Credit Markets and the Visible Hand: The Discount Window and the Macroeconomy

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In times of crisis such as the 2008 financial crisis and the 2020 COVID-19 pandemic central banks throughout the world engage in interventions with lasting effects on financial markets and the macroeconomy, for better and worse. The negative political consequences of these interventions—fears of politicizing central banking and inflationary concerns about dramatic interventions among them—can dampen the enthusiasm for such interventions early in the face of crisis. This dynamic creates a dilemma for the US central bank, the Federal Reserve, causing it to eschew interventions beyond monetary policy until the crisis has already crashed, at which point the Fed moves into every aspect of policy throughout the economy. This Article highlights the inadequacy of this dynamic. Sole reliance on monetary policy is insufficient in the face of growing crisis, while the Fed's vast emergency lending facilities face ever stiffer political, inflationary, and equity concerns. The Article advocates instead for a new approach to macroeconomic stability, not just through monetary policy or emergency interventions, but through judicious use of the sleeping giant of Fed policy, the bank-intermediated discount window. Focusing on the problematic credit market for debtors-in-possession in the midst of bankruptcy, the Article suggests a reformed system that safeguards the Fed, supports small and medium-sized enterprises, and stabilizes the macroeconomy without exposing the system to the pockets of instability that the Fed's overreliance on dramatic intervention can do.

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Introduction

This Article proposes a new paradigm for the U.S. government to respond to economic crises that would better solve the problems of bailouts, undue politization of crisis response, and overuse of the central bank as the crisis fighter par excellence.[1] The tool, ironically implemented through the Federal Reserve (the Fed) itself, is a new approach to the Fed's existing lending capabilities that, for historical reasons explained below, the central bank has largely abandoned. These new facilities could be tailored to specific credit problems deemed an adequate threat to macroeconomic stability, thus placing such lending well within the Fed's existing legal authority. Such an approach would help the government avoid the twin risks of standing pat in the face of rising systemic risks followed by overwhelming, distortionary, and politically costly ex post bailouts.[2]

We demonstrate the need for and basic contours of this new facility by focusing on one area which, in a macroeconomic slowdown, is likeliest to need such middle-gear interventions: the debtor-in-possession (DIP) credit markets, especially for small- and medium-sized businesses. If the government's response to these bankruptcies continues as it has been, the likeliest outcome is to ignore the problem until it becomes especially egregious, then provide overwhelming fiscal or monetary support through fractured political pathways or ever-more unstable central banking ones.[3]

By creating a new, more moderate path for such interventions by focusing on the Fed's more traditional lending tools, this Article promotes a governmental lending regime that better preserves market superiority in organizing information, political superiority in managing catastrophic crisis, and central banking superiority as a core monetary policymaker and lender of last resort in more purely financial panics.[4]

This proposal—which we call the Debtor-in-Possession Discount Window Facility, for reasons explained below—might appear to

1. The academic literature on crisis policy response is united in at least one respect: almost everyone is unhappy. *See, e.g.*, ERIK GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION 313 (2014) (arguing that existing governmental reactions to crises are heavily procyclical); Kathryn Judge, *Guarantor of Last Resort*, 97 TEX. L. REV. 707 (2019) (criticizing crisis policy for, among other things, failing to solve the basic problems of the instability of major financial institutions); LEV MENAND, THE FED UNBOUND: CENTRAL BANKING IN A TIME OF CRISIS 60 (2022) (criticizing the Fed's response to COVID-19 as beyond its historical remit); Christina Parajon Skinner, *Central Bank Activism*, 71 DUKE L.J. 247, 250 (2021) (criticizing the Fed for drifting beyond its historical roots).

2. *See, e.g.*, Anthony J. Casey & Eric A. Posner, *A Framework for Bailout Regulation*, 91 NOTRE DAME L. REV. 479, 480 (2016) (describing political unpopularity of bailouts).

3. Aaron Klein, *The Financialization of Recession Response*, 4 J. FIN. CRISES 47 (2022) (criticizing Fed responses to the 2020 crisis as being too rooted in the financial system).

4. Lev Menand, *The Federal Reserve and the 2020 Economic and Financial Crisis*, 26 STAN. J.L. BUS. & FIN. 295 (2021) (advocating for a narrower approach to crisis response by focusing on support for financial institutions rather than the real economy).

institutionalize the Fed's support of an economy in crisis. It would in fact do the opposite: a regularized facility would normalize banking relationships for bankruptcies in a way that would put market actors on the front lines to manage their own risks, rather than pushing those risks more squarely into the hands (and balance sheets) of the public. Financial intermediation during such crises is slow and uneven. Expanding the Fed's discount window would remedy these problems while preserving what is vital about intermediated finance.

The proposal to expand the Fed comes at an important moment of transition in the way that scholars, policymakers, and the general public conceptualize the government's relationship to markets. Until recently, prevailing norms among most technocrats held that the financial markets should be left to their own devices rather than steered or channeled by regulators in any way.[5] Questions about capital allocation—in capital markets or through the banking system—were seen through the lens of market efficiency.[6] Other than requiring disclosure and policing fraud—and even these were contested by some—regulators, it was thought, should defer to the wizardry of market actors operating in their own self-interest. Hands off—or "light touch," as it was called in the United Kingdom—was the best mode of regulation and market support.[7]

The two financial crises of the 21st century changed all of this. The first of these crises—the Global Financial Crisis of 2008-2009 and the associated Great Recession and Eurozone crises that followed—pushed monetary policy and financial policy into a creative, experimental, and active posture (even as politicians pulled back on fiscal support). So it was, for example, that JPMorgan Chase's acquisition of the failing Bear Stearns, the storied investment bank that had been largely unregulated and unsupervised prior to the crisis, received emergency support from the Fed, support that had not been forthcoming since the Great Depression.[8] The government nationalized Freddie Mac and Fannie Mae six months later;[9] Lehman Brothers failed thereafter, even with some support, seeming to prove to many that the government should have done more,

5. For more on the regulatory and legislative ethos of the 1990s, see Peter Conti-Brown & Brian Feinstein, *The Contingent Origins of Financial Legislation*, 99 WASH. U. L. REV. 145, 190-96 (2021).

6. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 549-50 (1984).

7. *See Light Touch No More*, ECONOMIST (Dec. 1, 2012), https://www.economist.com/britain/2012/12/01/light-touch-no-more [https://perma.cc/J9GZ-USY6].

8. Parinitha Sastry, *The Political Origins of Section 13(3) of the Federal Reserve Act*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., Sept. 2018, at 1, 1, 3.

9. *See* Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843, 897 & n.238 (2016).

not less;[10] and then, as the world came apart, the Fed and Treasury did more and more for institutions further afield from the core banking perimeter, from money-market mutual funds to insurance companies and much else besides.

This trend of increasing the government's interaction with markets continued into the next major crisis of the 21st century, the COVID-19 pandemic and its associated financial crisis in March 2020. Although the pandemic was not caused or accelerated by inadequate regulation of market transactions, the public role in addressing the limitations of markets was even more pronounced. Both federal and state lawmakers imposed moratoria on mortgage payments and evictions that might otherwise have caused massive numbers of foreclosures and evictions after the economy was shut down in response to COVID-19.[11] Congress also stepped in to support businesses with loans (forgivable in many instances) under the Coronavirus Aid, Relief and Economic Security (CARES) Act and its other pandemic interventions.[12] And once again Congress turned to the Fed as the instrument of its policies: the Federal Reserve, in collaboration with the United States Treasury, would provide much of the liquidity support in the initial response to the pandemic.[13]

With such extraordinary interventions has come extraordinary backlash. It is now the conventional wisdom that the political tumult of the post-2008 era marks a "new political order," in the words of historian Gary Gerstle.[14] The disgust at crisis reactions to 2008 helped spawn the Occupy Wall Street and Tea Party movements, themselves leading to the rise of right-wing nationalism and left-wing socialism as responses to the same political disorder.[15]

Policymakers, scholars, and citizens need a middle road. The extremes of "light touch" regulation and heavy, kitchen-sink

10. For a critical evaluation of this idea, see DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS UNINTENDED CONSEQUENCES (2010).

11. For a helpful overview of the vast array of federal and state responses to the pandemic, see Sarah Hammer, Economic and Financial Policy Responses to the COVID-19 Pandemic: Review and Analysis (Jan. 20, 2021) (unpublished manuscript), https://ssrn.com/abstract=3772327 [https://perma.cc/L2TQ-Z4L4]; and Menand, *supra* note 4, at 295.

