release] (detailing the package of guarantees, liquidity access, and capital the US government agreed to provide Citigroup). For a description of the loss-sharing program, see *Summary of Terms of USG/Citigroup Loss Sharing Program*, CITIGROUP, http://www.citigroup.com/citi/press/2009/090116b.pdf (last visited Apr. 22, 2019).

35. Joint Press Release, Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America (Jan. 16, 2009), http://www.federalreserve.gov/newsevents/press/bcreg/20090116a.htm. For a discussion of the Bank of America Corporation guarantee, see FED. RESERVE, REPORT PURSUANT TO SECTION 129 OF THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008: AUTHORIZATION TO PROVIDE RESIDUAL FINANCING TO BANK OF AMERICA CORPORATION RELATING TO A DESIGNATED ASSET POOL, http://www.federalreserve.gov/monetarypolicy/files/129bofa.pdf [hereinafter BANK OF AMERICA 129 REPORT].

36. For a discussion of the guarantees, see CONG. OVERSIGHT PANEL, 111TH CONG., NOVEMBER OVERSIGHT REPORT, GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS (2009).

37. The termination agreement for Citigroup can be found at http://www.sec.gov/Archives/edgar/data/831001/000095012309073343/y81154exv10w1.htm.

38. *See* Press Release, Bank of America, Bank of America Terminates Asset Guarantee Term Sheet (Sept. 21, 2009), http://investor.bankofamerica.com/phoenix.zhtml?c=71595&p=irol-newsArticle&ID=1333936#fbid=f0zLgxJA1RK (announcing Bank of America's agreement with the US government to terminate its term sheet regarding the government's guarantee of up to $118 billion in assets).

39. This chart is based on the one originally published in Johnson, *supra* note 12, at 285.

Program Name	Description	Original Balance (USD)
Bear Stearns Loan (Mar. 14, 2008)[40]	Emergency Discount Window loan to Bear Stearns secured by USD $13.8 billion of Bear Stearns Assets (repaid Mar. 17, 2008).	$12.9 billion
Maiden Lane (SPV) (Mar. 2008)[41]	Facilitated the acquisition of Bear Stearns by JPMorgan Chase by non-recourse loan to special purpose vehicle (Bear Stearns). Loan has been repaid.	$28.82 billion
AIG Revolving Credit Facility (Sept. 16, 2008)[42]	Revolving loan for general corporate purposes to AIG. Loan has been repaid.	$85 billion
AIG Secured Borrowing Facility (Oct. 8, 2008)[43]	Secured loan for general corporate purposes. Repaid and terminated. Loan has been repaid.	$19.494 billion
Maiden Lane II (SPV) (Dec. 12, 2008)[44]	Formed to purchase residential mortgage security assets from AIG. Loan has been repaid.	$19.5 billion
Maiden Lane III (SPV) (Nov. 25, 2008)[45]	Formed to purchase multi-sector CDOs on which the Financial Products group of AIG had written credit default swaps and similar contracts. Loan has been repaid.	$24.339 billion
Citigroup Loss Sharing Facility (Nov. 23, 2008)[46]	Obligated to fund non-recourse loan of approximately USD $250 billion after USD $300 billion asset pool has suffered approximately US $50 billion in losses.	$0
Bank of America Corp Loss Sharing Facility (Jan. 15, 2009)[47]	Obligated to fund non-recourse loan of USD $97 billion after pool of Merrill Lynch assets incurs USD $18 billion of mark-to-market losses.	$0

3. Section 13(3) Lending Facilities

In addition to the individual assistance required by certain large systemically important non-depository institutions as discussed above, the Federal Reserve found itself having to react on an ad hoc basis as different financial sectors of the economy collapsed. In response, the Federal Reserve developed a series of lending facilities to assist non-depository institutions under its Section 13(3) lending authority.[48] Each of these facilities provided liquidity in the hundreds of billions of dollars to non-depository institutions unable to obtain necessary credit otherwise. Although the balances in these facilities were measured in the hundreds of billions of dollars, each of these programs has been terminated and the amounts lent under them repaid. These include[49]:

1. Primary Dealer Credit Facility[50]
2. Term Securities Lending Facility (not technically a 13(3) program)[51]

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40. *Bear Stearns, JPMorgan Chase, and Maiden Lane LLC*, *supra* note 24.

41. *Maiden Lane Transactions*, FED. RES. BANK N.Y., https://www.newyorkfed.org/markets/maidenlane.html (last visited Apr. 22, 2019) [hereinafter *Maiden Lane Transactions*] (providing a financial overview of the facilities).

42. *Actions Related to AIG*, FED. RES. BANK N.Y., https://www.newyorkfed.org/aboutthefed/aig/index.html (last visited Apr. 22, 2019) (describing key actions of Sept. 16, 2008).

43. *Id.* (describing the key actions of Oct 8, 2008); U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-574, TROUBLED ASSET RELIEF PROGRAM: GOVERNMENT'S EXPOSURE TO AIG LESSENS AS EQUITY INVESTMENTS ARE SOLD 17 (2012).

44. *Maiden Lane Transactions*, *supra* note 41.

45. *Id.*; U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 43, at 17.

46. *Summary of Terms of USG/Citigroup Loss Sharing Program Summary of Terms of USG/Citigroup Loss Sharing Program*, *supra* note 34.

47. BANK OF AMERICA 129 REPORT, *supra* note 35.

48. For a general discussion of these programs, see DAVIS POLK, FINANCIAL CRISIS MANUAL: A GUIDE TO THE LAWS, REGULATIONS AND CONTRACTS OF THE FINANCIAL CRISIS 20–40 (2009).

49. The following list is based on the one in Johnson, *supra* note 12, at 286.

50. For a complete discussion of the Primary Dealer Credit Facility, see Tobias Adrian, Christopher R. Burke & James J. McAndrews, *The Federal Reserve's Primary Dealer Credit Facility*, CURRENT ISSUES ECON. & FIN., August 2009, at 1. For the terms and conditions of the program, see *Primary Dealer Credit Facility: Program Terms and Conditions*, FED. RES. BANK N.Y. (June 25, 2009), http://www.newyorkfed.org/markets/pdcf_terms.html. The facility was closed on February 1, 2010. *Primary Dealer Credit Facility (PDCF)*, FED. RES. (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-pdcf.htm.

