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Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the COVID-19 Bankruptcy Crisis

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ABSTRACT

This paper outlines how the Federal Reserve can use its non-emergency statutory authority to substantially improve the functioning of debtor-in-possession financing markets during the bankruptcy crisis triggered by the COVID-19 pandemic. We argue that, contrary to restrictions on the Fed's emergency lending authority in Section 13(3) of the Federal Reserve Act, Section 10B permits the Fed to increase support for bank-led debtor-in-possession financing sufficient to meet the scale that this crisis presents. After explaining in detail the Fed's statutory authority to intervene in these markets, we discuss several important benefits and manageable costs of this approach. The benefits include, first, better facilitation of bank-based financing for bankrupt firms and the reciprocal reduction of financing from the shadow banking sector and, second, better insight for the central bank into this important sector of the financial system for macroeconomic and financial stability purposes. The costs include perceptions of illegality given the limitations on the Fed's emergency lending authority, the risk of undermining the Fed's independence for monetary policy, and concerns about central bank meddling in the political prerogatives of Congress and the President. We argue that these costs, though real, are manageable and in any case less than the benefits of intervention.

THIS PAPER IS ONLINE AT

https://www.brookings.edu/research/using-the-federal-reserves-discount-window-for-debtor-in-possession-financing-during-the-covid-19-bankruptcy-crisis/

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Introduction

In February 2020, the world entered into a profound and unprecedented economic contraction in response to the COVID-19 pandemic and the policy response to that public health emergency. In its role as the nation's—and increasingly, the world's—monetary policymaker, the U.S. Federal Reserve reacted swiftly, using conventional and unconventional policies to soften the blow to the macroeconomy. Its reactions included conventional monetary policy, which dropped its benchmark interest rate by 175 basis points in two weeks, the steepest such drop in its history. The Fed significantly increased its support of primary dealers, through liquidity provisions to the repo markets. It reanimated its large-scale asset purchases authorized under Section 14 of the Federal Reserve Act, the backbone of its monetary policy response in the aftermath of 2008. And it broke the glass on newly reshaped emergency lending policies by activating all of the emergency lending facilities created in response to the 2008 under Section 13(3) of the Federal Reserve Act as a baseline before expanding even further.

It quickly became clear that numerous businesses would be forced to file for bankruptcy during the crisis. Some of these firms were already on the brink of bankruptcy, despite record economic growth and sky-high asset valuations in the capital markets. But thousands more would be caught in a vice where their debt required servicing but their revenues evaporated, often as the result of the requirement that the businesses themselves shut off access to those revenues.

If these firms are forced to confront bankruptcy in a financial environment under severe distress, they will face several potentially severe problems. The first problem is congestion. Although Chapter 11, the reorganization provisions in U.S. bankruptcy law, generally works well, the process is much less effective if the bankruptcy court is congested: small and medium-sized firms are significantly less likely to reorganize successfully, and the reorganization of large firms is more costly and takes longer. Second, and related, many businesses, especially small and medium-sized businesses, may find it impossible to arrange the financing they need to fund their operations during the bankruptcy process. Firms that are unable to obtain financing—known as "debtor in possession" or "DIP" financing—are far less likely to reorganize than those that do. That failure to reorganize means liquidation and all the macroeconomic harms associated with it: job loss, loss of economic productivity, consumer choice, local culture, and much more.

Responding to the second of these concerns, several commentators have recommended greater participation of the federal government in preventing COVID-related liquidation.[1] Stanford economists Peter DeMarzo, Arvind Krishnamurthy, and Joshua Rauh argue that the Fed should use its emergency authority to provide a Debtor-in-Possession Financing Facility (DIPFF). The DIPFF "would offer DIP

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1. See Adam J. Levitin, Lindsay Owens, and Ganesh Sitaraman, "No More Bailouts: A Blueprint for a Standing Emergency Economic Resilience and Stabilization Program," Great Democracy Initiative, June 2020, available at https://greatdemocracyinitiative.org/wp-content/uploads/2020/06/No-More-Bailouts-Final-Copy-.pdf; Kathryn Judge, "Congress Should Allow the Fed to Make Loans to Bankrupt Companies,"Forbes, July 22, 2020, available at https://www.forbes.com/sites/kathrynjudge/2020/07/22/congress-should-allow-loans-to-bankrupt-companies/#60e5d7e63a7f; David Skeel, "Bankruptcy and the Coronavirus," Economic Studies at Brookings (April, 2020).

financing" at 0% interest directly to bankrupt firms, with various contracted parties underwriting the process, the loans fully collateralized.[2]

We agree that the Fed has an important role to play in supporting viable firms whose substantial loss of revenue will require reorganization. But there are three problems with the Stanford proposal and others like it. First, it is illegal, since the Federal Reserve Act (as amended in 2010 by Dodd-Frank) explicitly forbids emergency loans of any kind "if the borrower is in bankruptcy."[3] Second, the Fed has very little experience with credit policy of the kind described and is likely to become highly politicized should it undertake this kind of bilateral exposure. This is even truer in the context of bankruptcy reorganization than it is in the Fed's other forays into credit policy in 2020. Third, it makes the Fed a competitor to the banks it regulates, providing financing that might best be subject to market forces that are, even in this crisis, still operable.

In this paper— the precursor to a larger law review article that will develop and defend these ideas at more length—we outline and defend a proposal that would capture the benefits of Fed participation in debtor-in-possession financing while avoiding the three costs identified above. We propose that the Fed use its existing authority under Section 10B of the Federal Reserve Act—the so-called "discount window"—to lend to depository institutions already subject to bank supervision and regulation to provide that DIP lending directly. Subject to the restrictions identified in Section 10B, we argue that the Fed should open a separate discount window facility with added inducement for participating firms to enter the DIP space and develop the requisite expertise to fuel bankruptcy reorganization and to minimize the deadweight loss that liquidations might impose on a system in crisis.

Of course, the discount window is open and available for business, as it has been since the Federal Reserve Banks opened their doors in 1914. But the existing conceptions of the Fed's discount window make it ill-suited for this occasion.[4] We propose a specific discount-window facility to move forward the Fed's evolution of the discount window away from crisis lending to support the banks and toward a more effective instrument of credit policy whereby bank-intermediated liquidity with specific purposes can arise to meet the needs of specific crises. Whereas the three general discount window facilities—for primary, secondary, and seasonal credit—and one emergency discount-window facility—the term-auction facility of 2008-2010—could arguably accomplish some of the tasks we describe below, a more specialized facility can accomplish three things that these generic facilities cannot. First, it places the Fed more squarely in the role of pushing credit to specific markets, as opposed to awaiting, reactively, for banks to make use of the Fed's credit availability as a last resort. This forward-leaning scheme—similar to what in the United Kingdom is called "Funding for Lending"[5]—would give a specific purpose to the lending that does not exist in the generic facilities.

Second, the institutional development of a DIP Discount Window Facility would beckon bankers who do not traditionally provide this financing with incentives—positive and negative—to develop that expertise in ways that a generic discount window would not invite. Finally, it would present the Fed an

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2. Peter M. DeMarzo, Arvind Krishnamurthy, and Joshua D. Rauh, "Debtor-in-Possession Financing Facility (DIPFF) Proposal, June 20, 2020, available at https://www.gsb.stanford.edu/sites/default/files/publication-pdf/dipff.pdf

3. 12 USC § 343

4. For one articulation of the discount window's purpose as a reactive lender to banks, see Lev Menand, "Unappropriated Dollars: The Fed's Ad Hoc Lending Facilities," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3602740

5. See Bank of England, "The Bank of England's Operations Under the Funding for Lending Scheme," June 3, 2019, available at https://www.bankofengland.co.uk/-/media/boe/files/markets/funding-for-lending/operating-procedures.pdf

opportunity to re-evaluate the regulatory structure around discount window facilities that could be created for specific challenges. Not all collateral is created equal for the kinds of lending that its discount window facilities would require, and not all access is created equal, either. The Fed's increase of discount-window facilities would provide it with more opportunity to develop credit policy adjacent to discount-window lending, a process the Fed has already undertaken quietly but has not yet fully justified.