12. Coronavirus Aid, Relief and Economic Security (CARES) Act, Pub. L. No. 116-136, 134 Stat. 281 (2020); *see* Hammer, *supra* note 11 at 5-8. For an overview of the CARES Act's Paycheck Protection Program, which provided for often forgivable loans, see David Autor et al., *An Evaluation of the Paycheck Protection Program Using Administrative Payroll Microdata*, 211 J. OF PUB. ECON. art. no. 104664 (2022).

13. *See, e.g.*, Hammer, *supra* note 11, at 8-18.

14. GARY GERSTLE, THE RISE AND FALL OF THE NEOLIBERAL ORDER: AMERICA AND THE WORLD IN THE FREE MARKET ERA 290 (2022).

15. *See, e.g.*, *id.* at 1-4 ("Even before the pandemic struck, developments that ten years earlier would have seemed inconceivable now dominated politics and popular consciousness: the election of Donald Trump and the launch of a presidency like no other; the rise of Bernie Sanders and the resurrection of a socialist left.").

interventions are economically and politically destabilizing. Our basic argument is simple: the Fed is uniquely well-positioned to address a variety of structural flaws in the credit markets by resuming its former role of using its conventional lending authority to allocate a specific kind of credit through the banking system. In particular, we argue that the Fed should add to its three existing discount-window facilities a fourth, the DIP Discount Window, to facilitate more orderly bankruptcies in the event of a major economic, but not financial, crisis. Doing so will improve the market for distressed debt for bankrupt small- and medium-sized enterprises, improve the Fed's ability to operate within its legal and political constraints, and improve outcomes for the macroeconomy.

Nowhere is this overuse-leads-to-backlash dynamic more perfectly illustrated than in the government's dramatic interventions into the banking system in March 2023. Despite years of careful debate, legislation, regulation, and supervision, the government tossed out the Dodd-Frank toolkit[16] in favor of direct, emergency intervention, when a series of medium-sized banks faced a rational run on their basic business model.[17] Indeed, although the Fed *did* make its discount-window facilities open to banks, it did so on favorable terms only *after* it had declared a banking emergency through its more extreme powers.[18] Indeed, in the confusion over its decision to invoke its emergency powers, even observers who had worked closely with the Fed expressed alarm and confusion about what, exactly, the central bank's purpose was in this debacle.[19] The consequence was bipartisan ire directed at the Fed for appearing to pick winners and losers in a financial crisis that might have been averted through more aggressive—and more traditional—use of its non-emergency lending powers.[20]

16. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. II, 124 Stat. 1376, 1442-1520 (2010) (codified as amended at 12 U.S.C. §§ 5381-5394). This toolkit consists of relying on bankruptcy for large holding companies or, absent that, orderly liquidation under Dodd-Frank Title II. See SKEEL, *supra* note 10 at 117-129.

17. The idea that the banking crisis of 2023 represented a run on the banks' business model comes from Steven Kelly, *Misdiagnosing SVB*, WITHOUT WARNING (Mar. 26, 2023), https://www.withoutwarningresearch.com/p/misdiagnosing-svb [https://perma.cc/7DPV-LHYW].

18. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *Federal Reserve Board Announces It Will Make Available Additional Funding to Eligible Depository Institutions to Help Assure Banks Have the Ability to Meet the Needs of All Their Depositors* (Mar. 12, 2023), https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312a.htm [https://perma.cc/QD5J-GW2K].

19. See, for example, this tweet from Michael Held, former general counsel of the Federal Reserve Bank of New York, who expressed confidence that the new facility was under the discount window, not emergency lending, authority. Michael Held (@mikeheld5), TWITTER (Mar. 12, 2023, 7:24 PM), https://twitter.com/mikeheld5/status/1635059255798829056 [https://perma.cc/3FU7-RSVT].

20. *See* Ben Werschkul, *Neither Democrats or Republicans are Happy About How the Fed Handled SVB*, YAHOO! FIN., (Apr. 28, 2023), https://finance.yahoo.com/news/neither-democrats-or-republicans-are-happy-about-how-the-fed-handled-svb-182055020.html [https://perma.cc/67D2-DMAZ].

The Federal Reserve and U.S. society need a better way in the face of macroeconomic distress. The rest of the Article outlines the nature of the problems that afflict both sides of this divide—both the dysfunction of the market for distressed debt and the dysfunction of the current ethos to depend on the Fed as the source for all macroeconomic stability. Briefly, we see four benefits that arise from this new conception, two from each side of this divide.

First, the status quo risks further politicization of the Federal Reserve.[21] The (over)use of the Fed's emergency powers comes at a cost of politicization, a cost that limits the Fed's range of actions even in places where its statute permits experimentation.[22] The basic problem with emergency lending in an economic crisis is that the public (and the politicians that represent them) will be divided about who should receive what kind of assistance, on what terms, from the Fed. This was the central problem the Fed faced in 2020-2021. This tension will not go away and is likely to get worse before it gets better.[23]

The role we advocate for the Fed—intervening through the financial system in credit markets that are not functioning properly—occupies an intermediate ground between ordinary monetary policy and emergency lending as a lender of last resort. We take our cue, in a sense, from a recent call by Professor Kathryn Judge for the Fed and commentators to "acknowledg[e] that the Fed is currently involved in credit policy, acknowledg[e] the contours of who it has helped and who its efforts have failed to reach, and figur[e] out where the Fed can and should go from here."[24]

Second, the failures of intermediation during both crises—that is, the failure of banks in distress to lend more freely to support a fragile macroeconomy—has led to calls for removing private banks from this vital role completely.[25] Fed support for the DIP debt market will improve this role by creating more incentives for Fed participation. One reason for this ability to direct credit while managing the downside risk of political contention is that these efforts would be intermediated—

21. *See* Skinner, *supra* note 1, at 249.

22. Peter Conti-Brown & David A. Wishnick, *Technocratic Pragmatism, Bureaucratic Expertise, and the Federal Reserve*, 130 YALE L.J. 636, 696 (2021).

23. For an overview of the political tensions that the Fed has faced, see Jeanna Smialek, *The Year the Fed Changed Forever*, N.Y. TIMES (Dec. 23, 2021), https://www.nytimes.com/2020/12/23/business/economy/jerome-powell-federal-reserve.html [https://perma.cc/QC8L-HZBS]. For critiques of the Fed's responses, see generally KAREN PETROU, ENGINE OF INEQUALITY: THE FED AND THE FUTURE OF WEALTH IN AMERICA (2021); and CHRISTOPHER LEONARD, THE LORDS OF EASY MONEY: HOW THE FEDERAL RESERVE BROKE THE AMERICAN ECONOMY (2021).

24. Kathryn Judge, *Why the Fed Should Issue a Policy Framework for Credit Policy* (Colum. L. Sch., L. & Econ. Working Paper No. 632, 2020), https://ssrn.com/abstract=3716600 [https://perma.cc/KJJ4-KDXR].

25. *See infra* Section III.C.3.

businesses would borrow from private banks, rather than directly from the Federal Reserve.[26] Intermediation provides two core benefits over emergency lending. First, it insulates the Fed from the thorny role of evaluating candidates for credit, a role the Fed did not relish during the 2020 pandemic.[27] Second, it puts the Fed in a position of learning about key elements of the economy to which it would otherwise lack access, since the banks lending through the discount window are necessarily supervised by the Fed, giving the central bank greater visibility into the lending decisions of the banks that participated in the program.

Third, and turning to bankruptcy, creating DIP-dedicated lending can help cure problems endemic to this market. These oddly named loans are used by debtors to fund their operations while they try to reorganize in Chapter 11.[28] A debtor that obtains DIP financing is much more likely to reorganize than one that does not.[29] Given that tens of thousands of companies file for bankruptcy every year,[30] the market is extremely important. It is also extremely broken. The first warning sign is that corporate debtors are forced to pay extremely high interest rates for these loans, despite invariably having the highest priority claim to the debtor's assets. One recent study (which predated the pandemic) found that lenders charge several percentage points higher than a competitive interest rate;[31] another concluded that DIP loans are priced similarly to junk debt, despite being far less risky.[32] This pattern continued during and after the pandemic: JCPenney paid 11.75 percentage points above the

26. In this sense, it differs from other recent proposals to focus on Fed-directed support that is not so intermediated. *See, e.g.*, Saule T. Omarova, *The People's Ledger: How to Democratize Money and Finance the Economy*, 74 VAND. L. REV. 1231, 1235-36 (2021); John Crawford, Lev Menand & Morgan Ricks, *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113 (2021).

27. NICK TIMIRAOS, TRILLION DOLLAR TRIAGE: HOW HAY POWELL AND THE FED BATTLED A PRESIDENT AND A PANDEMIC—AND PREVENTED ECONOMIC DISASTER 287-88 (2022).

