Do Municipalities Need a Lender of Last Resort? Evaluating the Federal Reserve's Pandemic-Era Municipal Lending Program

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In March 2020, the COVID-19 pandemic pushed the $4 trillion American municipal debt market—a critical source of funding for state and local governments—to the brink of collapse. On March 27, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security Act, which in part empowered the Board of Governors of the Federal Reserve and the Department of the Treasury to establish a Municipal Liquidity Facility to "help state and local governments better manage cash flow pressures in order to continue to serve households and businesses in their communities." Although the Federal Reserve authorized the Municipal Liquidity Facility to lend up to $500 billion to municipalities, only two borrowers, who drew on 1.27% of the total capacity, tapped the facility. The debates that sprang up around the Municipal Liquidity Facility demonstrate that scholars have yet to grapple with the institutional, legal, and historical constraints of Federal Reserve support for state and local governments.

This Note addresses that gap. It begins by situating the Municipal Liquidity Facility within the history of the Federal Reserve's monetization of municipal bonds. The Note goes on to evaluate Congress' legislative mandate for the Municipal Liquidity Facility and the operational, political, and legal dynamics of the program. Finally, based on the institutional history, legal authority, and politics of the Federal Reserve, this Note examines policy proposals to reform the Federal Reserve's role for supporting municipalities during crises. Ultimately, this Note attempts to place the pandemic-era policy experiment in historical context, and then draw out lessons to help answer a critical question for policy makers: when municipal governments face financing crises, what is the proper role for the Federal Reserve?

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INTRODUCTION

States, cities, counties, and their operating subsidiaries (together, for the purpose of this Note, "municipalities") are a critical pillar of American life. Municipalities employ more than 20 million workers (thirteen percent of the national workforce), including nurses, firefighters, and teachers; they provide fundamental services and infrastructure, including managing and maintaining roads, bridges, schools, hospitals, voting systems, public safety, power grids, and more.[1] State and local governments spent $2.3 trillion in 2019, accounting for 10.9% of gross domestic product.[2] Municipalities fund their spending through (i) local taxes (mainly property, but also sales and income taxes), (ii) intergovernmental transfers from the federal or state level, and, (iii) the municipal bond market.

Balanced budget rules are a defining feature of municipal financing and are applicable to almost all municipalities; they require that a municipality spend no more than it collects in revenue in any given year. These rules are designed to help control public spending and demonstrate to the market the low risk of lending to the constrained municipality.[3] Balanced budget rules, however, also limit municipalities' ability to pay for multiple major infrastructure projects in a single year.

In the face of restrictions on spending imposed by balanced budget rules, municipalities turn to the bond market to issue long-

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1. HOUSE CMT. ON THE BUDGET, STATE AND LOCAL GOVERNMENTS ARE IN DIRE NEED OF FEDERAL RELIEF (Aug. 19, 2020), https://budget.house.gov/publications/report/state-and-local-governments-are-dire-need-federal-relief [https://perma.cc/J4HM-YA5A]; *see also* Andrew F. Haughwout et al., *Helping State and Local Governments Stay Liquid*, LIBERTY STREET ECON. (Apr. 10, 2020), https://libertystreeteconomics.newyorkfed.org/2020/04/helping-state-and-local-governments-stay-liquid.html [https://perma.cc/9YLQ-2VWC].

2. ANDREW HAUGHWOUT ET AL., FED. RSRV. BANK OF N.Y. STAFF REPS. NO. 985, THE MUNICIPAL LIQUIDITY FACILITY (Sept. 2021), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr985.pdf [https://perma.cc/GLH6-YLQ4].

3. Balanced budget rules originated at the state level in the 1840s, in response to Congress' refusal to assume any portion of state debts that had accumulated up to and through the economic crisis of 1837. With states unable to borrow to fund local infrastructure, municipalities stepped into the fold. Frantic local government investment in the railroads, however, eventually led to a debt crisis at the local level during the 1873 recession. The federal government, and particularly the Supreme Court, ultimately forced localities to honor these debts and frustrated their widespread efforts to avoid payment by default or repudiation. As a result, by the late nineteenth century, most states had adopted constitutional reforms or other rules to limit the ability of local government entities to issue debt. *See* DAVID SCHLEICHER, HANDS ON! PART I: THE TRILEMMA FACING THE FEDERAL GOVERNMENT DURING STATE AND LOCAL BUDGET CRISES 15–35 (July 28, 2020), https://ssrn.com/abstract=3649278 [https://perma.cc/3TT7-EZQ4].

term debt to finance their major infrastructure and service investments. Long-term debt allows municipalities to spread the cost of major projects over many years. For example, to build a new bridge, school, or park, a municipality can borrow the money needed for construction immediately, and then pay the loan back in manageable increments over the course of, say, 25 years, as they receive the revenue from taxes.[4]

Municipalities also raise short-term debt to help bridge cash flow gaps across fiscal years.[5] Because municipalities depend on revenues (e.g., taxes, federal grants, or bond proceeds) whose receipt may not align with the timing of municipal spending needs (e.g., payroll or interest payments), short-term debt creates a method by which municipalities can smooth out spending in anticipation of receipt of revenue. As such, short-term debt is a critical budget management tool—especially during crises—because it provides liquidity and flexibility for municipalities.

Economic recessions will typically force municipal governments to reduce their own spending if they are unable to borrow in excess of their revenues.[6] As the economy contracts, people and businesses tend to spend less, which means that municipalities collect less in tax revenues. To comply with balanced budget rules, public officials must make the unpleasant choice either to increase taxes or to cut spending to match the reduction in tax income, lest the budget become unbalanced. Thus, absent an infusion of aid from the federal government, negative economic shocks tend to force municipalities into a *de facto* austerity trap.

Government austerity programs implemented during a recession are problematic because they tend to make the recession worse.[7] While people and businesses are spending less, increased taxes further reduce private spending, and the deterioration of

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4. Most long-term debt (60%) is secured by defined revenue sources (like road or bridge tolls), while the remaining are not backed by specific revenue sources, but are instead backed by the "full faith and credit" of the taxing authority. The federal government directly supports state and local borrowing, most notably by making interest on municipal debt exempt from federal income taxes.

5. See HAUGHWOUT ET AL., *supra* note 2, at 3–5 (providing an overview of the municipal bond market and the types and purposes of various securities that trade within it).

6. SCHLEICHER, *supra* note 3, at 11.

7. *See* John Mullin & Santiago Pinto, *State and Local Governments: Economic Shocks and Fiscal Challenges*, FED. RSRV. BANK OF RICHMOND (Oct. 20, 2020), https://www.richmondfed.org/research/regional_economy/regional_matters/2020/rm_10_20_2020_state_and_local#footnote5 [https://perma.cc/RN5A-HU7A] (documenting how reduced tax revenues lead to reduced municipal spending and less economic growth).

core public services (including employment) further depresses economic activity.[8] The post–Great Recession economic recovery, for instance, was historically weak due, in part, to widespread municipal austerity programs.[9] Similarly, austerity programs implemented in the outside the United States inflicted structural damage in terms of growth and inequality in the wake of the 2011 European sovereign debt crisis.[10] The harm of municipal austerity is bitter because municipal spending during a recession is particularly fruitful: each dollar spent supporting state and local governments during a recession yields more than one dollar in overall benefit to the economy.[11]

Yet, as with much else, the COVID-19 pandemic threw municipalities and the municipal bond market into chaos in March 2020. The pandemic forced municipalities into an austerity posture, with reduced tax revenues resulting in severe cuts to spending and jobs.[12] Meanwhile, the pandemic pushed the

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8. *See* JIRI JONAS, IMF WORKING PAPER NO. 12/184: GREAT RECESSION AND FISCAL SQUEEZE AT U.S. SUBNATIONAL GOVERNMENT LEVEL (July 2020), https://ssrn.com/abstract=2169729 [https://perma.cc/99S7-QN47] (examining the impact of balanced budget rules on municipalities following the Great Financial Crisis and discussing the efficacy of those rules).

9. *See* Josh Bivens, *Why is Recovery Taking So Long—and Who's to Blame?*, ECON. POL'Y INST. (Aug. 11, 2016), https://www.epi.org/publication/why-is-recovery-taking-so-long-and-who-is-to-blame [https://perma.cc/V8HW-JWMJ].

10. *See* Matteo Fragetta & Roberto Tamborini, *It's Not Austerity. Or is it? Assessing the Effect of Austerity on Growth in the European Union, 2010-15*, 62 INTL. REV. ECON. & FINANCE 196 (2019), https://doi.org/10.1016/j.iref.2019.03.013 [https://perma.cc/3D3U-PJJZ].

11. *See* MOODY'S ANALYTICS, WEEKLY MARKET OUTLOOK 7 (May 21, 2020), https://www.moodysanalytics.com/-/media/article/2020/weekly-market-outlook-default-outlook-markets-appear-less-worried-than-credit-analysts.pdf [https://perma.cc/5Q6Y-4C2T] (finding that each dollar spent supporting state and local government during a recession yields $1.39 in overall benefit to the economy); *but see* Amanda Page-Hoongrajok, *Can State and Local Government Capital Spending be a Vehicle for Countercyclical Policy? Evidence from New Interview and Survey Data*, 44 J. POST KEYNESIAN ECON. 184 (2021), https://doi.org/10.1080/01603477.2021.1875246 [https://perma.cc/4EWV-B4H7] (arguing that the rules and timelines of municipal budgets make the effectiveness of municipal spending as countercyclical macroeconomic policy unclear.).

12. Municipal tax revenues fell dramatically as stay-at-home orders shut down swaths of the economy. *See* Colin Gordon, *Without Another Massive Federal Stimulus, State and Local Governments Will Face Brutal Austerity*, JACOBIN (Nov. 10, 2010), https://www.jacobinmag.com/2020/11/covid-coronavirus-state-local-government-austerity [https://perma.cc/797U-Z3WN]; *but see* J.P. MORGAN, N. AM. FIXED INCOME STRATEGY, MUNICIPAL MARKETS WEEKLY 9 (Nov. 13, 2020) [on file with the *Columbia Journal of Law & Social Problems*] (estimating a 1.03% decline in September year-to-date total tax receipts compared to the same period in 2019). From February 2020 through the end of that year, state and local governments cut over 1.3 million jobs. Michael Ettlinger & Jordan Hensley, *COVID-19 Economic Crisis: By State*, UNIVERSITY OF NEW HAMPSHIRE CARSEY SCHOOL OF PUBLIC POLICY (Dec. 23, 2020), https://carsey.unh.edu/COVID-19-Economic-Impact-By-

municipal bond market to the brink of collapse.[13] Borrowing costs for municipalities skyrocketed beyond the levels seen during the 2008 Financial Crisis, and investors pulled over $41 billion of assets out of the municipal bond market within three weeks.[14] State and local governments were effectively unable to borrow, with most planned debt offerings canceled due to lack of investor demand.[15] It was a perfect storm: not only were tax income streams disappearing and the bond market drying up, but municipalities also now needed to find funding to support the front-line pandemic response.[16]

To avoid the negative feedback loop of pandemic-induced municipal austerity on the economy, Congress included two provisions in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) designed to aid municipalities. First, Congress provided $150 billion in direct aid to help municipalities with costs "due to" the pandemic.[17] Second, Congress authorized the Federal Reserve (Fed) to loan money directly to municipalities.[18]

State [https://perma.cc/LM5B-NZ5B]. Twenty-eight states enacted a total of fifty-two indiscriminate, across-the-board budget cuts in 2020. NAT'L CONF. OF STATE LEG., STATE ACTIONS TO CLOSE BUDGET SHORTFALLS IN RESPONSE TO COVID-19 (2020), https://app.powerbi.com/view?r=eyJrIjoiZjhmODk1MjctOTc3Ni00MDE3LTgyNGUtZjNkYTk3NTQ1OTU5IiwidCI6IjM4MmZiOGIwLTRkYzMtNDEwNy04MGJkLTM1OTViMjQzMmZhZSIsImMiOjZ9 [https://perma.cc/T4S8-FTJZ]. These balance sheet pressures caused 337 municipal issuer credit ratings downgrades and 80 first-time defaults in 2020. MUNICIPAL MARKET ANALYTICS, WEEKLY OUTLOOK (Jan. 4, 2021), [on file with the *Columbia Journal of Law & Social Problems*] (noting that 2020 also saw 208 municipal issuer "impairments," the highest levels of distress since 2012); *see also* Jim Grabovac, *Why Municipal Market Demand Remains Robust Despite Rising Defaults*, ADVISOR PERSPECTIVES (Nov. 10, 2020), https://www.advisorperspectives.com/commentaries/2020/11/10/why-municipal-market-demand-remains-robust-despite-rising-defaults-1 [https://perma.cc/44FL-NS33].

13. *See* Christina S. Chung, *The Impact of COVID-19 on the Municipal Securities Market During the Spring of 2020*, THE FINREG BLOG (Sept. 21, 2020), https://sites.law.duke.edu/thefinregblog/2020/09/21/the-impact-of-covid-19-on-the-municipal-securities-market-during-the-spring-of-2020/ [https://perma.cc/KN9E-AVPF].

14. *See Hearing on the Mun. Liquidity Facility Before the Cong. Oversight Comm'n*, 116th Cong. (Sept. 17, 2020), https://coc.senate.gov/sites/default/files/2020-09/MLF%20Testimony%20-%20HITESHEW_0.pdf [https://perma.cc/JV5B-DME6] (statement of Kent Hiteshew, Deputy Associate Director, Division of Financial Stability, Board of Governors of the Federal Reserve).

15. HAUGHWOUT ET AL., *supra* note 2, at 8.

16. *See* Linda J. Bilmes, Opinion, *A Perfect Fiscal Storm of Revenue Shortfalls For Cities and Towns*, Boston Globe (June 25, 2020), https://www.bostonglobe.com/2020/06/25/opinion/perfect-fiscal-storm-revenue-shortfalls-cities-towns [https://perma.cc/DB25-SAFD].

17. *See* Coronavirus Aid, Relief, and Economic Security Act § 5001(a), 42 U.S.C. § 801 [hereinafter CARES Act].

18. *See* CARES Act, *supra* note 17, at § 4003(a), 15 U.S.C. § 9042(b)(4).

The CARES Act municipal loan program was dubbed the Municipal Liquidity Facility (MLF). Armed with up to $500 billion, the Fed was empowered to lend money directly to state and local governments to help them cope with the pandemic.[19] Yet, during its life—from May 15 through December 31, 2020—the MLF made only four loans to two borrowers, amounting to 1.27% of the total available capital.[20]

Throughout 2020, scholars, practitioners, politicians, and municipal governments engaged in a wide-ranging debate over the fate and legacy of the MLF.[21] Some argued that the MLF was a success because it helped stabilize the municipal bond market, noting the quick rebound of borrowing costs in the municipal bond market following the policy interventions in March and April 2020, and how municipalities raised a record volume of debt in 2020 after the market stabilized.[22] Others saw the program as failing to realize its promise; very few municipalities actually borrowed from the MLF because, for 97% of those eligible, MLF loans were more expensive than loans available in the municipal bond market.[23] Meanwhile, state and local governments around the country bore

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19. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., *Federal Reserve Takes Additional Actions to Provide Up to $2.3 Trillion in Loans to Support the Economy* (Apr. 9, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm [https://perma.cc/5Y23-YG4X].

20. BD. OF GOVERNORS OF THE FED. RSRV. SYS., PERIODIC REPORT: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT 6 (Jan. 9, 2021), https://www.federalreserve.gov/publications/files/pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnlf-mself-msplf-nonlf-noelf-01-11-21.pdf [https://perma.cc/GN6Z-XFVT] [hereinafter Periodic Report (Jan. 2021)].

