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ALERT MEMORANDUM

Response to COVID-19: Break Out the Financial Crisis Toolkit?

March 17, 2020

As stock markets plummet and economic activity in the United States is nearly brought to a halt due to COVID-19, a natural question many are asking is: What tools were used by the government in the last financial crisis? Below we have provided a succinct answer to that question to assist clients as they consider what steps the U.S. government might take, or should be urged to take. We have also highlighted the authority utilized and what new restrictions now apply to that authority, in some cases as a result of the Dodd-Frank Act.

The next questions are: Which of those 2008 crisis tools could help us today? And what else do we need? Unlike the 2008 financial crisis, which stemmed from within the financial sector, today the immediate risks are posed by a pandemic that is affecting nearly all sectors of the economy. Thousands of businesses will be unable to generate revenue in the coming weeks or months, and as businesses stop paying workers, families will lack money to buy goods and pay bills. Therefore, it is businesses and individuals that need liquidity support in the first instance, and financial institutions may be sources and conduits for assistance, rather than the primary targets of aid.

While today's challenge will therefore require some measures that differ from those used in the last crisis, those tools will likely provide models to be adapted, and some 2008 crisis measures either have been or likely will be adopted in a form similar to 2008. In the short term, the turmoil in the market is likely to unfold in some respects similarly to what we saw in 2007-2009 and require similar responses. In the medium term, if there are widespread failures and defaults, financial institutions themselves could again be threatened. In many cases, however, measures taken during the last financial crisis depended on authorities that either no longer exist or were curtailed through post-crisis legislation. For example, if money market funds were to require support similar to that provided in the 2008 financial crisis, including guarantees, this may require congressional authorization. And just as the TARP authority was used to assist the auto industry, new congressional authority will likely be required to permit the government to provide assistance to industries hardest hit in this crisis, such as the airlines. This is particularly the case given that the Federal Reserve's lending authority was curtailed to prevent assistance to particular institutions, as opposed to "broad-based" programs.

Aside from programmatic responses, U.S. bank regulators have begun to use their supervisory authority to provide flexibility for banks to answer client calls for liquidity. Regulators have begun to alleviate concerns about capital and liquidity requirements, encouraging the use of "management" buffers held above banks' minimum capital and liquidity coverage ratios. More could likely be done, however. In the last crisis, quick release of temporary or interim rules added flexibility, particularly in allowing banks to lend more freely to affiliates. Similar initiatives could be announced in this context, such as temporary lifting of lending limits or relaxation of investment grade analyses for the purchase of bonds. Other ideas range from delaying deadlines for new credit loss accounting standards to postponing implementation of the new stress capital buffer.

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To assist our clients as events unfold and responses are considered, below is a concise outline of the measures taken so far to confront the financial impact of COVID-19 and the key 2008 financial crisis programs and restrictions on their use today.