28. The term, which is quite non-intuitive to those who are not bankruptcy experts, comes from the fact that bankruptcy law deems the debtor and its managers to be a "debtor in possession"—that is, a debtor that has authority over its assets—when the debtor files for bankruptcy. *See* 11 U.S.C. § 1107 (2018) (powers of debtor in possession). If the debtor obtains financing for its operations in bankruptcy, the funds are thus Debtor-in-Possession (DIP) financing.

29. *See, e.g.*, Maria Carapeto, Does Debtor-in-Possession Financing Add Value? 2-3 (Oct. 6, 2003) (unpublished manuscript), https://citeseerx.ist.psu.edu/pdf/ede0e615c314d43391c5c88b237307a02e1da14c [https://perma.cc/WJF7-FLW6]; Sris Chatterjee, Upinder S. Dhillon & Gabriel G. Ramírez, *Debtor-in-possession Financing*, 28 J. BANKING & FIN. 3097, 3098 (2004).

30. *See, e.g.,* American Bankruptcy Institute, *Quarterly U.S. Business Filings by Year (1980-Present)* (2022), https://abi-org.s3.amazonaws.com/Newsroom/Bankruptcy_Statistics/QUARTERLY-BUSINESS-1980-PRESENT.pdf [https://perma.cc/Y6ED-5PZY].

31. B. Espen Eckbo, Kai Li & Wei Wang, *Loans to Chapter 11 Firms: Contract Design, Repayment Risk, and Pricing*, J.L. ECON. (forthcoming) (manuscript at 2), https://ssrn.com/abstract=3384389 [https://perma.cc/7N75-5QPS].

32. Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. ON REGUL. 651, 685 (2020).

risk-free rate for bankruptcy financing, Hornbeck Offshore paid 12.5 points more, and 24 Hour Fitness 10 points.[33] High credit costs impose an undue burden on debtors seeking to reorganize and undermine the efficiency of the bankruptcy system.

The reason for such oppressively high rates is that the debtor's prebankruptcy lenders have a monopoly. Outside lenders that wish to offer alternative financing are at a severe competitive disadvantage to the inside lenders, both because of an information asymmetry—the inside lenders are privy to better information about the debtor's condition[34]—and because the inside lenders invariably have a lien on all of the debtor's assets. Unless the court gives the outsider a lien with priority even over the inside lenders' existing lien, the outsider would be foolish to make the loan, since the loan proceeds might simply subsidize the insiders' earlier loan.[35] Although courts have the power to give "priming liens," they can do so only if the insider's loan is "adequately protected," a standard they rarely find met if the inside lender does not consent.[36] As a result, the vast majority of DIP loans—75% or 80%, according to the most recent evidence—are made by the debtor's current lenders.[37]

Fourth, while the largest corporate debtors often obtain DIP financing, smaller businesses usually do not. It is important not to overstate the implications of smaller firms' inability to obtain financing. By the time smaller firms file for bankruptcy, many are not viable. The principal purpose of bankruptcy for non-viable firms is to receive a discharge of their debts so that they can move to something else.[38] But some small businesses would be viable if they had access to DIP financing that is not currently available.

A DIP Discount Window resolves the problems for both types of corporate debtors by providing a space through which banks—insider or

33. Email from Wei Wang, Professor of Finance, Queen's University (June 21, 2020) [hereinafter "Wang Email (June 21, 2020)"] (on file with authors).

34. For discussion of the asymmetric information issue, see Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1579-85 (2012) (discussing information asymmetry or "adverse selection").

35. This is known as a "debt overhang" problem in the finance literature. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149-55 (1977). *See also* Christopher A. Hennessy, *Tobin's Q, Debt Overhang, and Investment*, 59 J. FIN. 1717, 1727-36 (2004) (providing empirical evidence supporting the presence of debt overhang).

36. When would an inside lender consent? When the inside lender is the one making the new loan and the priming lien is simply further securing its own loan. This is almost the only time priming liens currently are approved. *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 525(2009).

37. Fred Tung found that insiders made 75% of DIP loans, while an even more recent study by Espen Eckbo, Kai Li, and Wei Wang found about 80%. Tung, *supra* note 32, at 655 n.13; Eckbo et al., *supra* note 31 (manuscript at 11).

38. *See* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. L. REV. 2310, 2311 (2005) (explaining that typical Chapter 11 debtors are small businesses whose businesses are not viable when they file for bankruptcy).

outsider, large or small—can participate more fully in these vital markets. It will thus break down the monopoly for large corporate bankruptcies and break down the insurmountable barriers to small firms that cannot access these loans at any cost.

After developing our proposal for a new credit channeling role for the Fed, and using the DIP Discount Window as an illustration, we compare our approach to three possible alternatives. The first possibility is to rely on the U.S. Treasury, either alone or together with the Fed, to channel credit, as it did with a small part of the Troubled Asset Relief Program (TARP) during the Great Recession of 2008-2009 and more recently—and even more aggressively—with the CARES Act legislation enacted during the pandemic.[39] Where a program requires that one or a handful of major institutions be signaled out for funding, as with the TARP loans to General Motors and Chrysler, Treasury involvement is preferable, given that the Treasury is more politically accountable than the Fed. This preference is why, following the passage of Dodd-Frank, such Treasury involvement is also required under law for the Fed's emergency lending.[40] But the programs we have in mind do not have this quality—they would be available for any banks that qualify, for any corporate-debtor counterparty that the banks deem eligible. The key point is that the banks, not the politicians and not the technocrats, would be the ones making the actual loans.

Similar considerations show why the discount-window strategy is preferable to a second alternative, amending the Fed's emergency lending powers to enable the Fed to make loans to particular debtors in bankruptcy.[41] When it uses its emergency powers, the Fed ordinarily makes loans directly, which could raise political concerns if, invariably, some of the loans did not pay out or otherwise proved controversial. Preserving the Fed's emergency powers for true emergencies would also help it navigate the political controversies better than the alternative.

Finally, several scholars have proposed that Congress create a new investment authority to make loans and other investments.[42] Modeled on the Reconstruction Finance Corporation in the New Deal, this approach could easily be extended to the DIP financing market. The problem with this approach is that it would again put the government in the position of deciding which loans to make and could, arguably, destabilize financial intermediation as we know it. Although a discount-window program would include clear lending requirements, it would rely on banks to do

39. This possibility is discussed in Section III(C)(1), *infra*.

40. Federal Reserve Act § 13(3)(B)(iv), 12 U.S.C. § 343(3)(B)(iv) (2018) ("The Board may not establish any program or facility under this paragraph without the prior approval of the Secretary of the Treasury.").

41. *See infra* Section III(C)(2).

42. *See infra* Section III(C)(3).

the actual lending. It also would be temporary, and could be ended as soon as the financing market was functioning more effectively.

We are not suggesting, of course, that the Fed is the optimal regulator to correct structural flaws in every part of the credit markets. Indeed, as noted earlier, the Consumer Financial Protection Bureau was created precisely because the Fed and other regulators that had consumer protection responsibilities had not effectively protected consumers' interests.[43] But the Fed is well-positioned to intervene, through the financial system, in contexts where insufficient lending or a lack of competition undermine the credit markets. Indeed, the Fed was designed for precisely this purpose. Its discount-window lending authority is the supple tool Congress originally designed for this purpose.

The Article proceeds as follows. Part I describes the fiscal-monetary response to the COVID-19 crises—financial and economic—and the backlash that those responses provoked. These backlashes call into question the very economic support that likely staved off the worst of a bankruptcy crisis and prompt the effort to design governmental responses better tailored to the occasion, with fewer risks of destabilizing the political system in the name of stabilizing the economy. Part I also describes the government's response to the banking crisis of 2023 and why its sprint toward emergency powers undermined the Fed's other responsibilities. It concludes by describing the unique features of the DIP Financing market and other proposals that arose during the 2020 crisis meant to address them.

Part II describes the history and evolution of the discount window, including its atrophy beginning in the middle of the 20th century until its partial revival in 2008. We also discuss why its use to correct credit market dysfunction is superior to the alternatives of open-market operations, unconventional monetary policy, and emergency lending. Part II then introduces the DIP Discount Window, the restrictions it would have, and how the Fed would be made whole in the event of bank defaults on these loans.

Part III describes the benefits and costs of a DIP Discount Window and other forms of forward-leaning discount-window facilities, especially as compared to its alternatives, including oversight by the U.S. Treasury, using the Fed's emergency lending powers, or performing the credit channeling function through a National Investment Authority. Discount-window facilities are not perfect, but they do represent real benefits not obtainable through these alternatives.

We conclude by briefly summarizing our case for a new credit channeling role and the benefits it would provide.

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43. *See, e.g.*, SKEEL, *supra* note 10, at 106 (discussing conflicts of interest the Federal Reserve and other regulators faced in the consumer protection context).

