Transcript of Open Board Meeting
November 30, 2015

CHAIR YELLEN. Good morning. I'd like to welcome our guests to the Federal Reserve as we consider a final rule to implement the Dodd-Frank Act's amendments to our emergency lending authority. Emergency lending is a critical tool that can be used in times of crisis to help mitigate extraordinary pressures in financial markets that would otherwise have severe, adverse consequences for households, businesses, and the U.S. economy. The Federal Reserve has long had this authority, but has used it only sparingly and only in severe financial crises. Most notably, during the recent severe financial crisis, the Federal Reserve established several broad-based emergency lending programs to provide liquidity to markets, to ensure that credit continued to be available to U.S. households and businesses for mortgages, auto loans, credit card loans, student loans, and other forms of credit. In the Dodd-Frank Act, Congress reviewed the scope of the Federal Reserve's emergency lending authority, and determined to make significant modifications that enabled the Federal Reserve to extend emergency credit only through broad-based facilities and programs designed to provide liquidity to the financial system. The Dodd-Frank Act amendments eliminated the authority to lend for the purpose of aiding a failing firm or preventing a firm from entering bankruptcy or another resolution process, such as was done with loans to Bear Stearns and AIG. In place of this authority to lend to specific firms, Congress enacted a framework for orderly resolution and provisions that encouraged large financial firms to develop plans for their resolution and bankruptcy. These modifications have been in effect since the passage of the Dodd-Frank Act and would govern any lending pursuant to Section 13(3). The ability to engage in emergency lending through broad-based facilities, to ensure liquidity in the financial system is a critical tool for responding to broad and unusual

market stresses. We have received helpful and constructive comments from many sources on the rule to implement these Dodd-Frank Act provisions. In response to these comments, we have made significant changes to the proposed rule, to ensure that our rule will be applied in a manner that aligns with the intent of the Congress and the Dodd-Frank Act. Staff has also consulted with the Treasury department in developing this final rule as required by the Dodd-Frank Act. Laurie Schaffer will describe these changes, but before I turn to Laurie, I would like to ask for unanimous consent that Governor Brainard who has reviewed the memo, rule, and other materials, but who is on travel today, be promoted -- be permitted to vote on this matter electronically. I understand she expects to vote before the end of the meeting this morning. Do I have unanimous consent on that?

VICE CHAIR FISCHER, GOVERNOR TARULLO, GOVERNOR POWELL: Yes.

CHAIR YELLEN. Thank you. With that consent, I now turn to Laurie Schaffer.

LAURIE SCHAFFER. Good morning, thank you Chair Yellen. As you noted, the Dodd-Frank Act made extensive changes to the emergency lending provisions of Section 13(3). Among other things, the amendments repeal the Federal Reserve's authority to extend emergency credit for the purpose of assisting a specific company avoid bankruptcy or resolution and replace that with the authority to extend emergency credit only for the purposes of providing liquidity to the financial system through a facility with broad-based eligibility. As you noted, we have consulted with the Treasury on the draft rule as required by the Dodd-Frank Act, and appreciate their thoughtful suggestions. The draft final rule has been modified to address matters raised by commentators. First, the draft final rule includes two significant changes to limit the definition of a broad-based facility. The final rule requires that at least five persons be eligible to participate in a facility. Importantly, the final rule also has been changed to provide that a facility may not be designed to