51. Press Release, FOMC Statement: Federal Reserve and Other Central Banks Announce Specific Measures Designed to Address Liquidity Pressures in Funding Markets (Mar. 11, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080311a.htm. For a study of the effectiveness of the facility, see MICHAEL J. FLEMING, WARREN B. HRUNG & FRANK M. KEANE, FED. RESERVE BANK OF N.Y., REPO MARKET EFFECTS OF THE TERM SECURITIES LENDING FACILITY (2010), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr426.pdf; Michael J. Fleming, Warren B. Hrung & Frank M. Keane, *The Term Securities Lending Facility: Origin, Design, and Effects*, CURRENT ISSUES ECON. & FIN., February 2009, at 1.

3. Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility[52]
4. Commercial Paper Funding Facility[53]
5. Money Market Investor Funding Facility[54]
6. Term Asset-Backed Securities Loan Facility[55]

The following table[56] summarizes the liquidity programs the Federal Reserve created, listing the amount and date of the highest outstanding balances prior to the programs being terminated:

52. Press Release, Fed. Reserve, Federal Reserve Board Announces Two Enhancements to Its Programs to Provide Liquidity to Markets (Sept. 19, 2008), http://www.federalreserve.gov/newsevents/press/monetary/20080919a.htm. For terms and conditions, see *Asset Backed Commercial Paper (ABCP) Money Market Mutual Fund (MMMF) Liquidity Facility Terms and Conditions*, FED. RES. (Feb. 5, 2010), https://www.frbdiscountwindow.org/Archive/Asset-Backed-Commercial-Paper-ABCP-Money-Market-Mutual-Fund-MMMF-Liquidity-Facility-Terms-and-Conditions. All amounts were paid in full, and the facility was closed on February 1, 2010. *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)*, FED. RES. (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-amlf.htm.

53. See *Commercial Paper Funding Facility: Program Terms and Conditions*, FED. RES. BANK N.Y. (Feb. 3, 2009), https://www.newyorkfed.org/markets/CPFF_Terms_020309.html for the terms and conditions of the facility. *See also* Tobias Adrian, Karin Kimbrough & Dina Marchioni, *The Federal Reserve's Commercial Paper Funding Facility*, FRBNY ECON. POL'Y REV., May 2011, at 25. The facility was closed on February 1, 2010. *Commercial Paper Funding Facility*, FED. RES. (Feb. 5, 2010), https://www.federalreserve.gov/monetarypolicy/cpff.htm.

54. *Money Market Investor Funding Facility*, FED. RES. (Feb. 5, 2010), http://www.federalreserve.gov/monetarypolicy/mmiff.htm. No loans were made under the facility, and it was closed on October 30, 2009. *Money Market Investor Funding Facility (MMIFF)*, FED. RES. (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-mmiff.htm.

55. *Term Asset-Backed Securities Loan Facility*, FED. RES. (Nov. 24, 2015), http://www.federalreserve.gov/monetarypolicy/talf.htm; Adam Ashcraft, Allan Malz & Zoltan Pozsar, *The Federal Reserve's Term Asset-Backed Securities Loan Facility*, FRBNY ECON. POL'Y REV., November 2012, at 29.

56. The below table is based on the table in Johnson, *supra* note 12, at 290. The data in the table is taken from a review of *Aggregate Reserves of Depository Institutions and the Monetary Base—H.3*, FED. RES. (Apr. 18, 2019), https://www.federalreserve.gov/releases/h3/.

Program Name	**Amount (USD)**	**Highest Outstanding Balance (USD)**
Term Securities Lending Facility (Mar. 11, 2008)	$0	$234 billion (Oct. 1, 2008)
Primary Dealer Credit (Mar. 16, 2008)	$0	$147 billion (Oct. 1, 2008)
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Sept. 19, 2008)	$0	$152 billion (Oct. 2, 2008)
Commercial Paper Funding Facility (Oct. 7, 2008)	$7.78 billion	$349 billion (Jan. 21, 2009)
Money Market Investor Funding Facility (Oct. 21, 2008)	$0	$0
Term Asset-Backed Securities Loan Facility (TALF) (Nov. 25, 2008)	$47.3 billion	$48 billion (Jan. 20, 2010)

II. CONTROVERSIES AND AMENDMENTS TO SECTION 13(3)

The passage and history of Section 13(3) is an enigma. Although it provided the Federal Reserve with extraordinary lending powers to deal with financial crises over the past century, it was never actively used until the Great Financial Crisis.

A. Unprecedented Use of Section 13(3)

There is a rich history behind the passage of Section 13(3).[57] When the Federal Reserve was established, it did not have authority to lend to a non-depository institution.[58] Congress realized, eventually, that the Federal Reserve could be a potential source of liquidity in a financial crisis.

In response to the Great Depression, Congress added Section 13(3) to

57. David Fettig, *The History of a Powerful Paragraph: Section 13(3) Enacted Fed Business Loans 76 Years Ago*, REGION, June 2008, at 33, https://www.minneapolisfed.org/~/media/files/pubs/region/08-06/section13.pdf; Mehra, *supra* note 18, at 232–34; Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, FRBNY ECON. POL'Y REV., September 2018, at 1.

58. Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251.

allow the Federal Reserve to provide additional liquidity to financial markets.[59] Restrictions on the type of collateral that could be offered, however, limited the liquidity that Section 13(3) could provide.[60] Although the Federal Reserve did some lending during the Great Depression, the amount of lending was small, totaling only USD $1.5 million.

In spite of its availability, the Federal Reserve had not invoked its authority under Section 13(3) until it was used during the Great Financial Crisis.[61] Commentators have suggested anecdotally that the Federal Reserve considered using Section 13(3) to deal with the Penn Central failure,[62] the financial difficulties of New York City in 1975,[63] the Crash of 1987,[64] the Y2K problems,[65] and the airline industry problems after 9/11.[66]

In analyzing the 1987 financial crisis, Congress believed that the collateral limitations in Section 13(3) may have been too restrictive, hampering the Federal Reserve's ability to deal with future crises.[67] Congress expanded the collateral eligibility when it amended Section 13(3) in 1991:

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59. Emergency Relief and Construction Act of 1932, Pub. L. No. 72-302, 47 Stat. 709. For a discussion of the history of Section 13(3), see Evan A. Johnson, *Developments in Banking Law: Revisions to the Federal Reserve's Emergency Lending Rules*, 35 REV. BANKING & FIN. L. 529, 534–35 (2016).