I. Emergency Lending, Political Economy, and the DIP Discount Window Facility

Given that the COVID-19 pandemic and its associated financial and economic crises did not require credit intervention in bankruptcy, an important question we must answer is why such interventions should be necessary in the next crisis. After all, if institutions are layered[44] and crisis responders expand the playbook from the last crisis in responding to the next, shouldn't we expect the Fed and Congress to respond in the same ways in that future crisis as they did in 2020?

In a word, no. There is good reason to expect that neither Congress nor the Fed will be well-suited to the kind of crisis we envision, in a time when the economy is tanking and credit support for companies is disappearing. In this Part, we explain how COVID-19 arguably destabilized both Congress's and the Fed's ability to rerun its 2020 playbook and then explain how DIP financing in general and our proposal in particular would function in that new crisis.

A. The COVID-19 Crisis and the Fiscal-Monetary Response

The state of the global economy in January 2020 was unusually robust. The global growth rate in 2019 was estimated at a brisk 3%.[45] In the United States, the unemployment rate had continued to tick down to a low of 3.5% in February 2020, a figure not reached since 1969.[46] Sky-high asset valuations led to uncertainty, and inflation remained persistently lower than central bank targets and projections,[47] to be sure, but the state of the economy was unprecedentedly strong.

Much had changed by January 2022. In the two intervening years, the world had been whipsawed by the novel coronavirus and the disease it created, COVID-19. The United States entered into recession in March 2020, at the same time as the Fed launched an all-out war against COVID, that recession, and the quickly-materializing financial crisis that loomed over the economy.[48] Unemployment, as measured later,

44. See Jeroen van der Heijden, *Institutional Layering: A Review of the Use of the Concept*, 31 POLITICS 9 (2011) for an overview of this literature.

45. IMF, *Tentative Stabilization, Sluggish Recovery?*, World Economic Outlook (Jan. 2020), https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020 [https://perma.cc/5YKZ-K99W].

46. U.S. Bureau of Lab. Stat., *Unemployment Rate*, FRED (Sept. 1, 2023), https://fred.stlouisfed.org/series/UNRATE [https://perma.cc/TH5W-FNPR].

47. *Monetary Policy Report - February 2020*, BD. GOVERNORS FED. RSRV. SYS. (Feb 7, 2020), https://www.federalreserve.gov/monetarypolicy/2020-02-mpr-summary.htm [https://perma.cc/4VV6-RCRA].

48. *See, e.g.*, *Business Cycle Dating Committee Announcement*, NAT'L BUREAU ECON. RSCH. (June 8, 2020), https://www.nber.org/news/business-cycle-dating-committee-announcement-june-8-2020 [https://perma.cc/XKL4-SNWD]; Justin Baer, *The Day Coronavirus*

skyrocketed above 20% in mid-March, the highest rate since the Great Depression, only to fall back to 3.9% in December 2021.[49] Meanwhile, the national debt increased from $23.2 trillion in January 2020 to $29.6 trillion in December 2021, a 26% increase.[50] (For context, during the previous two-year period, from January 2018 to December 2019, the debt rose from $20.5 trillion to $23.2 trillion, or an increase of 13%).[51]

The question of how the economy responded to the exogenous shock of COVID-19 and the endogenous policies of the government will likely be one to occupy scholars and policymakers for generations to come. But we do know the basic contours of fiscal and monetary policy. In two emergency meetings in early March 2020, the Fed dropped its target interest rate 150 basis points, the largest such drop in the Fed's history.[52] It announced a significant injection of liquidity into short-term funding markets, expanding a similar intervention it had engineered in September 2019.[53] It announced an initially limited, though eventually unlimited, large-scale asset purchasing program.[54] It broke the glass on an array of emergency lending policies first engineered in response to the 2008 financial crisis, including a commercial paper funding facility,[55] a primary dealer lending facility,[56] a money-market fund liquidity facility,[57]

Nearly Broke the Financial Markets, WALL ST. J. (May 20, 2020, 9:44 AM ET), https://www.wsj.com/articles/the-day-coronavirus-nearly-broke-the-financial-markets-11589982288 [https://perma.cc/9J8Y-N89J].

49. *See* U.S. Bureau of Lab. Stat., *supra* note 46.

50. US. Treasury Monthly Statement of the Public Debt, U.S. TREASURY FISCAL DATA (Nov. 6, 2023), https://fiscaldata.treasury.gov/datasets/monthly-statement-public-debt/historical-data [https://perma.cc/U763-QJYS].

51. *Id.*

52. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Issues FOMC Statement (Mar. 3, 2020), https://www.federalreserve.gov/monetarypolicy/files/monetary20200303a1.pdf [https://perma.cc/WCF5-HDYG]; Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Issues FOMC Statement (Mar. 15, 2020), https://www.federalreserve.gov/monetarypolicy/files/monetary20200315a1.pdf [https://perma.cc/Y7MH-KBRH]; *Open Market Operations*, BD. GOVERNORS FED. RSRV. SYS. (July 26, 2023), https://www.federalreserve.gov/monetarypolicy/openmarket.htm [https://perma.cc/Z524-WUDN].

53. Gara Afonso, Marco Cipriani, Adam Copeland, Anna Kovner, Gabriele La Spada & Antoine Martin, *The Market Events of Mid-September 2019*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., Aug. 2021, at 1, 2.

54. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Issues FOMC Statement (Mar. 3, 2020), https://www.federalreserve.gov/monetarypolicy/files/monetary20200303a1.pdf [https://perma.cc/WCF5-HDYG].

55. *Commercial Paper Funding Facility*, BD. GOVERNORS FED. RSRV. SYS. (June 11, 2021), https://www.federalreserve.gov/monetarypolicy/cpff.htm [https://perma.cc/GX7R-MSDN].

56. *Primary Dealer Credit Facility*, BD. GOVERNORS FED. RSRV. SYS. (June 11, 2021), https://www.federalreserve.gov/monetarypolicy/pdcf.htm [https://perma.cc/79DA-S69D].

57. *Money Market Mutual Fund Liquidity Facility*, BD. GOVERNORS FED. RSRV. SYS. (June 11, 2021), https://www.federalreserve.gov/monetarypolicy/mmlf.htm [https://perma.cc/Y792-PZX9].

and renewed international swap lines for a select number of foreign central banks.[58]

These tools in the face of the pandemic represented a renewal of earlier commitments forged during the 2008 crisis. But the Fed also quickly departed from that 2008 baseline by continuing to innovate, including by—controversially—supporting bond issuances for corporate debt issuers in the primary and secondary debt markets.[59] It later created a facility to purchase the bonds of state and local governments, revising the parameters of the facility to increase its reach.[60] The Fed also attempted, with minimal success and even more political controversy, to lend through banks to small businesses in need of more assistance.[61] All told, the Fed's monetary policy and emergency lending doubled its balance sheet from $4.1 trillion in January 2020 to over $8.7 trillion in the fall of 2020. Figure 1 illustrates the expansion.

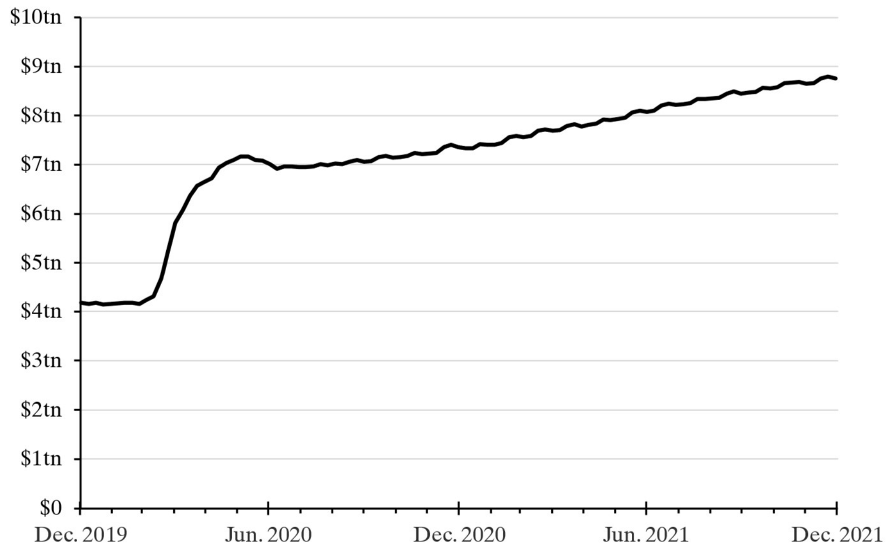
58. *Central Bank Liquidity Swaps*, BD. GOVERNORS FED. RSRV. SYS. (July 29, 2020), https://www.federalreserve.gov/monetarypolicy/central-bank-liquidity-swaps.htm [https://perma.cc/5LTF-TSWX].