21. *See* Sean Fulmer, *Disagreements over the Municipal Liquidity Facility Erupt*, YALE SCH. OF MGMT. (Oct. 21, 2020), https://som.yale.edu/blog/disagreements-over-the-municipal-liquidity-facility-erupt [https://perma.cc/B42E-84MP]; David Dayen, *Unsanitized: How the Muni Bond Market Is Preventing Economic Recovery*, AM. PROSPECT (Sep. 25, 2020), https://prospect.org/coronavirus/unsanitized-how-muni-bond-market-preventing-economic-recovery-federal-reserve-mlf/ [https://perma.cc/PVC8-MEGG].

22. *See, e.g.*, Senator Pat Toomey, *Intended Purpose of CARES Act Lending Facilities Has Been Achieved* (Dec. 1, 2020), https://www.toomey.senate.gov/newsroom/press-releases/12/01/2020/toomey-intended-purpose-of-cares-act-lending-facilities-has-been-achieved [https://perma.cc/F5U6-7KD5].

23. *See* CTR. FOR POPULAR DEMOCRACY, AIMING TO UNDERACHIEVE: HOW A FEDERAL RESERVE LENDING PROGRAM FOR LOCAL GOVERNMENTS IS DESIGNED TO FALL SHORT (June 14, 2020), https://populardemocracy.org/news/publications/aiming-underachieve-how-federal-reserve-lending-program-local-governments-designed [https://perma.cc/GLM7-C4PH]; *see also* HAUGHWOUT ET AL., *supra* note 2, at 13 ("These revised rates generally remained above the rates that could be found in private markets for issuers in most credit ratings, although the substantially slower recovery of yields for issues carrying lower credit ratings meant that MLF participation was attractive for the relatively small set of issuers in the A and BBB ratings groups.").

the brunt of the pandemic response in managing schools, public health facilities, and even the 2020 election. Accordingly, some pushed for liberalizing the terms of the MLF to make it easier for municipalities to access pandemic relief funds.[24]

This Note adds a unique historical perspective and legislative analysis to contemporary MLF debates. Part I begins by recounting the legal and political history of the Fed's purchases of municipal bonds heretofore not discussed in the academic literature. In doing so, it reveals the Fed's long-standing aversion to municipal lending. Part II adds to that history the chapter of the MLF; it analyzes how the legal design of the CARES Act and the institutional design of the Fed all but pre-determined the fate of the MLF. Part III, finally, concludes by evaluating reform proposals and attempting to inform future policy efforts. The goal is to address the question of whether and how the Fed should assist municipalities and the municipal bond market during crises.

I. MUNICIPAL FINANCE AND THE FEDERAL RESERVE

Before 2020, the Fed stayed well out of municipal finance matters. Two provisions in the Federal Reserve Act (FRA), however, do allow the Fed to support state and local governments in certain circumstances: Section 13 enables the Fed to *lend* widely (including to municipalities) during financial crises, and Section 14 empowers the Fed to *purchase* municipal bonds in the open market (i.e., from primary dealer banks).[25] Yet, for much of the Fed's history, these powers have gone unused. As Part I proceeds to document, prior to 2020, the Fed had never made a direct loan to an American municipality under Section 13, and it had not purchased a municipal bond on the open market under Section 14

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24. *See, e.g.*, Robert C. Hockett, *Optimize Community QE—An Open Letter To Fed Chairman Powell*, FORBES (June 14, 2020), https://www.forbes.com/sites/rhockett/2020/06/14/optimize-community-qean-open-letter-to-fed-chairman-powell/?sh=1a694e5e24d2 [https://perma.cc/B85U-RYNY].

25. *Compare* 12 U.S.C. § 343(3) ("In unusual and exigent circumstances, the [Board] . . . may authorize any [FRB] . . . to discount . . . notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank . . . "), *with* 12 U.S.C. § 355(1) ("Every Federal Reserve bank shall have the power: (1) [t]o buy and sell, at home or abroad . . . bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States . . . ").

since 1933. Nevertheless, as discussed in Part II, Sections 13 and 14 of the FRA formed the basis of competing proposals as Congress debated how the Fed might help deliver pandemic aid to municipalities.

Part I provides a lens through which to view the MLF and to understand the Fed's ability to support municipalities during crises. Accordingly, Part I.A begins by providing an overview of (i) the Fed and its operations, and (ii) the origin of the Fed's authority to purchase municipal bonds and lend to municipalities. Parts I.B and I.C explore the use and development of the Fed's authority to purchase municipal bonds and to lend directly to municipalities during financial crises under Sections 14 and 13, respectively.

A. BACKGROUND ON THE FEDERAL RESERVE AND ITS AUTHORITY TO ACQUIRE MUNICIPAL DEBT

1. *The Structure & Powers of the Federal Reserve*

The Federal Reserve System (Fed) is the central banking system of the United States.[26] The Fed is governed by a seven-member Board of Governors (the Board), located in Washington, D.C.[27] The Board sits atop twelve regional Federal Reserve Banks (Reserve Banks) that are spread across the country. Each Reserve Bank, owned jointly by the Board and private banks in the district, gathers data and other information about the businesses and the needs of local communities in its region.[28] Monetary policy decisions (such as target interest rates) are made by a committee composed of the Board, the president of the Federal Reserve Bank of New York, and a rotating cast of the other eleven Reserve Bank presidents.[29]

According to statute, the Fed's purpose is to conduct the nation's monetary policy in pursuit of three objectives: promoting maximum employment, ensuring stable prices, and managing interest rates in the economy.[30] To effect stable prices and to

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26. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., THE FED EXPLAINED: WHAT THE CENTRAL BANK DOES 12–22 (11th ed. 2021), https://www.federalreserve.gov/aboutthefed/files/the-fed-explained.pdf [https://perma.cc/BG4Q-XVU6] [hereinafter THE FED EXPLAINED].

27. *See id.* at 7–8.

28. *See id.* at 8–11.

29. *See id.* at 12–13.

30. *See id.* at ch. 3.

control interest rates, the Fed is empowered to increase or constrict the nation's monetary supply. Influencing the supply of money in the economy allows the Fed to influence the cost of money (i.e., interest rates).

The Fed makes its decision about the appropriate interest rate to target by evaluating inflation (the rate of increase in prices over time) and the unemployment level, and then adjusting the supply of money in response.[31] High interest rates make borrowing more expensive, which makes investment more expensive. Conversely, lower interest rates mean that borrowing costs for new investment are lower. For instance, if the economy is running hot and inflation exceeds its targets, the Fed may raise interest rates to make new investment and borrowing more expensive. It attempts to establish the desired interest rate by adding or removing money from circulation. The Fed influence on interest rates, in turn, affects total employment in the economy.

The FRA provides two ways for the Fed to issue currency into circulation. One option is for Reserve Banks to buy bonds from banks in the open market under Section 14 of the FRA. Another option is for Reserve Banks to lend directly to banks under Section 13.

The primary method by which the Fed regulates the amount of currency in the economy is through its power to buy and sell bonds in the open market under Section 14 of the FRA, known as open market operations (OMO).[32] In conducting OMO, the Federal Reserve Bank of New York (N.Y. Reserve Bank) buys or sells securities from "primary dealers," a set list of private-sector firms that are active in the market for federal government securities.[33] Each primary dealer—including household names like J.P. Morgan Chase and Citibank—holds a special account at the N.Y. Reserve Bank called a "reserve account." A reserve account is effectively a bank account for primary dealers, and Reserve Banks act as banks for banks; just as a retail debit account allows one to exchange hard currency for a deposit balance in one's bank

31. *See id.* at 24–27.

32. *See* 12 U.S.C. § 335(1) ("Every Federal Reserve bank shall have the power: (1) [t]o buy and sell, at home or abroad . . . bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by any State, county, district, political subdivision, or municipality in the continental United States . . . ").

33. *See* FED. RSRV. BANK OF N.Y., *Primary Dealers*, https://www.newyorkfed.org/markets/primarydealers [https://perma.cc/DP3E-XXJB].

account, a primary dealer can exchange certain bonds for "bank reserves" in its reserve account.[34]

When the Fed buys or sells securities through OMO, the supply of money in the banking system increases or decreases, respectively.[35] Banks use increased bank reserves to support their business of taking deposits and making loans, and thereby indirectly inject money into the economy. For example, if the Fed decides to buy $100 billion of Treasury bonds, and Citi wins the bid, the Fed pays for those securities by crediting the Citi reserve account with bank reserves. Citi then channels that $100 billion into the real economy by making loans to individuals and businesses.

The second method by which the Fed can inject money into the economy is through its emergency lending power, a regulatory function known as the lender of last resort (LLR).[36] Embodied in Section 13 of the FRA, the LLR authority empowers the Fed to provide emergency loans to the financial system during times of distress.[37] When major shocks severely distress the financial system, people, businesses, and financial institutions need access to money and credit.[38] This distress often takes the form of liquidity crises, which occur when banks and other lenders stop (or greatly reduce) their lending to other firms, even though those firms are solvent and would normally have no trouble repaying loans.[39] Thus, a central bank acting as a LLR provides a backstop source of credit during liquidity panics.[40]

Notably, the LLR authority is an emergency power. A supermajority of the members of the Board of Governors (five out

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34. *See* THE FED EXPLAINED, *supra* note 26, at 28–35.

35. See *id.* at 36 (Box 3.3).

36. 12 U.S.C. § 343(3) ("In unusual and exigent circumstances, the [Board] . . . may authorize any [FRB] . . . to discount . . . notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal reserve bank . . . ").

37. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., ABOUT THE FED: PROMOTING FINANCIAL STABILITY 64 (Box 4.2) (2021), https://www.federalreserve.gov/aboutthefed/files/pf_4.pdf [https://perma.cc/Y4K4-8S2S].

38. *See id.*

39. *See* Eric Posner, *What Legal Authority Does the Fed Need During a Financial Crisis?*, 101 MINN. L. REV. 1529, 1533 (2017).

40. *See id.* at 1536–40 (providing the standard economic description of LLR authority). The LLR also serves a monetary function: the authority allows the central bank to prevent drastic reductions in money supply that might depress economic activity. *See* Lev Menand, *The Federal Reserve and the 2020 Economic and Financial Crisis*, 26 STAN. J.L. BUS. & FIN. 295, 303–14 (2021) (elaborating on the monetary theory elements of LLR authority).

of seven) must vote to determine that "unusual and exigent circumstances" exist sufficient to warrant the use of LLR authority, and the Board must receive prior approval from the Secretary of the Treasury before making any LLR loans.[41] Further, the loans must be "secured to the satisfaction of the Federal Reserve bank" that makes the loan, and the borrowers must be "unable to secure adequate credit accommodations from other banking institutions."[42] The LLR authority functionally operates through the "discount window" at the N.Y. Reserve Bank, although the Board sitting in Washington, D.C., determines the interest rates charged.[43]

2. *The Origin Story*

As the 63rd Congress debated the bill that would become the original Federal Reserve Act (the 1913 Act), a central policy question concerned who was to benefit from the new central bank's authority to control the money supply by purchasing bonds (under Section 14) and lending money (under Section 13).[44] The companies eligible to trade with the Reserve Banks, and the issuers of the types of assets that would underlie those trades, stood to gain significantly.

The companies eligible to interact with the Reserve Banks receive an enormously special privilege, because they have access to Reserve Bank accounts and to a standing bailout tool in the LLR.[45] A business that has access to a reserve account held at the Reserve Banks effectively has a lower cost of capital because it can more easily access safe liquidity through its reserve account than can any other ineligible market entity. Further, access to the LLR

41. 12 U.S.C. § 343(3)(A).

42. *Id.*

43. 12 U.S.C. § 357. Banks and other financial institutions, however, are disinclined to make use of the LLR authority because of the stigma attached with taking loans from the LLR, which implies an inability to secure loans from the private market. *See* Posner, *supra* note 39, at 1544.

44. *See generally* Nadav Orian Peer, *Negotiating the Lender of Last Resort: The 1913 Federal Reserve Act as a Debate over Credit Distribution*, 15 N.Y.U. J.L. & Bus. 367 (2019).

45. *See* Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. 1143, 1147 (2017) (identifying this privilege as the "Finance Franchise"). The authors argue that "the modern financial system is effectively a public-private partnership that is most accurately, if unavoidably metaphorically, interpreted as a franchise arrangement. Pursuant to this arrangement, the sovereign public, as franchisor, effectively licenses private financial institutions, as franchisees, to dispense a vital and indefinitely extensible public resource: the sovereign's full faith and credit." *Id.*

reduces the risk of instability at each eligible firm and the eligible industry as a whole because that the public knows that the government is ready to stand behind the industry during financial panics.

Moreover, when the FRA set out the types of assets that Reserve Banks could accept in exchange for bank reserves under Section 14, or as collateral for loans made under Section 13, the issuers of those assets would see an increase in demand for their debt. Those assets would hold special status in the financial markets, because banks understood that the Reserve Banks could accept them in exchange for bank reserves. For instance, if Reserve Banks could only buy, sell, or make loans against private debt, then the issuers of that type of debt—large business interests across the economy—would benefit. Additionally, the assets that the proposed Reserve Banks could trade in would need to be low-risk, stable, and in sufficient supply to ensure the system's stability.

The framers of the FRA reached a compromise among various policy proposals that offered to confer these benefits on different factions in the economy. In terms of the entities that could interact with the Fed, the 1913 Act only permitted nationally chartered banks to hold reserve accounts and access the LLR discount window during financial crises. As for the assets that Reserve Banks could accept, the resulting compromise was that under Section 14 OMO authority, Reserve Banks could only purchase and sell *public bonds*;[46] meanwhile, the original Section 13 only allowed the Reserve Banks to lend money against *private bonds*.[47] Thus, private banks were to benefit from access to the Reserve Banks, and the benefits of the asset classes chosen inhered to the federal government, municipal governments, and larger commercial concerns.

The compromise in the 1913 Act demonstrated that public bonds (including municipal bonds) were less favored than private

46. Reserve Banks could purchase or sell (i) bonds issued by the United States Treasury Department or (ii) municipal bonds if such bonds (a) were set to come due and settle in not more than six months from the date of purchase, and (b) were secured by a specific collection of taxes. Federal Reserve Act § 14, 38 Stat. 251, 264–65 (1913) (current version at 12 U.S.C. § 335).

47. Reserve Banks could loan money against are bonds "issued or drawn for agricultural, industrial, or commercial purposes" provided they have a maturity at the time of discount of not more than 90 days. Federal Reserve Act § 13, 38 Stat. 251, 262–63 (1913) (current version at 12 U.S.C. § 335).

bonds in the financial system. Reserve Banks could buy municipal bonds from primary dealer banks under Section 14 in exchange for bank reserves. But Reserve Banks could not accept municipal bonds as collateral for loans of dollars made to banks during financial crises under Section 13. In other words, private banks could exchange municipal bonds for bank reserves (i.e., the form of money held by primary dealers in their reserve accounts), but could not exchange municipal bonds as collateral for loans of dollars.

In the decades since the passage of the 1913 Act, the distinction between securities that qualify for use under Section 14 and those that qualify under Section 13 has collapsed. Congress gradually permitted public debt securities (previously only allowed under Section 14) to secure dollars, and municipal bonds were brought into the fold in 1980.[48] Parts I.B and I.C proceed to document the history of the Fed's monetization of municipal bonds under Section 14 OMO authority and Section 13 LLR authority, respectively.

B. THE FEDERAL RESERVE'S AUTHORITY TO PURCHASE MUNICIPAL DEBT

Section 14 of the FRA grants explicit authority for the Fed to purchase municipal bonds in the open market. Although the Fed did purchase municipal bonds in its early history, the authority to do so has gone unused since 1933. The history documented in this Part provides precedent for, and demonstrates the feasibility of, the proposals made in March 2020 to utilize the Fed's dormant Section 14 OMO authority to purchase municipal bonds as a vehicle for pandemic financial aid. However, the history also demonstrates that the Section 14 OMO authority was never considered, let alone intended, to be used as a federal loan program for municipalities.