Measures Already Taken to Confront Financial Impact of COVID-19

- In recent days, the Federal Reserve has employed a number of measures that were taken during the 2008 financial crisis, including:
  - *Discount Window Access.* On March 15, 2020, the Federal Reserve encouraged depository institutions to turn to the discount window to meet demands for credit, lowered the primary credit rate to 0.25% and extended the timeframe for borrowing to 90 days to support credit demands.
  - *Cutting Interest Rates.* On March 3, 2020, the Federal Reserve lowered interest rates by half a percentage point, which was its first unscheduled and largest interest rate cut since 2008. On March 15, 2020, it further lowered interest rates to 0–0.25%, an additional full percentage point cut.
  - *Large-Scale Asset Purchases.* On March 15, 2020, the Federal Reserve announced that, over the coming months, it would purchase at least $500 billion in U.S. Treasury securities and at least $200 billion in agency mortgage-backed securities. The Federal Reserve will also reinvest all principal payments from its holdings of agency debt and agency mortgage-backed securities in agency mortgage-backed securities. Federal Reserve Chairman Powell indicated, on March 15, 2020, that the Federal Reserve is not currently, or actively considering in the future, seeking authority from Congress to buy assets other than U.S. Treasuries and agency mortgage-backed securities.
  - *Central Bank Liquidity Swap Lines.* On March 15, 2020, the Federal Reserve announced it was coordinating with the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank to enhance the provision of liquidity via the standing U.S. dollar liquidity swap line arrangements. The central banks will lower the pricing for such arrangements by 25 basis points, such that the new rate is the U.S. dollar overnight index swap rate plus 25 basis points. The foreign central banks also agreed to offer additional maturities of U.S. dollars (84 days in addition to one week) to increase the swap lines' effectiveness.
  - *Commercial Paper Funding Facility ("**CPFF**").* On March 17, 2020, the Federal Reserve announced it was establishing a CPFF utilizing its authority under Section 13(3) of the Federal Reserve Act ("**Section 13(3)**"). Similar to that established during the 2008 financial crisis, the CPFF provides a liquidity backstop to U.S. issuers of commercial paper, including U.S. issuers with a foreign parent, through a Federal Reserve-financed special purpose vehicle which will purchase unsecured three-month U.S.-denominated commercial paper (including asset-backed commercial paper ("**ABCP**")) rated A1/P1/F1. In a change from the financial-crisis era CPFF, Treasury is also using the Exchange Stabilization Fund ("**ESF**"), which was creatively used during the financial crisis in connection with the Temporary Guarantee Program for Money Market Funds, to provide a $10 billion backstop to the Federal Reserve in connection with the CPFF.
- The Federal Reserve has taken the following additional actions:
  - *Capital and Liquidity Buffers.* On March 15, 2020, the Federal Reserve encouraged banks to use capital and liquidity buffers built up since the 2008 financial crisis to lend to households and businesses affected by the coronavirus. On March 17, 2020, the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency reiterated in a joint statement that banks should use their buffers to support lending activity.

- *Reserve Requirements.* On March 15, 2020, the Federal Reserve announced the elimination of the reserve requirement for depository institutions, a move designed to free up funds to support lending to households and businesses.
- *Restrictions on Distributions.* On March 17, 2020, the Federal Reserve released an interim final rule focused on alleviating the possibility of sudden onset of restrictions on distributions if banks dip into their required capital buffers. All banking organizations will be able to calculate their distribution restrictions based on the greater of (1) a banking organization's net income for the four preceding calendar quarters, net of any distributions and associated tax effects, and (2) the average of a banking organization's net income over the preceding four quarters.

Measures Used During the 2008 Financial Crisis Not Yet Implemented

- Federal Reserve Programs: Provision of Short-Term Liquidity to Financial Institutions
  - *Term Auction Facility*
    - **Purpose:** To provide depository institutions with the necessary credit to meet their liquidity needs without the stigma that institutions could associate with use of the discount window.
    - **Structure:** The Federal Reserve utilized its normal discount window authority under Section 10B of the Federal Reserve Act to hold auctions for one- and three-month discount window loans to banks against eligible collateral. The auction process determined the rate at which funds were lent, with all bidders receiving the lowest winning bid rate, which could not be lower than the prevailing federal funds rate.
    - **Congressional Approval:** Not required.
    - **Other Approvals or Limitations:** None.
  - *Primary Dealer Credit Facility*
    - **Purpose:** To provide cash loans to primary dealers to address liquidity strains in the repo markets.
    - **Structure:** The Federal Reserve utilized lending authority under Section 13(3) to provide overnight cash loans to primary dealers at its discount window. Primary dealers are a designated group of broker-dealers and banks that transact with the Federal Reserve Bank of New York in its conduct of open market operations
    - **Congressional Approval:** Not required.
    - **Other Approvals or Limitations:** The Dodd-Frank Act limited the Federal Reserve's emergency lending powers under Section 13(3) by requiring that any emergency lending provide liquidity to the financial system based on "broad-based eligibility" and not to a particular failing financial company or insolvent borrower. The amendments also require the approval of the Secretary of the Treasury prior to the establishment of a Section 13(3) program. In addition, the approval of five governors of the Federal Reserve would be required. The Federal Reserve currently has five governors, creating an effective unanimity requirement.
  - *Term Securities Lending Facility*
    - **Purpose:** To provide short-term liquidity for primary dealers by lending them U.S. Treasury securities for use in repurchase transactions, expanding the System Open Market Account Securities Lending Program, which provided loans only on an overnight basis.
    - **Structure:** The Federal Reserve utilized lending authority under Section 13(3) to make term loans to primary dealers of U.S. Treasury securities for a period of up to 28 days in exchange for collateral.