59. *See* Menand, *supra* note 4, at 317.

60. *Municipal Liquidity Facility*, BD. GOVERNORS FED. RSRV. SYS. (Aug. 11, 2020), https://www.federalreserve.gov/monetarypolicy/muni.htm [https://perma.cc/FZ8E-ZZSU].

61. For an overview and postmortem of the Main Street Lending Program, see Nick Timiraos, *Fed Had a Loan Plan for Midsize Firms Hurt by COVID. It Found Few Takers.*, WALL ST. J. (Jan. 4, 2021, 10:34 AM ET), https://www.wsj.com/articles/fed-had-a-loan-plan-for-midsize-firms-hurt-by-COVID-it-found-few-takers-11609774458 [https://perma.cc/J9JN-PF4V].

Figure 1. Federal Reserve Balance Sheet,
January 2020 to December 2021[62]



Despite accusations that dysfunctional gridlock was leading Congress to defer entirely to the Fed, Congress acted quickly, too. After a series of smaller packages meant to prepare for the economic instability of COVID-19,[63] on March 27 Congress passed the largest fiscal stimulus in U.S. history, the $2.2 trillion CARES Act. The Act created a stimulus program that sent checks to families below certain income limits, supplemented unemployment insurance, created a forgivable loan system for firms that committed to protect their payroll, and, as relevant to the Federal Reserve, created a $454 billion fund, appropriated to the U.S. Treasury, to invest in programs operated by the Fed under its 13(3) emergency lending authority.[64]

Remarkably, although unemployment surged from 3.5% in February 2020 to 14.7% in April, it then steadily declined, dropping to 7.9% by September 2020 before settling into 3.9% by December 2021.[65] And after significant give-and-take, Congress passed an omnibus spending bill that

62. Bd. of Governors of the Fed. Rsrv. Sys., *Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level*, FRED (Nov. 9, 2023), https://fred.stlouisfed.org/series/WALCL [https://perma.cc/LDY3-ZXT9].

63. *See, e.g.*, Families First Coronavirus Response Act, Pub. L. No. 116-127, 134 Stat. 178 (2020).

64. CARES Act, Pub. L. No. 116-136, 134 Stat. 281 (2020).

65. U.S. Bureau of Lab. Stat., *supra* note 46.

included significant fiscal stimulus on December 23, 2020, and another on March 10, 2021.[66]

Commentators attribute the lower-than-expected unemployment rate to a number of factors, not least is the overwhelming monetary and fiscal response from the Fed and Congress in March 2020.[67] And while some scholars and policymakers expected a significant rise in business bankruptcies, state financial distress, and household and individual insolvency,[68] the reality is that 2021 ended up being an economically buoyant year. It seemed that Congress and the Fed did what they were designed to do: they supported the economy and softened the landing in the face of generational calamity.

And then came the pushback.

B. The Fragility of the 2020 Fiscal-Monetary Consensus

The arguments against the fiscal-monetary consensus of 2020—with the Fed and Treasury yoked closely together in favor of deep fiscal and monetary commitments to financial stability and economic accommodation—have come in three principal veins: (1) that such efforts are inherently inflationary, (2) that such efforts exacerbate inequality, and (3) that such efforts stretch the Fed beyond its core commitments and into new areas of experimentation that it should avoid.

1. The Inflation of 2021-2023

At the end of December 2020, with COVID-19 vaccines in full production and having received emergency approval, economic forecasters were optimistic. The Fed anticipated that GDP would grow at 4.2% in 2021 (it grew at 5.7%); it anticipated that unemployment would be 5.0% by the end of 2021 (it ended at 4.2%); and it expected core

66. *See* Seung Min Kim, Jeff Stein, Mike DeBonis & Josh Dawsey, *Trump Signs Stimulus and Government Spending Bill into Law, Averting Shutdown*, WASH. POST (Dec. 27, 2020, 9:34 PM EST), https://www.washingtonpost.com/us-policy/2020/12/27/trump-stimulus-shutdown-congress [https://perma.cc/369N-5MM7]; Checkpoint Editorial Team, *Congress Passes ARPA With Many COVID-19 Payroll-Related Provisions,* THOMSON REUTERS (Mar. 10, 2021), https://tax.thomsonreuters.com/blog/congress-passes-arpa-with-many-covid-19-payroll-related-provisions/ [https://perma.cc/PK7L-2RT8].

67. *See, e.g.*, *Chart Book: Tracking Recovery From the Pandemic Recession*, CTR. ON BUDGET AND POL'Y PRIORITIES (Dec. 21, 2023), https://www.cbpp.org/research/economy/tracking-the-recovery-from-the-pandemic-recession [https://perma.cc/EKR9-V42Q].

68. *E.g.*, Jerome H. Powell, Chair, Fed. Rsrv. Bd., Speech at the National Association for Business Economics Virtual Annual Meeting: Recent Economic Developments and the Challenges Ahead (Oct. 6, 2020), https://www.federalreserve.gov/newsevents/speech/powell20201006a.htm [https://perma.cc/HX9U-YH47].

personal consumption expenditures inflation to be 1.8% at the end of 2021 (it ended at 3.9%).[69]

That the Fed's forecast on unemployment and GDP growth was off is perhaps not surprising. Few others anticipated the surge in inflation either. But the inflationary jump was the largest since 1981, when the Fed's primary interest rate averaged 16.39%.[70] What is more striking is how quickly the question of inflation has become the dominant macroeconomic narrative since early 2022.

Where did this inflation come from? There are a variety of views. Some viewed the inflation as driven primarily by the exogenous shock of pandemic-related supply chain disruptions.[71] Others saw it as reflecting the failures of overreactive fiscal policies.[72] The Fed's Jay Powell has not been explicit about how his own view is evolving, but the central bankers have regarded combating inflation as the central challenge of the past two years.[73]

69. *Summary of Economic Projections*, FED. OPEN MKT. COMM. (Dec. 16, 2020), https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20201216.pdf [https://perma.cc/5XGF-FBKE]; *U.S. Labor Market Shows Improvement in 2021, but the COVID-19 Pandemic Continues to Weigh on the Economy*, U.S. BUREAU OF LAB. STAT. (June 2022), https://www.bls.gov/opub/mlr/2022/article/us-labor-market-shows-improvement-in-2021-but-the-covid-19-pandemic-continues-to-weigh-on-the-economy.htm [https://perma.cc/7KAM-MJQ6]; *Gross Domestic Product, Fourth Quarter and Year 2021 (Second Estimate)*, BUREAU OF ECON. AFFS. (Feb. 24, 2022), https://www.bea.gov/news/2022/gross-domestic-product-fourth-quarter-and-year-2021-second-estimate [https://perma.cc/D6KQ-RGFY].

70. Christopher Rugaber, *U.S. Inflation at New 40-year High as Price Increases Spread*, ASSOCIATED PRESS (June 10, 2022, 4:36 PM EST), https://apnews.com/article/key-inflation-report-highest-level-in-four-decades-c0248c5b5705cd1523d3dab3771983b4 [https://perma.cc/MST6-UEFM]; Bd. of Governors of the Fed. Rsrv. Sys., *U.S. Federal Funds Effective Rate*, FRED (Dec. 21, 2023), https://fred.stlouisfed.org/graph/?g=1d0dh [https://perma.cc/YN8R-4V7N].

71. *See, e.g.*, David Harrison, *Supply Crunch Risks Extending Into 2022, Stoking Inflation*, WALL ST. J. (June 20, 2021, 10:00 AM ET), https://www.wsj.com/articles/supply-crunch-risks-extending-into-2022-stoking-inflation-11624197600 [https://perma.cc/9E6R-PH5X]; Gwynn Guilford & Anthony DeBarros, *Supply-Chain Bottlenecks, Elevated Inflation to Last Well Into Next Year, Survey Finds*, WALL ST. J. (Oct. 17, 2021, 10:00 AM ET), https://www.wsj.com/articles/supply-chain-bottlenecks-elevated-inflation-to-last-well-into-next-year-survey-finds-11634479202 [https://perma.cc/J63P-V2YY] ("Around half of respondents [to a Wall Street Journal survey of economists] cited supply-chain bottlenecks as the biggest threat to growth in the next 12 to 18 months . . . ."); Julian di Giovanni, *How Much Did Supply Constraints Boost U.S. Inflation?*, FED. RSRV. BANK N.Y.: LIBERTY ST. ECON (Aug. 24, 2022), https://libertystreeteconomics.newyorkfed.org/2022/08/how-much-did-supply-constraints-boost-u-s-inflation [https://perma.cc/2VSU-YL9N] (tying much of the inflation surge to supply problems).