We see several benefits of Fed-supported, bank-intermediated DIP funding. First, and most importantly, bankruptcy financing support for viable businesses in the current crisis is vital for the economy's ability to rebound. Fed support will enhance financial stability, too, as viable companies accept low-interest loans to weather the crisis, providing useful assets for banks in an otherwise uncertain time. Second, it will do more to bring the DIP financing into the bank regulatory and supervisory framework rather than in shadow banking, where a growing percentage (roughly 22%) of DIP financing currently resides.[6] Third, it will give the Fed useful insights into the operations of bankrupt institutions, insights that will be essential in both monetary policy and financial regulation. Finally, unlike Section 13(3)-based proposals, a discount-window facility would clearly be legal, giving it legitimacy as the Fed honors the constraints that Congress has imposed on it.

Developing another discount-window facility is not without costs. First, a discount-window authority relies on the assumption that banks will participate, an assumption that emergency lending facilities and fiscal programs—including the Main Street Lending Facility, as currently configured—have sometimes exposed as faulty. We argue that the economics of DIP financing should be made favorable for the bankrupt entity and banks in ways that may not apply to other lending facilities, and that participation can be encouraged by supervisory pressure.

Second, bankruptcy lending puts the Fed in a position of supporting specific bankruptcy plans, including those that impose significant payroll losses, for example, or impose haircuts on politically active creditors. We see the non-emergency nature of the discount window and the intermediation by banks as the answer to this concern: decisions will be bank-driven and Fed-supported, just as is the case in the traditional discount window.

Third, the Fed's participation in a process that is primarily fiscal, as in the case of the GM or Chrysler bankruptcies, prompts concerns about protecting the Fed from politics and protecting politics from the Fed. These concerns are valid, perhaps even dispositive when normalcy returns at some post-COVID date. But by using the underwriting processes of banks, a discount-window facility would in fact take the Fed out of the business of credit policy and place it more comfortably into the business of providing (targeted) liquidity to regulated and supervised banks.

Perhaps because of the Fed's swift responses to the crisis, the fiscal stimulus that occurred at the end of March, or for other reasons, a predicted wave of bankruptcies has not yet landed. But the first hints of a steep rise in business bankruptcy filings seem to be emerging.[7] We argue that, in the likely event a wave materializes, greater liquidity support, narrowly tailored, by the Fed —especially for small- and medium-sized firms—will be vital for speeding recovery to this economic cataclysm.

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6. B. Espen Eckbo, Kai Li, & Wei Wang, "Rent extraction by super-priority lenders," working paper, March 13, 2020, pp. 12-13. Eckbo at al find distinguish between insider-provided and new loans made by hedge and private equity funds. We have combined the two.

7. See Katy Stech Ferek, "U.S. Business Bankruptcies Rose 48% in May," Wall Street Journal, June 4, 2020.

I. Bankruptcy and COVID-19

When a company files for bankruptcy, seeking to reorganize under Chapter 11, its most immediate need is usually liquidity to fund its operations. Bankruptcy's automatic stay— a standstill that prohibits creditors from continuing to take measures to collect what they are owed[8]—is helpful in this regard, since it enables the debtor to stop paying its current obligations. But business debtors often need access to additional funding, either from the pre-bankruptcy lenders or from new lenders.

Under the DIP financing provision, the bankruptcy judge can give the new loan several kinds of priority treatment, including "administrative expense status" (which is the highest priority after creditors who have collateral) or a lien secured by collateral of the debtor. If pre-bankruptcy lenders already have a lien on all of the debtor's assets, the court can even give the new lender a "priming lien" in some circumstances, as discussed below.

Companies that are preparing to file for bankruptcy usually attempt to line up their DIP financing before filing, so that it is available early in the bankruptcy process. If the proposed financing has been arranged, the debtor asks the bankruptcy judge to approve the financing as part of the debtor's request for "first day orders" at the beginning of the case. (Other standard terms in the first day orders are requests to continue paying the debtor's employees, to pay "critical vendors," and to formally retain the debtor's bankruptcy lawyers and financial advisors.) Courts often approve the proposed DIP financing on an interim basis and schedule a hearing to make a final determination a week or two later, giving other creditors enough time to lodge any objections.

A generation ago, DIP financers were almost always banks, of all sizes. More recently, hedge funds and other distressed debt investors now play an increasingly important role in the DIP financing market alongside only the largest banks. According to one recent study of the bankruptcy financing obtained by the largest bankruptcy debtors, banks protected roughly 78% of the funding and hedge funds 22%.[9] The bank funding tends to come from the largest banks. Smaller banks are much less likely to be a source of bankruptcy loans.

Numerous studies of DIP financing have found that debtors that obtain DIP financing are far more likely to successfully reorganize than those who do not.[10] Similarly, the market value of a company's debt rises if it obtains DIP financing.[11] Whether this is because the firms that obtain DIP financing are stronger or because the DIP financing enhances the firms' ability to reorganize (or both) is not clear. Either way, DIP financing is often essential for reorganization.

For the purposes of thinking through the COVID-19 bankruptcy crisis and appropriate policy responses, three features of the debtor-in-possession financing market are of particular interest. First, the largest firms are much likelier to obtain DIP financing than smaller businesses.[12] In recent weeks, firms

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8. 11 U.S.C. § 362(a).

9. Eckbo et al *supra* note 6 at 12-13. As noted earlier, *supra* note 8, the authors distinguish between insider-provided and new loans, whereas we combine the two.

10. Early studies finding debtors with DIP financing are more likely to reorganize include Sandeep Dahiya, Kose John, Manju Puri, and Gabrile Ramirez, "Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence," Journal of Financial Economics 69 (2003): 259; Maria Carapeto, "Does Debtor-in-Possession Financing Add Value?," Working Paper, 2003.

11. Frederick Tung, "Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis," Yale Journal on Regulation 37 (2020): 651, 659-60.

12. Dahiya et al, *supra* note 10.; Carapeto *supra* note 10.; Eckbo et al *supra* note 6.

such as J.C. Penney and Neiman Marcus have had ready access to bankruptcy loans, but this is less likely to be true for smaller debtors. For the smallest businesses, the absence of financing may not be problematic. The principal benefit of bankruptcy for them, as for many consumer debtors, is to shed their debt and start over. With medium-sized businesses, by contrast, the potential lack of access to bankruptcy funding is more problematic, at least during the current crisis, since many medium-sized businesses that were healthy prior to the crisis may need to file for bankruptcy in the coming months. (For our purposes, we use "small businesses" to refer to companies with assets under $10 million and "medium-sized" as firms with assets of $10 million to 50 million.)

