Legal Sidebar

The Federal Reserve's Legal Authorities for Responding to the Economic Impacts of COVID-19

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The COVID-19 coronavirus has upended financial markets and the real economy. As the virus has spread, businesses across the country have closed their doors, major stock indexes have lost over a quarter of their value, and debt and commodity markets have experienced extreme volatility. While Congress is considering the appropriate fiscal response to these developments, the Federal Reserve (the Fed) has implemented several monetary policies and lending programs to stimulate demand and inject liquidity into the financial system. This Sidebar discusses the Fed's responses to the coronavirus, the legal bases for those actions, and the central bank's authority to take further steps to contain the economic fallout from the virus. A CRS summary of the Fed's recent actions is also available here.

The Fed's Response to the Virus

The spread of the coronavirus has taken a significant toll on the global economy, causing layoffs, supply-chain disruptions, and market turbulence. Many commentators contend that the virus is likely to produce a recession as commercial activity grinds to a halt and liquidity disappears from key financial markets. The Fed—which has a statutory mandate to promote full employment and can act as a "lender of last resort" during crises—has responded to the virus with a series of policies designed to support the economy and maintain financial stability.

Interest-Rate Cuts and Asset Purchases

The Fed's ability to set short-term interest rates is generally considered its primary tool for managing the economy. Since the outbreak of COVID-19, the Fed has implemented two emergency rate cuts to stimulate demand for goods and services. In early March, the central bank cut its target federal funds rate by half a percentage point, bringing it to a range of between 1 and 1.25 percent. Less than two weeks later, the Fed again cut rates an additional percentage point, lowering the benchmark rate close to zero.

The Fed can also influence long-term interest rates by purchasing assets with long-term maturities, like Treasury and mortgage-backed securities. The spread of the coronavirus has coincided with sharp selloffs

of these traditionally safe assets, raising their yields and threatening to inhibit the Fed's efforts to loosen credit conditions. To bring down long-term interest rates and improve liquidity in these markets, the Fed has announced plans to purchase as many Treasury and mortgage-backed securities as necessary to implement its monetary-policy goals and smooth market functioning.

While the Fed has already dialed up these elements of its 2008-crisis playbook, it may have another option in its monetary-policy toolkit: following its peers in Europe and Japan by taking rates negative. The most straightforward way the Fed could implement negative rates would involve charging banks for holding excess reserves, which could encourage more lending. But the Fed's legal authority to adopt such a policy is not clearly established. Section 19(b)(12)(A) of the Federal Reserve Act allows the Fed to *pay* interest on banks' excess reserves, authorizing depository institutions to "receive earnings to be paid by the Federal Reserve." However, whether this authority includes the power to pay a *negative amount* is unsettled.

Some commentators have suggested that the Fed could avoid this uncertainty by using its authority to levy fees, which arguably allows it to charge banks for the accounts they maintain with the Fed. But this option also faces potential legal difficulties. Under Section 11A(c)(3) of the Federal Reserve Act, the Fed's fees for services must reflect the long-run costs of providing those services. As a result, the Fed's power to implement negative rates using its fee-setting authority may be limited by the costs it incurs in providing banks with accounts.

Aside from these legal uncertainties, Fed officials have raised operational and policy objections to negative rates. But some observers—including former Fed Chairman Ben Bernanke and President Trump—view negative rates as a live option as the Fed reaches the zero lower bound and exhausts other tools in its policy arsenal.

Lender-of-Last-Resort Activities

Besides its rate-setting authority, the Fed has certain powers to act as a "lender of last resort" during crises. The Fed has deployed several of these authorities in response to the coronavirus.

First, the Fed has lowered the rate it charges at the "discount window," where banks can obtain short-term liquidity during a cash crunch. While many banks shunned discount-window borrowing during the 2008 crisis to avoid appearing weak, a group of large banks has already used the window during the coronavirus crisis to help eliminate this stigma. This effort may be working, as the Fed has said it is "encouraged" by a "notable increase" in discount-window borrowing.

Second, the Fed has used its authority under Section 14 of the Federal Reserve Act to activate dollar swap lines with certain foreign central banks. These swap lines allow foreign central banks to borrow U.S. dollars in exchange for their local currencies, which in turn enables them to lend dollars to banks within their jurisdictions that cannot borrow directly from the Fed. The Fed activated the swap lines in response to a surge in the dollar against other major currencies, which threatened to tighten credit conditions both in the U.S. and abroad.