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48. U.S. Treasury bonds were added to Section 16 in 1932, although the provision was time-limited and renewed every two years until 1945 when Congress eliminated the sunset clause. Bonds guaranteed by the federal government or a federal agency were debt added in 1978. Finally, in 1980, Section 16 was amended to allow for any security that an FRB could buy to secure U.S. Dollars, including those under Section 14. The 1980 amendment thus made municipal bonds eligible under section 16. But the addition was only a technical amendment, increasing the universe of eligible U.S. Dollar collateral to cope with the structural changes made to the banking system by the 1980 bill. *Federal Reserve Membership: Hearing on Amendment No. 398 to S. 85 and S. 353 and H.R. 7 Before the S. Comm. On Banking, Housing, and Urban Affairs*, 96th CONG. 14 (Sept. 26, 1979) (statement of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System).

The 1913 Act provided the Fed with OMO authority to purchase federal and municipal bonds for a number of reasons, but policy makers at the time considered it an auxiliary tool for monetary policy.[49] Not only did the authority to buy and sell federal and municipal bonds allow the Fed to influence the supply of money and, thereby, the interest rate, but federal and municipal bonds guaranteed by tax receipts were a relatively safe and stable asset class that would provide a source of revenue to the fledgling Reserve Banks.[50] The 1913 Act required that Reserve Banks purchase municipal bonds that were set to come due within six months and backed by anticipated tax revenues.[51]

The Reserve Banks made significant use of their Section 14 OMO authority to purchase municipal bonds between 1915 and 1917, although the practice came to an end by 1933.[52] To enable and govern Reserve Bank purchases of municipal bonds, the Board promulgated Regulation F in January 1915 (later, Regulation E) capping the amount that any Reserve Bank could purchase at either 10 percent of the total assets of the Reserve Bank or 25

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49. Where the House proposal allowed the purchase of any municipal security, the Senate and the final version, restricted that to only revenue bonds with 6 months or less to maturity. H.R. REP. NO. 63-163, at 66-67 (1913) (Conf. Rep.). The maturity and revenue bond restrictions were meant to provide safety for FRBs and disallow banks from encouraging speculation. *See Hearing on H.R. 7837 (S. 2639) Before S. Comm. On Banking and Currency*, 63rd CONG. 2500–02 (Oct. 16, 1913) (statement of Edmund D. Fisher, Comptroller of the City of New York) (discussing the safety of municipal bond as an asset class: "I fully recognize what our friend here says about the question of the commercial as against municipal credit; but these are strictly fluid credits; they are always promptly paid, as you know from your experiences, and I believe for capital purposes it would be a very desirable and a very useful l type of investment."); *id.* at 774–75 (Sep. 20, 1913) (statement of William W. Flanagan of Montclair, N.J.) ("Now, the purpose [of the discrepancy between securities eligible under section 13 and section 14] seems to be in that connection to prohibit speculation, so that banks that are in the habit of loaning to people who buy and sell stocks on margin could not utilize the reserve banks through the member banks."). Interestingly, for the purpose of this Note and the MLF, the Republican minority in the 63rd Congress would have allowed States to borrow on their full faith and credit (i.e., overrule balanced budget rules), and allow them to apply to the Treasury Secretary for loans of dollars "for the purpose of defraying the current expenses of the State or any of its political subdivisions." H.R. REP. NO. 63-69, at 152–53 (1913).

50. H.R. REP. NO. 63-69, at 52 (1913); S. REP. NO. 63-133, at 26 (1913). *See also* DAVID H. SMALL & JAMES A. CLOUSE, BD. OF GOVERNORS OF THE FED. RSRV. SYS., THE SCOPE OF MONETARY POLICY ACTIONS AUTHORIZED UNDER THE FEDERAL RESERVE ACT 17 (July 19, 2004), https://www.federalreserve.gov/pubs/feds/2004/200440/200440pap.pdf [https://perma.cc/5ST9-53RW].

51. H.R. REP. NO. 63-69, at 52 (1913).

52. Letter from Mr. McClelland to Mr. Van Fossen, Municipal Warrants Purchased by Federal Reserve Banks 3 (Apr. 29, 1932), *available at* https://fraser.stlouisfed.org/archival/1344/item/469329 at 39 [https://perma.cc/85JH-MKA4]. *See also* Table 1, *infra*.

percent of the issuance itself.[53] Reserve Banks' demand for municipal bonds was high enough following passage of the 1913 Act that they made regular requests of the Board to waive the then-Regulation F caps.[54]

Table 1

Year	Purchased	Average Daily Holdings
1914 (Nov. 16 to Dec. 31)	$574,000	$66,000
1915	$65,859,000	$17,417,000
1916	$90,686,000	$26,541,000
1917	$16,522,000	$6,893,000
1918	$1,710,000	$352,000
1919	-	$1,000
1920	-	-
1921	$985,000	$44,000
1922	$176,000	$66,000
1923	$536,000	$85,000
1924	$58,000	$19,000
1925	$64,000	$5,000
1926	$131,000	$10,000
1927	$270,000	$37,000
1928	$315,000	$40,000
1929	$1,708,000	$315,000
1930	$919,000	$46,000
1931	$7,615,000	$839,000
1932	$3,121,500	$4,185,000
Total:	**$191,249,500**	

53. Letter from Mr. Van Fossen to Mr. Smead, Regulation E—Purchase of Municipal Warrants (Apr. 19, 1932), *available at* https://fraser.stlouisfed.org/archival/1344/item/469329 at 42 [https://perma.cc/J3J5-P8NX].

54. After learning that the Federal Reserve Bank of Cleveland had purchased $1 million of a bond issued by the State of Kentucky, the President of the Federal Reserve Bank of St. Louis wrote to the Board seeking permission to buy $2.5 million of the same issue, writing, "We want Kentucky to know that we are doing the best we can for the district tributary to this bank." Letter from W.C. Martin, Chairman of the St. Louis Reserve Bank to A.C. Miller, Chairman of the Federal Reserve Board (Apr. 3, 1916) *available at* https://fraser.stlouisfed.org/archival-collection/records-federal-reserve-system-1344/municipal-obligations-fr-district-8-469266 at 27, 28 [https://perma.cc/5CRJ-3MZR].

The Board took an accommodating view of Reserve Banks' requests to purchase more of any given municipal bond offering than Regulation F allowed, granting all forty-four Regulation F waiver requests during this period.[55] For thirty of these municipal bond offerings, Reserve Banks purchased the entire issue. Reserve Bank purchases of municipal bonds not only helped provide liquidity to banks in their respective districts, the purchases also indirectly helped municipalities fund public services and investment by providing a market for their securities and encouraging private banks to lend to municipalities. For instance, Reserve Bank purchases of education-related bond offerings helped fund school districts across the country, including in Louisville, Kentucky; Chicago, Illinois; Minneapolis, Minnesota; Salt Lake City, Utah; and Seattle, Washington.[56]

Congress' vote to declare war on Germany in April 1917 changed the domestic and international financial landscape and, with it, the importance of municipal bonds within the Fed's ambit. To prevent the crowding out of investment funds in the economy available to support the war effort, the Board discouraged municipalities from issuing new bonds and stopped granting Regulation F waivers to Reserve Banks.[57] Moreover, the mass issuance of Treasury bonds, which were safer and more stable than municipal bonds, reduced the need for Reserve Banks to purchase municipal bonds. Meanwhile, the increase in supply of federal debt sparked a shift in the Fed's view of potential OMO purchasing

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55. The Federal Reserve Bank of St. Louis' FRASER archive library documents Reserve Bank purchases of municipal bonds from 1914 to 1935 in Box 1449. Folders 2 through 7 in that box contain the correspondence between the Reserve Banks and the Board concerning the purchases of municipal bonds. The Author reviewed Box 1449 for each jurisdiction to catalogue Regulation F waiver requests and their outcomes; the Author's notes and summaries are on file with the *Columbia Journal of Law & Social Problems*.

56. *See id.*

57. Paul M. Warburg, *Capital Issues for State and Municipal Debts and Their Relation to War Financing*, Delivered at the National Conference on War Economy, Academy of Political Science at Columbia University (June 6, 1918) (arguing to municipalities to support the war effort by halting new bond issues and voiding active contracts to free up capital and labor to support the war effort); Letter from W.B.G. Harding, Governor of the Federal Reserve Board (Feb. 20, 1917), *available at* https://fraser.stlouisfed.org/archival-collection/records-federal-reserve-system-1344/fr-banks-open-market-operations-1919-1936-469329 at 187 [https://perma.cc/SB68-FNVA] (explaining that because of hardening economic conditions, the "Board thinks that it is inadvisable to invest the funds of Federal Reserve Banks in [municipal] warrants").

authority from that of a mere investment tool into an effective monetary policy mechanism able to influence the money supply.[58]

Therefore, just as OMO purchasing authority was taking center stage in the Fed's toolbox in the 1920s, the practice of using that power to purchase municipal bonds was falling out of favor. By 1932, Fed officials wrote that the reasons that led to the inclusion of Section 14 OMO authority to purchase municipal bonds "appear[ed], therefore, to have little or no significance" in connection with the exercise of OMO purchasing authority.[59] In 1978, the Fed rescinded Regulation E, the rule governing these purchases.[60] Ultimately, the significant increase in supply of federal debt that accompanied and followed World War I obviated the need for Reserve Banks to purchase municipal bonds—but the latent statutory power remained.

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58. *See* FED. RSRV. BANK OF N.Y., *Answers to Questionnaire No. 9, Open Market Operations* (Feb. 25, 1921), https://fraser.stlouisfed.org/archival/1344/item/469329 at 77 [https://perma.cc/6SA4-XLP2] ("Since the purchase of securities has a tendency to make money easier and thus has an influence toward stimulating business activity, and since the sale of securities tend to make money firmer and has an influence toward checking excesses, it may be said that the purchases and sales of government securities since 1922 have been such as might reasonably be expected to exercise some influence toward business stability by aiding recovery at time of depression, and retarding excesses at time of prosperity."); *see generally* LESTER V. CHANDLER, BENJAMIN STRONG: CENTRAL BANKER (1958) (discussing how the individual Federal Reserve Banks "discovered" the power of open market operations following World War I when trying to replenish their earnings by investing in government securities).

59. Letter from Mr. Wyatt to Mr. Smead (Feb. 23, 1932), *available at* https://fraser.stlouisfed.org/archival-collection/records-federal-reserve-system-1344/fr-banks-open-market-operations-1919-1936-469329 at 67 [https://perma.cc/Z45D-TW5C]; During the Great Depression, the Federal Reserve also rejected expansive interpretations of its Section 14 authority to purchase municipal bonds, rejecting pleas from municipalities around the country. The Federal Reserve Bank of San Francisco, in denying a request from Douglas, Oregon to purchase a bond that had no technical maturity, but would still be paid back in six months by a defined stream of taxes, agreed that "[t]here is no question about the need for better machinery to finance political subdivisions, particularly the smaller ones. It seems to us, however, that . . . the problem should be approached" through municipal financing laws. Letter from Mr. Clerk, Deputy Governor of the St. Louis Reserve Bank to Chester Morrill, Secretary of the Federal Reserve Board (June 1, 1933), *available at* https://fraser.stlouisfed.org/archival/1344/item/469166 at 54 [https://perma.cc/S3DD-PJRF].

60. *See* Rescission of Regulation E, 43 Fed. Reg. 53,701, 53,708 (Nov. 11, 1978).

C. THE FEDERAL RESERVE'S AUTHORITY TO LEND TO MUNICIPALITIES

Unlike the history of Section 14 of the FRA, which featured an explicit authorization of power to purchase municipal bonds, and actual use of said power, the history of Section 13 Lender of Last Resort (LLR) authority and municipalities is less straightforward. The Fed had never used its Section 13 LLR power to loan money to municipalities until 2020.[61]

As a matter of central banking theory, the LLR is traditionally reserved for use in the financial system, and the post–Great Recession policy debates around the scope of LLR concerned whether the central bank should lend only to banks or also to other large firms that operate in the financial system (e.g., broker-dealers, investment banks, money market mutual funds).[62] As discussed above, the LLR power is most easily understood as a policy solution meant to solve liquidity crises in financial markets, which arise when negative economic shocks cause banks and other lenders to reduce or outright stop lending to individuals, businesses, and one another.[63] To keep the spigot of credit flowing throughout the economy during economic crises, the LLR power provides a backstop source of money for the banks. The banks, supported by their access to LLR loans, are able to continue servicing the real economy. Thus, LLR lending traditionally targets credit providers within the real economy, rather than real economy entities themselves.

From 1913 through 2020, the scope of the Fed's Section 13 LLR authority generally expanded as the financial system evolved. At the outset, only national banks could access the LLR discount window, and the types of collateral accepted for LLR loans were strictly limited to short-term, private debt.[64] In 1932, Congress opened up the potential availability of LLR loans to "any

61. Kellie Mejdrich & Victoria Guida, *Fed to Buy Municipal Debt for First Time, Underscoring Peril Facing Cities*, POLITICO (Apr. 9, 2020), https://www.politico.com/news/2020/04/09/fed-to-buy-municipal-debt-178222 [https://perma.cc/YR7N-2VMG].

62. Paul Tucker, *The Lender of Last Resort and Modern Central Banking: Principles and Reconstruction*, in BANK FOR INT'L SETTLEMENTS, BIS PAPERS NO. 79: RE-THINKING THE LENDER OF LAST RESORT 27-28 (2014), https://www.bis.org/publ/bppdf/bispap79.pdf [https://perma.cc/TXV2-7TYK].

63. *See* Posner, *supra* note 39, at 1532–40.

64. H.R. REP. NO. 63-163, at 64–66 (1913) (Conf. Rep.).

individual, partnership, or corporation."[65] Since then, both the types of financial institutions that could access the LLR discount window and the securities that those entities could offer as collateral in exchange for LLR loans have steadily grown.[66] However, political backlash from the Fed's bailouts of the collapsing financial institutions Bear Stearns (an investment bank) and AIG (an insurance company) led Congress to somewhat limit the Fed's freedom under Section 13(3). Congress amended the FRA in 2010 to require that any loans made thereunder be "for the purpose of providing liquidity to the financial system," and not to bail out individual companies.[67]

Notwithstanding the expansion of the scope of the LLR authority, prior to 2020 the Fed had only once used its LLR authority to lend to entities outside of the financial system. The Depression-era Section 13(3) facility, established five days after Congressional authorization on July 26, 1932, enabled Reserve Banks to make loans to private corporations, but Board rules governing the types of collateral that Reserve Banks could accept were strict.[68] The facility lived for four years (five times longer than its 2020 counterparts); through it, Reserve Banks lent a total sum of $1.5 million (just over $30 million in 2022 dollars) to 123 private, non-bank companies under the program.[69]

Two primary dynamics help explain municipalities' absence from the history of the Fed's use of LLR emergency authority before 2020. First, congressional efforts to expand LLR authority to help combat the Great Depression targeted private companies and non-bank financial companies who were not permitted to

65. Emergency Relief and Construction Act of 1932 § 210, 47 Stat. 709, 715 (1935) (current version at 12 U.S.C. § 343).

66. The LLR authority expanded along the lines of (i) eligible counterparties to whom the discount window was accessible and (ii) eligible collateral that Reserve Banks could accept at the LLR discount window. To counterparties, the Federal Reserve brought within the LLR's scope nonmember banks temporarily in 1966, then permanently in 1980 as a result of the Savings & Loans Crisis of 1980. As for collateral, Congress expanded the universe to include a wider class of securities in 1991 after the Stock Market Crash of 1987. *See generally* 12 U.S.C. § 343 (as amended).