60. "This would have included certain US Treasury obligations and 'notes, drafts, and bills of exchange issued or drawn for agricultural, industrial, or commercial purposes' with a maturity of not more than 90 days." Johnson, *supra* note 12, at 280 n.52 (quoting Section 13(2) of the Federal Reserve Act, 12 U.S.C. 343 (2012)) (citing Walker F. Todd, *FDICIA's Emergency Liquidity Provisions*, FED. RES. BANK CLEVELAND ECON. REV., Third Quarter 1993, at 16, 18 n.10, https://www.clevelandfed.org/newsroom-and-events/publications/discontinued-publications/economic-review/1993-economic-review/er-1993q3-fdicias-emergency-liquidity-provisions.aspx).

61. *See* Fettig, *supra* note 57. For a review of the Bear Stearns failure, see KATE KELLY, STREET FIGHTERS: THE LAST 72 HOURS OF BEAR STEARNS, THE TOUGHEST FIRM ON WALL STREET (2009).

62. David Fettig, *Lender of* More Than *Last Resort*, REGION, December 2002, at 15, 46; Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, 74 FED. RES. BANK ST. LOUIS REV. 58, 62 (1992). For a discussion of the Penn Central Crisis, see STEPHEN SALSBURY, NO WAY TO RUN A RAILROAD: THE UNTOLD STORY OF THE PENN CENTRAL CRISIS (1982).

63. Fettig, *supra* note 62, at 46; Schwartz *supra* note 62, at 62–63.

64. Schwartz, *supra* note 62, at 66. For a discussion of the 1987 crisis, see David Wessel, *Fed Opposed Any Rise in Interest Rates Following the Oct. l9 Market Collapse*, WALL ST. J., Dec. 21, 1987; Thomas E. Ricks & Monica Langley, *Congress Puts On Fast Track Regulations for Wall Street*, WALL ST. J., Oct. 21, 1987; Kenneth H. Bacon, *A Repeat of '29? Depression in '87 Is Not Expected*, Wall St. J., Oct. 20, 1987.

65. Thomas C. Baxter, Jr. & Joseph H. Sommer, *Liquidity Crises*, 34 INT'L LAW. 87, 104 (2000).

66. Fettig, *supra* note 62, at 47.

67. Todd, *supra* note 60, at 19.

> SEC. 473. EMERGENCY LIQUIDITY.
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> Section 13 of the Federal Reserve Act (12 U.S.C. 343) is amended in the third paragraph by striking "of the kinds and maturities made eligible for discount for member banks under other provisions of this Act."[68]

This change allowed the Federal Reserve to accept collateral that was less liquid under Section 13(3) than it could accept for lending under the Discount Window.[69] This allowed an entirely new group of borrowers to be eligible since the collateral that they could pledge was now eligible under Section 13(3).

B. Consequences of the Federal Reserve's Actions

The Federal Reserve's actions in utilizing Section 13(3) to fight the Great Financial Crisis raised serious issues for policy makers. Some were concerned about the amount of discretion given to the Federal Reserve to exercise its lending power under Section 13(3). A practical issue was whether the Federal Reserve could exit from the various facilities and programs it had developed and whether all of the lending would eventually be repaid to the Federal Reserve. A policy issue was whether Section 13(3) exasperated concerns about the "too big to fail" problem in the US financial system.

1. Discretion and Power

The power and discretion that Section 13(3) gave the Federal Reserve to lend hundreds of billions of dollars gave many policymakers and regulators pause. This willingness to do anything necessary to blunt the financial crisis by the Federal Reserve and other regulators was reflected in an anonymous comment made by a Federal Reserve official:

> But the financial crisis was such a challenge that it led them to use tools they would normally keep locked away. One former Fed official once put it like this: "You don't want to be found dead after a shoot-out with unused ammunition."[70]

Under Section 13(3), the Federal Reserve, in literally a few days, was able to authorize governmental lending that was never before done so quickly and willingly. One commentator reflected that both liberals and conservatives were concerned "that the Federal Reserve had too much discretionary power under the prior emergency lending regime."[71]

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68. FDIC Improvement Act of 1991, Pub. L. No. 102-242, § 473, 105 Stat. 2236, 2386.

69. The result of this amendment was to "effectively *expand[]* the safety net." Todd, *supra* note 60, at 16.

70. Andrew Walker, *Has Quantitative Easing Worked in the US?*, BBC NEWS (Oct. 30, 2014), https://www.bbc.com/news/business-29778331.

71. Johnson, *supra* note 59, at 537.

In trying to understand the mood of Congress and other policymakers, they appear to grudgingly acknowledge the importance of the Federal Reserve's actions under Section 13(3) in dealing with the Great Financial Crisis. Because all of the amounts lent under Section 13(3) during the Great Financial Crisis were repaid and appear to have been an important element in fighting the crisis, it is difficult, if not impossible, to find serious criticism that such steps were not necessary at the time. However grateful they were, it is clear that they were unwilling to provide the Federal Reserve with the same amount of power and discretion in the future.[72]

2. Exit and Repayment Strategy

Due to the sheer size and volume of lending that the Federal Reserve provided under Section 13(3) during the Great Financial Crisis, there was a question whether the Federal Reserve would suffer significant losses, in spite of the fact that the lending was collateralized. The concern was compounded given that the Federal Reserve did not regulate the entities to which it was lending. The speed with which the programs were conceived and the lending that was being done were also breathtaking. Although the borrowers under Section 13(3) eventually paid back everything to the Federal Reserve, such a successful result was not guaranteed or assured during the financial crisis.

Although the Federal Reserve is often inaccurately described as being able to print money that could be used to offset any losses, these losses would have a direct impact on the US economy since Federal Reserve profits are returned to the US Treasury.[73] In trying to reassure financial markets, Chairman Bernanke stated that "[t]he Federal Reserve has never suffered any losses in the course of its normal lending to banks and, now, to primary dealers."[74] This bold comment, however, was made before the exponential increase in lending as the Federal Reserve exercised its power under Section 13(3).