assist any number of identified firms to avoid bankruptcy or resolution. This change addresses a concern raised by commentators that the rule not permit grouping of failing or insolvent firms in a single facility. In addition to enhance transparency, the draft final rule provides that the Board will make public and report to Congress a description of the marketer sector of the financial system to which a facility with broad-based eligibility is intended to provide liquidity. Second, a number of commenters urged the Board to adopt a definition of insolvency for purposes of the statutory prohibition on lending to insolvent firms, that is broader than the definition of insolvency and contained in the Dodd-Frank Act. The draft rule expands the definition of insolvency by including potential borrowers that have generally not been paying their undisputed debt as they became due during the 90-days preceding their borrowing from the facility. The rule also provides that the Board may otherwise determine on other basis that a borrower is insolvent. The final rule clarifies that loans may not be made to companies that are borrowing for the purpose of lending to insolvent companies. Third, the Dodd-Frank Act amendments to Section 13(3) permit the Federal Reserve to rely on a certification from a borrower that the borrower is not insolvent. To improve the reliability of a certification, the final rule provides that all loans to a borrower will become immediately due, including all interest, fees, and penalties, if the borrower has made a willful material misrepresentation. Significantly, the rule has been changed to provide that the Federal Reserve will refer the matter to law enforcement for appropriate action if a certification contains such a misrepresentation. Fourth, commenters urge the Board to specify that emergency loans must charge a penalty rate of interest. The Federal Reserve's practice in extending emergency credit has been to impose a penalty rate designed to encourage borrowers to repay the credit as quickly as possible once conditions have normalized. The draft final rule explicitly includes a requirement that emergency loans be made at a penalty rate, and

contains a list of factors that the Board will take into account in establishing the penalty rate. Fifth, the draft final rule provides that the Board will review each facility, at least every six months, to ensure that it continues to be needed. In addition, the final rule has been changed to provide that each facility will terminate within one year from its first extension credit or its latest renewal, unless the Board determines, with the approval of the Secretary of the Treasury, to renew the facility. The final rule also includes all of the provisions required by the Dodd-Frank Act, such as the requirement that the facility be approved by the Secretary of the Treasury and that the reserve banks determine the lendable value of any collateral accepted. There are a number of other changes discussed in more detail in the memo and the *Federal Register* notice that accompanies the rules. These include a provision prohibiting discrimination lending on the basis of race, gender, color, religion, national origin, age, or disability, and providing that the selection of third-party vendors used in the implementation emergency facilities will be on equal-opportunity basis consistent with law. This concludes my prepared remarks. My colleagues and I would be pleased to answer your questions. Thank you.

CHAIR YELLEN. Thank you very much, Laurie. Let me just ask you one question pertaining to the penalty rate. Some of the commenters proposed that we simply establish a fixed spread over LIBOR or UST bills, and the final rule doesn't do that. I wonder if you could define -- discuss the thinking that went behind the definition and implementation of the penalty rate?

LAURIE SCHAFFER. I'm going to defer to Bill Nelson.

BILL NELSON. Over the course of the crisis, of course, we were faced with a number of different situations and lent in a number of different ways, each of which required a different base rate or a different -- a different penalty that was appropriate, but in each and every case, we imposed a substantial penalty over an appropriate-based rate in the order of 50 to 100 basis

points typically across the different facilities. Some cases, 300 basis points, and in every case, all of those premium rates led to the facilities' use, either dropping off quickly as the situation normalized, or if the loans were a bit longer-termed, the loans themselves were repaid early and promptly. So it's our expectation that -- so we need -- although we need flexibility to confront situations, which could be different than those that we've experienced and we can't predict in advance precisely how the lending will be needed. We think that sticking to our current -- the practice that we followed of charging a substantial penalty over what was -- what prevailed in normal times, should give us the flexibility while still at time be consistent with speedy repayment and not providing a subsidy to the borrowers.

SCOTT ALVAREZ. Chair Yellen, in order to make that effective, the rule specifically provides that the Board will charge a penalty rate, that it will be a premium above the rate in normal times, that it will be a rate that encourages repayment as the conditions normalize. So we've laid out factors specifically in the regulation that were used in the past and were successful in the past, but are now in the rule itself.

CHAIR YELLEN. Great, thank you very much. Vice Chair?

VICE CHAIR FISCHER. Just a few questions. Thank you Madame, Madame Chair. First, let me say that you conclude--near the end, you mentioned that Gramm-Leach-Bliley specified that the Fed banking agencies should use plain language in all proposals and final rules published after January 1, 2000. This one amply meets that standard, namely I was able to understand it, and I thank you for, for taking that request seriously.

SCOTT ALVAREZ. Thank you, that's an accomplishment for lawyers.