67. 12 U.S.C. § 343(3)(B)(i); *see also* Todd H. Eveson, *Exigent Circumstances: Section 13(3) of the Federal Reserve Act and Federal Emergency Lending Programs*, 25 N.C. BANKING INS. 103, 114–116 (2020) (discussing Dodd-Frank amendments to Section 13(3) of the FRA).

68. Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 232–33 (2010).

69. *See id.* at 233 (noting that the largest loan of $300,000 was made to a typewriter manufacturing company; another for $250,000 was extended to a vegetable grower).

access the LLR discount window under the 1913 Act; the Great Depression reforms to the FRA were not made with state and local governments in mind.[70] Second, also in July 1932, Congress authorized the newly created Reconstruction Finance Corporation (RFC) to lend up to $300 million to municipalities to bolster public investment (nearly $6.5 billion in 2022 dollars).[71] Although, the RFC only extended $180 million of such loans before Congress revoked its authority in June 1933.[72]

Still, the Fed has a long history of resisting calls to use LLR authority to lend to municipalities. In 1975, the Fed rejected calls for it to use the Section 13 LLR authority to lend money to New York City, which was embroiled in a debt crisis.[73] More than three decades later, Fed Chairman Ben Bernanke echoed the same reasoning in a 2008 letter opposing FRA amendments that would provide new authority for the Fed to lend to states and localities. He argued that such decisions were inherently political and therefore jeopardized the freedom of localities from federal financial oversight.[74] More recently, the Fed has rebuffed *ad hoc* calls for it to use LLR authority to aid municipalities under financial duress, like Detroit in 2012 and Puerto Rico and Illinois in 2016.[75]

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70. *See* Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, 24 ECON. POL. REV. 1, 19–28 (2018).

71. Buel W. Patch, *The R.F.C. Under Hoover and Roosevelt*, in EDITORIAL RESEARCH REPORTS 1935, at 69–88 (1935), http://library.cqpress.com/cqresearcher/cqresrre19350 71700 [https://perma.cc/B9KA-QT6G].

72. *Id.* ("All projects were to be self-liquidating, the law stipulating that 'a project shall be deemed self-liquidating if such project will be made self-supporting and financially solvent and if the construction cost thereof will be returned within a reasonable a period by means of tolls, fees, rents, or other charges, or by such other means (other than by taxation) as may be prescribed by the statutes which provide for the project.'").

73. FREDERICK C. SCHADRACK & FREDERICK S. BREIMYER, FED. RSRV. BANK OF N.Y. RECENT DEVELOPMENTS IN THE COMMERCIAL PAPER MARKET, 280–91 (Dec. 1970), https://www.newyorkfed.org/medialibrary/media/research/monthly_review/1970_pdf/12_3 _70.pdf [https://perma.cc/Q3P9-V85G] (describing that there was a run in the commercial paper market and the steps the Federal Reserve did take to calm the financial panic that relieved the pressure for it to make emergency loans to New York City.); *see also* Jeff Nussbaum, *The Night New York Saved Itself from Bankruptcy*, NEW YORKER (Oct. 16, 2015), https://www.newyorker.com/news/news-desk/the-night-new-york-saved-itself-from-bankruptcy [https://perma.cc/HRC4-DR8W].

74. *See* Brian Tumulty, *Congress Considers Requiring Fed to Buy Muni Bonds for Coronavirus Fight*, BOND BUYER (Mar. 19, 2020), https://www.bondbuyer.com/news/congress-considers-requiring-fed-to-buy-muni-bonds-for-coronavirus-fight [https://perma.cc/V5WB-QGH3].

75. *See, e.g.*, Judith Crown, *Illinois Pension Crisis: Ripe For Fed Rescue?*, BETTER GOV'T ASS'N (Jan. 27, 2016), https://www.bettergov.org/news/illinois-pension-crisis-ripe-for-fed-rescue/ [https://perma.cc/S6MF-6HUY]; Fred Dews, *Bernie Sanders Called on the Fed to*

Yet, the CARES Act's legislative mandate for the MLF broke with the long-standing tradition that had resisted using Section 13 LLR authority beyond the financial system. In the MLF, the Fed used its Section 13 LLR authority to lend directly to municipal governments, which are wholly distinct from the financial institutions normally within the LLR's purview.

II. THE MUNICIPAL LIQUIDITY FACILITY

Part II adds the chapter of the Municipal Liquidity Facility (MLF) to the history laid out in Part I. Part II.A begins at the statutory origin, examining the curious combination of conflicting views, compromise, haste, and politics that resulted in the CARES Act. Part II.B continues the story by providing an overview of the structure and operation of the MLF. Finally, Part II.C analyzes the legal, operational, and political dynamics that determined the MLF's fate.

A. THE CARES ACT

As Congress debated the bill that would become the CARES Act during the first three weeks of March 2020, both municipalities and the municipal bond market faced an existential threat in the COVID-19 pandemic.[76] At the frontline of the pandemic response, state and local governments needed money. But their tax income was disappearing while the municipal bond market was drying up. Borrowing costs for new and existing debt were skyrocketing.[77]

In the case of the CARES Act appropriation for the MLF, political dysfunction drove Congress to a compromise. The

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Restructure Puerto Rico's Debt, But Can it Happen?, BROOKINGS INST. (May 18, 2016), https://www.brookings.edu/blog/brookings-now/2016/05/18/bernie-sanders-called-on-the-fed-to-restructure-puerto-ricos-debt-but-can-it-happen/ [https://perma.cc/PWU3-Q2UN].

76. *See supra* note 12 (noting that municipal tax revenues fell dramatically as stay-at-home orders shut down swaths of the economy).

77. *See also* BIN WEI & VIVIAN Z. YUE, THE FED. RSRV. BANK OF ATL. POLICY HUB, THE FEDERAL RESERVE'S LIQUIDITY BACKSTOPS TO THE MUNICIPAL BOND MARKET DURING THE COVID-19 PANDEMIC 4, (May 2020), https://www.frbatlanta.org/-/media/documents/research/publications/policy-hub/2020/05/28/the-federal-reserves-liquidity-backstops-to-the-municipal-bond-market-during-the-covid-19-pandemic.pdf [https://perma.cc/6FXS-9SZ5] (finding that the early-March 2020 sell-off increased supply of a certain kind of municipal bond held by broker-dealers increased by four to eight standard deviations); Justin Baer, *The Day Coronavirus Nearly Broke the Financial Markets*, WALL ST. J. (May 20, 2020), https://www.wsj.com/articles/the-day-coronavirus-nearly-broke-the-financial-markets-11589982288 [https://perma.cc/D9VW-795S].

Democrats, who controlled the House of Representatives, were hesitant to offer the Republicans, who controlled the Senate and the White House, unconstrained power over such a large appropriation.[78] Meanwhile, Republicans were ardently opposed to providing any direct municipal aid in the CARES Act whatsoever.[79] Senate Majority Leader McConnell went as far as to suggest that municipalities struggling to battle the pandemic should declare bankruptcy.[80] To compromise, Democrats and Republicans enlisted the Fed—an independent and well-respected agency—to help channel some of the pandemic aid for municipalities.

After making the political decision to involve the Fed, Congress needed to decide whether to base the program on the Fed's Section 13 LLR lending authority or its Section 14 OMO purchasing authority. The bill passed by the House Financial Services Committee (HFS Bill) incorporated Representative Rashida Tlaib's proposal to amend the FRA to establish a program for municipal bond purchases under the Section 14 OMO purchasing authority.[81] The HFS Bill was specific: the program was only permitted to operate if there was a finding of "unusual and exigent circumstance;" the HFS Bill required that MLF loans not be priced at an above-market rate; it suspended the FRA's restrictions on type and maturity of municipal bonds that the Reserve Banks can legally purchase, thereby allowing the Fed flexibility; and it

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78. Though political gridlock drove Congress to enlist the Federal Reserve in the CARES Act, the reliance on the Federal Reserve is the natural result of the gradual increase in the power and importance of the American central bank over the past several decades that only accelerated after the Great Recession. In one sense, this represents another turn in the "stately dance" between elected and unelected power, with Congress discharging its own responsibility for economic affairs to a politically unaccountable body, the Federal Reserve. *See* PAUL TUCKER, UNELECTED POWER: THE QUEST FOR LEGITIMACY IN CENTRAL BANKING AND THE REGULATORY STATE 48–71 (2018) (describing the political economy of modern central banking and arguing that increased reliance on central banks by legislatures poses a risk to central bank legitimacy).

79. Brian Tumulty, *Muni Provisions Lacking in McConnell Stimulus Bill*, BOND BUYER (Mar. 23, 2020), https://www.bondbuyer.com/news/muni-provisions-absent-from-mcconnell-stimulus-bill [https://perma.cc/T692-3JUQ].

80. John Wagner, *McConnell Takes Flak After Suggesting Bankruptcy for States Rather than Bailouts*, WASH. POST (Apr. 23, 2020), https://www.washingtonpost.com/powerpost/mcconnell-takes-flak-after-suggesting-bankruptcy-for-states-rather-than-bailouts/2020/04/23/f70311fe-8560-11ea-a3eb-e9fc93160703_story.html [https://perma.cc/255A-6B32].

81. Financial Protections and Assistance for America's Consumers, States, Businesses, and Vulnerable Populations Act, H.R. 6321, 116th Cong. § 301 (2020).

required that the Fed establish the MLF within seven days.[82] A similar bill was proposed in the Senate.[83]

The MLF legislative proposal in the HFS Bill ultimately failed to pass Congress. Democratic House Leadership eliminated the HFS Bill's design for the MLF and replaced it with weaker, vaguer language that would end up in the final text of the CARES Act.[84] Unlike the HFS Bill, the CARES Act did not amend the FRA and only required that the MLF be structured under Section 13(3) LLR authority. Further, the CARES Act included no hard timeline, no rules about generous pricing, no explicit requirement for the Fed to even establish the MLF and purchase bonds thereunder, and no benchmarks or measures of success.[85] Democratic leadership in the House even refused a plea from Representative Tlaib and her colleagues to clarify the statutory mandate for municipal aid in the CARES Act proposal that was to go to the floor.[86]

Thus, the final text of the CARES Act allocated $454 billion to the Treasury Secretary "to make . . . investments in, programs or facilities established by the [Fed] for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, States, or municipalities."[87] But the CARES Act is silent on the Fed's authority under the FRA, instead only mentioning the FRA to require that any program that the Treasury

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82. *Id.* § 301(b)(1)–(2) ("Within seven days after the date of enactment of this subsection, the [Board] shall establish a facility. . . . The [Board] shall establish policies and procedures to require the direct placement of bills, notes, bonds, and warrants . . . with the Board at an interest cost that does not exceed the Federal funds rate target for short-term interbank lending, within seven days after the date of enactment of this section."). The HFS Bill would have attempted to improve conditions by authorizing and requiring the Federal Reserve to purchase municipal bonds from banks and investors. The HFS Bill set a price ceiling, but still allowed the Federal Reserve flexibility to determine the specific terms on which it would purchase the bonds. Once the Federal Reserve announces the terms of its purchasing program under the HFS Bill, then municipalities and their bankers would create those bonds because they know that the Federal Reserve stands ready to purchase them.

83. Municipal Bonds Emergency Relief Act, S. 3350, 116th Cong. § 2 (2020).

84. *Compare* H.R. 6321 § 301, *supra* note 81 *with* CARES Act § 4003(d)(4), *supra* note 17.

85. CARES Act § 4003(c)(3)(E) ("The Secretary *shall endeavor to seek the implementation of* a program or facility in accordance with subsection (b)(4) that provides liquidity to the financial system that supports lending to States and municipalities.") (emphasis added).

86. Letter from Representative Tlaib et al. to Speaker of the House Nancy Pelosi & Majority Leader Kevin McCarthy (Mar. 25, 2020), https://tlaib.house.gov/sites/tlaib.house.gov/files/Support%20for%20State%20and%20Local%20Municipalities%20Letter_Rashida%20Tlaib.pdf [https://perma.cc/76D5-HJGX].

87. CARES Act § 4003(d)(4).

Secretary invest in be created under Section 13(3).[88] Despite the lack of statutory details on the program, Congressional Democrats on the HFS Committee expected the MLF to offer "robust" support for municipalities.[89]

B. THE MLF

The MLF contemplated by the CARES Act was an emergency loan program to help municipalities deal with the pandemic. Two weeks after the passage of the CARES Act, on April 9, 2020, the Fed and Department of the Treasury announced the formation of the MLF to:

(i) help manage the impact of cash flow pressures related to further delays in tax receipts;

(ii) lessen the impact of revenue reductions owing to diminished economic activity and offset increases in costs associated with fighting the pandemic; and,

(iii) help borrowers make debt service payments on existing obligations.[90]

The MLF itself was a Delaware-registered, limited liability company designed as a stand-alone entity that would make loans directly to municipalities.[91] The N.Y. Reserve Bank was the "managing member" of the MLF, and thus retained the exclusive right to manage the day-to-day operations of the program.[92] As managing member, the N.Y. Reserve Bank was responsible for employing staff to operate the MLF and contracting on behalf of the MLF LLC. The Treasury was the "preferred equity member"

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88. CARES Act § 4003(d)(4).

89. 117 CONG. REC. H1732, H1851 (daily ed. Mar. 27, 2020) (Statement of Rep. Maxine Waters) ("Given how urgent the needs are, Congress expects this program to be stood up quickly, and for the support that it provides for state and local borrowing to be robust, including through the direct purchase of new debt issuances and long-dated municipal securities.").

90. FED. RSRV. BANK OF N.Y., FAQS: MUNICIPAL LIQUIDITY FACILITY https://www.newyorkfed.org/markets/municipal-liquidity-facility/municipal-liquidity-facility-faq [https://perma.cc/BL48-LTCW] [hereinafter MLF FAQs]; *see also* BD. OF GOVERNORS OF THE FED. RSRV. SYS., *Federal Reserve Takes Additional Actions to Provide up to $2.3 Trillion in Loans to Support the Economy* (Apr. 9, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200409a.htm [https://perma.cc/NG6N-5JNE].

91. FED. RSRV. BANK OF N.Y., THIRD AMENDED & RESTATED MUNICIPAL LIQUIDITY FACILITY LIMITED LIABILITY COMPANY AGREEMENT (May 26, 2020) [hereinafter MLF LLC Agreement] https://www.newyorkfed.org/medialibrary/media/markets/mlf/MLF-limited-liability-company-agreement [https://perma.cc/2WF3-94CK].

92. *Id.* at 4 (¶ 7).

and agreed to invest up to $35 billion of funds allocated by the CARES Act.[93]

The Treasury's equity investment effectively provided the seed capital for the MLF. Congress allocated $35 billion to the Treasury Secretary to invest in a Fed program under Section 13(3) designed for municipalities. The Treasury Secretary invested that money into the MLF LLC. The Fed was then authorized to leverage (i.e., borrow against) that equity investment to lend up to $500 billion to municipalities.[94] The equity investment also served to protect the Fed from sustaining any losses on the MLF loans.

All qualifying municipalities were able to borrow from the MLF on predetermined terms set by Fed and Treasury officials (in the Term Sheet).[95] The Term Sheet restricted MLF access to municipalities that met a population size threshold; further, it specified that the MLF loans must reach maturity (i.e., are due back) in no more than 36 months and that any such loan must be secured by a specific source of tax receipts.[96] Borrowers were required to certify that they could not access better rates in the private market.[97]

Though the N.Y. Reserve Bank ran the MLF day-to-day, Treasury enjoyed significant statutory and contractual power over the MLF. First, the FRA grants the Treasury Secretary veto power over the creation of all Section 13(3) programs, including the MLF.[98] Second, the MLF LLC's formation documents formalized and increased Treasury's power over the MLF. Under the Credit Agreement between the MLF LLC and the N.Y. Reserve Bank, the MLF could only extend loans pursuant to the Term Sheet.[99] The LLC Agreement, moreover, required that the Treasury Secretary, as the preferred equity member, approve all significant changes to

93. *Id.*

94. *Id.* at 7 (¶ 12).