The most obvious concern was the huge loans that were made to AIG. As explained above, the Federal Reserve eventually lent over USD $125 billion to AIG. Given the unprecedented market turmoil, there was no guarantee that AIG would be able to continue to operate as a going

72. Daniel J. Hunt, *Just Grin and Bear It: Why Consistent Use of Individual Bailouts Under Section 13(3) of the Federal Reserve Act Is a Necessary Evil to Combat Economic 'Mass Destruction'*, 6 GEO. MASON J. INT'L COM. L. 59, 78–81 (2014).

73. For a discussion of the effect of losses suffered by Discount Window borrowing, see Schwartz, *supra* note 62, at 65.

74. Ben S. Bernanke, Chairman, Fed. Reserve, The Crisis and the Policy Response (Jan. 13, 2009), https://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm.

concern or that the Federal Reserve would be able to liquidate the collateral to cover its exposure if AIG were to file for bankruptcy. Similar concerns could also be raised about the lending and liquidity made available to Bear Stearns, although eventually these loans were also repaid.

In spite of the financial crisis, AIG eventually did repay everything that it owed to the Federal Reserve.[75] With 20/20 hindsight, there is an argument that these loans were not as problematic as they appeared. The 2007 annual report for AIG[76] showed assets of USD $1 trillion and shareholder's equity of USD $95 billion. In 2007, AIG had earned net income of over USD $6 billion. Assuming that the economy came out of its nosedive, AIG should have had the wherewithal to pay back the Federal Reserve given the liquidity necessary to weather the storm.

A little known or understood action that the Federal Reserve took under Section 13(3) was the financial backstops provided to both Citigroup and Bank of America Corporation. These backstops could have cost the Federal Reserve tens of billions of dollars had these two huge banks continued to deteriorate. Instead, however, both backstops were terminated, and the Federal Reserve earned millions of dollars in fees for providing this assistance.

Similar arguments could be made about the possible losses that could have been suffered under the various Section 13(3) programs or facilities. The value of the assets in the large-scale asset purchase programs could also swing widely as interest rates move, perhaps generating losses as it liquidates its portfolio.[77] Again, however, all of the amounts lent under these programs were repaid, and the programs were wound down and terminated.[78]

3. Moral Hazard and Too Big to Fail

As legislators, regulators, and academics sorted out the Federal Reserve's actions, there was enormous concern that "moral hazard" had been reintroduced into the financial system in a new and profound way and that the Federal Reserve was now in the business of saving those institutions "too big to fail."[79] Moral hazard and "too big to fail" concerns

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75. *See* text accompanying note 33, *supra*.

76. AIG, 2007 ANNUAL REPORT 1 (2008), http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/2007-annual-report.pdf.

77. *Heard on the Street / Financial Analysis and Commentary, Dream Mortgage Bailout Has a Darker Side*, WALL ST. J., Apr. 3, 2009, at C14.

78. *See* text accompanying note 33, *supra*.

79. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183 (2009); Stephen Labaton, *Trying to Rein in 'Too Big to Fail' Institutions*, N.Y. TIMES, Oct. 25, 2009, at A1, http://www.nytimes.com/2009/10/26/business/economy/26big.html; Interview by

are a frequent topic as policymakers try to determine how to deal with financial crises.[80]

Although the Federal Reserve and the US Treasury allowed Lehman Brothers to fail, they provided key liquidity with respect to the "bail outs" of Bear Stearns, AIG, Citigroup, and Bank of America Corporation. As described above, they also provided hundreds of billions of dollars of key liquidity to both depository institutions and non-depository institutions such as primary dealers, money market mutual funds, and issuers of commercial paper.

In a prescient view of the Federal Reserve's actions, Anna Schwartz, a senior research fellow at the National Bureau of Economic Research, questioned "whether [the Federal Reserve] will be firm in the future in resisting pressures to fund insolvent firms that are politically well-connected."[81] Going forward, many believed that bankers would become less risk averse, believing that the Federal Reserve would once again step in if the economy experiences a liquidity crisis and/or credit crunch in its credit sector. Policy makers were also concerned that bankers would become dependent upon the Federal Reserve's power under Section 13(3) to bail them out if a systemically important institution teetered on the brink of insolvency, similar to what was done for the creditors of AIG.[82]

C. The Tradeoff of Liquidation Authority for Reduced Emergency Powers

Although grudgingly grateful for the Federal Reserve's actions during the Great Financial Crisis, it became clear that Congress and regulators were unhappy with the tremendous amount of discretion and power the Federal Reserve enjoyed to inject liquidity into the market under Section 13(3).

During 2008 and 2009, the Federal Reserve, by the literal stroke of a

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Paul Solman with George Shultz, *How Big is Too Big to Fail?*, PBS NEWS HOUR (Dec. 15, 2009, 12:00 AM), https://www.pbs.org/newshour/show/how-big-is-too-big-to-fail.

80. U.S. GOV'T ACCOUNTABILITY OFF., GAO-14-621, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT (2014), https://www.gao.gov/assets/670/665162.pdf; SORKIN, *supra* note 5. *See* Viral V. Acharya, Deniz Anginer & A. Joseph Warburton, *The End of Market Discipline? Investor Expectations of Implicit State Guarantees* (2013), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961656. (proposing a corrective tax requiring financial institutions to shoulder the full cost of their debt to help create a more stable and efficient financial system, thus addressing moral hazard that accompanies "too big to fail" mentality).

81. Schwartz, *supra* note 62, at 63.

82. It is important to understand that it is the creditors of the failing institution that are bailed out, and not the shareholders. Shareholders in both Bear Stearns and AIG essentially lost all of their equity investment in spite of the Federal Reserve's actions.

pen, injected over a trillion dollars of liquidity into the US financial markets in ways that it had never been done before. To curb that power, Congress eliminated the Federal Reserve's powers to make loans under Section 13(3) to single entities as it did to Bear Stearns and AIG. Congress replaced that safety valve with the creation of what is referred to as Orderly Liquidation Authority (OLA).