72. Lawrence H. Summers, *On Inflation, It's Past Time for Team 'Transitory' to Stand Down*, WASH. POST (Nov. 15, 2021, 8:00 AM EST), https://www.washingtonpost.com/opinions/2021/11/15/inflation-its-past-time-team-transitory-stand-down [https://perma.cc/3AFJ-37FM].

73. *See* Howard Schneider, *The Fed's Stages of Inflation Grief, in Powell's Words*, REUTERS (June 14, 2023, 3:10 PM EST), https://www.reuters.com/markets/us/feds-stages-inflation-grief-powells-words-2023-06-14/ [https://perma.cc/EQC5-WHMD]; Jerome H. Powell, Chair, Fed Rsrv. Bd., Speech at the Jackson Hole Economic Policy Symposium: Inflation:

The unexpected surge in inflation will complicate, perhaps dramatically, the ability of Congress and the Fed to rerun the fiscal-monetary approaches of 2020 in the future. The rare moment of bipartisanship in 2020 around the CARES Act and the enthusiasm for the Fed's experimentation has already waned substantially and become an important flash point in partisan politics. Should the economy teeter on the edge of calamity again—potentially causing a wave of small- and medium-sized bankruptcies—there is significant risk that neither the Fed nor Congress will be available to provide that relief in the same way.

2. The Rise of the Hawkish Left

Historically, the partisan cleavages around central banking consisted of doves and hawks: the former likelier to weigh risks to the economy in favor of supporting employment (and thus looser monetary policy), the latter likelier to emphasize price stability (and therefore to favor more restrictive policy on the margin). Doves were likelier to be associated with economic policy ideas within the Democratic Party; hawks with the Republicans.[74]

The aftermath of the 2008 and especially 2020 crises have scrambled this old political order, with a growing chorus from what might be called the hawkish left. This group is characterized by intense criticism of the Fed's accommodative policies, but not because they are likely to cause inflation. They are critical because these policies are likely to exacerbate inequality or otherwise reward bankers and investors at the expense of working people. As Christopher Leonard, one of the intellectual leaders of this movement describes it, these are the "Lords of Easy Money," or, in another leading critical view, "the engine of inequality."[75] It may be too early to label this political upheaval as a fundamental restructuring of monetary politics in America. But this rising critique from the left in favor of *less* economic accommodation bodes ill for future Fed experimentation during crises. The Fed depends on bipartisan support for politically risky activities. This support is part of the Fed's DNA and gives it cover to do the sometimes politically difficult work of "leaning against the wind," in one favored central banking metaphor.[76] In the absence of this kind of support, the Fed's ability to intervene in crises is diminished,

Progress and the Paths Ahead (Aug. 25, 2023), https://www.federalreserve.gov/newsevents/speech/powell20230825a.htm [https://perma.cc/M9NL-3DYL].

74. *See* Michael D. Bordo & Klodiana Istrefi, *Perceived FOMC: The Making of Hawks, Doves, and Swingers* 2 (Nat'l Bureau of Econ. Rsch., Working Paper No. 24650, 2021), https://www.nber.org/papers/w24650 [https://perma.cc/7SGV-PL2M].

75. LEONARD, *supra* note 23; PETROU, *supra* note 23.

76. These metaphors are documented in PETER CONTI-BROWN, THE POWER AND INDEPENDENCE OF THE FEDERAL RESERVE (2016).

leaving the plausibility of future interventions on the scale facilitated by the fiscal-monetary consensus of 2020, much less likely.

C. The Banking Crisis of 2023: The Road Not Taken

The hawkish left, in at least some corners, felt ready to declare victory at the onset of inflation in 2021. There is no doubt, as discussed above, that this inflation caught the Fed by surprise, despite some warnings from prominent places.[77] But once the Fed made the decision to get in front of the inflation, it did not look back, beginning an unrelenting campaign of monetary tightening that included 25, 50, and even 75 basis point hikes in the target rate in every meeting of the Federal Open Market Committee from March 2022 through May 2023.[78]

The fundamental business model of banking faced some challenges in this kind of environment. Bankers traditionally applaud increased interest rates, certainly above the zero lower bound. This is because the business of banking is to generate net interest income, or the difference between the interest generated from bank assets (loans and securities, principally) and the interest paid to the bank's creditors (here, chiefly depositors).[79] While higher interest rates are generally better for banks, moving as quickly as the Fed did in 2022 to 2023 posed a different kind of problem: banks that had assets that generated interest rates at fixed terms faced a problem of losing net interest income as their funding became more expensive and their assets stayed stuck at the interest rate at the time of purchase.

The banking crisis unfolded in roughly this kind of environment.[80] As the worst of the pandemic macroeconomy subsided in the face of unprecedented fiscal support, some banks found themselves awash in funding. One such bank was Silicon Valley Bank (SVB), whose clientele

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77. *See, e.g.*, Christopher Rugaber, *Fed's Powell Says Inflation Temporary, Will 'Wane*,' ASSOCIATED PRESS (June 22, 2021), https://apnews.com/article/inflation-health-coronavirus-pandemic-business-6e7c813472a3eb706e0cdafe305c1477 [https://perma.cc/AJH4-28BE]; Jeanna Smialek, *Larry Summers Warned About Inflation. Fed Officials Push Back*., N.Y. TIMES, (Mar. 25, 2021), https://www.nytimes.com/2021/03/25/business/economy/larry-summers-federal-reserve.html [https://perma.cc/TL4P-D49W].

78. *Open Market Operations*, BD. GOVERNORS FED. RSRV. SYS., https://www.federalreserve.gov/monetarypolicy/openmarket.htm [https://perma.cc/E636-KKEJ].

79. Carl De Souza & Michael Driscoll, *A Closer Look at the Impact of Rising Rates on Canadian Banks' Profitability*, Morningstar DBRS at 1 (Nov. 15, 2021) ("[R]ising interest rates are a positive for banks, as their balance sheets are asset-sensitive (assets will reprice higher faster than liabilities). Thus, net interest margins should expand, bolstering profitability."), https://www.dbrsmorningstar.com/research/388109/a-closer-look-at-the-impact-of-rising-rates-on-canadian-banks-profitability [https://perma.cc/E9XK-KUC8].

80. *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. at 62-65 (Apr. 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf [https://perma.cc/J4WH-ALXN].

consisted primarily of venture capitalists (VCs) and the early-stage entrepreneurs those VCs supported. In the face of a booming VC industry, SVB saw the assets on its balance sheet balloon, from $71 billion to $211 billion in two years.[81] Those liabilities in turn needed to fund assets, and quickly. The management of SVB decided to park them in high-quality, low-interest bonds.

Unfortunately, there were problems for both the liabilities and assets for Silicon Valley Bank. On the liabilities, the deposits in question were largely uninsured, a category of funding that bankers and their supervisors have long characterized as unstable. Where traditional banks like JPMorgan Chase or Bank of America saw ratios of deposits at two-to-one or even one-to-one, SVB had a ratio of 22:1.[82] This meant that in signs of any distress, any sense that the bank could not meet the withdrawal demands of its customers, those uninsured depositors would sprint for the exits.

The asset-side of the balance sheet was, if anything, even worse. In most banking crises, asset-side problems tend to arise when banks get too adventurous in their underwriting, deploying their funding to projects that don't pay out as expected. In the banking crisis of 2023, on the other hand, the risk mismanagement problem was that these assets were so plain vanilla in their composition that they exposed a different risk: so-called duration risk, meaning that as the background interest rate increased substantially because of Fed policy, the market value of those bonds collapsed. This is basic bond arithmetic: when interest rates increase, the value of bonds decreases.

The combination of these factors was fatal to SVB. When its bankers finally came to the conclusion that their business model could not sustain itself, they raised alarms among their flighty depositors by attempting to raise capital. Forty billion dollars of deposits were transferred out the door. The Federal Deposit Insurance Corporation (FDIC) put the bank into resolution, while the Fed, FDIC, and Treasury declared the bank "systemically important" enough to justify an exception to make the uninsured depositors whole.[83] This included $1 billion for the large

81. *Compare* SVB Fin. Grp., Consolidated Financial Statements for Holding Companies (Form FR Y-9C) 17 (Feb. 14, 2020), https://www.ffiec.gov/npw/FinancialReport/ReturnFinancialReportPDF?rpt=FRY9C&id=1031449&dt=20191231 [https://perma.cc/L7BJ-S9GZ], *with* SVB Fin. Grp., Consolidated Financial Statements for Holding Companies (Form FR Y-9C) 17 (Feb. 14, 2022), https://www.ffiec.gov/npw/FinancialReport/ReturnFinancialReportPDF?rpt=FRY9C&id=1031449&dt=20211231 [https://perma.cc/4TPH-VV8J].