Third, the Fed has used its emergency-lending authority under Section 13(3) of the Federal Reserve Act to establish several liquidity facilities backstopping key financial markets. Under Section 13(3), the Fed can lend to non-banks in "unusual and exigent circumstances" with the Treasury Secretary's approval, as long as the relevant program has "broad-based eligibility" and the loans are secured to the Fed's satisfaction. When determining whether loans extended under Section 13(3) are adequately secured, Federal Reserve Banks must ensure that the relevant collateral is sufficient "to ensure protection for the taxpayer."

Many of the Fed's Section 13(3) facilities involve loans to special-purpose vehicles (SPVs) that purchase certain categories of assets. The Treasury Department has taken an equity stake in several of these SPVs to limit the Fed's credit risk. The use of this SPV structure allows the Fed to finance the purchase of

certain assets—like corporate bonds—that it lacks the authority to buy directly. And the Treasury's equity stake in the SPVs presumably buttresses the argument that the programs comply with Section 13(3)'s requirement that emergency lending be adequately secured. As of the publication of this Sidebar, the Fed has established the following emergency liquidity facilities:

- The Commercial Paper Funding Facility will create an SPV to purchase commercial paper—a form of unsecured short-term debt often used to finance payrolls, inventory, and accounts payable—from blue-chip companies and state and local governments. The Treasury Department has made a $10 billion equity investment in the SPV using money from its Exchange Stabilization Fund (ESF), and the Federal Reserve Bank of New York (New York Fed) will lend the SPV additional funds.
- Under the Primary Dealer Credit Facility, the New York Fed will offer short-term collateralized loans to primary dealers—the banks and broker-dealers authorized to trade government securities directly with the Fed, which play a critical role in financial intermediation.
- The Money Market Mutual Fund Liquidity Facility will support money market mutual funds (MMFs)—a major source of short-term financing for companies and state and local governments. Under this facility, the Federal Reserve Bank of Boston will lend to financial institutions against certain collateral that they purchase from MMFs, encouraging those institutions to purchase assets from MMFs facing large redemption requests.
- The Term Asset-Backed Securities Loan Facility will create an SPV to purchase asset-backed securities collateralized by certain categories of consumer and small-business loans, including auto loans, student loans, credit-card receivables, and certain Small Business Administration loans. The Treasury Department has made a $10 billion equity investment in the SPV using money from the ESF and the New York Fed will lend the SPV additional funds.
- The Primary Market Corporate Credit Facility will create an SPV to purchase investment-grade bonds and loans directly from eligible issuers. The Treasury Department has made a $10 billion equity investment in the SPV using money from the ESF and the New York Fed will lend the SPV additional funds.
- The Secondary Market Corporate Credit Facility will create an SPV to purchase investment-grade corporate debt in the secondary market. The Treasury Department has made a $10 billion equity investment in the SPV using money from the ESF and the New York Fed will lend the SPV additional funds.

Regulatory Relief

The Fed also has significant authority as a bank regulator that it can use to supplement its monetary-policy and lending activities. The central bank has used this power to respond to the coronavirus in three ways. *First*, the Fed has lowered banks' reserve requirements—which dictate the minimum amount of cash that banks must hold relative to their liabilities—to zero. By reducing these requirements, the Fed will allow banks to lend more of their cash to businesses and consumers in need of credit. *Second*, the Fed has encouraged banks to use their excess capital and liquidity to lend to households and businesses affected by the coronavirus. *Third*, the Fed has joined other federal banking regulators in announcing that it will not automatically treat loan modifications to borrowers affected by the virus as "troubled debt restructurings"—an accounting category that can have significant implications for banks' regulatory compliance.

While the Fed has already taken these steps in its role as bank regulator, some observers have identified other avenues for regulatory relief that would add liquidity to the financial system. Several commentators have argued that the Fed should follow certain foreign central banks in temporarily suspending bank liquidity requirements, including the Liquidity Coverage Ratio (LCR). The LCR—which ensures that banks have a sufficient cushion to withstand "runs" during crises—dictates the amount of high-quality liquid assets banks must hold as a proportion of their projected net cash outflows. Temporarily suspending this requirement would arguably allow banks to extend more credit to businesses and consumers.

Proposals for Additional Fed Actions

As discussed, the Fed has already mounted a vigorous effort to contain the economic damage from COVID-19. But some commentators have proposed steps Congress could take to expand the Fed's authority to support the economy. This section of the Sidebar discusses four additional powers that Congress could grant to the Fed.