Second, in a majority of cases a debtor's pre-bankruptcy lenders also serve as the DIP financers. One new empirical study finds that the DIP loan is made by existing lenders in 75% of the cases in the sample.[13] Other studies also have found that a substantial majority of DIP loans are made by pre-bankruptcy lenders.[14] The pattern has an obvious logic: the prebankruptcy lenders already have substantial information about the debtor and are often well positioned to provide the operating funds the debtor needs. From this perspective, the prevalence of insider loans is appropriate and to be expected. There also is a risk, however, that the insider lenders' information advantage will discourage other potential lenders from competing to serve as the DIP financer. The structural advantage enjoyed by the debtor's current lender could be part of the explanation for researchers' findings that DIP lenders have consistently earned supra-competitive profits on bankruptcy loans.[15]

Third, because most debtors desperately need funding, the DIP lender has significant leverage, which it can often use to dictate the course of the case. While DIP lender control dates back several decades, it seems to have increased in intensity more recently.[16] According to one recent study, 86% of recent DIP financing agreement impose "milestones"—such as a requirement that the debtor agree to an asset sale if it is not able to quickly propose a reorganization plan.[17] Lender control sometimes enhances the efficiency of the bankruptcy process. For the first decade or so after the current bankruptcy framework was enacted in 1978, the debtor's managers were thought to have too much power, since only they were permitted to propose a reorganization plan. The managers often seemed to prolong the case, which enabled them to extract concessions from creditors. By imposing strict constraints in DIP financing agreements, DIP financers have counteracted this inefficiency.

Lender control also has a dark side, however. The DIP financer may insist on benefits that improve its position at the expense of other creditors. One common strategy—known as a "roll-up"—is to insist that the debtor pay off the earlier loan with proceeds of the DIP loan, which ensures that the earlier loan is paid in full even if it was not actually fully collateralized.[18] The DIP financer may also ask the debtor to waive causes of action the debtor may have against the DIP financer.

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13. Tung, *supra* note 11 at 655 n.13..

14. *See, e.g.,* Eckbo et al, *supra* note 6 at 12-13 (also finding that 75% of DIP loans are made by pre-bankruptcy lenders).

15. Eckbo et al, *supra* note 6. Similarly, Tung finds that the pricing of DIP loans is similar to that of junk bonds, despite the low default rate. Tung *supra* note 11 at 687.

16. For early discussion of DIP lender control, see Douglas G. Baird & Robert K. Rasmussen, "The End of Bankruptcy," Stanford Law Review 455 (2002): 751; David A. Skeel, Jr., "Creditors' Ball: The 'New' New Corporate Governance in Chapter 11," University of Pennsylvania Law Review 152 (2003): 917.

17. Kenneth Ayotte & Jared A. Ellias, "Bankruptcy Process for Sale" (unpublished manuscript, May 26, 2020).

18. See, for example, Tung, *supra* note 11 at 667.

The other major risk is that the DIP lender will use its leverage to dictate an outcome that benefits the DIP lender but diminishes the overall value of the firm. Rather than allow the debtor to pursue a traditional reorganization, the DIP lender may condition its loan on a prompt sale of the debtor's assets. One study found that DIP lenders are particularly likely to press for a sale if they are significantly overcollateralized, since they derive little benefit from a lengthy reorganization and are likely to be paid in full in connection with a sale.[19]

Each of these factors needs to be considered in ensuring there is sufficient access to necessary bankruptcy funding during the current crisis.

II. Federal Reserve Support for Debtor-in-Possession Through the Discount Window

Leaving market actors to handle the coming bankruptcy tumult on their own is likely to exacerbate—perhaps severely—the macroeconomic crisis. In this section, we discuss two proposals for addressing this issue through the Federal Reserve.

A. The Stanford Proposal

In a widely cited policy brief posted to their websites, Stanford economists Peter DeMarzo, Arvind Krishnamurthy, and Joshua Rauh argue for a "Debtor-in-Possession Financing Facility" wherein the Fed would become the financier to bankrupt entities. They note that most systemic efforts, through conventional monetary policy, large-scale asset purchases, and market-level emergency lending facilities, however useful for economic stability, are too "diffuse" in their benefits to do much more than stabilize marginal firms. Instead, they argue for the creation of the DIP Financing Facility to intervene directly into these markets to "offer DIP financing at an interest rate equal to the Federal Reserve Discount Rate (currently zero)." They also envision that the Treasury will participate in making an "equity investment" in the special-purpose vehicle designed to accomplish this purpose.[20]

The many benefits of the Stanford proposal are summarized above in Part I: Fed intervention to stabilize and add liquidity to the DIP markets would permit far more firms to weather the COVID-19 crisis and emerge ready to participate in the macroeconomy as producers, consumers, and employers.

The major problem with the Stanford proposal is that it is illegal. Although the Stanford proposal does not identify the legal authority that the Fed would use in creating the DIP financing facility, the only one available for lending to non-depository institutions is the Fed's emergency lending authority under section 13(3) of the Federal Reserve Act. After the extensive use of this authority in 2008-2010, Congress substantially altered the basis on which the Fed may make emergency loans. As relevant here, the revised Section 13(3) requires "a certification from the chief executive officer (or other authorized officer) of the borrower . . . that the borrower is not insolvent." Lest there be any doubt whether a bankrupt entity is insolvent, the statute clarifies that "[a] borrower shall be considered insolvent for purposes of this subparagraph if the borrower is in bankruptcy."[21]

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19. Ayotte & Ellias develop additional theories as to why DIP financers may have an inefficient tendency to press for early sales, although they do not find strong evidence of this effect. Ayotte & Ellias, *supra* note 17.

20. Peter M. DeMarzo, Arvind Krishnamurthy, and Joshua D. Rauh, "Debtor-in-Possession Financing Facility (DIPFF) Proposal, June 20, 2020, available at https://www.gsb.stanford.edu/sites/default/files/publication-pdf/dipff.pdf

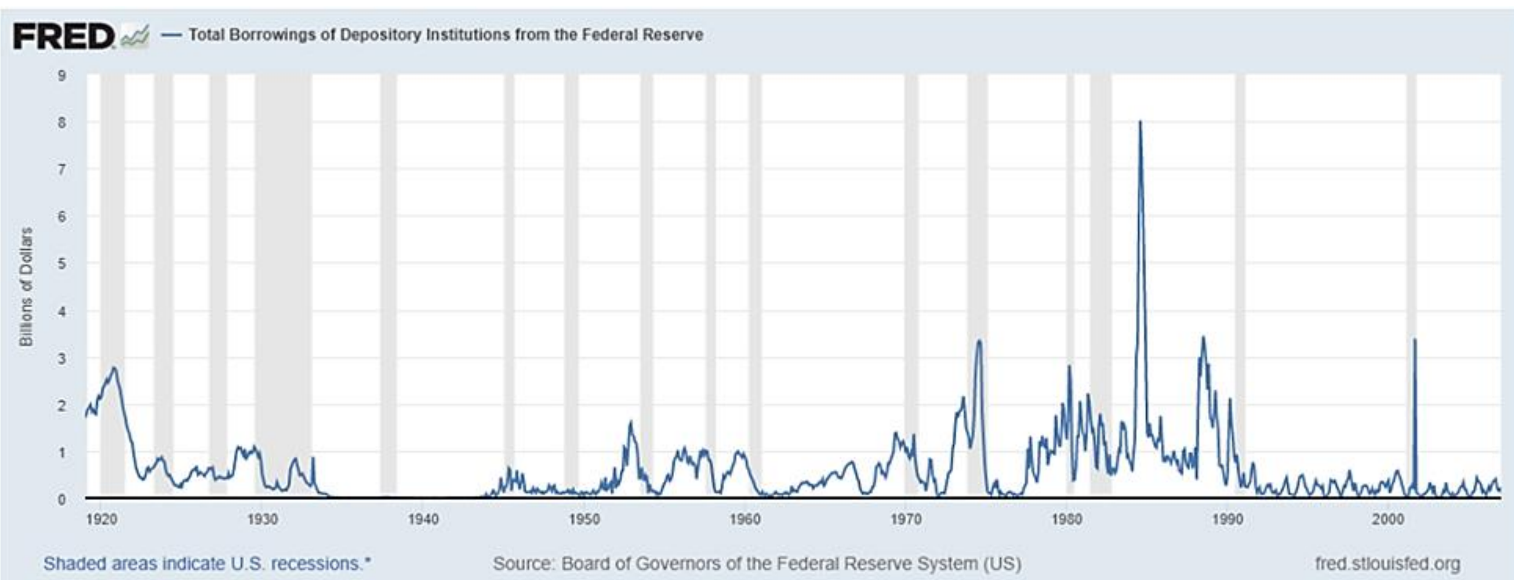
21. 12 USC § 343.