82. Dorothy Neufeld, *Ranked: The US Banks With the Most Uninsured Deposits*, VISUAL CAPITALIST (Apr. 5, 2023), https://www.visualcapitalist.com/ranked-the-u-s-banks-with-the-most-uninsured-deposits [https://perma.cc/Q6TS-7YWU].

83. Press Release, Fed. Deposit Ins. Corp., Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC (Mar. 12, 2023), https://www.fdic.gov/news/press-releases/2023/pr23017.html [https://perma.cc/59U4-WJ5P] ("Secretary Yellen approved actions

venture capitalist Sequoia, $3 billion to the stablecoin Circle, and $420 million to the tech entertainment company Roku. Each of these companies, and many others, received a taxpayer bailout.[84]

There are many questions that this episode leaves for policymakers and future scholars to digest and analyze. For our purposes, the most important of these is this: why did the Fed choose to open up its emergency lending facilities instead of promoting discount-window lending well ahead of the crisis? For several months, we could only speculate as to the answer. Fed Chair Jay Powell, when asked at a press conference about this question, dismissed it. "[W]e have a little more flexibility under section 13(3)," Powell said. "Really no magic to that."[85]

In June 2023, however, Richard Ostrander—the general counsel of the Federal Reserve Bank of New York—offered a bit more clarity on this question. He felt that 13(3) was superior to the discount window principally because the discount-window authority in section 10B of the Federal Reserve Act "does not authorize reserve banks to lend for a period greater than four months."[86] Ostrander also cited the idea that "under traditional discount window policies, loans are extended against collateral that is assigned a lendable value by the reserve bank based on a haircut applied to the asset's fair market value."[87] Hence the Fed's conclusion that "traditional discount window operations could not fully meet the acute needs of the banking sector."[88]

There are three problems with this explanation. First, while it is true that discount-window loans must be for an initial four-month term, there is nothing in the statute or in lending practice that prevents these loans from being rolled over indefinitely, as indeed has been done consistently in recent history. The timing is thus no significant barrier. Second, the "lendable value" requirement does not in fact require the Federal

enabling the FDIC to complete its resolution of Silicon Valley Bank, Santa Clara, California, in a manner that fully protects all depositors. Depositors will have access to all of their money starting Monday, March 13."); Press Release, Fed. Deposit Ins. Corp., FDIC Acts to Protect All Depositors of the Former Silicon Valley Bank, Santa Clara, California (Mar. 13, 2023), https://www.fdic.gov/news/press-releases/2023/pr23019.html [https://perma.cc/WW52-QN2B] ("The transfer of all the deposits was completed under the systemic risk exception approved yesterday. All depositors of the institution will be made whole.").

84. Matt Egan, *FDIC Accidentally Reveals Details About Silicon Valley Bank's Biggest Customers*, CNN (June 23, 2023, 1:07 PM EDT), https://www.cnn.com/2023/06/23/investing/svb-bank-fdic/index.html [https://perma.cc/Y6VS-49A6].

85. *Transcript of Chair Powell's Press Conference*, BD. OF GOVERNORS FED. RSRV. SYS. 15 (Mar. 22, 2023), https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230322.pdf [https://perma.cc/F558-28N9].

86. Richard Ostrander, Gen. Couns., Fed. Rsrv. Bank of N.Y., Remarks at the Paris Meeting of the Committee on International Monetary Law of the International Law Association (June 17, 2023), https://www.newyorkfed.org/newsevents/speeches/2023/ost230617 [https://perma.cc/CK6D-ME9M].

87. *Id.*

88. *Id.*

Reserve Banks to use mark-to-market accounting on the value of the collateral.

Third and most significantly, though, these justifications do not explain the Fed's biggest error in its discount-window policy: it failed to present the discount window as a viable liquidity alternative *before the crisis began*. The discount window is at its best in periods of intermediate stress. But the Fed's own discouragement of its use in liquidity planning and failure to reverse the image of a stigmatized source of funding has undermined this effort. Even if the Fed wanted to make better use of the discount window in a crisis, it could not have done so—the banks were too skittish about its use, largely as a result of the Fed's own policies to that end.

The banking crisis of 2023 illustrates the gravity of the Fed's policy error when it over-relies on its emergency authorities. These authorities do indeed give the Fed more "flexibility," as Chair Powell suggested. But they do so at an important risk to the Fed's own credibility. The Fed's actions make clear that we can reach one of two conclusions about its actions in the spring of 2023. Either the banking system, just ten years after the Fed redesigned most of its crisis response authority, was so fragile that we encountered another financial crisis that required emergency response, or the Fed has so neglected its tools of intermediate financial stress that it does not know how to use them. Neither would represent a policy success. The remainder of our article discusses what we might do to remedy the second—and we think likelier—conclusion.

D. Credit Market Dysfunction: DIP Finance in Bankruptcy

Given the sensitivities identified above, while we argue in this Article for a robust role for the Fed in channeling credit policy, the Fed should not simply become a roving commission to meddle in every corner of the credit markets. Some credit markets are relatively efficient. In these markets, intervention is unnecessary under ordinary circumstances, although it may be needed in a market-wide crisis or other economic disruption. If the Federal Reserve identifies a market that has structural deficiencies, by contrast, the credit channeling function may be warranted even in the absence of a crisis.

In this Section, we highlight an area of the credit markets which, without fiscal-monetary support as in 2020, could turn quickly into economic calamity: the market for Debtor-in-Possession financing in bankruptcy. Although the market appears to be robust by some measures, it suffers from persistent structural deficiencies that call for some kind of structured, flexible, and seasonal regulatory intervention. We begin by briefly describing the history of DIP financing, which hints at a strategy that could be incorporated into the Federal Reserve discount-window facility we propose in the next part. We then give an overview of the current DIP financing market, highlighting the two dysfunctional elements that are sufficiently serious to warrant intervention by the visible hand.

1. The Origins of Debtor-in-Possession Financing

Well over a century ago, the foundations of debtor-in-possession financing emerged in connection with a common law process called equity or railroad receivership that was used to reorganize troubled railroads. Then as now, corporate debtors needed new financing to fund their operations during the restructuring process. A new lender would be extremely reluctant to lend, however, because all of the debtor's assets were usually encumbered by previous lenders (generally the holders of mortgage bonds). Unless the new lender could be given priority status, the proceeds of its loans would simply serve to benefit the prior lenders—a classic "debt overhang" problem.[89]

Courts devised an ingenious solution to the dilemma. To address a railroad's financing needs in an equity receivership, the court authorized the receiver to issue a "receiver's certificate," which was a promissory note "by which the railroad borrowed from investors against the credit of the 'whole estate' of the railroad" on a short-term basis.[90] Because the railroad's assets were in receivership, the reasoning went, bondholders and other creditors of the debtor were entitled to payment only after expenses of the receivership were paid. In current lingo, they now had a net pledge rather than a gross pledge.[91] As an expense of the receivership, the receiver's certificate therefore slipped in front of the bondholders' mortgages in payment priority: the receiver's certificate was entitled to be paid first, and it also had first claim on the proceeds of the sale of any property securing the receivership. Given this priority, and the high probability the obligation would be repaid, investors were happy to help finance the receivership by investing in receiver's certificates.

In the early years, the receiver would identify the immediate cash needs for protecting the railroad's tangible assets and ask the court to authorize receiver's certificates to cover the expenses. In time, courts began authorizing certificates for the costs of operating the railroad, even where these costs didn't relate directly to protecting tangible collateral. Under the distinction that emerged, receiver's certificates could be used

89. *See, e.g.*, Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 8 (1997).

90. *Id.* For a full discussion on the nuances of early receiver's certificate doctrine, see William A. Carr, *Receiver's Certificates*, 1 PA. L. SERIES 595 (Philadelphia, The Blackstone Publ'g Co. 1895).

91. In current municipal bankruptcy, section 928(b) has a similar effect, making revenue bonds subject to any operating expenses. 11 U.S.C. § 928(b) (2018).

for "preservation" but not for "operations."[92] When Congress codified large-scale corporate reorganization for the first time in the 1930s, it authorized the use of receiver's certificates for short-term borrowing, without any reference to preservation and operations.[93] The distinction gradually disappeared in practice as well.

The most striking feature of this history for our purposes is courts' ingenuity in facilitating lending even when the debtor's assets were already fully encumbered. This tradition of ingenuity will inspire one feature of the solution we advocate in the next part.[94]

2. The Structural Flaws in the DIP Financing Market

When Congress enacted the current bankruptcy laws in 1978, it included an extremely expansive provision for Debtor-in-Possession financing.[95] Gone was any reference to preservation or operations, or any restriction on which debtors can obtain DIP financing and what they can use it for.