95. *See* MLF FAQs, *supra* note 90.

96. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., MLF TERM SHEET 1 https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200811a1.pdf [https://perma.cc/KZQ8-PA8S] [hereinafter MLF Term Sheet].

97. PEW, *The Municipal Liquidity Facility: How It Works* (Oct. 21, 2020), https://www.pewtrusts.org/en/research-and-analysis/fact-sheets/2020/10/the-municipal-liquidity-facility-how-it-works [https://perma.cc/QF43-6VBN].

98. *See* 12 U.S.C. § 343(3)(B)(iv).

99. FED. RSRV. BANK OF N.Y., CREDIT AGREEMENT BETWEEN MUNICIPAL LIQUIDITY FACILITY LLC, AS BORROWER, AND FEDERAL RESERVE BANK OF NEW YORK, AS LENDER § 3.11 (May 26, 2020), https://www.newyorkfed.org/medialibrary/media/markets/mlf/MLF-credit-agreement [https://perma.cc/A9CN-2CNC].

the Term Sheet.[100] And any amendment to the LLC Agreement affecting the rights and obligations of Treasury could only be implemented with Treasury approval.[101] The result was that Treasury enjoyed statutory and contractual power over the terms offered to municipalities by the MLF, even though the Fed operated the program.

The MLF did help soothe the municipal bond market.[102] The MLF Term Sheet effectively set a price ceiling in the market for municipal bonds.[103] Any qualifying municipality could go to the MLF and borrow money in accordance with the Term Sheet. Knowing this (and enabled by low interest rates), investors stepped into the market to offer nearly all municipalities better loan prices than those offered by the MLF, lest they lose out on the business to the MLF. By May 2020, improved credit conditions allowed municipalities to either issue new, cheap debt or refinance old, more expensive debt at lower rates.[104] The stabilized

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100. MLF LLC Agreement, *supra* note 91, at 1.

101. *Id.* at 10 (¶ 20(b)).

102. *See* ANDREW F. HAUGHWOUT, BENJAMIN HYMAN, & OR SHACHAR, FED RSRV. BANK OF N.Y. STAFF REP. NO. 988: THE OPTION VALUE OF MUNICIPAL LIQUIDITY: EVIDENCE FROM FEDERAL LENDING CUTOFFS DURING COVID-19 21 (Sept. 2021), https://static1.squarespace.com/static/5acbd8e736099b27ba4cfb36/t/6156302b104d633150dd517a/1633038382327/HHS_MLF_Draft_30Sept2021.pdf [https://perma.cc/5KYW-ZYLJ] (finding that that lower-rated municipalities narrowly eligible for the MLF terms at the end of April saw a reduction in their borrowing costs of roughly 0.72% relative to those narrowly not eligible); MICHAEL D. BORDO & JOHN V. DUCA, FED. RSRV. BANK OF DALLAS, HOW THE NEW FED MUNICIPAL BOND FACILITY CAPPED MUNI-TREASURY YIELD SPREADS IN THE COVID-19 RECESSION 28–30 (Jan. 2021), https://www.dallasfed.org/-/media/documents/research/papers/2021/wp2101.pdf [https://perma.cc/MT64-L3K6] (finding that the MLF kept rates from rising for municipalities between an estimated 5 and 8 percent as the economy deteriorated in spring and summer of 2020); ROBERT BERNHARDT, STEFANIA D'AMICO, & SANTIAGO I. SORDO PALACIOS, FED. RSRV. BANK OF CHI., THE IMPACT OF THE PANDEMIC AND THE FED'S MUNI PROGRAM ON ILLINOIS MUNI YIELDS 5 (Dec. 2020), https://www.chicagofed.org/~/media/publications/chicago-fed-letter/2020/cfl449-pdf.pdf [https://perma.cc/5QYA-6W55] (finding a roughly 1.1% reduction in borrowing costs for a sample study of 20 states, including a 2.2% drop for Illinois). *See also* Figure 1, *infra*.

103. Daleep Singh, *The Fed's Emergency Facilities: Usage, Impact, and Early Lessons*, Remarks at Hudson Valley Pattern for Progress (delivered via videoconference) (July 8, 2020), https://www.newyorkfed.org/newsevents/speeches/2020/sin200708 [https://perma.cc/8LV9-6H27].

104. *Quarterly CARES Act Report to Congress: Hearing Before S. Comm. on Banking, Housing, & Urban Affairs* 116th CONG. 48–56 (Dec. 1, 2020) (statement of Jerome H. Powell, Chairman of the Board of Governors of the Federal Reserve) ("The MLF has contributed to a strong recovery in municipal securities markets, which has facilitated a historic issuance of approximately $275 billion of bonds since late March. State and local governments and other municipal bond issuers of a wide spectrum of types, sizes, and ratings have been able to issue bonds, including long maturity bonds, with interest rates that are at or near historical lows. Those municipal issuers that do not have direct access to the Federal Reserve under the MLF have still benefited substantially from a better-functioning

municipal bond market provided some degree of fiscal relief to state and local governments by lowering debt service costs.[105]

Figure 1

The MLF, however, did not operate in a vacuum, nor was it the silver bullet that calmed the bond market.[106] By March 16, 2020, the Fed had already cut the target interest rate to a range of zero

municipal securities market."); *see also* Lynne Funk, *New York Issuers Lead Top 10 of 2020*, BOND BUYER (Jan. 8, 2021), https://www.bondbuyer.com/list/new-york-issuers-lead-top-10-of-2020 [https://perma.cc/GH2Y-2E52].

105. *See, e.g.*, Yvette Shields, *Savings from Chicago O'Hare Airport Refunding Will Add Cushion for 2021*, BOND BUYER (Sept. 15, 2020), https://www.bondbuyer.com/news/savings-from-chicago-ohare-airport-refunding-add-cushion-for-2021 [https://perma.cc/AV77-VBLP] (estimating that the O'Hare International Airport $1.24 billion refinancing transaction would yield savings of about $200 million subject to market conditions); Editorial, *District is Poised for Future*, ST. JOSEPH NEWS-PRESS (Nov. 27, 2020), https://www.newspressnow.com/opinion/editorials/district-is-poised-for-future/article_f075 1216-2e6f-11eb-81aa-0b961efd078e.html [https://perma.cc/SP38-FYNF] (estimating that the St. Joseph, Missouri school district would save "$1.7 million in future interest expenses with a decision to refinance and prepay a $6.2 million portion of bonds from 2014, which were used to build Carden Park and Oak Grove elementary schools.").

106. For example, the MLF, along with the other Federal Reserve interventions, might be seen as a successful application of the "bazooka principle" proffered by former Treasury Secretary Hank Paulson. *See* Yves Smith, *The Mnuchin-Powell Affair Over the Fed's "Special Purpose Vehicles" in Dollars & Effects*, NAKED CAPITALISM (Nov. 23, 2020), https://www.nakedcapitalism.com/2020/11/the-mnuchin-powell-affair-over-the-feds-special -purpose-vehicles-in-dollars-effects.html [https://perma.cc/UR46-7TUB].

to 0.25 percent to make borrowing money effectively free for banks and very cheap for all borrowers.[107] In addition, (i) other Fed facilities helped soothe related financial markets, leading to some indirect calming effect on the municipal bond market, and (ii) the mere announcement of the CARES Act on March 27, as well as the announcement of the MLF on April 9, helped arrest the worst of the panic in the municipal bond market.[108]

Nevertheless, the MLF's lending activity fell far short of the potential some imagined: the MLF lent only 1.27% of its available capital in four transactions with two municipal borrowers, the State of Illinois and the New York's Metropolitan Transportation Authority (MTA).[109] Both of these municipal borrowers were infamously under financial duress.[110] Even after repeated

107. For example, the Federal Reserve's Money Market Mutual Fund Liquidity Facility was established on March 18, 2020, before the CARES Act was even signed. This mutual fund facility provided significant relief for mutual funds, who were major holders of municipal securities, and had just suffered $43 billion in outflows during March 2020. HUIXIN BI & W. BLAKE MARSH, FEDERAL RESERVE BANK OF KANSAS CITY, RESEARCH WORKING PAPER NO. 20-19: WHAT DID POLICY INTERVENTIONS FIX IN THE MUNICIPAL BOND MARKET—LIQUIDITY OR CREDIT? 65–68 (2022), https://www.kansascityfed.org/documents/7596/rwp20-19bimarsh.pdf [https://perma.cc/8DV4-EM6S].

108. *Id.* at 3 ("For instance, after a unanimous CARES Act vote in the U.S. Senate, municipal bond spreads declined more than 110 basis points, which accounted for 25 percent of the average municipal bond spread over Treasury yields at the time. Cumulatively, a series of positive news regarding the CARES Act lowered municipal spreads by more than 200 basis points. Later, the Federal Reserve's announcement of a dedicated municipal market lending facility led to a decline of close to 30 basis points in average spreads. Conversely though, we also find that policy announcements had little immediate impact on alleviating credit risk concerns in the municipal bond market.").

109. BD. OF GOVERNORS OF THE FED. RSRV. SYS., PERIODIC REPORT: UPDATE ON OUTSTANDING LENDING FACILITIES AUTHORIZED BY THE BOARD UNDER SECTION 13(3) OF THE FEDERAL RESERVE ACT, Spreadsheet C: MLF Transaction-specific disclosures (Jan. 11, 2021), https://www.federalreserve.gov/publications/files/mlf-transaction-specific-disclosures-01-11-21.xlsx [https://perma.cc/5UKK-QC2K].

110. Indeed, the MTA only tapped the MLF after (1) it received a favorable credit rating from one of the credit rating agencies and (2) the Federal Reserve agreed to reduce the price of the MLF loans by 50 basis points. *See* Brian Chappatta, Opinion, *New York's MTA Is Saved Less by Fed and More by Kroll*, BLOOMBERG (Aug. 19, 2020), https://www.bloomberg.com/opinion/articles/2020-08-19/new-york-s-mta-saved-less-by-fed-and-more-by-kroll [https://perma.cc/T85L-97LA]. The state of Illinois was first driven to the MLF by a quirk in its legislative calendar. *See* Amarnath et al., *How The Fed Jammed In A Penalty Rate Requirement For All Emergency Lending When It Didn't Have To*, MEDIUM (Sep. 18, 2020), https://medium.com/@skanda_97974/how-the-fed-jammed-in-a-penalty-rate-requirement-for-all-emergency-13-3-lending-when-it-didnt-3c4f5ba6a417 [https://perma.cc/5ARH-8AAL] (citing INST. FOR ILLINOIS' FISCAL SUSTAINABILITY, *Illinois FY2021 Budget Relies on Federal Loans and Backlog Borrowing* (June 2, 2020), https://www.civicfed.org/iifs/blog/illinois-fy2021-budget-relies-federal-loans-and-backlog-borrowing [https://perma.cc/4GZW-M82D]); *see generally* David I. Backer, *Illinois and the MTA: Two Case Studies of Actually Existing MLF Loans*, WEST CHESTER UNIV. (Aug. 25,

liberalizations of the Term Sheet (see Table 2 below), the MLF remained the least used CARES Act facility in terms of dollars lent.[111]

Table 2. Evolving Terms of the Municipal Liquidity Facility

Date	Action	Duration	Eligibility	Pricing
April 9, 2020	First Term Sheet	< 2 years	States, cities > 1 mil., and counties > 2 mil.	Details TBD + 10 basis points (bps) origination fee
April 27, 2020	Second Term Sheet (expands eligible borrowers)	< 3 years	States, cities > 250,000, and counties > 500,000; at least rated Investment Grade as of Apr. 8, 2020.	Details TBD + 10 bps origination fee
May 11, 2020	Third Term Sheet (extends duration)	< 3 years	States, cities > 250,000, and counties > 500,000; at least rated Investment Grade as of Apr. 8, 2020.	10 bps origination fee + comparable maturity OIS + spread of 150 bps for AAA, 250 bps for A, and 380 bps for BBB-

2020), https://digitalcommons.wcupa.edu/cgi/viewcontent.cgi?article=1019&context=profseced_facpub [https://perma.cc/EU9E-MY8W].

111. *Compare* $6.4 billion lent by the MLF *with* the $16.5 billion under the Main Street Lending Program for small- and medium-sized businesses and nonprofits *and* the $14.1 billion under the Corporate Credit Facilities for large employers. *See* Periodic Report (Jan. 2021), *supra* note 20.

Date	Action	Duration	Eligibility	Pricing
June 3, 2020	Fourth Term Sheet (adds eligible borrowers)	< 3 years	States, cities > 250,000, counties > 500,000, designated counties, and designated revenue bonds; at least rated Investment Grade as of Apr. 8, 2020.	10 bps origination fee + comparable maturity OIS + spread of 150 bps for AAA, 250 bps for A, and 380 bps for BBB-
August 11, 2020	Fifth Term Sheet (drops pricing by 50 bps)	< 3 years	States, cities > 250,000, counties > 500,000, designated counties, and designated revenue bonds; at least rated Investment Grade as of Apr. 8, 2020.	10 bps origination fee + comparable maturity OIS + spread of 100 bps for AAA, 200 bps for A, and 330 bps for BBB-

The primary contributor to the lack of uptake was the MLF's pricing scheme. The MLF loans were substantially more expensive than those available in the market for nearly all municipal borrowers.[112] Even after the Term Sheet amendments intended to liberalize the program, 97% of eligible municipalities remained "functionally excluded" by the MLF pricing scheme.[113] Part II.C explores in further detail how and why the MLF went so unused.

C. ANALYZING THE CARES ACT AND MLF

Part II.C analyzes how the legislative design of the CARES Act impacted the MLF's performance and trajectory over the course of 2020. Congress made two legislative decisions in the CARES Act that spawned a separate host of barriers that limited the MLF's utility to municipalities struggling to fight the pandemic. Part

112. See CTR. FOR POPULAR DEMOCRACY, *supra* note 23, at 3–6.
113. *Id.*

II.C.1 discusses the operational and political impediments that arose from the decision to use the Fed to implement fiscal policy, and Part II.C.2 evaluates the consequences of Congress' choice to design the program under Section 13(3) of the FRA.

1. *Can't and Won't: Federal Reserve Municipal Lending*

The original sin of the MLF saga was the choice to involve the Fed without amending the FRA to clarify the statutory authority and mission of the program. Congress tasked the Fed to deliver some of the pandemic aid to municipalities, which is fundamentally a mission of fiscal policy. Fiscal policy involves use of government funds to influence the real economy.[114] Because fiscal policy involves picking winners and losers, it is an inherently political enterprise. On the other hand, the Fed conducts monetary policy—central bank activities that are directed toward influencing the quantity of money and credit in an economy.[115]

Monetary policy is considered apolitical because it concerns price stability and credit conditions on a *systemic* level; because monetary policy is not involved in the *direct* allocation of credit to individual entities, it is properly agnostic to the fate of all individual borrowers.[116] To ensure that it can carry out monetary policy independent of short-term political pressure, the Fed is the only organ of the government exempt from Congressional appropriations, and the members of the Board of Governors enjoy 14-year terms (although the Chairman of the Board is appointed for a four-year term).[117] Independence serves the Fed's institutional credibility, legitimacy, and effectiveness. Accordingly, the Fed clings to the distinction between its own

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114. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., *What is the Difference Between Monetary Policy and Fiscal Policy, and How Are They Related?* (Aug. 9, 2017), https://www.federalreserve.gov/faqs/money_12855.htm [https://perma.cc/L7PJ-NNHB].