That said, there is a separate mechanism for accomplishing the same goals without the need to amend Section 13(3): the Fed's discount window, governed by a separate provision of the Federal Reserve Act, Section 10B. This solution is not only legal, it is also superior from policy and institutional perspectives, skipping as it does bilateral lending arrangements, mandated interest rates on the loans, Treasury participation, and the increased ratchet of emergency lending as the solution to all market failures.

B. The Discount Window: History, Theory, Experience

When the Fed was first organized in 1913, its primary mechanism for lending was through the so-called "discount window."[22] The Fed offers the discount window to depository institutions so that they can "manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress."[23] At the beginning of the Federal Reserve System, the discount window was the Fed's principal strategy for intervening in banking markets to "furnish an elastic currency" and "to afford means of rediscounting commercial paper,"[24] as the Federal Reserve Act required. In jargon-free terms, a "discount" is just a collateralized loan to eligible banks. From 1914-1980, those eligible banks had to be members of the Federal Reserve System, subject to Fed supervision and regulation. After the passage of the Monetary Control Act of 1980, any depository institution can access the Fed's discount window.[25]

Figure 1 shows the take-up (in billions) from the Fed's discount window from 1919-2007.



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22. See Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis Review, September/October 1992, pp. 58-69.

23. Board of Governors of the Federal Reserve System, "Discount Window Lending," available at https://www.federalreserve.gov/regreform/discount-window.htm

24. Public Law 63-43, ch. 6, 38 Stat. 251 (1913)

25. Public Law 96-221, 94 Stat. 132 (1980).

Shortly after the passage of the Federal Reserve Act and accelerating (with important exceptions) ever since, the discount window began to decline in prominence in favor of the Fed's open-market operations, whereby the Fed buys and sells securities in the open market to influence their prices. Open-market operations constituted the dominant monetary regime from the 1930s through 2008.[26]

The impetus came from an intellectual change in the understanding of banking and finance and an appreciation for how different parts of the Federal Reserve Bank balance sheets operated. Indeed, the use of the discount window in 1970 and in the 1980s led several prominent economists—including Anna Schwartz,[27] Goodfriend and King,[28] and Michael Bordo[29]—to call for its elimination because of abuses. The basic critique is two-fold: (1) that any reasonable macroeconomic function that the Fed needs to perform around the availability of money can be most efficiently accomplished through open-market operations, and (2) discount-window lending invites strategic use by insolvent banks.[30]

Charles Calomiris argued that the discount window, in fact, accomplished a different set of goals: to defuse "liquidity crises that occur in particular non-bank financial markets," especially in "periods of financial disruption."[31] In that way, Calomiris viewed the discount window as an answer to a collective action problem, a "mutually beneficial agreement among depositors not to reduce their deposits during panics."[32] The advent of deposit insurance rendered some of the need for this collective action moot, but not for those within the economic and financial system who operated outside the formal banking system.

Until the 2008 financial crisis, there were three primary mechanisms for borrowing through the discount window: primary credit, secondary credit, and seasonal credit.[33] In that crisis, the Fed modified its primary credit facility to create a Term Discount Window Program that extended the maturities of discount window lending beyond the overnight markets that had come to dominate this lending. It also created a fourth facility, the Term Auction Facility (TAF), in December 2007. TAF, an auction with a large number of participants and a three-day lag between auction and settlement, was designed to resolve the

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26. For a defense on the regime that succeeded it, interest-on-excess reserves, see Ben Bernanke and Donald Kohn, "The Fed's interest payments to banks," Brookings Institution, February 16, 2016, available at brookings.edu/blog/ben-bernanke/2016/02/16/the-feds-interest-payments-to-banks/. For a critical view, see George Selgin, Floored!: How a Misguided Fed Experiment Deepened and Prolonged the Great Depression (2018).

27. See Schwartz, *supra* note 22.

28. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking;' in William S. Haraf and Rose Marie Kushmeider, eds., *Restructuring Banking and Financial Services in America*. American Enterprise Institute, 1988, pp. 216—53.

29. Michael D. Bordo, "The Lender of Last Resort: Alternative Views and Historical Experience," Federal Reserve Bank of Richmond Economic Review (January/February 1990), pp. 18—29.

30. According to data released after the surge in discount-window lending in the S&L crisis, fully 60% of failed institutions had outstanding Fed loans from the discount window. See Schwartz, *supra* note 22.

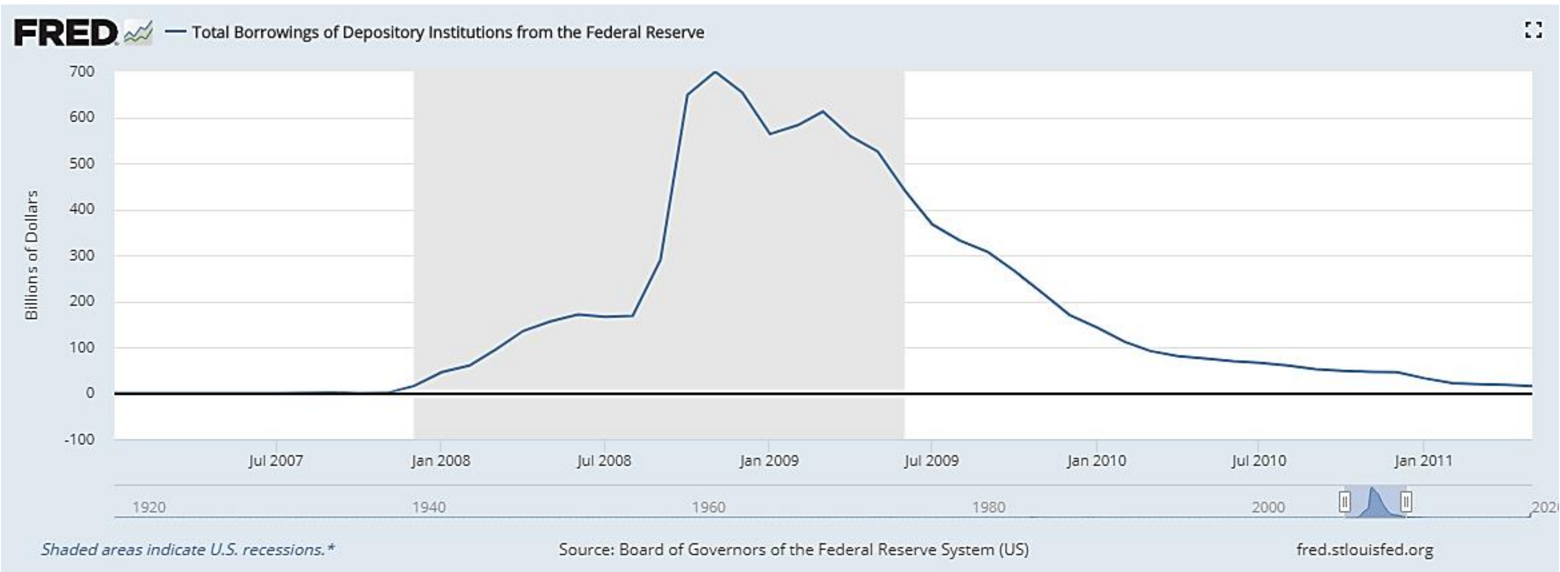
31. Charles W. Calomiris, "Is the discount window necessary? a Penn Central perspective," Review, Federal Reserve Bank of St. Louis, issue May, 1994, pages 31-55.

