November 20, 2015

TO: Board of Governors

FROM: Staff[1]

SUBJECT: Final amendments to the emergency lending provisions to implement the Dodd-Frank Act.

ACTION REQUESTED: Approval of the attached draft final rule implementing amendments enacted by the Dodd-Frank Act to the Federal Reserve's emergency lending authority under section 13(3) of the Federal Reserve Act (the "FRA").

BACKGROUND AND SUMMARY: The Dodd-Frank Act made extensive changes to the emergency lending provisions of section 13(3) of the FRA. Among other things, the amendments authorize the Federal Reserve to extend emergency credit under that section only for the purpose of providing liquidity to the financial markets through a program or facility with broad-based eligibility, and generally prohibit extending emergency credit for the purpose of assisting any single specific company avoid bankruptcy or resolution. The Dodd-Frank Act requires the Board to adopt rules outlining its procedures for section 13(3) lending in consultation with the Secretary of the Treasury.[2] Staff has consulted with the Treasury Department and addressed its suggestions in the attached documents.

On December 23, 2013, the Board invited public comment on a proposal to revise Regulation A, which implements section 13(3). The Board received comments, fewer than a dozen in number, from financial institutions, policy institutions, individuals, and members of Congress. While some commenters expressed support for parts of the proposed rule, most commenters recommended revisions to the proposed rule. In addition to adopting all of the limitations and revisions required by the Dodd-Frank Act, the attached draft final rule includes a

---

[1] Mr. Alvarez, Ms. Schaffer, Ms. Allison, and Mr. Schwarz (Legal Division).

[2] Dodd-Frank Act Section 1101(a)(6).

number of changes from the original proposal to address matters raised by the commenters, including changes that:

- further define what it means for a program or facility to be "broad-based" by requiring that at least 5 persons be eligible to participate in the program or facility and the program or facility not be designed to assist any number of person avoid resolution;

- broaden the definition of insolvency for purposes of the prohibition on lending to insolvent borrowers that includes failure to pay undisputed debts as they become due during the 90 days prior to borrowing;

- clarify that solvent firms may not borrow for the purpose of passing the proceeds of emergency loans on to insolvent firms;

- specify that emergency loans would only be made at a penalty rate that exceeds the market rate for such loans and provide specific criteria for setting a penalty rate;

- require review by the Board every six months of whether each program or facility should be terminated;

- limit to one year the initial duration and each renewal of an emergency credit program or facility and require notice to the public and Congress and a vote of the Board, with the approval of the Secretary of the Treasury, of any renewal; and

- require acceleration of the loan, including interest, fees and penalties, for willful misrepresentation regarding the solvency of a borrower and referral of the matter to the relevant law enforcement authorities for appropriate action.

DISCUSSION OF DRAFT FINAL RULE:

A. Broad-based eligibility

As required by the Dodd-Frank Act, the original proposal would have amended Regulation A to limit emergency lending to programs and facilities with "broad-based eligibility" and removed references authorizing lending to any

individual, partnership, or corporation. The original proposal adopted the explicit wording of the Dodd-Frank Act, which specifies that a program or facility would not be considered "broad-based" if it is designed for the purpose of aiding any failing financial company, structured to remove assets from the balance sheet of "a single and specific company," or established for the purpose of assisting "a single and specific company" avoid bankruptcy, resolution, or any other insolvency proceeding.[3]

Multiple commenters complained that references in the proposed rule to a "single and specific company" (the words of the Dodd-Frank Act) implied that a program would be "broad-based" if it provided credit to as few as two firms. Commenters believed this suggested the Board could evade the Dodd-Frank Act limits by helping two failing firms in a single program. Commenters urged the Board to specify a larger number of eligible borrowers as a requirement for a program to be "broad-based."

To better reflect the intent of the original proposal and of the Dodd-Frank Act amendments, the draft final rule incorporates two changes from the original proposal to address this concern. First, the draft final rule provides that, in order for a program to have "broad-based eligibility," at least 5 persons must be eligible to participate in the facility at the time it is established. This additional limitation is consistent with and provides further support to the revisions made by the Dodd-Frank Act that a program should not be for the purpose of aiding a single and specific company.

Also, to provide further clarity regarding the Dodd-Frank Act requirement that a program not be for the purpose of aiding any failing financial firm, the draft final rule has been revised to provide that a program or facility may not be

[3] 12 U.S.C. 343(3)(B)(i) and (iii).

designed to assist "one or more" specific companies to avoid bankruptcy or resolution. This change is intended to accent that a program or facility would not qualify as a broad-based program or facility if it is designed for the purpose of assisting any number of persons or entities to avoid resolution by grouping any number of specified failing firms in the same facility.