Title II of Dodd-Frank (Title II) created OLA.[83] The Treasury Department explained that the passage of OLA was to provide "an alternative to the unsatisfactory choice between potentially destabilizing bankruptcies and the taxpayer-funded bailouts provided during the 2008–09 financial crisis,"[84] namely Bear Stearns and AIG. Title II imposes requirements on financial institutions to become more financially resilient. It also provides the power for the FDIC to resolve insolvencies of financial institutions that are too large or complex to be resolved by either the US Bankruptcy Code or the Federal Deposit Insurance Act.[85]

The bargain behind OLA's creation was the simultaneous limitation of emergency powers for the Federal Reserve under Section 13(3) of the Federal Reserve Act. Former chairman of the Federal Reserve, Ben Bernanke, explained that this was "the trade of liquidation authority for

83. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. 2, 124 Stat. 1376, 1442 (2010) (codified at 12 U.S.C. §§ 5381–94 (2012)).

84. U.S. DEP'T OF THE TREASURY, ORDERLY LIQUIDATION AUTHORITY AND BANKRUPTCY REFORM 7 (2018), https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf [hereinafter TREASURY, OLA & BANKRUPTCY REFORM].

85. For general discussions of Orderly Liquidation Authority, see 1 BANKS & THRIFTS: GOVERNMENT ENFORCEMENT & RECEIVERSHIP § 14.09; Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. RICH. L. REV. 1143 (2011); Alison M. Hashmall, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-Bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 847 (2010); Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part I*, 128 BANKING L.J. 771 (2011); Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part II*, 128 BANKING L.J. 867 (2011); Mark A. McDermott & David M. Turetsky, *Restructuring Large, Systemically-Important, Financial Companies: An Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 19 AM. BANKR. INST. L. REV. 401 (2011); Joshua Mitts, *Systemic Risk and Managerial Incentives in the Dodd-Frank Orderly Liquidation Authority*, 1 J. FIN. REG. 51 (2015); Sabrina R. Pellerin & John R. Walter, *Orderly Liquidation Authority as an Alternative to Bankruptcy*, 98 FED. RES. BANK RICHMOND ECON. Q. 1 (2012); Kwon-Yong Jin, Note, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 YALE L.J. 1746 (2015); Viral V. Acharya & T. Sabri Öncü, *A Proposal for the Resolution of Systemically Important Assets and Liabilities: The Case of the Repo Market* (2012), https://www.federalreserve.gov/Events/conferences/2012/cbc/confpaper6/confpaper6.pdf; Stanley Fischer, Vice Chairman, Fed. Reserve, Comments on the Resolution Framework for Banks and Bank Holding Companies in the United States (June 22, 2016), https://www.federalreserve.gov/newsevents/speech/fischer20160622a.htm.

reduced emergency powers."[86] Not only would Title II make it unlikely that Section 13(3) would be needed, but it would also create an additional means for regulators to fund any liquidity needs upon the use of OLA.

In assessing the creation of OLA, Bernanke, the dominant user of Section 13(3) during the crisis, made the following comment:

> With the creation of the liquidation authority, the ability of the Fed to make loans to individual troubled firms like Bear and AIG was no longer needed and, appropriately, was eliminated. As Fed chairman, I was delighted to see my institution taken out of the business of bailing out failing behemoths.[87]

Although grateful for having the Federal Reserve removed from the "hot seat" during a financial crisis, the curbing of such powers has not necessarily made our financial systems safer or more resilient to future crises.

D. Amendments to Section 13(3) and Regulations

Congress, as part of Dodd-Frank, significantly amended Section 13(3) of the Federal Reserve Act,[88] reasoning that OLA now made such powers much less necessary and important.[89] It also provided that the Federal Reserve was to promulgate regulations to interpret the revised Section 13(3).[90] The primary effect of these statutory changes and regulations was to eliminate the ability of the Federal Reserve to lend to a single entity as it did with AIG and Bear Stearns. Second, it required that any lending must be done through a *program* or *facility* "with broad-based eligibility."[91] Finally, it required that the Treasury approve use of Section 13(3) by the Federal Reserve.

1. Amendments to Federal Reserve Act Section 13(3)

First, the Dodd-Frank amendments to Section 13(3) eliminated the ability of the Federal Reserve to take action similar to what it did in lending to Bear Stearns and AIG. The amendments eliminated the Federal Reserve's emergency lending power to lend to an "individual,

86. Ben S. Bernanke, *Warren-Vitter and the Lender of Last Resort*, BROOKINGS (May 15, 2015), https://www.brookings.edu/blog/ben-bernanke/2015/05/15/warren-vitter-and-the-lender-of-last-resort/.

87. *Id.*

88. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a), 124 Stat. at 2113 (codified at 12 U.S.C. § 343).

89. *See* 12 U.S.C. § 343 ("Discount of obligations arising out of actual commercial transactions"). For a discussion of the amendments to Section 13(3), see Johnson, *supra* note 59.

90. *See* 12 U.S.C. § 343(3)(B)(i) ("As soon as is practicable after July 21, 2010, the Board shall establish, by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending under this paragraph.").

91. 12 U.S.C. § 343(3)(A).

partnership, or corporation."[92] The elimination of single-entity lending was reinforced by the limitation that lending under 13(3) must only be done through a *program* or *facility* "with broad-based eligibility."[93] The amendments clarify that "broad-based eligibility" under Section 13(3) excludes any program or facility "that is 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 [to] avoid . . . insolvency."[94]

Second, the amendments imposed the requirement that the Secretary of the US Treasury approve the establishment of any program or facility under Section 13(3).[95] In addition, upon the use of Section 13(3) by the Federal Reserve's Board of Governors, the statute imposes on the Board extensive disclosure and reporting requirements to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives.[96]

2. Federal Reserve Regulations

The statutory amendments to Section 13(3) directed the Federal Reserve to promulgate regulations to carry out the revised purposes of Section 13(3) as set out in Dodd-Frank.[97] The regulations the Federal Reserve promulgated as required by Dodd-Frank were published in the Federal Register on December 18, 2015.[98] The explanation and text of the regulations take up eight single-spaced, three-column pages.[99]

III. Issues and Recommendations

The changes to Section 13(3) are problematic and worrisome on many levels. The first concern is the Federal Reserve's loss of independence from the executive branch. In addition, the changes create a significant limitation to providing liquidity that would have severely limited the Federal Reserve during the Great Financial Crisis. Finally, whether the tradeoff of emergency powers for orderly liquidation authority left the financial system in a better position is still an open matter.