115. *Id.*

116. Paul Tucker, Myron Scholes Lecture: The Only Game in Town? A New Constitution for Money and Credit Policy 3–4 (May 22, 2014), http://paultucker.me/wp-content/uploads/2015/06/Chicago-Booth-School-of-Business-Only-Game-InTown-May2014.pdf [https://perma.cc/FQ95-K9R9].

117. Peter Conti-Brown, *The Institutions of Federal Reserve Independence*, 32 YALE J. ON REG. 258, 276–99 (2015) (discussing the origin and development of Federal Reserve budgeting authority and practice, as well as the law and doctrine of the Presidential authority to remove Federal Reserve officials).

apolitical (i.e., independent) monetary policy ambit and the political fiscal policy appropriately exercised by Congress.[118]

When the Fed crosses over the line from monetary to fiscal policy, it begins to tread on the constitutional justification of its own power.[119] The Constitution vests in Congress the ultimate authority over fiscal policy decisions, providing that "No Money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law."[120] But the Fed is exempt from Congressional funding, and instead funds itself through its own operations and by printing money.[121] Indeed, when the Fed injects currency into the financial system through Section 13 lending or Section 14 purchases, it prints the money on its own and distributes it to market actors. If the Fed has discretion over which real economy actors get those funds, it may be exercising spending power properly in the domain of Congress.[122]

Although the issue has never been litigated, scholars suggest that the constitutional justification for the Fed's authority to create and spend money is not an encroachment on Congress' spending power because it only operates on a systemic level to support general credit conditions, and does not interact with the real economy.[123] By adhering to these norms, the Fed avoids making inherently political decision of fiscal policy—it does not have to decide who gets what from government spending, or who

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118. Tim Sablik, *Econ Focus: The Fed's Emergency Lending Evolves*, FED. RSRV. BANK OF RICHMOND (2020), https://www.richmondfed.org/publications/research/econ_focus/2020/q2-3/federal_reserve [https://perma.cc/ZR7F-B88L] ("'The question is whether it is appropriate to burden a central bank that has the mandate of achieving price stability and maximum sustainable employment with also managing the supply of credit directly to nonfinancial organizations, such as businesses, corporations, or municipalities,' says Schoenholtz [of New York University's Stern School of Business]. 'Those credit allocation decisions are politically fraught.'").

119. Christine A. Desan & Nadav Orian Peer, *The Constitution and the Fed after the COVID-19 Crisis*, JUST MONEY (2021), https://justmoney.org/the-constitution-and-the-fed-after-the-covid-19-crisis-2/ [https://perma.cc/X5WD-94Q6].

120. U.S. CONST. art. I, § 9, cl. 7.

121. Conti-Brown, *supra* note 117, at 273–86.

122. *See* Desan & Peer, *supra* note 119; *see also* Hal S. Scott, *An Essay on The Fed and the U.S. Treasury: Lender of Last Resort and Fiscal Policy*, 2021 HARV. J.L. & PUB. POL'Y PER CURIAM 7–9 (2021).

123. *See* Desan & Peer, *supra* note 119, at 2–3. Desan and Peer argue that the Section 13 lending power "was understood merely as a backstop for banks making the real decisions, as opposed to a source of funds that would compete with Congress," and that, concerning the Section 14 purchasing power, "Americans adopted approaches to central banking that cast purchasing operations as simply supporting a healthy market for credit. As opposed to 'picking winners and losers,' that activity was seen as loosening or tightening credit conditions in general." *Id.*

in the real economy the government is willing to lend money and risk not getting it all back. As discussed in Pat I.C, the same justification was used to refuse *ad hoc* municipal bailouts via the Fed's Section 13(3) LLR authority in the last half century.

The CARES Act and MLF pushed the Fed into fiscal policy space, and thereby collapsed the constitutional justification for the use of Section 13(3) LLR authority in the first place.[124] By requiring the Fed to lend to municipalities and interface directly with the real economy, the MLF challenges the notion that the role of the LLR is only to support private sector lending and prevent runs in the financial system.[125] Further, because the CARES Act required the Fed to determine which municipalities could access federal loans and on what terms, and assume some risk of potential loss on those contracts, the CARES Act effectively authorized the Fed to exercise fiscal policy—the "power of the purse."[126]

The break in constitutional logic that underpinned the Fed's Section 13 LLR authority demonstrates how the decision to not amend the FRA to give clear authority for the Fed to make loans available for municipalities created an inherent contradiction in the MLF. Congress created in the CARES Act a fiscal policy program operated by the Fed, but it only equipped the Fed with tools of monetary policy. The disagreements over the MLF are rooted in the dissonance between the fiscal policy mandate in the CARES Act and the monetary policy character of the LLR authority in the FRA's Section 13 (laid out in Part I.C).

The decision to involve the Fed in fiscal policy was momentous because the Fed lacks both the capacity and the appropriate political incentives to provide sufficiently generous financial loans to municipalities in crises. In other words, the Fed cannot

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124. Whether the CARES Act design of the MLF is in fact unconstitutional is unclear, but the topic is discussed further, in conjunction with other reform proposals, in Part III.D.

125. Desan & Peer, *supra* note 119, at 5 ("First, the Fed's facilities are offering support not to credit providers but to the end-borrowers: corporations, local and state government, consumers etc. These recipients are not in the business of maturity transformation and are not vulnerable to runs. Here, recall that its use to support private credit allocation and to prevent runs was the condition that distinguished central bank money creation from Congressional spending. With COVID-19, this limitation is gone.").

126. *Id.* ("Second, setting some nuance aside, the COVID-19 facilities are structured in ways that leave each facility directly exposed to the credit risk of end-borrowers (corporations, local and state government, consumers). That risk further undermines the appearance that real decisions over credit, like a private filter, stay with private lenders. COVID-19 facilities engage in a kind of credit distribution that makes it impossible to ignore that public authority is 'picking winners and losers.' That sounds a lot like power of the purse.").

effectively carry out fiscal policy, and its institutional history and political incentives suggest that it will not.

The Fed cannot effectively run a fiscal policy of municipal loans because it lacks capacity. It does not possess the institutional experience required to evaluate hundreds of unique borrowers and determine the price of a loan and the appropriate treatment of collateral.[127] Prior to 2020, no Reserve Bank had made a loan to a non-financial company since the Korean War, and no Reserve Bank had ever lent directly to a municipality.[128] Because the Reserve Banks do not engage in the traditional banking business of evaluating borrowers and lending them money, their staff do not have the practical ability to quickly and responsibly loan money to individual municipal borrowers.[129] The pandemic facilities designed for large private companies were done through commercial banks precisely because those banks had the appropriate expertise and capacity that Reserve Banks lacked.[130]

The retinue of specialists—bankers, lawyers, asset managers, and consultants—that the Fed had to hire to help set up and run the MLF evinces its institutional incapacity. The Fed needed nine consultants for the MLF alone, compared to an average of less than three consultants for the other pandemic-era Section 13(3) facilities.[131] In terms of dollars lent, the spending on the MLF was the least effective of all the pandemic-era Section 13(3) facilities: the MLF lent out about $700 for each dollar spent on consultants, whereas the Corporate Credit Facilities managed to lend over $14,000 for each dollar spent on consultants.[132]

Not only does the Fed lack capacity, the Fed's political incentives vis-à-vis municipalities and other political institutions may have limited the MLF's usefulness. For one, the Fed's political incentives are not aligned with the municipalities that the MLF

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127. Lev Menand, *The Federal Reserve and the 2020 Economic and Financial Crisis*, 26 STAN. J.L. BUS. & FIN. 295, 318 (2021).

128. *Id.*

129. *Id.*

130. Matthew Goldstein, *The Fed Asks Blackrock for Help in an Echo of 2008*, N.Y. TIMES (Mar. 25, 2020), https://www.nytimes.com/2020/03/25/business/blackrock-federal-reserve.html [https://perma.cc/6F75-5K4Z].

131. FED. RSRV. BANK OF N.Y., *Vendor Information* (2021), https://www.newyorkfed.org/aboutthefed/vendor_information#vendor_costs [https://perma.cc/8V8V-VDM3] [hereinafter Vendor Information].

132. The Federal Reserve spent $2.25 million to lend $1.65 billion in the MLF, compared to spending $0.96 million to lend $13.68 billion in the Primary and Secondary Corporate Credit Facilities. *Compare* Vendor Information, *supra* note 131, *with* Periodic Report (Jan. 2021), *supra* note 109.

was designed to help. Second, the MLF created political frictions at the institutional level among Congress, the Fed, and the Treasury. The Fed was caught in a push and pull over the MLF between Congressional Democrats and municipalities seeking more accessibility on one hand, and Congressional Republicans, the Trump administration, and the FRA restricting its ability to acquiesce on the other.

And as an initial matter, the MLF opened up the Fed to lobbying from an entirely new constituency. Municipalities, academics, and their political champions lobbied the Fed aggressively to win five Term Sheet amendments that liberalized eligibility and access (as demonstrated by Table 2).[133] Furthermore, the MLF raised a conflict between the needs of municipalities during crises and the Fed's commitment to institutional independence and legitimacy.[134] The Fed is extremely hesitant to be "on the hook" for municipal debt if and when losses arise.[135] Further, by taking on municipal debt, the Fed risks being cast as the "bad guy" by politicians forced to impose austerity in the name of paying back Fed loans.

The political risk of a central bank assuming a creditor posture toward subnational units of government is exemplified by the recent developments concerning the European Central Bank (ECB), which has faced increased politicization since the European

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133. Peter Conti-Brown, *What's Next for the Treasury-Fed COVID-19 Lending Facilities?*, BROOKINGS INST. (Nov. 24, 2020), https://www.brookings.edu/blog/up-front/2020/11/24/whats-next-for-the-treasury-fed-covid-19-lending-facilities/ [https://perma.cc/7WC7-F8MN].

134. James A. Dorn, *Maintaining Distance between Monetary and Fiscal Policy*, CATO INST. (Nov. 18, 2020), https://www.cato.org/publications/pandemics-policy/maintaining-distance-between-monetary-fiscal-policy [https://perma.cc/9UPD-QVE7] ("By engaging in credit allocation and fiscal policy, the Fed risks becoming more politicized and less independent as Congress looks to it as a way to bypass the democratic process and dodge its constitutional duty to make the difficult choices about spending and taxing.") .

135. This hesitance goes back to the 1950s, when Federal Reserve Chair William McChesney Martin told Congress during testimony that while there might be a role for the government to address gaps in private sector lending, it was not one that the Fed should play. Rather, he said it was the preference of the Board of Governors for the Fed to "devote itself primarily to the objectives set for it by the Congress, namely, guiding monetary and credit policy so as to exert its influence toward maintaining the value of the dollar and fostering orderly economic progress." David Fettic, *Lender of More Than Last Resort*, FED. RSRV. BANK OF MINNEAPOLIS (Dec. 1, 2020), https://www.minneapolisfed.org/article/2002/lender-of-more-than-last-resort [https://perma.cc/7PAH-5X92] (summarizing the history of Section 13(3)); *see also*, George Selgin, *When the Fed Tried to Save Main Street*, ALT-M (Mar. 30, 2020), https://www.alt-m.org/2020/03/30/when-the-fed-tried-to-save-main-street/ [https://perma.cc/64HB-X2P8].

sovereign debt crisis in 2011.[136] The ECB was one leg of the "troika" that imposed damaging austerity on Greece in particular and across the European Union periphery in general. The austerity sparked protest movements across the Eurozone and earned the ECB scathing criticism.[137] The Fed's hesitancy toward purchasing municipal loans through a highly accessible MLF reflects, in part, a determination to avoid the ECB's fate.

A second political front opened by the MLF was the Fed's entanglement with Treasury within the MLF LLC. The manner in which Section 13(3) provides Treasury control over a Fed program ultimately muddied accountability of the program: even though the MLF was a Fed facility, the substance of the lending arrangement shows that Treasury controlled the MLF without taking responsibility.[138] Almost immediately, political frictions between the Fed and Treasury reportedly caused delays in the implementation of the MLF, which was not announced until two weeks after the first wave of facilities that targeted corporate bond and money markets.[139]

Moreover, the Treasury Secretary's equity investment (mandated by the CARES Act) provided it with yet another vector

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136. *See generally* David M. Woodruff, *Governing by Panic: The Politics of the Eurozone Crisis*, LEQS PAPER NO. 81 (Oct. 22, 2014), https://ssrn.com/abstract=2513391 [https://perma.cc/TUA6-RF6J] (describing the political economy of the Sovereign Debt Crisis and the ECB's response).

137. *See, e.g.*, *Germany Riot Targets New ECB Headquarters in Frankfurt*, BBC (Mar. 18, 2015), https://www.bbc.com/news/world-europe-31938592 [https://perma.cc/KN8A-2T6F]; *see also*, *Varoufakis Says ECB Policy on Greece "asphyxiating"*, REUTERS (Mar. 11, 2016), https://www.reuters.com/article/uk-eurozone-greece-finmin/varoufakis-says-ecb-policy-on-greece-asphyxiating-idUKKBN0M72N720150311 [https://perma.cc/VS3K-9F8J].

138. *See* Desan & Peer, *supra* note 119. Desan and Peer express concern that arrangements like the MLF:

> [O]bscure . . . the exercise of power by the Treasury, while misusing the notion that a central bank should have independence. The latter is an organizing principle of modern central banking, intended to insulate the power of money creation from improper manipulation for short-term electoral gain. What we're seeing now is a kind of backward use of central bank independence. On the one hand, the Fed, which is timid to make loans that can result in losses, is taking cover in loan guarantees from the politically accountable Treasury. On the other hand, the Treasury, which is effectively controlling . . . Fed lending . . . is taking cover in the notion that lending is administered by the Fed, a neutral institution, based on Fed expertise, rather than political influence. In this way, the Treasury gets to avoid the very same political accountability that the Fed cites as justification for its risk taking.

Id.

139. Alan Rappeport & Jeanna Smialek, *Clash Over Municipal Loan Program Delays Stimulus Report*, N.Y. TIMES (Oct. 9, 2020), https://www.nytimes.com/2020/10/09/business/congress-municipal-loan-oversight-coronavirus.html [https://perma.cc/U9P2-QA6W].

of control.[140] As the preferred equity member, Treasury provided an "equity cushion" to the MLF. The equity cushion was meant to help the Fed meet its obligation to avoid losses on MLF loans.[141] Treasury Secretary Mnuchin, however, adopted a "base case" scenario in which even the equity cushion did not sustain any losses.[142] This elevated the price of MLF loans because no part of the MLF LLC capital structure was willing and able to sustain losses.

Finally, the fight over the future of the MLF in the waning months of 2020 makes clear the political dynamics of Section 13(3) programs like the MLF.[143] In a November 19, 2020 letter to Fed Chairman Jerome Powell,[144] outgoing Treasury Secretary Mnuchin announced that the MLF was to end on December 31, 2020 and demanded that the Fed return unspent money allocated by the Treasury under the CARES Act.[145] The Fed opposed the Treasury Secretary's move to shutter the MLF.[146] The Fed

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140. A key issue is how much risk the Treasury, as agent for the taxpayers, is willing to take, given the 13(3) requirement that Fed lending is secured to its satisfaction. This determination will determine how many businesses the program can help. *See* Nellie Liang, *The Federal Reserve, which already has moved aggressively, can do more for small businesses*, BROOKINGS INST. (Mar. 30, 2020), https://www.brookings.edu/blog/up-front/2020/03/30/the-federal-reserve-which-already-has-moved-aggressively-can-do-more-for-small-businesses/ [https://perma.cc/3RXN-9NJ8].

141. Jenna Smialek, *A Coffee Chain Reveals Flaws in the Fed's Plan to Save Main Street*, N.Y. TIMES (June 9, 2020), https://www.nytimes.com/2020/07/09/business/economy/federal-reserve-treasury-main-street.html [https://perma.cc/JF8Z-MKJG].