VICE CHAIR FISCHER. Yes, that's what I thought. I have four questions. First, where does the number five come from? How did we decide on five participants?

LAURIE SCHAFFER. The number five was contained in legislation that was introduced in Congress, and it provided--since the rule defines broad-based eligibility to a marketer sector, it seemed that the number five was an appropriate number in considering that the purpose was to lend to a specific--to a marketer sector, which would likely have at least five participants in it.

SCOTT ALVAREZ. But one addition I would make to that is while the number five is--was in legislation, we took it from the legislation as one criteria for deciding broad-based, five does not dictate the number of failing firms that could be in a facility. There's no number of failing firms. A facility could not be designed to help any number of failing firms, because the statute does not permit a facility for the purpose of aiding failing firms avoid bankruptcy. So five is a symbol of the minimum number of market participants, but not intended to define--to override the failing firm prohibition.

VICE CHAIR FISCHER. Thanks. There's a specification that the rate could be set by analysis by the Fed, but could be done by an auction. Will the auction rate dominate? Suppose the auction rate happens to come in below the rate the Fed would have fixed, what happens?

BILL NELSON. At least during the crisis, in almost all cases, we did set a rate, but there were some instances--the one that jumps out is the TSLF which was an emergency facility—that, for which the fee associated was set by an auction, but there was a minimum set, stop-out, for that fee which was itself chosen to be above the fee that would have prevailed for a similar type of facility in normal times, and the fee in auction was never allowed to fall below that minimum fee. So that would be a way to combine both an auction mechanism of setting the rate while at the same time ensuring that the rate, or in this case the fee, was above what would be normal, in normal times, while still potentially below what was prevailing in the market in the crisis.

VICE CHAIR FISCHER. Okay, and that's what would be done in this?

BILL NELSON. Yes, it would be done.

VICE CHAIR FISCHER. Thanks. Next question. The draft proposes that all facilities be closed after a year. What does closing mean?

SCOTT ALVAREZ. That would be no further extensions of credit from that facility. If, for example, we had a facility like the TALF, where the extensions of credit were, when they were initially given, the term of the credit was three years or five years, those credits would stay outstanding until repaid, but there'd be no new credits issued after one year unless the Board renewed the facility, found that that the facility continued to meet all the statutory requirements, and the Secretary of the Treasury agreed and approved.

VICE CHAIR FISCHER. So there'd have to be a positive finding by the Board?

SCOTT ALVAREZ. Yes.

VICE CHAIR FISCHER. And finally, you mentioned in the beginning a list of comments that have been received and then you proceeded to discuss those. Did all of the comments that you received get mentioned in this presentation?

SCOTT ALVAREZ. So the memo goes through all the comments that we received. There were--some of the commenters--there were two or three commenters who didn't make specific suggestions, just generally spoke about the importance of facilities, but then other commenters, we did try to note their comments, and some of them were very general, so not always specific--with specific suggestions, but more just ideas that we should consider, but others with specific suggestions, and we noted those in the memos.

VICE CHAIR FISCHER. Now I have a grammatical point. “Indorsement” is the same as “Endorsement?” And what is the rule in legalese? Does “I” substitute for “E” if it becomes before an “N”?

SCOTT ALVAREZ. Except after "C"? Yes, it's indorsement because that's the way that it's in the statute--that's all. Otherwise we would have moved to a modern term with an E.

LAURIE SCHAFFER. It's in the statute.

VICE CHAIR FISCHER. Oh, that's--it's an old spelling?

SCOTT ALVAREZ. Yes.

SOPHIA ALLISON. It's more archaic.

VICE CHAIR FISCHER. Okay, well thank you very much. Thank you, Madame Chair.

CHAIR YELLEN. Thank you. Governor Tarullo?