A. Loss of Federal Reserve Independence in Exercising Section 13(3)

92. Pub. L. No. 111-203, § 1101(a)(2), 124 Stat. 2113 (codified at 12 U.S.C. § 343).
93. 12 U.S.C. § 343(3)(A).
94. 12 U.S.C. § 343(3)(B)(iii).
95. 12 U.S.C. § 343(3)(B)(iv).
96. 12 U.S.C. § 343(3)(C).
97. 12 U.S.C. § 343(3)(B)(i).
98. Extensions of Credit by the Federal Reserve Banks, 80 Fed. Reg. 78,959 (Dec. 18, 2015).
99. *Id.* For a discussion of the new regulations, see generally Johnson, *supra* note 59.

Powers

Perhaps the most serious loss to the Federal Reserve's powers under Section 13(3) comes from the requirement that it obtain prior approval from the Secretary of the Treasury prior to establishing any liquidity programs or facilities under Section 13(3).[100] The amendments to Dodd-Frank now effectively give the executive branch a veto over the Federal Reserve's use of its power under Section 13(3).

Independence is one of the key attributes that the Federal Reserve was intended to enjoy upon its creation.[101] The appointment process for the chairman of the Federal Reserve and the Board of Governors insulates the Federal Reserve from the partisan pushes and pulls that the executive and legislative branches place on our government.

This is in direct contrast to the lack of independence enjoyed by the Secretary of the Treasury. In contrast to the Federal Reserve, the Department of the Treasury is an "executive department of the United States Government."[102] The Secretary of the Treasury is "appointed by the President, by and with the advice and consent of the Senate."[103] In effect, the Treasury Secretary serves at the pleasure and will of the President of the United States.

Commentators have written extensively about the intense political pressure that the Great Financial Crisis brought upon the Federal Reserve.[104] Many have speculated that this political pressure effectively stopped the Federal Reserve from providing the liquidity that Lehman needed prior to bankruptcy, effectively throwing the financial world into crisis. Commentators also directly dispute the Federal Reserve's

100. *See* 12 U.S.C. § 343(3)(B)(iv) ("The Board may not establish any program or facility under this paragraph without the prior approval of the Secretary of the Treasury.").

101. *See* Peter Conti-Brown, *The Institutions of Federal Reserve Independence*, 32 YALE J. ON REG. 257, 276 (2015) (detailing the origins of the Federal Reserve's independence); *Born of a Panic: Forming the Fed System*, FED. RES. BANK MINNEAPOLIS (Aug. 1, 1988), https://minneapolisfed.org/publications/the-region/born-of-a-panic-forming-the-fed-system (discussing the origins and intentions of the Federal Reserve Act); *U.S. Monetary Policy: An Introduction*, FED. RES. BANK S.F. (Feb. 6, 2004), http://www.frbsf.org/education/teacher-resources/us-monetary-policy-introduction/federal-reserve-structured/ (discussing features of independence).

102. 31 U.S.C. § 301(a) (2012).

103. 31 U.S.C. § 301(b).

104. *E.g.*, De Vito, *supra* note 24, at 310–11; Laurence Ball, *The Fed and Lehman Brothers: Introduction and Summary* (Nat'l Bureau of Econ. Research, Working Paper No. 22410, 2016), https://www.nber.org/papers/w22410.pdf; William R. Cline & Joseph E. Gagnon, *Lehman Died, Bagehot Lives: Why Did the Fed and Treasury Let a Major Wall Street Bank Fail?*, PETERSON INST. INT'L ECON. (Sept. 2013), https://piie.com/publications/policy-briefs/lehman-died-bagehot-lives-why-did-fed-and-treasury-let-major-wall-street. *But see* Phillip Swagel, *Why Lehman Wasn't Rescued*, N.Y. TIMES: ECONOMIX (Sept. 13, 2013, 1:18 PM), https://economix.blogs.nytimes.com/2013/09/13/why-lehman-wasnt-rescued/?_r=0.

explanation that it did not have the legal authority to lend to Lehman.[105] Some have suggested that the political pressure was such that the Federal Reserve deferred to the Secretary of the Treasury.[106]

There was clearly political pressure on both the US Treasury and the Federal Reserve immediately prior to the Lehman bankruptcy filing,[107] although no one appeared to have anticipated the economic fallout from the decision.[108] Many believe that the economic fallout from the Lehman bankruptcy[109] overcame political resistance to bailouts and permitted the Federal Reserve to bail out AIG.[110]

In an era of intense partisanship,[111] there is no guarantee that the executive branch will respect the judgment and actions of the Federal Reserve. Presented with another financial crisis as deep and severe as the Great Financial Crisis, will the Federal Reserve, in its role as an independent central bank, be able to act in the future to resolve a crisis as quickly and decisively as it did in the past? By requiring approval of the Secretary of the Treasury, there is no guarantee that the Federal Reserve's actions under Section 13(3) would not be thwarted by the executive branch, stopping it from acting as swiftly and effectively as it did.

B. Loss of an Important Source of Liquidity During a Financial Crisis for Single-Entity Lending

Although the Federal Reserve did not use Section 13(3) from the Great Depression until the Great Financial Crisis, its importance (as described above) cannot be understated. By limiting the Federal Reserve's powers to respond under Section 13(3) to a future unimagined or unanticipated crisis, there is no question that the US government's ability to act in a

105. *See* Ball, *supra* note 104, at 1–2.

106. *Id.* at 3.

107. *Id.* at 14.

108. *Id.*; Binyamin Appelbaum, *Fed Misread Crisis in 2008, Records Show*, N.Y. TIMES (Feb. 21, 2014), https://www.nytimes.com/2014/02/22/business/federal-reserve-2008-transcripts.html.

109. *See* ALAN S. BLINDER, AFTER THE MUSIC STOPPED: THE FINANCIAL CRISIS, THE RESPONSE, AND THE WORK AHEAD 428 (2014) (discussing global implications of the Lehman fallout). *See also How Lehman Shook the Global Economy*, NEWSWEEK (Sept. 13, 2009, 8:00 PM), http://www.newsweek.com/how-lehman-shook-global-economy-79633 (noting how Lehman's failure sparked a series of global economic consequences); Richard Wachman, *The Lehman Brothers Collapse: The Global Fallout*, GUARDIAN (Sept. 4, 2009), https://www.theguardian.com/business/2009/sep/04/lehman-collapse-global-impact (analyzing effects of Lehman's failure on global economy and emerging markets).

