

The History of a Powerful Paragraph

Section 13(3) enacted Fed business loans 76 years ago

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When the Federal Reserve Board authorized the Federal Reserve Bank of New York to lend \$29 billion to JPMorgan Chase in connection with its purchase of Bear Stearns, much was written about *why* the Federal Reserve took such an action, and appropriately so. That discussion will likely ensue for many years. However, little attention was focused on *how* the Federal Reserve was able to take such action; that is, by what legal authority did the Federal Reserve intervene in the business of a non-bank (in this case an investment firm).

The broad answer to that question is the obvious one—the Federal Reserve Act provides such authority. The specific answer is Section 13 paragraph 3 of the Act, which begins: “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 ...,” and then there’s a lot of technical language which essentially means that the Federal Reserve can lend money to “any individual, partnership, or corporation,” as long as certain requirements are met.

And with that paragraph comes a story. However, it’s a rather long story, and one that we’ve already told in the *Region* magazine, so we’re going

to give you the executive summary here and direct you to our online archives and the December 2002 issue where we explored the history of this lending authority in greater length (“Lender of *More Than Last Resort*”).

When describing the Federal Reserve’s response to the Bear Stearns episode, observers have used words like “extraordinary” and “unprecedented.” And that’s true, to a point; namely, this is the first time the Federal Reserve has used this power since the Federal Reserve Act was amended in 1991 (see below). But it’s not the first time that Federal Reserve banks have made loans to businesses—all types of businesses, not just those related to the financial services industry. It won’t surprise you to learn that these loans began during the Great Depression, but they also continued for nearly 20 years.

This isn’t simply a story about extraordinary measures taken long ago that have no meaning for today. Rather, it’s a story about the long-standing debate about the nature and purpose of Federal Reserve banks. In that regard, this story ultimately gets to the heart of the *why* question regarding the Federal Reserve’s recent actions.

Here are key legislative dates and related events:

1932 Emergency Relief and Construction Act: Added paragraph 3 to Section 13 of the Federal Reserve Act, opening the discount window to nonbanks “in unusual and exigent circumstances.”

123 loans were made over four years by all 12 Federal Reserve banks, totaling about \$1.5 million.

1933 Emergency Banking Act: Allowed 90-day advances to nonbanks on the security of direct obligations of the U.S. government, at interest rates fixed by the Reserve banks.

1934 Industrial Advances Act: Added Section 13(b) to the Federal Reserve Act, allowing Federal Reserve district banks to make advances of working capital to established businesses if these enterprises were unable to find such capital from usual sources. These loans were made either in partnership with a commercial bank or directly to a business, with maturities up to five years and no loan limits.

Nearly \$280 million, or about 0.43 percent of gross national product, with each district apportioned a fraction, was made available for loans to businesses from Federal Reserve banks.

Through 1935, 1,993 loans totaling about \$124.5 million met with Reserve bank approval. The following year, 287 loans were approved, and 126 in 1937.

Section 13(b) would reap its largest single-year total in 1942, when war production spurred over \$128 million in loans.

1958 Small Business Investment Act: Repealed Section 13(b).

1970 The Nixon administration asked for discount window assistance in response to the financial problems of Penn Central Railroad. This request stalled in Congress, but the Federal Reserve worried that the company’s default would spark a financial crisis, and it made clear that it would assist banks that needed help with businesses caught up in Penn Central paper.

1975 The financial difficulties faced by the city of New York raised questions about whether the Federal Reserve might serve as a source of emergency credit. Federal Reserve officials cautioned against such an idea and, in the end, the Federal Reserve served only as a fiscal agent for the government’s eventual loans to the city. (The Federal Reserve also served as fiscal agent for loan guarantees made to Lockheed in 1971 and Chrysler in 1979.)

1991 The Federal Reserve discount window was invoked to dispense \$25 billion as a direct loan to the Federal Deposit Insurance Corporation’s Bank Insurance Fund. Then-FDIC Chairman L. William Seidman requested the loan, through Congress, but Fed Chairman Alan Greenspan testified in opposition. Undeterred, the Treasury Department made another pitch to Congress for the \$25 billion based, in part, on the initial Fed subscription imposed by Congress in 1933, but Congress said no.

1991 FDIC Improvement Act: Amended Section 13 paragraph 3 to allow the Fed to lend directly to nonbank firms during times of emergency.

2001 In the days following the terrorist attacks of Sept. 11, 2001, some observers suggested that—based on the 1991 amendment—the U.S. airline industry could receive emergency loans. “[T]his sector’s key economic role and the unpredictable after-effects of September 11 justify putting discount-window loans on the table while discussing the carriers’ current crisis,” the Financial Markets Center said in a Sept. 18, 2001, statement. The Fed did not make such loans.

2008 The Federal Reserve Bank of New York agreed to lend \$29 billion in connection with the acquisition of Bear Stearns by JPMorgan Chase. The loan was granted under the authority of Section 13(3) of the Federal Reserve Act. The Federal Reserve Board authorized the New York Fed to enter into this loan and made the findings required by Section 13(3) on Sunday, March 16, 2008.

For the rest of the story, please visit minneapolisfed.org/pubs/region/02-12/lender.cfm.