32. *Id*. at 4.

33. For an overview of the Term Discount Window Program and other discount window interventions, see Allen N. Berger, Lamont K. Black, Christa H.S. Bouwman, and Jennifer Dlugosz, "The Federal Reserve's Discount Window and TAF Programs: 'Pushing on a String?'" Working Papers 14-06, University of Pennsylvania, Wharton School, Weiss Center. 2016

so-called "stigma problem" associated with discount window lending.[34] TAF carried the bulk of the Fed's discount-window lending during the crisis, reaching $700 billion at its peak. To put the point differently, between 2003 and 2006, discount window lending across the system averaged $170 million per day; between 2007 and 2009, the number became $221 *billion*, or a 129,900% increase.[35]

Figure 2 presents the Fed's total discount window lending during the crisis.



To be clear, as legal scholar Kathryn Judge has argued, the Fed's 2007-2009 discount-window lending, however massive, came nowhere near matching the liquidity demands that banks required. This caused them to turn to alternatives, such as deposits or loans from the Federal Home Loan Bank System.[36] Even so, the discount window was not ignored during the crisis. Taken together, the funds lent through the 2008 crisis through these four discount-window facilities constituted the single largest bank intervention in the Fed's history. The results indicate something of an evolution of discount-window lending in two key ways. First, lender-of-last-resort theory would predict that discount-window lending would target weaker banks facing liquidity crises that they could not meet. Discount-window lending did indeed target smaller banks so constrained, but larger banks simply used discount-window funding strategically, whatever their strength.

Second, lender-of-last-resort theory is not specifically about credit policy in the real economy, but about stabilizing the financial system in panic. Thus, discount-window lending has not historically been viewed as the appropriate mechanism for encouraging bank lending to credit-deficient entities in the economy. In 2008, however, the Fed used discount-window lending for precisely that purpose. In its Monetary Policy Report in 2009, the Fed reported to Congress its justification for the dramatic expansion of the discount window: "By increasing the access of depository institutions to funding, the TAF has

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34. See Ben S. Bernanke, The Federal Reserve's balance sheet, speech delivered at the Federal Reserve Bank of Richmond 2009 Credit Markets Symposium on April 3, 2009.

35. Data reported in Berger et al supra note 33 at 2.

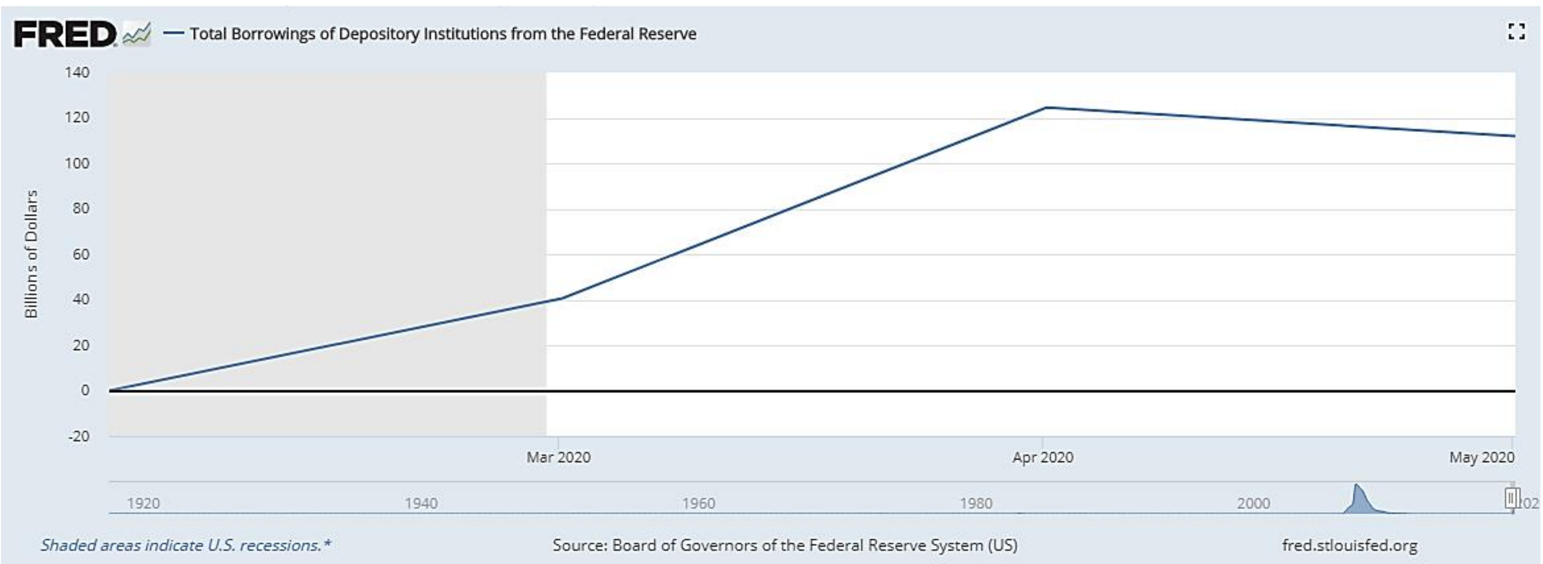
36. Kathryn Judge, "Three Discount Windows," Cornell Law Review 99 (2014): 795.

supported the ability of such institutions to meet the credit needs of their customers."[37] In this effort, they succeeded: according to the most comprehensive analysis of discount-window lending in the crisis, "for both small and large banks, an increase in [discount window] usage is associated with increased total lending, increased short-term and long-term lending, and increases in all of the loan types with the exception of residential real estate loans."[38]

In sum, the 2008 crisis not only changed the way the Fed did business through its controversial and well-documented use of emergency lending authority to support individual firms (AIG, Bear Stearns) and broader facilities (money markets, primary dealers), it also represented a shift in the use of the discount window.

In the COVID-19 crisis of 2020, the Fed has once again deployed the discount window for credit purposes. On March 15, 2020, the Fed announced that its primary credit discount window rate would drop to 0.25%, to match the target rate for its open market operations. It also extended the maturity of the loans to 90 days, consistent with the statute, "prepayable and renewable by the borrower on a daily basis" (thus providing much more stability than the 90-day maturity suggests).

Figure 3 shows the usage of the discount window from February to May 2020.



Once again, the Fed views the discount window not in the traditional lender-of-last-resort frame for preventing panic in the financial system, but as a mechanism to influence credit policy, as exemplified by the first sentence of its press release issued four days after its announced changes to the discount window: "The Federal Reserve Board is encouraged by the notable increase in discount window borrowing this

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37. Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress, February 24, 2009, page 47.

38. Berger et al at *supra* note 33 at 4.

week with banks demonstrating a willingness to use the discount window as a source of funding to support the flow of credit to households and businesses."[39]

C. The DIP Discount Window

Our approach to resolving the coming wave of bankruptcies through the discount window builds on two historical and theoretical insights about the discount window discussed above: first, the Fed's evolution of the discount window toward credit policy and away from emergency lending policy, and second, the insight (from Calomiris) that, post-deposit insurance, the discount window is best justified for its ability to provide relief beyond fragile banks.