110. De Vito, *supra* note 24, at 310.

111. *See* Opinion, *'Divided We Fall'*, WASH. TIMES (Oct. 19, 2017), https://www.washingtontimes.com/news/2017/oct/19/editorial-growing-partisan-divide-threatens-the-fu/; *The Primeval Tribalism of American Politics*, ECONOMIST (May 24, 2018), https://www.economist.com/united-states/2018/05/24/the-primeval-tribalism-of-american-politics.

crisis has been compromised.

The irony of the Great Financial Crisis is that few saw it coming and the system was ill-prepared for the crisis. In 2007, the Dow Industrial Average had reached an all-time high.[112] Housing lending was at an all-time high as well.[113] Bear Stearns and Lehman Brothers both enjoyed investment-grade credit ratings immediately before their failure. Finally, few would have expected that the failure of AIG, one of the largest and most respected insurance companies in the world, would throw the entire financial system into crisis.

Unfortunately, the changes made to prevent a future financial crisis focused on solving the past weaknesses in the financial system that triggered the Great Financial Crisis. The Dodd-Frank Act and other statutory and regulatory changes were aimed at solving the problems that have already occurred. Many believe that the banks are nearly as vulnerable to a crisis as they were previously because of changes in financial regulation, making them an unlikely source for a future crisis.[114]

Many have speculated what the next financial crisis will look like and what will trigger it. As explained above, Congress expanded the powers of the Federal Reserve under Section 13(3) precisely because it did not know what a future crisis would entail and how regulators would fight it.

Economists, financial analysts, and other commentators offer future possibilities that may require the same response from the Federal Reserve that the Great Financial Crisis required. The lists are long, albeit speculative. They include increases in global sovereign debt,[115] the issuances of large amounts of low-quality corporate debt,[116] the opaqueness and size of the shadow financial system,[117] populism and

112. *10 Years After the Financial Crisis*, JP MORGAN (2018), https://www.jpmorgan.com/global/research/10-years-after-crisis.

113. *Id.*

114. *Id.*

115. *Id.*; *see also* Howard Gold, *Opinion: These 4 Called the Last Financial Crisis. Here's What They See Causing the Next One*, MARKETWATCH (Sept. 14, 2018, 2:23 PM), https://www.marketwatch.com/story/the-4-called-the-last-financial-crisis-heres-what-they-see-causing-the-next-one-2018-09-13.

116. *See* Paul Davidson, *Ten Years After Financial Crisis: Is Corporate Debt the Next Bubble?*, USA TODAY (Sept. 14, 2018, 5:01 AM), https://www.usatoday.com/story/money/2018/09/14/financial-crisis-corporate-debt-trigger-next-meltdown/1290735002/ ("Corporate debt could worsen economic dip"); Gold, *supra* note 115 (labeling low-quality corporate debt as the "biggest danger").

117. *See* Gold, *supra* note 115; Francine McKenna, *Reforms Haven't Eliminated Risk of Another Lehman-Type Failure*, MARKETWATCH (Sept. 14, 2018, 3:38 PM), https://www.marketwatch.com/story/reforms-havent-eliminated-risk-of-another-lehman-type-failure-2018-09-07.

nationalism,[118] and pension fund woes.[119] Commentators also worry that cyberwarfare and cyber-attacks on the financial system could trigger a liquidity crisis similar to that during the Great Financial Crisis.[120]

C. Is OLA Sufficient?

As explained above, the political tradeoff for limiting the Federal Reserve's emergency powers under Section 13(3) was OLA. The concept is that regulators now have a regulatory framework that provides both the power and the liquidity to be able to deal with an "AIG" or "Lehman" crisis.

There is no question that OLA is superior to the regulatory tools that were in place prior to the Great Financial Crisis. One question, however, is whether OLA is the solution to a past crisis as opposed to the anticipatory answer to a future one. Is OLA flexible and forward-looking enough to deal with the black-swan event that will demand liquidity in a manner or level not yet imagined by policymakers and regulators?

Like Section 13(3) was before the Great Financial Crisis, OLA is also an untested tool in battle. One commentator noted that "[b]ecause OLA has never been triggered, we don't know if it will work as designed."[121] Others worry about how it will be employed and whether it will function: "This orderly resolution authority has not yet been used, and it is not clear if it will be successful . . . ."[122] Although there is no specific scenario set forth, the United States will go into the next financial crisis with financial regulatory tools that are untested and untried.

Perhaps what is most worrisome about OLA is that it continues to face political attack. Policymakers have not been reluctant to try to carve back the powers and authorities that were originally given under Dodd-Frank

118. Jaden Urbi, *Three Investors Who Manage More Than $900 Billion Combined Discuss the Next Financial Crisis*, CNBC (July 26, 2018, 8:00 AM), https://www.cnbc.com/2018/07/23/three-experts-predict-next-financial-crisis.html (expressing concern that territorialism and nationalism create a negative impact on global investment).

119. Randall W. Forsyth, *How to Spot the Next Financial* Crisis, BARRON'S (Sept. 7, 2018, 4:55 PM), https://www.barrons.com/articles/how-to-spot-the-next-crisis-1536353744 ("Pensions are at the top of the worry list . . . .").

120. *See generally* JUAN C. ZARATE, CENT. ON SANCTIONS & ILLICIT FIN., THE CYBER FINANCIAL WARS ON THE HORIZON: THE CONVERGENCE OF FINANCIAL AND CYBER WARFARE AND THE NEED FOR A 21ST CENTURY NATIONAL SECURITY RESPONSE (2015), https://daks2k3a4ib2z.cloudfront.net/594305fd681e5a5ac1d7ddf2/5945c4250d8aed43609fefa3_Cyber%20Financial%20Wars%20Paper.pdf.

121. Aaron Klein, *A Primer on Dodd-Frank's Orderly Liquidation Authority*, BROOKINGS (June 5, 2017), https://www.brookings.edu/blog/up-front/2017/06/05/a-primer-on-dodd-franks-orderly-liquidation-authority/.