142. *Id.*

143. Bill Lucia, *End Nears for Fed's Municipal Lending Program*, ROUTE FIFTY (Dec. 23, 2020), https://www.route-fifty.com/finance/2020/12/fed-municipal-liquidity-facility-lending-program-expires/171002/ [https://perma.cc/FGJ8-39YM]; *see also* Catarina Saraiva, *Democratic Senators Call for Expansion of Fed Lending Programs*, BLOOMBERG (Nov. 6, 2020), https://www.bloomberg.com/news/articles/2020-11-06/democratic-senators-call-for-expansion-of-fed-lending-programs [https://perma.cc/5HRF-26D4] (describing the Senators' demands as (i) extending the MLF into 2021, (ii) offering longer maturity loans beyond 3 years, and (iii) allowing direct access for smaller municipalities that do not meet the Term Sheet eligibility thresholds).

144. *Press Release, Letter from Secretary Steven T. Mnuchin on the Status of Facilities Authorized Under Section 13(3) of the Federal Reserve Act*, DEP'T OF THE TREASURY (Nov. 19, 2020), https://home.treasury.gov/news/press-releases/sm1190 [https://perma.cc/82KJ-SJQX] [hereinafter Treasury Letter]; *see also* Conti-Brown, *supra* note 133 (arguing that the return of unspent money was not, in fact, required by law).

145. Conti-Brown, *supra* note 133.

146. Rachel Siegel & Jeff Stein, *Treasury Secretary Mnuchin Cuts Off Several Federal Reserve Emergency Aid Programs, Sparking Unusual Rebuke from Fed*, WASH. POST (Nov. 19, 2020), https://www.washingtonpost.com/business/2020/11/19/emergency-lending-programs-fed-treasury/ [https://perma.cc/9YTF-SRAU] ("The Federal Reserve would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy . . . "). In addition, the effort to close the MLF was opposed by Wall Street banks

eventually had to acquiesce because of the complete subordination of the Fed to the Treasury within the MLF LLC.[147] In the end, the lame duck Republicans in the Senate and White House managed to terminate the MLF legislative mandate in the 2021 Consolidated Appropriations Act, signed on December 23, 2020.[148] Part II.C.1 shows that the decision to involve the Fed in fiscal policy runs contrary to its institutional capacity and political incentives, and the constitutional justifications for the Fed's expansive authorities and political independence. It also demonstrates how sharply the CARES Act broke with the history of the use of LLR authority laid out in Part I.C.

2. *The Section 13(3) Barriers to Federal Reserve Municipal Lending*

Congress' decision to establish the MLF under Section 13(3) created a separate set of barriers that ultimately diminished the direct usefulness of the MLF to municipalities in 2020. Section 13(3)'s unique legal requirements with respect to (i) facility design and (ii) pricing, in particular, proved incompatible to the mission of credit policy (i.e., the distribution of government credit, a type of fiscal policy) as envisioned in the MLF. And as a political matter, the choice to use Section 13(3) ultimately gave the Trump administration (via Treasury Secretary Mnuchin) significant control over the terms of the MLF.

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and Democrats alike. *See* Editorial, *State and Local Governments Still Need the Fed's Municipal Liquidity Facility*, BLOOMBERG (Nov. 17, 2020), https://www.bloomberg.com/opinion/articles/2020-11-17/state-and-local-governments-still-need-the-fed-s-municipal-liquidity-facility [https://perma.cc/87LL-8XUW]; *see also* Alexandra Scaggs, *The MTA Could Be the Last to Tap the Fed's Muni Facility. Wall Street Watchers Fret Its End.*, BARRON'S (Nov. 24, 2020), https://www.barrons.com/articles/the-mta-could-be-the-last-to-tap-the-feds-muni-facility-wall-street-watchers-fret-its-end-51606217401 [https://perma.cc/H4UC-SAL3]; David Dayan, *Unsanitized: Mnuchin Mothballs the Money Cannon, and I Feel Fine*, AM. PROSPECT (Nov. 20, 2020), https://prospect.org/coronavirus/unsanitized-mnuchin-mothballs-the-money-cannon-and-i-feel-fi/ [https://perma.cc/3QM7-KVJU] (discussing the response to the Treasury Letter).

147. *See* Philip Wallach, *How Congress Made the Secretary of the Treasury the Boss*, LEGBRANCH (Apr. 24, 2020), https://www.legbranch.org/how-congress-made-the-secretary-of-the-treasury-the-boss/ [https://perma.cc/LS3K-SPG9].

148. Brian Tumulty, *How State and Local Governments Fared in the Coronavirus Relief Bill,* BOND BUYER (Dec. 21, 2020), https://www.bondbuyer.com/news/how-state-and-local-governments-fared-in-the-coronavirus-relief-bill [https://perma.cc/A5VW-C7TY]. Although the Omnibus bill killed the MLF and did not provide for any direct aid, it did include $82 billion for elementary, secondary, and higher education, $45 billion for transportation that includes allocations for transit and airports, and $63 billion for healthcare that includes vaccine procurement and COVID-19 testing. *Id.*

The first and most glaring legal defect in the CARES Act is that its mandate to the Fed contradicts certain facility design provisions in Section 13(3) of the FRA. The FRA permits Section 13(3) lending only "for the purpose of providing liquidity to the financial system,"[149] thereby significantly limiting the Fed's ability to use Section 13(3) LLR authority to lend to nonfinancial entities. But in the CARES Act, Congress contemplates precisely this sort of lending.[150] To surmount the real economy lending prohibition of Section 13(3), Congress appears to have effectively amended Section 13(3) *sub silentio*: the CARES Act permits the Fed to lend to municipalities, even directly, but describes the facilities it is authorizing as being "for the purpose of the financial system."[151] *Sub silentio* lawmaking is a dubious practice in its own right, but even worse is the fact that if lending directly to municipalities is a way to provide liquidity to the financial system within the meaning of the FRA, then any lending meets the requirement, and the words added in 2010 have no meaning.[152] More generally, Congressional attempts to shoehorn a fiscal policy mandate into a monetary policy legal structure demonstrate the unsuitability of Section 13(3) as a legal vehicle for the purpose of crisis funding for municipalities.

The second legal issue concerns the pricing requirements of Section 13(3). Reserve Banks may purchase loans that are "indorsed or otherwise secured to the satisfaction of the [Reserve

149. 12 U.S.C. § 343(3)(B)(i); *see also* Menand, *supra* note 127 at 326 n.121 ("The best way to parse this sentence is: 'Such policies and procedures shall be designed to ensure (i) that any emergency lending program or facility is for the purpose of providing liquidity to the financial system[] and not to aid a failing financial company, and (ii) that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.' Whether the comma is included or not, the first clause plainly requires that 13(3) loans be for the *financial system*. Consistent with this reading, Congress stripped 13(3)(A) of its reference to 'individuals, partnerships and corporations' and replaced it with language regarding participants.").

150. CARES Act § 4003 ("(a) . . . to provide liquidity to eligible businesses, States, and municipalities related to losses incurred as a result of coronavirus, the Secretary is authorized to make loans, loan guarantees, and other investments in support of eligible businesses, States, municipalities . . . (b) . . . [Including] (4) [n]ot more than [$454 billion] . . . in, *programs or facilities established by the Board . . . for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, States, or municipalities by*—(A) *purchasing obligations . . . directly*; (B) . . . in secondary markets; or (C) making loans, including loans or other advances secured by collateral.") (emphasis added).

151. *Id.*

152. *See* Menand, *supra* note 127, at 351–53 (describing the costs of *sub silentio* rulemaking).

Banks]."[153] To assist the "satisfaction" determination, the Reserve Banks are required to assign a "lendable value to all collateral . . . consistent with sound risk management practices and to ensure protection for the taxpayer."[154] Regulation A goes further to require that the interest rate charged be set at a "penalty" level (i.e., the loans are to be priced above the prevailing market rate).[155]

Taken together, these two legal rules put significant upward pressure on the collateral and interest rate considerations in the Fed's pricing calculus. First, the Regulation A penalty rate requirement placed a high floor on the cost of MLF loans because it disallowed the Fed from lowering the price of MLF loans to at- or below-market rates. While the Fed could have amended Regulation A to remove the penalty rate requirement, it chose not to do so.[156]

Second, the FRA's requirement that the Fed secure collateral "sufficient to protect taxpayers from losses" means that the Fed needs a reasonable basis on which they expect to get their money back in nominal terms.[157] This raised the price of MLF loans because higher interest rates on MLF loans would protect the Fed against losses. Finally, the Fed must write down the value of the collateral, as well as regularly report to Congress.[158] All together, the Fed feels sufficiently chastened, politically, from making loans through 13(3) facilities where the rate is low enough that it might cause the Fed to lose money.

The political legacy of the choice to create the MLF under Section 13(3) was that it allowed Republican politicians to instrumentalize the Fed to accomplish a political goal.[159] House

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153. 12 U.S.C. § 343(3)(A).

154. 12 U.S.C. § 343(3)(B)(i); *see also* 12 C.F.R. § 201.4(d)(6)(ii).

155. 12 C.F.R. § 201.4(d)(7)(ii) ("The interest rate established . . . [w]ill be set at a penalty level that: (A) Is a premium to the market rate in normal circumstances; (B) Affords liquidity in unusual and exigent circumstances; and (C) Encourages repayment of credit and discourages use of the program . . . as the unusual and exigent circumstances . . . recede and economic conditional normalize.").

156. Amarnath et al., *How The Fed Jammed In A Penalty Rate Requirement For All Emergency Lending When It Didn't Have To*, MEDIUM (Sep. 18, 2020), https://medium.com/@skanda_97974/how-the-fed-jammed-in-a-penalty-rate-requirement-for-all-emergency-13-3-lending-when-it-didnt-3c4f5ba6a417 [https://perma.cc/5ARH-8AAL].

157. *See* Menand, *supra* note 127, at 330 n.134.

158. 12 U.S.C. § 343(3)(C) (requiring reports "not later than 7 days after the Board authorizes any loan . . . under this paragraph . . . and once every 30 days [thereafter] . . . ").

159. On April 22, 2020, Senate Majority Leader McConnell dismissed the calls for municipal aid and instead suggested that economically struggling states should declare bankruptcy. *See* Wagner, *supra* note 80. The following week, Treasury Secretary Mnuchin proclaimed that "[the MLF] is not going to be just a federal bailout of the states." Patti

Democrats agreed to channel some of the appropriation for municipal aid through the Fed to eliminate Treasury's *absolute* control over the funds. But their choice to create the MLF program under Section 13(3) defeated the attempt to end-run the Treasury. In fact, the creation of the MLF under Section 13(3) provided Treasury with effective control over the MLF.

III. REFORM

The primary macroeconomic policy lesson from the governmental responses to the 2008 Financial Crisis and the 2020 COVID-19 pandemic is that the federal government must step in with fiscal aid during crises to alleviate balance sheet pressure on municipal governments.[160] With respect to municipal governments, the response in 2020 was considerably better than the response in 2008. The CARES Act and the legislation that followed in 2021 contained direct fiscal transfers that prevented some amount of municipal defaults. Moreover, the federal government's unprecedented spending on loans and income subsidies to households, as well as the entire suite of the Fed's emergency programs—including the MLF—made the pandemic recession relatively short, which meant municipalities avoided the post-2008-style contraction that they might have otherwise experienced without the federal aid. The obvious lesson is that the federal government has the power and the moral imperative to prevent reductions in public spending at the state and local government level during recessions. But the question remains: what is the proper role for the Fed to play in supporting

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Domm, *The $3.8 Trillion Municipal Bond Market, Rocked by the Coronavirus, Looks to Washington for Help*, CBNC (Apr. 29 2020), https://www.cnbc.com/2020/04/28/the-3point8-trillion-municipal-bond-market-rocked-by-the-coronavirus-downturn-is-facing-a-key-test.html [https://perma.cc/U2D7-VGXP]. Upon passage of the Omnibus bill, Senator McConnell celebrated his party's ability to exclude "unconstrained bailouts for state and local government." Tumulty, *supra* note 148.

160. DANIEL J. WILSON, FED. RSRV. BANK OF S.F., THE COVID-19 FISCAL MULTIPLIER: LESSONS FROM THE GREAT RECESSION (May 26, 2020), https://www.frbsf.org/economic-research/publications/economic-letter/2020/may/covid-19-fiscal-multiplier-lessons-from-great-recession/ [https://perma.cc/N58R-4CUZ] (evaluating the economic impact of federal spending in March and April 2020); *but see* Mariely López-Santana & Philip Rocco, *Fiscal Federalism and Economic Crises in the United States: Lessons from the COVID-19 Pandemic and Great Recession*, 51 J. OF FEDERALISM 365–395 (2021), https://doi.org/10.1093/publius/pjab015 [https://perma.cc/LX5M-2Y3A] (showing that "that while the speed and magnitude of federal aid was unprecedented in 2020, it was nevertheless conditional in nature and beset by familiar political and institutional obstacles").

municipalities during crises? Part III evaluates various attempts to answer this question.

A. SECTION 13 PROPOSALS

The MLF demonstrated that a Section 13(3) Lender of Last Resort (LLR) facility can work well for targeting liquidity crises in municipal bond markets.[161] The CARES Act effectively made the Fed the lender of last resort for municipalities through the MLF, which helped calm the panic in the municipal bond market and stabilized borrowing costs for municipalities.

Therefore, one set of proposals center on creating a "shelf-ready" MLF program in advance of the next financial crisis.[162] These proposals would create a standing LLR discount window, which would allow municipalities to access emergency liquidity during crises. Making the MLF permanent would set expectations and allow government officials and market participants to make emergency plans effectively.

At a minimum, any standing MLF proposal should come with an amendment to the FRA to (i) clarify the Fed's legal authority to lend to municipalities under Section 13(3), thus avoiding hasty, *sub silentio* lawmaking composed in the haze of an emergency and to (ii) create specific requirements for the MLF that clarify congressional intent and measures of success. More specifically, Congress might learn from the MLF and make program design improvements by amending the FRA to (i) reduce the price of MLF loans, potentially by eliminating the penalty rate; (ii) extend the maturity of MLF loans; and (iii) expand eligibility for MLF loans.[163]

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161. Tom Sgouros, *'Build Back Better?' Start with the Fed's MLF*, BOND BUYER (Dec. 18, 2020), https://www.bondbuyer.com/opinion/build-back-better-start-with-the-feds-mlf [https://perma.cc/2KYX-4FQK].

162. *See, e.g.*, *Lending in a Crisis: Reviewing the Federal Reserve's Emergency Lending Powers During the Pandemic and Examining Proposals to Address Future Economic Crises: Hybrid Hearing Before the Subcomm. on Nat'l Sec., Int'l Dev. and Monetary Pol'y of the H. Comm. on Fin. Services*, 117th Cong. 5–9 (2021) (statement of Shawn T. Wooden, State Treasurer, Connecticut).

163. *Id.* (recommending, in addition, (i) removing the certification requirement, (ii) a more flexible form of state guarantee, (iii) allow for pooled borrowings, (iv) expanding eligible classes of securities, (v) making program permanent, and (vi) potentially creating a bank-administered MLF); *see also id.* at 36–46 (statement of Mike Konczal Director, Macroeconomic Analysis, Roosevelt Institute); *id.* at 57–65 (statement of Claudia Sahm, Senior Fellow, Jain Family Institute).