There are three ways that a DIP Discount Window Facility might be structured: (1) as primary credit to a depository institution, (2) as seasonal credit to a depository institution, and (3) as a new regulatory category that the Fed would define as being available specifically for DIP financing, and subject to specific concerns. We think the Fed could proceed with either (1) or (2) immediately, but think the best course would be to create a new facility entirely.

The first approach would be designed to mirror the existing discount window facilities with some modifications. The law governing the permissible design of such facilities is found in Section 10B of the Federal Reserve Act and Regulation A, the regulation that the Fed promulgated to implement this authority. The counterparty must be a depository institution, which means that hedge funds, investment funds, and other entities outside the regulatory and supervisory apparatus of banking cannot participate.[40] The maturity of discount-window lending is limited to four months, but can be renewed at the Fed's discretion (as it has committed to do both in 2008 and 2020).[41] The counterparty depository institution must not be "undercapitalized" at the time of the advance, with exceptions to "viable" depository institutions as certified by the relevant federal banking agency. These restrictions are largely statutory and would apply whether the Fed structured a DIP facility as primary, seasonal, or DIP-specific credit.

The Fed treats seasonal credit slightly more flexibly by permitting lending to occur "for periods longer than those permitted under primary credit." Seasonal credit has historically been available for those banks whose customers truly face "seasonal" demands—in agriculture, primarily, but not exclusively.[42] But a "seasonal" wave of bankruptcies associated with recessions and the steep financing that is imposed on otherwise viable entities in a recession could be enough on its own to trigger discount-window facility. Structuring it in this way would not require the Fed to alter Regulation A necessarily, even as it tailored DIP lending to meet these regulatory requirements.

These two alternatives notwithstanding, the far superior approach would be to issue an amendment to Regulation A under the emergency provisions of the Administrative Procedures Act that permit a "good cause" exception to notice-and-comment rulemaking when those procedures are "impracticable,

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39. Press Release, Federal Reserve Board encouraged by increase in discount window borrowing to support the flow of credit to households and businesses, March 19, 2020, available at https://www.federalreserve.gov/newsevents/pressreleases/monetary20200319c.htm

40. 12 USC 347b.

41. 12 USC 347b(b)(4).

42. 12 USC 461(b)(7)

unnecessary, or contrary to the public interest."[43] This approach also permits the Fed to be more deliberate about structuring a DIP facility for purposes unique to the DIP financing.

The most important regulatory decisions the Fed will face in determining the scope of DIP financing will be (1) eligibility, to the extent that specific capital standards will apply for depository institutions that participate; (2) acceptable collateral, which will likely differ from traditional collateral presented for discount-window lending; (3) incentives, positive and negative, for bank participation; and the appropriate scope for triggering a DIP lending facility, including whether such a facility would be established permanently, seasonally, or only in emergencies.

1. *Eligibility*

Given that the motivation for a DIP discount window facility is credit policy, not emergency lending policy, eligibility requirements should be maintained well within the statutory discretion that Congress provided for the discount window generally. The primary space for discretion for eligibility is in Section 10B(b)(2), the so-called "viability exception." An amended Regulation A should eliminate the viability exception for DIP financing, limiting participation only to well-capitalized banks.

2. *Collateral*

The Federal Reserve Act provides ample discretion for the Fed to determine the value and nature of collateral presented to the discount window, so long as the loans offered are "secured to the satisfaction" of the lending Federal Reserve Bank. This phrase has become important, used as it was to justify the failure to prevent the bankruptcy of Lehman Brothers. It lacks statutory definition and had no meaning in common law. [44]

The critical question with collateral arises from the fact that most of the businesses needing access to DIP financing already have lenders to which the debtor has pledged all of its assets as collateral. It is therefore not immediately clear how a new loan could be "secured to the satisfaction" of the Fed lender. Bankruptcy provides a potential solution to this problem— the "priming lien"—as we discuss in Part II. D below.

3. *Program Design*

A very real concern with creating a discount-window facility for credit policy, rather than emergency financial policy, is that banks will simply boycott the process because the economics are not favorable. There is some concern that, in credit-policy facilities aimed at the real economy via Section 13(3), banks are doing just this.[45] The Main Street Lending Program is a primary example of this.[46] The MSLP is open to banks on behalf of other counterparties. There are no clear eligibility requirements for banks; the

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43. 5 USC § § 553(b)(3)(B).

44. See Peter Conti-Brown, Yair Listokin, and Nicholas Parrillo, "Towards an Administrative Law of Central Banking," Yale Journal on Regulation, forthcoming (2020).

45. Paul Kiernan, "Fed's $600 Billion Main Street Lending Program Sees Lukewarm Interest," Wall Street Journal, July 1, 2020.

46. See William B. English & Nellie Liang, "Designing the Main Street Lending Program: Challenges and Options," Brookings Institution, June 18, 2020 for a cogent critique of the program.

secondary counterparties must be relatively small (15,000 employees and $5 billion in annual revenues).[47] The Fed's explanations for the MSLP are hardly a model of clarity—the Frequently Asked Questions sheet is 66 pages and full of jargon. It appears, though, that loans have "a five-year maturity, deferral of principal payments for two years, deferral of interest payments for one year."[48] Banks must retain 5% of the loans, which are priced uniformly at LIBOR + 3%.

A DIP Discount Window Facility should avoid some of the mistakes of the MSLP. First of all, the credit availability should be more highly subsidized, perhaps even beyond the levels of the generic discount window facilities. We recognize that, with the discount rate currently near the zero-lower bound, this would amount to paying banks to borrow instead of charging them interest. In other times, this differential will not be so pronounced. But the fact that the specialized facility would have a rate different than the primary discount window is itself not remarkable: the three main discount window facilities—primary, secondary, and seasonal—are also priced differently. And the Term Auction Facility had a rate set by auction.

The subsidy is appropriate for the aims of this discount window and for others that might follow. The point of Fed intervention in DIP financing markets is to prevent the liquidation of viable companies for whom efficiently priced DIP financing would mean the difference between survival and liquidation. As discussed more fully below, the facility should be targeted at small and medium-sized businesses for whom DIP financing is not generally available, and inside lenders of the businesses should not be permitted to participate.

Despite anticipating that the economics of a Discount Window DIP Facility would be favorable for bank participation—whether through subsidy or the nudge that the facility's institutional design would offer to first-time DIP financers—the Fed would have options in the event of a lack of interest on the merits. Bank supervision is a unique and uniquely powerful set of institutional practices distinct from regulatory authority. The Fed has in the past often invoked its supervisory authority, a kind of "moral suasion," to put pressure on market participants to act in pro-social ways.[49] Given the importance of the banks to the implementation of credit, financial, and monetary policy, it may be appropriate for supervisors to advocate for banks' participation in these programs as part of the supervisory process.

D. The Priming Lien

The principal obstacle to our proposal is that the assets of medium-sized companies that most need access to a Discount Window DIP Facility are likely to be encumbered by the lien of an existing lender or lenders. This complicates the ability to secure a new DIP loan "to the satisfaction" of the Fed. As it turns out, the same obstacle raises concerns in current bankruptcy cases. Both problems may be amenable to the same solution.

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47. Term Sheet, Main Street New Loan Facility, June 8, 2020, available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200608a1.pdf

48. Main Street Lending Program, Board of Governors of the Federal Reserve System, available at https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm

49. Examples of suasion in supervision to accomplish pro-social goals are legion. See Peter Conti-Brown, *The Power and Independence of the Federal Reserve* 235-242 (2016). Most recently, the borrowing from the discount window by eight major banks was effectively an answer to this same problem. See Kate Kelly, Andrew Ross Sorkin, and Jeanna Smialek, "As Market Convulses, Big Banks Plan to Borrow Funds from Fed," *New York Times*, March 16, 2020.