122. Swagel, *supra* note 104.

and OLA, leaving regulators with fewer tools and less flexibility.[123] In fact, President Trump issued a memorandum[124] instructing the US Treasury to review and determine the effectiveness of OLA.[125]

Similar to the concerns about independence issues now in place with Section 13(3), OLA requires a trifecta of approvals from the Federal Reserve, the FDIC, and the Treasury to move forward.[126] There is no guarantee that the three agencies will cooperate together in times of stress. Although the Federal Reserve has important independence from the political process, both FDIC and the US Treasury are directly under the executive branch's control.

It is unclear whether the liquidity funding in place under OLA will be sufficient to absorb one or more mega-corporate failures. In fact, OLA is only funded upon a failure.[127] For example, under Section 13(3), the Federal Reserve made available a total of USD $182 billion of credit in the AIG bailout alone. If there were one or more large failures, would OLA have sufficient liquidity to meet the demands placed upon it? Repealing OLA is likely to be considered by the House of Representatives in the first week of June 2019.

If moral hazard was a reason for limiting Section 13(3), in reality we may have only replaced one funding source (the Fed) with another (the FDIC). The jury is still out on whether policymakers have resolved this issue.[128]

D. Recommendations

If the Federal Reserve is to be able to meet its duty as caretaker and guardian of the financial system, Congress needs to revisit some of the changes that were put into place. Congress must reconcile the control given to the Secretary of the Treasury with respect to the Federal Reserve's independence. Serious consideration should also be given to

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123. *See* Klein, *supra* note 121 ("Repealing OLA is likely to be considered by the House of Representatives in the first week of June . . . ."); *see also* Press Release, Elizabeth Warren, Warren, Vitter Introduce Bailout Prevention Act (May 13, 2015), https://www.warren.senate.gov/newsroom/press-releases/warren-vitter-introduce-bailout-prevention-act (announcing the Bailout Prevention Act meant to curtail Federal Reserve lending that contributes to megabank bailouts).

124. *See generally* Memorandum from the Administration of Donald J. Trump on Orderly Liquidation Authority to the Secretary of the Treasury (Apr. 21, 2017), https://www.govinfo.gov/content/pkg/DCPD-201700266/pdf/DCPD-201700266.pdf.

125. *See* TREASURY, OLA & BANKRUPTCY REFORM, *supra* note 84.

126. *See id.* at 7–9 (discussing the required acquiescence among the FDIC, Federal Reserve, and Treasury); *see also* Klein, *supra* note 121 (discussing FDIC collaboration with the Treasury).

127. Klein, *supra* note 121.

128. *See generally* Bhanu Balasubramnian & Ken B. Cyree, *Has Market Discipline on Banks Improved After the Dodd-Frank Act?*, 41 J. BANKING & FIN. 155 (2014); Klein, *supra* note 121 (detailing those in favor of OLA versus those who are supporting the CHOICE Act, an alternative to OLA).

permitting the Federal Reserve to once again lend directly to individual institutions as was done prior to the amendments.

1. Treasury Secretary Approval

The most serious issue, both from an independence concern and an ability to respond to a crisis standpoint, is the amendment's requirement for Treasury approval before implementing a broad-based program. By requiring the Federal Reserve to receive approval from the Secretary of the Treasury prior to exercising its lending powers under Section 13(3), it risks tying the Federal Reserve's hands for political and/or partisan reasons when immediate action is required. This requirement should be eliminated from Section 13(3).

2. Lending to Individual Institutions

The Dodd-Frank Act clearly has eliminated any possibility that the Federal Reserve could lend directly to a single entity as it did with Bear Stearns and AIG. There is a strong argument for simply restoring the Federal Reserve's powers to lend to single entities.[129] Given the success that the Federal Reserve enjoyed using Section 13(3) to deal with the AIG financial crisis, maintaining such a tool would seem reasonable even in the face of the criticism discussed above. In the event that OLA is insufficient to deal with a particularly troubled entity, the Federal Reserve would be able to step in to deal with the "AIG-like" crisis.

As opposed to completely eliminating the tool for single-entity lending, there are several ways to deal with these criticisms. First, to deal with concerns about the Federal Reserve's discretion, a limitation or cap on the total amount that could be lent to one borrower could be considered. This would allow for the Federal Reserve to step in immediately and provide some relief during a crisis. Second, the power to lend to a single entity could require a supermajority of Board of Governors to approve any single-entity lending.

In order to limit the discretion of the Federal Reserve when lending to a single institution, the statute and regulations could lay out a specific and clear set of circumstances that would allow individual lending to occur. For example, it could be enumerated that, if an institution makes up a certain percentage of the market and a failure to lend to the institution could result in systemic harm to the financial system, then the Federal Reserve can lend to that individual institution. This could allow for quick action once the trigger events are met that would reflect the United States' experiences in the past without giving the Federal Reserve all-encompassing authority to lend to individual institutions at its sole

129. *See generally* Hunt, *supra* note 72.

discretion.

CONCLUSION

The Federal Reserve's success in fighting the Great Financial Crisis with Section 13(3) is one of the great stories and lessons learned. Section 13(3) turned out to be an extraordinarily strong and robust firehose of liquidity for the US financial system when it was needed.

One can only speculate whether the Great Financial Crisis would have continued on and perhaps permanently crippled the US financial system had the Federal Reserve not been able to lend to AIG and create the Section 13(3) programs, fighting the crisis with what appears to be a garden hose in comparison to is former self before it was amended.

The great irony about this success, however, is that Congress could not move quickly enough to remove and limit the Federal Reserve's powers under Section 13(3) once the apex of the crisis had passed. Although the passage of Dodd-Frank and the introduction of orderly liquidation authority have surely made the US regulatory structure stronger and more resilient, it is counterintuitive to believe that the first order of business for Congress was to constrain the Federal Reserve's powers once the crisis had been relieved.

After the amendments, Section 13(3) remains a potential tool for the Federal Reserve to use in the face of a crisis. The imposition of Treasury Secretary approval, however, has effectively given the executive branch a veto over the Federal Reserve's actions under Section 13(3). Until that requirement is eliminated, the Federal Reserve's use of Section 13(3) in a crisis could potentially be compromised. Congress should also reconsider allowing the Federal Reserve to continue as a lender of last resort to single entities in the event that such power is needed.