B. Prohibition on lending to insolvent borrowers

The Dodd-Frank Act amendments to section 13(3) require that the Board establish procedures to prohibit lending to persons that are "insolvent."[4] The Dodd-Frank Act defines a borrower as "insolvent" if the borrower is in bankruptcy, in resolution under Title II of the Dodd-Frank Act, or otherwise the subject of a Federal or State insolvency proceeding. The proposed rule would have incorporated the Dodd-Frank Act definition of "insolvent" into Regulation A and, as also provided for in the Dodd-Frank Act, would have permitted the Board to rely on a written certification from an authorized official of the borrower that the entity is not insolvent. In addition, the proposed rule provided that a borrower would have to update the certification if the information in it materially changed, and specified that, if a borrower became insolvent after initially obtaining emergency credit, the borrower would not be eligible for new extensions of credit. The proposed rule would not have required any change in terms for emergency credit already outstanding to such a borrower (though the credit may immediately become due pursuant to its terms).

Commenters urged the Board to broaden the definition of "insolvent" to include other situations where a company has not entered formal proceedings but may be "insolvent" from an accounting or other perspective. To address these comments, the draft final rule expands the circumstances in which a firm would be

[4] 12 U.S.C. 343(3)(B)(ii).

considered "insolvent" to include situations where a person or entity has generally failed to pay its undisputed obligations as they become due during the 90 days preceding the date of borrowing under the program or facility, as well as situations where the Board or lending Reserve Bank otherwise has determined that the borrower is insolvent. Inability to meet undisputed obligations as they come due is one of the considerations that qualifies a firm for bankruptcy proceedings.

As provided in the Dodd-Frank Act, the draft final rule provides that the Board and a lending Reserve Bank may rely on a written certification from a potential borrower (or its chief executive officer or equivalent) at the time the person or entity initially borrows under a program or facility that the person or entity is not in bankruptcy or in a resolution or other insolvency proceeding and has not failed to meet its obligations during the preceding 90 days.

To help ensure the accuracy of this certification, the draft final rule also adds a new provision that provides that all extensions of credit to a borrower that are outstanding will become immediately due, including all accrued interest, fees and penalties, if the borrower (or authorized person) has made a knowing material misrepresentation, such as a misrepresentation regarding the solvency of the borrower, in a certification. In addition, the draft final rule provides that the Board or lending Reserve Bank will refer a matter involving knowing material misrepresentation to relevant law enforcement authorities for investigation and appropriate criminal or civil action.

In response to comments, the draft final rule also provides that a Federal Reserve Bank may not extend credit through a program or facility to any person that is borrowing for the purpose of lending the proceeds of the loan to an insolvent entity. In addition, the public summary of the draft final rule explains that companies in conservatorship would not be eligible to borrow from a program or facility established under section 13(3).

C. Penalty Rate

Section 13(3) of the FRA has always provided that emergency credit extended under that section shall be at rates established in accordance with the provisions of section 14(d) of the FRA, which provides that the Board determines the appropriate rate. Commenters suggested that the Board amend the proposed rule to require that extensions of emergency credit be subject to a penalty rate of interest.

The practice of the Federal Reserve in extending emergency credit has been to set the relevant interest rate at a penalty rate designed to encourage borrowers to repay emergency credit as quickly as possible once the unusual and exigent circumstances that justify the program or facility have receded and financial conditions have normalized. As a result of this practice, emergency broad-based credit facilities established by the Federal Reserve under section 13(3) during the recent financial crisis terminated and wound down as economic conditions normalized.

The draft final rule has been changed from the original proposal to incorporate this practice of setting a penalty rate on emergency extensions of credit. The draft final rule specifies that the Board will determine a penalty rate for each emergency credit program or facility and sets forth a non-exhaustive list of factors that the Board will take into account when establishing the penalty rate. These factors include the condition of the affected markets and the financial system generally, the historical rate of interest for loans of comparable terms and maturity during normal times, the purpose of the program or facility, the risk of repayment, the collateral supporting the credit, and the duration, terms and amount of the credit. The draft final rule also explains that the rate on emergency credit under section 13(3) may be set by auction.

D. Termination of program or facility

The Dodd-Frank Act requires that the Board's policies and procedures governing emergency lending ensure that any emergency lending program or facility be terminated in a timely and orderly fashion. The proposed rule would have required the Board to periodically review emergency credit programs and facilities in order to meet this requirement. Some commenters suggested that a specific time period for review be adopted.