  - **Congressional Approval:** Not required.
  - **Other Approvals or Limitations:** Due to Dodd-Frank Act restrictions on Section 13(3) authority discussed above, the Secretary of the Treasury would need to provide prior approval. In addition, the approval of five governors of the Federal Reserve would be required. The Federal Reserve currently has five governors, creating an effective unanimity requirement.

- Federal Reserve Programs: Provision of Liquidity to Borrowers and Investors in Short-Term Debt Markets
  - *Money Market Investor Funding Facility*
    - **Purpose:** To provide liquidity to U.S. money market investors through a private-sector initiative.
    - **Structure:** The Federal Reserve utilized lending authority under Section 13(3) to provide senior secured funding to a series of special-purpose vehicles to facilitate an industry-supported, private-sector initiative to finance the purchase of dollar-denominated certificates of deposit and commercial paper issued by highly-rated financial institutions with remaining maturities of 90 days or less from U.S. money market funds ("**MMFs**") and other U.S. money market investors. This facility was authorized but never deployed by the Federal Reserve.
    - **Congressional Approval:** Not required.
    - **Other Approvals or Limitations:** Due to Dodd-Frank Act restrictions on Section 13(3) authority discussed above, the Secretary of the Treasury would need to provide prior approval. In addition, the approval of five governors of the Federal Reserve would be required. The Federal Reserve currently has five governors, creating an effective unanimity requirement.
  - *Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("**AMLF**")*
    - **Purpose:** To help MMFs that held ABCP meet investors' demands for redemptions and to foster liquidity in the ABCP market and money markets more generally.
    - **Structure:** The Federal Reserve utilized lending authority under Section 13(3) to provide nonrecourse loans to U.S. depository institutions, U.S. bank holding companies and their U.S. broker-dealer subsidiaries, and U.S. branches of foreign banks to fund purchases of eligible ABCP from MMFs. AMLF loans were fully collateralized by ABCP purchased by participants. The AMLF was limited to MMFs that had material outflows.
    - **Congressional Approval:** Not required.
    - **Other Approvals or Limitations:** Due to Dodd-Frank Act restrictions on Section 13(3) authority discussed above, the Secretary of the Treasury would need to provide prior approval. In addition, the approval of five members of the Board of Governors would be required. The Board currently has five members, creating an effective unanimity requirement.
  - *Term Asset-Backed Securities Loan Facility*
    - **Purpose:** To support issuance of asset-backed securities ("**ABS**") collateralized by consumer and commercial loans.
    - **Structure:** The Federal Reserve utilized lending authority under Section 13(3) to extend nonrecourse loans to any U.S. company (including the U.S. branches of foreign banks) holding AAA-rated ABS backed by newly and recently originated consumer and small business loans, in an amount equal to the market value of

the ABS less a small haircut. The loans were secured by the underlying ABS. Using its TARP authority, Treasury provided limited credit protection to the Federal Reserve.

- **Congressional Approval:** Not required.
- **Other Approvals or Limitations:** Due to Dodd-Frank Act restrictions on Section 13(3) authority discussed above, the Secretary of the Treasury would need to provide prior approval. In addition, the approval of five members of the Board of Governors would be required. The Board currently has five members, creating an effective unanimity requirement. The TARP authority Treasury relied on for its role in the TALF has since expired.