- ***Expanded emergency liquidity facilities***. Several commentators have urged the Fed to establish broader emergency liquidity facilities to prevent the failure of solvent firms facing cash shortages. For example, Senator Elizabeth Warren, former Fed Governor Kevin Warsh, and the Wall Street Journal editorial board have argued that the Fed should use its emergency-lending authority to extend loans to a wider range of companies affected by the virus. The Fed has moved in this direction, announcing that it plans to establish a "Main Street Business Lending Program" to provide credit to small and medium-sized businesses. But the details of such a program remain murky. As discussed, Section 13(3) requires that loans extended under an emergency liquidity facility have adequate security to protect taxpayers from losses. This limitation may require that any facilities for small and medium-sized businesses receive significant credit protection from the Treasury Department.

  This credit protection appears to be forthcoming. As of the publication of this Sidebar, Congress has passed legislation that makes $454 billion available to the Treasury Department to support additional Fed emergency lending. This legislation—the Coronavirus Aid, Relief, and Economic Security Act (CARES Act)—also directs the Treasury Secretary to "seek the implementation of" an emergency lending facility that provides financing for banks to lend to businesses that abide by certain conditions related to employee retention, share buybacks, and the preservation of collective-bargaining agreements, among other things. However, the limitations that apply to this emergency lending facility do not affect the Treasury's ability to backstop other Fed programs, including the Fed's inchoate "Main Street Business Lending Program." These separate Fed facilities are subject to narrower requirements if they receive CARES Act funding and involve direct lending to businesses.

  In putting this additional money to work, the Fed may confront legal limitations on borrower eligibility beyond those in the CARES Act itself. After the Fed made liberal use of its emergency-lending authorities during the 2008 crisis, Congress passed legislation that imposed certain restrictions on the Fed's Section 13(3) powers. Among other things, Congress required the Fed to adopt procedures to prohibit "insolvent" entities from participating in Section 13(3) facilities, defining an "insolvent" entity to mean a company in bankruptcy, a special-resolution procedure under the Dodd-Frank Act, or another federal or state insolvency proceeding. While this limitation in the relevant statutory text is not particularly restrictive, the Fed's regulations implementing the legislation adopted a broader definition of "insolvency" that may limit its efforts to make full use of CARES Act funds. Specifically, the Fed's regulations provide that a company is "insolvent"—and therefore ineligible for participation in a Section 13(3) program—if it falls within one of the statutorily identified categories of entities *or* is "generally not paying its

undisputed debts as they become due" during the previous 90 days. Because of this added limitation, the Fed's regulations may prohibit it from extending credit to illiquid businesses that are behind on their debts but not in bankruptcy, perhaps because of forbearance on the part of their creditors. The Fed may accordingly have to re-write its regulations to hew more closely to the relevant statutory text to fully leverage the Treasury's CARES Act funding.

- ***Expanded authority to purchase municipal bonds***. Some policymakers have supported expanding the Fed's power to purchase municipal bonds to support state and local governments. Under Section 14(2)(b) of the Federal Reserve Act, the Fed can directly purchase municipal debt with maturities of less than six months. The Fed has also used its emergency-lending powers to support states and localities by allowing its commercial-paper facility to purchase short-term municipal debt and designating certain forms of municipal debt as eligible collateral for its primary-dealer and MMF facilities. Some legislators have advocated expanding these authorities to include direct purchases of longer-term municipal debt as state and local bonds experience steep declines. The Fed could also plausibly finance the purchase of longer-term municipal debt using a Section 13(3) facility, though such a program may raise the types of legal issues discussed above concerning appropriate credit protections from the Treasury Department. The CARES Act endorses this latter approach, directing the Treasury Secretary to "seek the implementation of" a Fed program that "supports lending to States and municipalities."

- ***Equity purchases***. Some commentators have suggested that Congress authorize the Fed to purchase equities to boost consumer sentiment and spending. The Bank of Japan famously has the authority to purchase stocks and has used it aggressively both before and after the coronavirus outbreak. Should Congress authorize such purchases, it could require the Fed to buy equities via broad-based index funds, which may obviate concerns about the government picking winners and losers.

- ***Standing fiscal facility***. Finally, some economists—including former Fed Vice Chair Stanley Fischer—have suggested that Congress authorize the Fed to take a more active role in fiscal policy. These commentators have argued that Congress should empower the Fed to create a "Standing Emergency Fiscal Facility" (SEFF) that would deposit newly created money with the Treasury Department in certain predetermined circumstances (*e.g.*, when interest rates have hit the zero lower bound, inflation is still expected to undershoot a specific target, and the Treasury Secretary approves of such an action). The Treasury Department would then send the newly deposited money directly to individuals. The SEFF and the Treasury Department could repeat this process until the achievement of the Fed's inflation target. While the CARES Act appropriates money for similar direct cash payments administered by Treasury, proponents of the SEFF argue that a rules-based program run by the Fed would be more effective than an ad hoc approach that requires continuous congressional reauthorization.

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