Under current bankruptcy law, a debtor's current lenders have a significant competitive advantage over other potential lenders. This advantage is due in part to the prebankruptcy lenders' informational advantage, but it is magnified by the fact that they usually have a lien on all of the debtor's assets. Even if the prebankruptcy lender declines to provide DIP financing, other lenders may be unwilling to step in because the assets are fully encumbered. Unless the new lender can be given priority, despite the earlier lien, a new lender is likely to be unwilling to lend.

Bankruptcy law provides a potential solution to this problem: the priming lien. The bankruptcy financing provision permits the court to "authorize the obtaining of credit … secured by a senior or equal lien on property of the estate that is subject to a lien," so long as the pre-bankruptcy lender is given "adequate protection."[50] The prospect of a superior lien would give a new lender a significantly greater incentive to provide bankruptcy financing.

In practice, bankruptcy judges have been very reluctant to approve priming liens for new lenders. (They often approve priming liens when the pre-bankruptcy lender also provides the DIP financing, but this simply strengthens the pre-bankruptcy lender's position.) To some extent, this reluctance is invited by the statute, which makes clear that the debtor has the burden of proof to demonstrate that the pre-bankruptcy lender will be adequately protected.[51] Moreover, if the debtor's assets are not worth significantly more than the pre-bankruptcy lender is owed, as often appears to be the case, it may not seem clear that the debtor will be able to pay both the new lender and the pre-bankruptcy lender in full.

Courts' reluctance to approve priming liens for new lenders tends to entrench the pre-bankruptcy lenders and reduces a debtor's ability to obtain financing from other sources. The leading bankruptcy lawyer of the past generation once said the best way to improve the Chapter 11 restructuring process would be to permit more priming liens.[52] Although we would not favor abandoning the adequate protection requirement—indeed, the Constitution requires that a secured creditor's property interest be protected—we agree that a greater willingness to approve priming liens could loosen the stranglehold of pre-bankruptcy lenders and improve the efficiency of bankruptcy financing.

Two bankruptcy scholars have recently offered a strategy for expanding the use of priming liens.[53] Under their proposal, a court would "require a temporary period at the outset of the case (perhaps 60-90 days) in which a DIP loan can prime even secured creditors." After this initial period, the court would then "consider a more expansive set of DIP loan proposals in the usual way." Their proposal bears an intriguing resemblance to the practice from which DIP financing emerged well over a century ago, which gave new lenders a short-term priority over existing liens.[54]

The virtue of a temporary priming period is that the risk that a short-term loan will undermine the pre-bankruptcy lenders' interest in their collateral is less than with a longer-term loan. Two downsides of this approach are that in some cases, the pre-bankruptcy lenders may be at risk even with a short-term

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50. 11 U.S.C. section 364(d).

51. 11 U.S.C. section 364(d)(2).

52. See Kenneth Ayotte & David A. Skeel, Jr., "Bankruptcy Law as a Liquidity Provider," 80 University of Chicago Law Review 80 (2013): 1557, 1616 (citing statement by Harvey Miller).

53. Ayotte & Ellias, *supra* note 17 at 54.

54. When railroads defaulted in the late nineteenth century, their assets were invariably fully encumbered by mortgage bonds. To facilitate borrowing, courts authorized "receiver's certificates," which gave the lender a lien on revenues. Courts justified the superpriority lien by characterizing it as attaching to the revenues before they reached the railroad. See David Skeel, *Debt's Dominion.*

loan—if the value of the debtor's business truly is deteriorating rapidly, for instance—and the approach requires the parties to start over after the initial period. The need to negotiate for DIP financing twice could be quite disruptive for medium-sized companies that are anticipating a relatively prompt reorganization. For these companies especially, we believe that courts should be more open to permitting priming liens for a longer period of time.

As the discussion above suggests, the greater openness to priming liens that we advocate would not require any legislative amendment of current bankruptcy law. It can be achieved under current law by simply signaling an intention to interpret adequate protection more flexibly than bankruptcy judges have done in the past. Given the extent to which many medium-sized companies are encumbered, even a flexible interpretation of adequate protection will not always be sufficient to justify a new DIP loan, but it would greatly enhance access to bankruptcy financing for medium-sized businesses that are struggling due to the crisis.

E. Potential Legal Objections

The statute does make clear that the Fed is under no obligation to "make, increase, renew, or extend any advance or discount," making the commitment to renew DIP lending somewhat problematic.[55] We do not see this as a barrier to lending, for two reasons. First, the Fed has already made commitments to renew discount window lending. Second, the statute does not limit the Fed's discretion. It limits instead the counterparty's ability to present a legal obligation to the Fed that would itself remove that discretion. Regulation A clarifies this statutory limitation by making clear that the statute "does not entitle any person or entity to obtain any credit or any increase, renewal or extension of maturity of any credit" through the discount window.[56]

III. The Benefits and Costs of a DIP Discount Window Facility

As with any proposal, there are costs and benefits. For something as novel as a DIP Discount Window Facility, these costs and benefits will not easily be reduced to quantities. We therefore discuss these benefits and costs conceptually with the understanding that different people will evaluate costs and benefits differently.

A. The Benefits

The primary benefit of the DIP Discount Window Facility is to ensure the coming wave of bankruptcy filings does not become a macroeconomic crisis, as otherwise viable firms endure inefficient financing at best or forced liquidation at worst. There are more specific benefits, too. In this section, we discuss four: (1) improvements to the bankruptcy process by permitting better DIP financing for small and medium-sized firms in bankruptcy; (2) improvements to the bank regulatory and supervisory environment by pushing more DIP financing into depository institutions; (3) the benefits for monetary policy and central banking functions generally; and (4) a more tailored approach to crisis response that is more than the usual Fed lending and less than sweeping 13(3) interventions as we have seen in 2008 and now 2020.

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55. *Id.*

56. 12 CFR § 201.3

1. Improvements to Bankruptcy Process

The DIP Discount Window Facility would improve the bankruptcy process during the current crisis in two important respects. First, it would make bankruptcy financing available for companies that might not otherwise have access to it. As we have discussed, smaller companies struggle to obtain DIP financing even under ordinary circumstances. This gap in the market for financing is of particular concern during the current crisis, since many medium-sized companies that were not in financial distress prior to the crisis may be forced to file for bankruptcy. The expanded access to financing this solution would provide could be critical.

This solution also could expand the range of institutions that provide DIP financing, both during the crisis and after. DIP financing currently is provided almost entirely by the largest banks, along with hedge funds and equity funds. The top ten providers of DIP financing are all large banks (led by JP Morgan Chase and Bank of America), and only 21 banks made more than 5 DIP loans in the past several decades.[57] Although local banks would seem to be logical participants in the DIP financing market, they currently play very little role. The DIP Discount Window Facility that is available only for non-inside lenders might induce many to participate, increasing access to DIP financing for medium-sized firms and enhancing the competitiveness of the DIP financing market more generally.

2. The Mitigation of Shadow Banking in a Key Sector

The 2008 crisis was, in many important ways, a shadow banking crisis.[58] The extraordinary lengths the Fed has gone to through its emergency lending authority to stabilize non-bank financial markets suggests that the 2020 crisis has important shadow banking elements, too.

The introduction of Fed support for DIP financing limited to depository institutions would expand the banking regulatory and supervisory footprint at the expense of nonbank entities. This creates important benefits for pushing more maturity transformation and financial intermediation into the bank supervisory, regulatory, and insurance framework.