- FDIC Programs
  - *Temporary Liquidity Guarantee Program ("**TLGP**")*
    - **Purpose:** To preserve confidence and encourage liquidity in the U.S. banking system by (1) improving liquidity in term funding markets and (2) limiting further outflows of deposits.
    - **Structure:** The FDIC (1) provided unlimited insurance for all non-interest-bearing deposit accounts at participating insured depository institutions and (2) guaranteed new debt issued by banks and thrifts, and in certain circumstances their holding companies and affiliates. Entities could participate in TLGP if they were insured by the FDIC, bank or financial companies headquartered in the United States or savings and loan companies.
    - **Congressional Approval:** Would be required.
      - The Dodd-Frank Act provided temporary unlimited deposit insurance for non-interest-bearing transaction accounts that was similar to the original unlimited insurance provided by the FDIC under TLGP. The original unlimited insurance provided by the FDIC under TLGP expired in 2010, and the similar provisions in the Dodd-Frank Act expired at the end of 2012, such that transaction accounts can now only be insured to $250,000.
      - The Dodd-Frank Act provided permanent authority for the FDIC to establish a widely available program to guarantee certain debt obligations of solvent insured depository institutions or solvent BHCs during times of severe economic distress, upon a liquidity event finding. However, the FDIC's guarantee authority must be approved through a joint resolution of Congress.
    - **Other Approvals or Limitations:** The FDIC would need the Secretary of the Treasury, in consultation with the president of the United States, to determine the maximum amount of debt it could guarantee.

- Treasury Programs
  - *Troubled Assets Relief Program*
    - **Purpose:** To allow Treasury to acquire troubled financial assets and inject capital into, and purchase and guarantee the assets of, financial firms.
    - **Structure:** TARP consisted of several different program, which, among others, included the following:
      - *Capital Purchase Program.* TARP included authority for Treasury to infuse capital directly into banks by purchasing preferred shares or warrants in and subordinated debt of such banks. The purpose was to infuse sufficient capital into the banks in order to allow them to overcome the effects of the troubled assets on their balance sheets.

- *Public-Private Investment Program ("**PPIP**").* Pursuant to PPIP, TARP funds and guarantees were provided to private investors, which also contributed capital, for the purchase of mortgage-related securities from banks, facilitating the removal of these troubled assets from the banks' balance sheets. Although initially expected to provide up to $1 trillion in funding, PPIP was ultimately modest in comparison to the other TARP programs.

- *Asset Purchase Program ("**APP**") and Troubled Asset Auction Purchase Program ("**TAAP**").* APP allowed Treasury to buy from certain financial institutions, including banks, thrifts and mutual funds, mortgages and related instruments, including synthetic instruments written, directly or indirectly, on mortgages, and any other financial instrument that the Secretary of the Treasury, after consultation with the Chairman of the Federal Reserve, determined was "necessary to promote financial market stability." Similarly, TAAP allowed financial institutions to sell troubled assets to Treasury. In connection with sales of troubled assets, the institutions were required to provide Treasury with either a warrant or senior debt instrument. Treasury then had discretion to dispose of such assets, whether through private sector purchases or entering into securities loans, repurchase transactions or other financial transactions on such assets.

- *Asset Guaranty Program ("**AGP**").* Under AGP, Treasury would guarantee up to 100% of the principal of and interest on a troubled category or class of assets of financial institutions.

- **Congressional Approval:** Would be required, as TARP was authorized with the enactment of Emergency Economic Stabilization Act ("**EESA**"), and the authorization terminated in 2010.

- **Other Approvals or Limitations:** May be required depending on the specific program requirements.

- *Temporary Guarantee Program for Money Market Funds*

  - **Purpose:** To address dislocations in the credit markets caused by the net asset values ("**NAVs**") of MMF shares dipping below $0.995 (i.e., breaking the buck).

  - **Structure:** Treasury announced a guarantee that provided coverage to MMF shareholders for amounts they held in participating MMFs, which would be triggered if a participating fund's NAV broke the buck. Treasury required participating MMFs to pay an upfront fee of 0.01% or 0.15%, depending on its NAV. MMFs that had broken the buck when the guarantee program was announced were ineligible to participate. Treasury made available assets of the ESF to guarantee payments.

  - **Congressional Approval:** Would be required. EESA prohibited the Secretary of the Treasury from using the ESF for the establishment of any future guaranty programs for the U.S. MMF industry.

  - **Other Approvals or Limitations:** None.

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