Nevertheless, this Note demonstrates any LLR or MLF-style program designed under Section 13(3) is not an effective conduit for fiscal or credit policy meant to provide direct financial support to states, municipalities, and people during crises. Instead, the impact of any standing Section 13(3) municipal LLR is likely to be almost exclusively felt in the municipal bond market. This is because the LLR authority is only designed to create conditions in which municipalities can borrow from private parties, rather than to lend money to municipalities themselves.[164] A more accommodating Treasury Secretary, however, may exert control over future Section 13(3) programs to make loans more accessible, and, likewise, a more accommodating Fed may remove the penalty rate requirement. Still, it is inescapable that the use of Section 13(3) LLR authority to lend to the real economy runs against the Fed's history, capacity, and political incentives, as well as the text and spirit of the LLR authority in Section 13(3) of the FRA.

B. SECTION 14 PROPOSALS

Another set of proposals involves amending the FRA to create an emergency municipal facility under section 14 OMO authority. As discussed in Part I.B, the Fed used this power to purchase municipal debt in the market from 1915 to 1933. Although those municipal bond purchases were not made always made specifically to help struggling municipalities, the history and modern practice discussed in Part I.B reveals that the precedent exists and the function is well within the Fed's capabilities.

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164. Press Release, *Toomey Opening Statement from Today's Congressional Oversight Commission Hearing*, SEN. PAT TOOMEY (Sept. 17, 2020), https://www.toomey.senate.gov/newsroom/press-releases/toomey-opening-statement-from-todays-congressional-oversight-commission-hearing [https://perma.cc/S9WZ-BUNN]. Senator Toomey said:

> Some who criticize the Municipal Lending Facility may be ignoring its original intended purpose. The CARES Act was meant to resolve the immediate liquidity crunch and economic shock experienced in March of 2020. The Municipal Lending Facility was not meant to replace private capital markets, be a mechanism to bail out state and local governments, nor to be a substitute for fiscal policy. As the name implies and consistent with section 13(3) of the Federal Reserve Act on which the CARES Act was built, the municipal liquidity facility was meant to be a lender of last resort, to stabilize the municipal bond market, and to provide liquidity. . . . [T]he municipal bond markets have recovered, municipal bond issuance is higher—up 21 percent year-over-year through August as opposed to the down 30 percent of March—and importantly, municipal interest rates and spreads have returned to their pre-COVID-19 levels.

Id.

Along these lines, Section 801 of The Heroes Act attempted to revive Representative Tlaib's proposal to create a municipal lending program under Section 14 of the FRA, but the bill was sacrificed to political gridlock after passing the House of Representatives on October 1, 2020.[165] The Heroes Act would have authorized the Fed to purchase municipal bonds with maturity up to ten years at no more than the prevailing discount rate, regardless of credit rating, during financial crises.[166] Furthermore, by setting in law the rates, eligibility requirements, and loan maturity terms, such a proposal contains sufficiently specific language to ensure the efficacy of the program. The proposal, however, fails to contend with the fact that balanced budget and accounting rules might hamper municipalities' ability to issue long-term, unsecured debt.

Another solution—proposed by Research Director of the Modern Money Network, Nathan Tankus—is for the Fed to create a credit line for state and local governments using Section 14 OMO authority.[167] To comply with the restriction that Reserve Banks not purchase municipal debt in excess of six months to maturity, the Fed can commit to roll over short-maturity debts at certain specified prices. In this way, the Fed can "synthetically" create municipal securities of any maturity.[168] An accompanying

165. Li Zhou, *Why a Senate Vote on Stimulus Has Failed, Again*, Vox (Oct. 21, 2020), https://www.vox.com/2020/10/21/21525735/mitch-mcconnell-stimulus-senate-vote.

166. The bill also allows eligibility for any subdivision of a State with a population of more than 50,000 residents and any combination of states or territories, and eliminates the attestation requirement. The Heroes Act, H.R. 6800, 116th Cong. § 801 (2020); *see also* Press Release, *House Democrats Release Updated Version of The Heroes Act, House Committee on Appropriations* (Sept. 28, 2020), https://appropriations.house.gov/news/press-releases/house-democrats-release-updated-version-of-the-heroes-act [https://perma.cc/HMD3-Y5JQ]; Erica Werner & Jeff Stein, *House Democrats Pass $2.2 Trillion Stimulus Bill over GOP Opposition; Bipartisan Talks Continue*, WASH. POST (Oct. 1, 2020), https://www.washingtonpost.com/us-policy/2020/10/01/white-house-democrats-economic-stimulus/ [https://perma.cc/9926-5ZMU].

167. Nathan Tankus, *Is it Legal for the Federal Reserve to Provide State & Local Governments Unlimited Credit Lines?*, NOTES ON THE CRISES (Sept. 6, 2020), https://nathantankus.substack.com/p/is-it-legal-for-the-federal-reserve [https://perma.cc/HJ68-6EPJ]; *see also* Hockett, *supra* note 24 (advocating for a roll-over section 14 facility while also suggesting changes for the then-existing MLF, as well as adding the suggestion that the MLF be administered and operated locally by the regional Federal Reserve Banks).

168. Tankus, *supra* note 167 ("Want a 30 year security paying 3% interest? Promise to purchase a 3 month IOU and purchase a new one at the same price when the first one 'rolls off.' Alternatively, have a local government issue a security that continues to accrue interest after maturity and commit to holding the security for 30 years. Whatever the specific structure, the point is that the Federal Reserve has an unbounded capacity to create U.S. dollars and, when combined with a believable and credible commitment, it can effectively

proposal for a municipal credit line would be for Congress to allow state and local governments to hold accounts at the Fed through a special fiscal agent, which would functionalize and intermediate the relationship between the Fed and municipal governments.[169] Finally, Tankus suggests dealing with moral hazard (i.e., the risk that municipalities would use access to the rescue funds to enable their profligacy) in the credit line agreement by holding the municipal borrowers to strict terms of conduct.[170]

C. PROPOSALS NOT INVOLVING THE FEDERAL RESERVE

The tension between the goals of fiscal policy during crises on one hand, and the monetary policy character of the FRA and the Fed's long-standing institutional resistance to lend directly to the real economy on the other hand, suggests that policymakers should also consider proposals that look beyond the Fed. Congress could set up a new entity, as they did with the Reconstruction Finance Corporation during the Great Depression, to extend federal grants or cheap loans to municipalities during crises. Congress could even charge that agency with managing a system of automatic fiscal stabilizers that kicks-in upon the onset of a recession.[171] An automated program that helps municipalities directly maintain spending is better than a program that simply creates conditions for municipalities to borrow their way through downturns, because

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create securities of whatever maturity necessary out of its ability to buy local and state securities with nominally short maturities.").

169. *Id.* ("The Federal Reserve can simply create a special reserve account for the fiscal agent (i.e., banker) of the state or local government while the fiscal agent, in turn, creates a special checking account for the state and local government. Thus, the fiscal agent would serve as a pass-through entity, intermediating the relationship between the Federal Reserve and the local government. It's relevant here that the recent push for creating local public banks would facilitate this process greatly. That is, while a state or local government may not themselves have the authority to get a reserve account, they can create a corporation which gets a bank charter and gains federal reserve membership which will then be granted a reserve account. In any case, the state or local government could draw on their credit line as needed and the Federal Reserve can rollover, or simply continue holding, the state or local government's IOUs.").

170. *Id.* ("For example, an agreement might require the state and local government not to cut spending in aggregate during the recession. Such an agreement could require the government not to pursue tax increases during the recession. Maintaining access to the credit line would be a sufficient incentive to follow the agreement.").

171. Alex Williams, *Structuring Federal Aid To States As An Automatic (and Autonomous) Stabilizer*, EMPLOY AM. (June 12, 2020), https://employamerica.medium.com/structuring-federal-aid-to-states-as-an-automatic-and-autonomous-stabilizer-b0fe711e4662 [https://perma.cc/5M5B-68J2].

it would counteract the negative impact of municipal austerity.[172] Of course, any such program must protect against moral hazard by creating disciplining terms and conditions on the grants or loans.

A municipal aid program administered by an agency other than the Fed could avoid many of the issues that plagued the MLF. The Fed was destined to be a conservative administrator of the MLF because the FRA requires that it not lose any money, and the Fed lacks capacity and appropriate incentives to lend directly to distressed municipalities. Another agency, free from such restrictions and enabled to make loans even in the face of some risk, may serve better and be more politically accountable than the Fed.

D. EVALUATING SECTION 13 AND 14 PROPOSALS

These proposals under Sections 14 and 13 have a variety of benefits and trade-offs. For one, Section 14 explicitly allows for the purchase of municipal bonds (for which there is historical precedent, as documented in Part I.B), whereas the language of Section 13 must be stretched to some lengths to justify Fed purchases of municipal bonds. Section 14 contains none of the pricing and collateral rules that raised the prices of MLF loans under Section 13. Further, Section 14 programs cut the Treasury Secretary out of the process almost entirely, whereas Section 13 proposals necessarily involve Treasury. In a divided government, shielding the program from political influence of Treasury may be efficacious or may implicate concerns of political accountability and legitimacy.[173]

Section 14 proposals also have the benefit of being slightly easier for the Fed to administer than Section 13 programs. Because Section 14 involves purchasing existing bonds in the open market (which the Fed does very regularly) as opposed to lending money directly to municipalities, Section 14 proposals require less of the credit analysis and traditional banking capacity that the Fed

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172. *Id.*

173. Compare, for example, the situation in 2020 with that in 2008. In 2020, the Presidential administration's hostility toward municipal aid certainly made the MLF less accessible to borrowers, and circumventing Treasury's political control could have made it easier for the Federal Reserve to offer more generous terms. On the other hand, concerns about the section 13(3) bailouts of Bear Stearns and American International Group—and the lack of political accountability—led Congress to amend section 13(3), in 2010, to require Treasury Secretary approval of any section 13(3) program.

currently lacks. All the Fed would need to do is confirm that the bond meets the eligibility requirements of Section 14 (i.e., that the bond is set to mature in six months and that it is secured by tax receipts).

Section 13 and Section 14 emergency municipal funding policy solutions are not without flaws. Each set of proposals ensnares the Fed in amorphous and uncomfortable territory between fiscal policy and monetary policy. Accordingly, each proposal requires amendments to the FRA to clarify the purpose of the program and the Fed's goal and operating berth.

A separate policy concern is that forcing states to borrow their way through a crisis comes with significantly more costs than providing aid through direct grants of funds from the federal government. State and local government borrowing is no substitute for direct fiscal aid: a borrowing program targeted at short-term loans is unlikely to help states overcome the fundamental problem of reductions in revenue and increases in expenses for health care and education; excessive municipal borrowing could impose high interest rate expenses on future generations, forcing cuts to spending or increases in taxes; and any program using loans, especially medium- and long-term loans, will clash with municipal balanced budget rules that severely restrict borrowing.[174]

Furthermore, the proposals outlined in Part III create two constitutional wrinkles—one that likely poses no problem, but another that could trip up any future reform efforts institutionalizing the Fed's municipal finance rescue authority.[175] The first question is whether any Fed program for emergency municipal funding violates the Tenth Amendment's protections of state sovereignty.[176] However, the proposals outlined in Part III are unlikely to pose any Tenth Amendment or anti-commandeering issues because, at bottom, the programs are

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174. Elizabeth McNichol et al., *States Need Significantly More Fiscal Relief to Slow the Emerging Deep Recession*, CTR. ON BUDGET POL'Y AND PRIORITIES (Apr. 14, 2020), https://www.cbpp.org/sites/default/files/atoms/files/4-14-20sfp.pdf [https://perma.cc/4MZ2-RQPS].

175. The subsequent discussion merely surveys the relevant constitutional issues for the various reform proposals involving the Federal Reserve in emergency municipal funding, and leaves open to future scholarship their further explication.

176. U.S. CONST. amend. X.

voluntary and the federal government already makes loans to states regularly.[177]

The second and more significant constitutional wrinkle concerns the Constitution's delegation of spending power to Congress. As discussed in Part II.C.1, the Fed's power to print and inject money into the real economy is not considered an unconstitutional exercise of Congress' spending power because it operates on a systemic level and not as a source of funds for the real economy. All of the proposals outlined in this Part, however, directly violate the justifications for the Fed's authority to create money and inject it into the economy on its own.[178]

Therefore, the reform proposals have some constitutional implications. For one, the CARES Act design of the MLF (and any similar future program) may have unconstitutionally delegated Congress' spending power to Fed[179] or Treasury.[180] Under this view, the Fed might renounce its authority to make loans on which it anticipates material risk of loss.[181] Alternatively, the allocation of funds to Treasury to invest in the MLF or any future program may eliminate the constitutional issue because if Treasury protects Fed from loss, the program may hew close enough to constitutional norms to be acceptable.[182]

CONCLUSION

State and local governments are too vital a strand in the fabric of American society to allow the episode of the MLF to pass without learning lessons about the institutional and legal design of

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177. For instance, the federal government offers offer loans or loan guarantees to state and local governments for infrastructure projects. CONG. BUDGET OFF., FEDERAL SUPPORT FOR FINANCING STATE AND LOCAL TRANSPORTATION AND WATER INFRASTRUCTURE 6–14 (Oct. 2018), https://www.cbo.gov/system/files/2018-10/54549-InfrastructureFinancing.pdf [https://perma.cc/X8GN-W4NY].

178. *See* Desan & Peer, *supra* note 119, at 5. Although, the risk is more indirect in the case of Section 14 proposals because those purchases do not involve direct lending to municipalities (and instead involve purchases in the market), the difference is more in degree than in kind.

179. *See* Scott, *supra* note 122, at 7–9 (2021).

180. *See* Desan & Peer, *supra* note 119, at 7; *see also* Kate Stith, *Congress' Power of the Purse*, 97 YALE L.J. 1343 (1988) (describing Congress' authority to delegate its spending power); Gillian E. Metzger, *Taking Appropriations Seriously*, 121 COLUM. L. REV. 1075 (2021).

181. George Selgin, *The Constitutional Case for the Fed's Treasury Backstops*, ALT-M (Apr. 13, 2020), https://www.alt-m.org/2020/04/13/the-constitutional-case-for-the-feds-treasury-backstops/ [https://perma.cc/9F2D-QAC9].

182. *Id.*

effective policy responses during crises.[183] Municipalities provide critical services and ultimately structure the way communities live. Increased public spending at the municipal level means better schools and education for our children, cleaner air and water, more stable households that are connected to the community, and a more robust public health system that is capable of outfitting our front-line healthcare professionals with appropriate medical protective equipment during the next pandemic.

Therefore, how should the Fed help municipalities during crises? Formalizing the Fed's role as the lender of last resort for municipalities under Section 13(3) is a bare minimum. A Section 14 MLF program might work slightly better than a program designed under Section 13, but could have unintended consequences. To effect either proposal, amendments to the FRA are sorely needed. Instead of a Fed program aimed at the municipal bond market under Section 13 or Section 14, Congress might consider creating a separate authority within the Executive branch to administer grants or provide emergency loans to municipalities.

Policymakers must draft legislation with both the MLF's successes and failures at the top of mind. The MLF experiment demonstrates that the Fed perhaps can and should stand ready to loan money to municipalities as their lender of last resort. Policymaker, however, should understand well that that the Fed will run a Section 13(3) program is a lender of *last* resort, and not as an institutional vehicle to transfer money from the federal government to states and localities. Instead, all it can do is create conditions that encourage private banks to make loans. As Fed Chairman Jerome Powell was fond of saying throughout 2020: "the Fed has lending powers, not spending powers."[184] The FRA, as it stands, requires that the Fed design and run the MLF without losing a dime. As such, any program designed under Section 13(3) LLR authority, without an amendment to the FRA, is unlikely to provide meaningful direct aid to municipalities during a crisis. And yet, the stakes are too high to allow for anything less.

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183. *See* Sgouros, *supra* note 161.

184. Jerome H. Powell, Chair, Bd. of Governors of the Fed. Rsrv. Sys., Current Economic Issues (May 13, 2020), https://www.federalreserve.gov/newsevents/speech/powell20200513a.htm [https://perma.cc/6DQ2-9Q2Q].