The draft final rule has been modified from the original proposal to provide that a program or facility will terminate no later than one year after the date of the first extension of credit under the program or facility. Under the rule, the Board may renew the program or facility if it finds, by a vote of at least 5 members,[5] that unusual and exigent circumstances continue to exist and the Secretary of the Treasury has approved the renewal. Each renewal may extend for not more than one year. The draft final rule also provides that the Board will report publicly and to its congressional oversight committees any renewal of an emergency lending program or facility under section 13(3).

The draft final rule also provides that the Board will, not less frequently than every six months, review whether each emergency lending program or facility should be terminated. It provides that the Board may terminate an emergency lending program or facility at any time, and will terminate an emergency program or facility upon finding that conditions no longer warrant continuation of the program or facility. The draft final rule retains the provisions of the proposed rule providing factors for the Board to consider in conducting this review, with some additional modifications. Specifically, it provides that the Board will consider

[5] Fewer members are authorized to take action in certain specified emergency circumstances. See, 12 U.S.C. 248(r) of the Federal Reserve Act.

such factors as the continued existence of unusual and exigent circumstances, the extent of usage of the program or facility, the extent to which the continuing authorization of the program or facility facilitates restoring or sustaining confidence in the identified financial markets, the ongoing need for the liquidity support provided by such program or facility, and other appropriate factors.

E. Other requirements

Approval by the Board and the Secretary of the Treasury. Section 13(3) continues to require that all lending under that section be approved by at least five members of the Board, except in certain limited circumstances.[6] The draft final rule incorporates the requirement included in the Dodd-Frank Act that all lending programs under section 13(3) also be approved by the Secretary of the Treasury.

The Dodd-Frank Act did not affect the requirement that the Board find "unusual and exigent circumstances" as a pre-condition to authorizing emergency credit under that section, or the requirement that the lending Reserve Bank obtain evidence, which may include a certification from borrowers, that borrowers are unable to secure adequate credit accommodations from other banking institutions. Accordingly, these requirements are reflected in the draft final rule.

Public and Congressional Reports. The Dodd-Frank Act requires that the Board make certain reports and disclosures with respect to emergency lending programs and facilities within certain timeframes. In particular, information regarding participants, the amounts borrowed, the interest rate or discount rate charged, and a description of the amount and type of collateral pledged under each facility must be disclosed to Congress (on a confidential basis if approved by the Chairman) within seven days of the Board's authorization of lending. The Board must also disclose to the public information regarding the identity of participants

[6] Id.

and the amount borrowed by each participant (as well as other information) no later than one year after the termination of the program or facility. A program or facility is deemed to have terminated under the Dodd-Frank Act on the earlier of the date the Board terminates the program or facility or the date that is 24 months following the time that the program or facility ceases to extend new credit. These provisions have been incorporated by reference in the draft final rule because they are already set forth in detail in the Dodd-Frank Act.

Collateral requirements. Commenters suggested that limits be imposed on the types of collateral that may be accepted under emergency lending programs and that independent appraisals be required to value all collateral accepted under an emergency lending program. The draft final rule does not contain limits on specific types of collateral and does not require third-party valuations of collateral. The preamble to the draft final rule emphasizes that Reserve Banks have extensive procedures for, and experience in, selecting and valuing collateral. The draft final rule also requires the lending Reserve Banks to assign a lendable value to all collateral for each emergency lending program, consistent with sound risk management practices and to ensure protection for the taxpayer. This latter requirement mirrors the collateral requirement of the Dodd-Frank Act.

Diversity regarding Participants and Vendors. The draft final rule reflects existing legal requirements that participation in any program or facility under section 13(3) of the Federal Reserve Act will not be limited or conditioned on any legally prohibited basis, such as on the basis of the race, religion, color, gender, national origin, age or disability of the borrower. Moreover, in accordance with existing law, the selection of third-party vendors used in the design, marketing or implementation of any program or facility under this subsection will be without regard to race, religion, color, gender, national origin, age or disability, and, to the

extent possible and consistent with law, will involve a process designed to support equal opportunity and diversity.

CONCLUSION: Staff recommends that the Board adopt the draft final amendments to Regulation A implementing the Dodd-Frank Act amendments to section 13(3), as reflected in the attached draft Federal Register notice. Staff also recommends that the Board authorize staff to make any minor and technical changes to the draft Federal Register notice that may be necessary prior to publication in the Federal Register.

Attachment