3. Monetary Policy and Macroprudential Benefits

Every decade or so, there is a debate about whether to strip the Fed of its bank supervisory role.[59] The Fed's primary defense is that bank supervision provides key insights into the Fed's ability to conduct monetary policy. In former Fed Chair Ben Bernanke's words in 2010, "the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has as both a bank supervisor and central bank."[60]

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57. Email from Wei Wang, Queen's University, to David Skeel, June 21, 2020 (describing findings in a large dataset of 267 cases with DIP loans).

58. See Gary Gorton & Andrew Metrick, "Regulating the Shadow Banking System," Brookings Papers on Economic Activity, 2010, vol. 41, issue 2 (Fall), 261-312.

59. For an overview of these debates, see Elizabeth F. Brown, "Prior Proposals to Consolidate Federal Financial Regulators," The Volcker Alliance, available at https://www.volckeralliance.org/sites/default/files/attachments/Background%20Paper%201_Prior%20Proposals%20to%20Consolidate%20Federal%20Financial%20Regulators.pdf

60. Ben S. Bernanke, Testimony before the House of Representatives Committee on Financial Services, March 17, 2010.

Facilitating greater oversight over DIP financing will provide precisely this benefit to the Fed by giving great insights into the real economy. Recognizing when bankruptcy spikes occur, how sensitive those spikes are to the availability of efficiently-priced credit, and the quality of outcomes associated with different kinds of funding mechanisms would all inform and improve the quality of the Fed's monetary policies. As Kate Judge argued in criticizing the relative lack of take-up from the discount window in 2008, alternatives to traditional discount-window lending—be they through 13(3) facilities or the Federal Home Loan Banks—"lack a meaningful check on the solvency of the bank receiving the funds" and prevents the flow of supervisory information and the development of regulatory expertise to handle the systemic consequences of these credit flows.[61] Discount window lending for the purposes of credit policy can alleviate those concerns.

4. Improvement of Fed Reliance on Emergency Lending

The Fed's formerly once-in-a-century use of its emergency authority under 13(3) has become a once-in-a-decade phenomenon. This authority is deeply controversial, even as most experts regard its ongoing availability as vital to financial stability. Even so, there are essential questions about the overuse of such significant authority that some scholars have already begun to evaluate.[62] These questions will set the agenda for discussions about Fed legitimacy, independence, and accountability for many years to come.

A DIP Discount Window will encourage the Fed to develop tools that, even if used only rarely, need not await the "unusual and exigent circumstances" that open floodgates of Fed creativity in providing emergency support. An intermediate standard—perhaps "usual but exigent," or "unusual but non-exigent" circumstances—can be invoked to permit Fed liquidity to increase to target specific markets, through the banking system.

B. Costs

The costs of a DIP Discount Window Facility include (1) compromising Fed independence by forcing the Fed into politically embarrassing situations when DIP-financed firms must take actions that will be unpopular, such as firing employees, closing plants, or even liquidating; (2) institutionalizing Fed interventions that distort otherwise-functioning markets; (3) manipulating the discount window beyond its traditional purposes; and (4) exploiting a legal loophole to finance firms—i.e., those in bankruptcy—that Congress has explicitly restricted from participating in the Fed's emergency lending facilities.

1. Fed Independence and Bankruptcy

There is no question that the dramatic increase in Fed financing for the bankruptcy process will associate Fed lending with decisions that will be politically toxic. Firms will have to restructure, including by closing plants, restructuring debt, firing employees, etc. When they do so with Fed financing, the public may come to associate the Fed with these actions. Such a public association could decrease public confidence in the Fed to perform core central banking policies that require political independence.

However valid these concerns, they are almost identical to nearly every emergency intervention that the Fed has *already* undertaken. Indeed, the only difference is that permitting banks to undertake the

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61. Judge, supra note 36 at 837-845.

62. See Menand, *supra* note 4.

underwriting process means that the banks, not the Fed, will be the counterparties to restructuring entities. This will present a buffer between the Fed's actions and the actions of private parties.

Furthermore, the restructuring process is a highly judicialized one. This stands in stark contrast to the Fed's other activities, which are almost completely immune to judicial oversight.[63] By adding the Fed into such a process, there would be more accountability for Fed participation, not less.

2. *Institutionalizing Fed Interventions*

Some fear governmental support could "crowd out" private financing, contending that the DIP market is sufficiently robust for the current crisis.[64] Although this is indeed a risk whenever the Fed intervenes in a market, it is important to keep in mind that medium-sized businesses generally do not have access to financing even under ordinary circumstances. There currently is not a significant market to crowd out. Moreover, the intervention would reduce the dominance of inside lenders, another important benefit that needs to be weighed against any crowding out effect.

3. *Manipulating the Discount Window*

Another concern, echoing the 1990s critique of Anna Schwartz, is that such a clear provision of funds through banks to non-bank counterparties is an abuse of the discount window.[65] But as discussed above, the discount window has been a tool of credit policy, not emergency lending, since at least 2008, if not in fact the 1980s (giving rise to Schwartz's original critique). While we do not disagree with idea that this represents a change from the traditional purposes of discount window lending as originally conceived in a world without deposit insurance, it is an evolution that has already occurred.

Indeed, as discussed above, we see this evolution as superior to another evolution already underway, namely, the conception of the Fed as economic policymaker par excellence. With a robust, expansive, but still limited discount window, perhaps the Fed will not feel the pressure to resort so quickly to dramatic non-financial interventions via emergency lending.

4. *Exploiting a Legal Loophole*

Finally, there is a concern that using Section 10B—not Section 13(3)—for lending to bankrupt entities exploits a legal loophole, since Congress clearly limited emergency lending under Section 13(3) to non-bankrupt entities.

Such a critique would be a political one, not a legal one. Legally, it is important that the Fed's authority for discount-window lending exist separately from its emergency lending authority, since the purposes and functions of these different programs will be different. It is therefore natural that Congress would tailor these programs differently. Section 10B lending has greater flexibility to lend through banks to bankrupt entities, but much less discretion in selecting counterparties. Section 13(3) represents the reciprocal determination. Creating facilities that are sensitive to Congress's differentiated tailoring shows more legal sensitivity to Congress's requirements, not less.

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63. See Peter Conti-Brown, "The Institutions of Federal Reserve Independence," Yale J. Reg. 32 (2015): 258.

64. See, for example, Elliot Ganz & David Smith, "It's Not Time for a Government Bankruptcy Facility," RealClear Markets, June 15, 2020, available at https://www.realclearmarkets.com/articles/2020/06/15/its_not_time_for_a_government_bankruptcy_facility_496152.html.

65. See Schwartz, *supra* note 22.

Indeed, it is important to note that banks *already* use the discount window while also lending to bankrupt entities. Given the fungibility of money, large banks that engage in DIP financing while also borrowing from the discount window are creating the DIP Discount Window in fact, if not in form. Our proposal would give added liquidity, rigor, regulatory clarity, and opportunity for more of what has already occurred.

Conclusion

We propose a new lending facility through the Federal Reserve, a Debtor-in-Possession Discount Window Facility, whereby banks of all sizes would find liquidity to support the coming wave of small-, medium-, and large-sized bankruptcies. The costs for such a program are manageable, and represent in important respects an alternative to two dire extremes: On the one hand, Fed retreat from credit policy--an increasingly unlikely outcome given recent history since 2008; on the other hand, a permanent state of Fed emergency lending to all sectors of the economy. Our proposal responds to the immediate needs of bankrupt entities, but also provides a roadmap for how the Fed can engage in credit policy in support of duly chartered, regulated, and supervised depository institutions.

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