GOVERNOR TARULLO. Thank you, Madame Chair. I actually don't have any further questions, because I've had an opportunity through the individual briefing process to ask the staff a number of things. But as I think you know, because I have a prior longstanding commitment that I have to leave for, it's probably useful if I state my position now. So let me just say that, I think as everybody on the Board is aware, we've got a longstanding tension between the policy aims of containing moral hazard through ex-ante constraints on how we can provide liquidity on the one hand, with wanting to retain flexibility to provide such liquidity as may be needed to combat unanticipated sources of serious financial stress on the other. We will recall that our predecessors observed at the time of the failures to which the chair alluded, Bear Sterns and AIG, that the then Board thought it confronted a very unpalatable choice between a disorderly failure of one of those institutions, which could have had serious knock-on consequences for the rest of the economy, and having to use the 13(3) capacity to provide substantial amounts of liquidity at the time. Congress, in changing 13(3), didn't just change 13(3), it also created Title 2 and required us to do resolution planning, and I think we need to look at the those three pieces of Dodd-Frank as a package and to interpret 13(3) in light of those other provisions. And I would

say I think the proposed final rule does a much better job of balancing the tradeoffs between the ex-ante moral hazard constraining policy aim and the ex-post desire to be able to provide liquidity to the financial system when that be, when that's needed. So I'm in support of the rule and will vote at such time as you tell me to, Madame Chair.

CHAIR YELLEN. Would you like to vote now given the time constraint? If so, let's let you do that, and then we will return to questioning. So I need a motion to approve the 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 and related changes recommended by staff, and also to authorize staff to make technical and minor changes to prepare the related *Federal Register* documents for publication.

VICE CHAIR FISCHER. So move.

CHAIR YELLEN. Thank you. Second?

GOVERNOR TARULLO. Second.

CHAIR YELLEN. Good. So Governor Tarullo, why don't I ask you to vote now and then the rest of us will complete questioning and vote, vote subsequently?

GOVERNOR TARULLO. I vote in favor then.

CHAIR YELLEN. Thanks very much.

GOVERNOR TARULLO. And thank you for your consideration.

CHAIR YELLEN. Thank you. Okay, so let's continue questioning, Governor Powell?

GOVERNOR POWELL. Great. Thank you, Madame Chair. I would start by saying that I think the staff has done quite a good job of considering and incorporating, where possible, the public comments, and I think the result is to clarify and meaningfully strengthen the new restrictions on our emergency lending powers under section 13(3), but in a way that is very much in keeping

with the spirit of those restrictions. One area in which we held off from incorporating comments, I believe, is in the treatment of collateral. There were suggestions among commenters that limits be imposed on the kinds of collateral that we could accept under the emergency lending programs and that there be independent appraisals and that kind of thing. We didn't include those, and I just wonder if you could address the thinking behind that.

SCOTT ALVAREZ. So the Federal Reserve, in its lending both to banks and nonbanks, has taken a variety of collateral through the years, and to address the various risks associated with collateral, we have a pretty robust process for valuing the collateral and giving--taking haircuts to the collateral to ensure that there's sufficient value there, and so that is the current plan. We've referred commenters to our discount window process which explains how collateral is valued and the discounts, the haircuts that are taken. We do require that, in the rule, that the Reserve Bank make a valuation of collateral that it accepts as credit for a loan, and also ensure in doing the valuation that the collateral be sufficient to protect taxpayers from losses. And I would say that we have not had any losses in our credit extension so far, so that process that's already in place has worked very well. Bill, did you want to add anything?

BILL NELSON. I think that's a complete answer.

GOVERNOR POWELL. Thank you. Thank you, Madame Chair.

CHAIR YELLEN. Any other questions? Okay. Then why don't we go around and state positions, and then we will vote. Vice Chair?

VICE CHAIR FISCHER. I support the passage of these rules.

CHAIR YELLEN. Governor Powell?

GOVERNOR POWELL. As do I.

CHAIR YELLEN. And so do I. So we already have, Bob, is that right? The motion is--has already been made, so let's vote. All in favor?

ALL. Aye.

CHAIR YELLEN. And opposed? No. Thank you. The rule passes. Thank you to all of the staff who've worked so hard to bring this to fruition. Appreciate it.