The current provision envisions that a business that is seeking to reorganize under Chapter 11 will first attempt to borrow funds on an unsecured, administrative-expense basis, without a lien on any of the debtor's assets.[96] Administrative expenses are one of the highest priorities of creditors that do not have a lien,[97] but they come after liens in priority.[98] If lenders will not make a loan on an unsecured, administrative basis alone, the court is authorized to give the lender a lien on any assets that do not already have a lien, and/or a second priority lien on assets that other creditors have liens on.[99] DIP lenders invariably insist on receiving a lien.[100]

92. These developments are recounted in Harvey J. Baker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1, 8-16 (1976).

93. *Id*.

94. *See infra* Section III(C).

95. 11 U.S.C. § 364 (2018).

96. *Id.* § 364(b).

97. Administrative expenses also must be paid in full in cash at the time the debtor's reorganization plan is confirmed and becomes effective. *Id.* § 1129(a)(9).

98. *Id.* § 725 (treatment of property interests); *Id.* § 726(1)(A) (treatment of unsecured priority claims).

99. *Id.* § 364(c).

100. Neiman Marcus's request for approval of its bankruptcy financing in 2020 is typical. Neiman's motion stated that "the Debtors, together with their advisors, sought and marketed alternative sources of postpetition financing to determine whether the Debtors could obtain debtor-in-possession financing as an administrative expense. No parties were willing to provide postpetition financing solely on an unsecured, administrative priority basis . . . ." Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief, at 41, *In re* Neiman Marcus Grp. Ltd LLC, No.

Finally, and most dramatically, the court can authorize a so-called "priming lien"—a lien that takes priority even over existing liens.[101] Before granting a priming lien, the court must conclude that the prior lenders who are being trumped will be "adequately protected."[102] This, as we shall see, has proven to be a very significant obstacle.

There are two major structural problems in the market: the pricing for DIP financing is seriously out of kilter; and DIP financing is generally available for the largest corporate debtors, but almost entirely unavailable for small debtors.

Start with the first problem: the unusually high cost of DIP financing. In an ordinary market, one might have expected lenders to earn supracompetitive profits for a few years after the current Bankruptcy Code was adopted, given the breadth of the new DIP financing provision and the other changes brought by the new law.[103] Within a few years, however, profits should have declined as new lenders entered and offered more competition to the early entrants.

The DIP financing market has developed quite differently. More than forty years after the financing provision was enacted, the lenders that provide bankruptcy financing continue to earn extraordinary profits—profits that suggest the market is not genuinely competitive. One recent study found that lenders charge several percentage points higher than a competitive interest rate;[104] another concluded that DIP loans are priced similarly to junk debt, despite being far less risky.[105]

For a clue as to why lenders are able to charge such high rates for financing, we need only look at the source of the funds. Recent empirical studies have found that at least 75% of the loans come from the debtor's prebankruptcy lenders—thus, from insiders.[106] The most recent data peg the number at about 80%, and one of their authors suggests the percentage is even higher in the past five years or so.[107]

20-32519 (Bankr. S.D. Tex. May 7, 2020) https://cases.stretto.com/public/X064/10214/PLEADINGS/1021405072080000000240.pdf [https://perma.cc/9Z9X-A398]. *See also* Eckbo et al., *supra* note 31 (manuscript at 11) (noting that "almost all [of the DIP loans in the authors' study] have a first or second lien on a debtor's assets").

101. 11 U.S.C. § 364(d) (2018).

102. *Id.*

103. For a recent description of this dynamic in competitive markets and factors, such as monopoly, that can interfere, see PHILIPPE AGHION, CÉLINE ANTONIN & SIMON BUNEL, THE POWER OF CREATIVE DESTRUCTION: ECONOMIC UPHEAVAL AND THE WEALTH OF NATIONS (2021).

104. Eckbo et al., *supra* note 31 (manuscript at 3).

105. Tung, *supra* note 32, at 685.

106. *Id.* at 655.

107. Eckbo et al., *supra* note 31 (manuscript at 28). Wang Email (June 21, 2020), *supra* note 33 (noting that "between 2015 and 2019, about 90% of DIP loans for large firms are provided by prepetition lenders").

Several factors seem to create the monopoly enjoyed by debtors' inside lenders. The first is an information asymmetry. Because the debtor's principal lenders have more and better information about the debtor than outside lenders (due, for instance, to their access to ongoing financial information from the debtor as they monitor the loan), outside lenders are discouraged from competing to finance corporate debtors.[108] Second, and even more important, this competitive advantage is magnified by the debt overhang issues discussed earlier.[109] Outside lenders will be reluctant to offer alternative financing unless their loan is given priority treatment; but the inside lenders usually have a lien on all of the debtor's assets, which means that priority is only possible if the bankruptcy court can be persuaded to give the outside lender a priming lien, based on the court's conclusion that the insider's interests will not be adversely affected (they will be "adequately protected").[110] Courts rarely grant so-called nonconsensual priming liens—that is, a priming lien to an outside lender over the objection of the insider lender.[111] These factors make it extremely difficult for an outside lender to compete.[112]

The discussion thus far involves bankruptcy financing of large corporate debtors. These debtors often do receive DIP loans, but at highly noncompetitive prices. The second structural problem in the DIP financing market is with smaller debtors. Unlike their larger peers, most smaller corporate debtors are unable to get any DIP financing at all.

Prior research has found a strong correlation between receiving DIP loans and successfully reorganizing; firms that obtain DIP financing are much more likely to reorganize than those that do not.[113] The existing research also has found that the largest firms are the ones most likely to obtain financing.[114] There is very little empirical evidence about small

108. *See, e.g.*, Ayotte & Skeel, *supra* note 34, at 1557-85.

109. *See supra* note 35 and accompanying text.

110. 11 U.S.C. § 364(d)(2) (2018). For evidence that debtors' assets are fully encumbered, see Ayotte & Morrison, *supra* note 36, at 513-14 (finding that 75% of bankruptcy debtors obtain senior secured financing before bankruptcy and the loans are secured by all of the debtor's assets 97% percent of the time).

111. For discussion of this phenomenon and other obstacles to obtaining outside financing, see David Skeel, *Pandemic Hope for Chapter 11 Financing*, 131 YALE L.J. F. 315 (2022).

112. A final factor also may further deter outside bids: in recent cases, inside lenders have often provided DIP financing as part of a larger set of agreements that gives the inside lenders control of the case and may enable to insiders to acquire the company (sometimes while also offering benefits to the debtor's managers). Ayotte & Ellias emphasize this feature of many DIP loans in their recent work. *See generally* Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, 39 YALE J. ON REGUL. 1 (2022). If the insider lenders expect significant profits from the arrangement, they could underbid any outside lender and still expect to profit overall.

113. *See, e.g.*, Sreedhar Bharath, Sandeep Dahiya, Anthony Saunders, & Anand Srinivasan, *So What Do I Get? The Bank's View of Lending Relationships*, 85 J. FIN. ECON. 368 (2007); Carapeto, *supra* note 29; Eckbo et al., *supra* note 31.

114. *See* Tung, *supra* note 32, at 681 (finding that the median firm that received a DIP loan in the author's study had $637 million in assets).

firms, but anecdotal evidence suggests that few small firms receive DIP financing.[115]

It is important to emphasize that the absence of financing does not mean that large numbers of viable, small corporate debtors are forced to liquidate due to an inability to obtain bankruptcy financing. Many small businesses are not viable when they file for bankruptcy—they are restaurants that never attracted a clientele or business ideas that did not succeed.[116] For them, bankruptcy is an opportunity to extinguish their debts and start over. But at least some of these corporate debtors are potentially viable companies that do not obtain the financing they need for their operations in bankruptcy and fail as a result.[117] Moreover, if there were an economic crisis or other disruption in the markets that caused otherwise healthy businesses to default, large numbers of potentially viable smaller firms could fail if DIP financing were not available.

Perhaps there are few viable firms among the small debtors that file for bankruptcy. But a worrisome feature of the DIP financing market strongly suggests that the market is poorly structured to provide financing for small, viable firms. Unlike with large businesses, which borrow from a range of bank and non-bank lenders, the principal lender for small businesses often is a single bank.[118] Not surprisingly, the banks that lend to smaller businesses tend to be local and regional banks. Although banks in general do play a major role in the DIP financing market,[119] the banks that play this role are large banks, not local and regional banks. The two most frequent DIP lenders in a large recent study were JPMorgan Chase and Bank of America, followed by Wells Fargo and Citigroup.[120] These

115. Our own analysis of nonpublic data from Deal Pipeline confirms the perception that few small firms receive DIP financing. Because we are not at liberty to publish the data, we do not include the details here.

116. Baird and Morrison refer to these small businesses as "serial entrepreneurs." *See* Baird & Morrison, *supra* note 38.

117. This statement is not inconsistent with findings that courts generally do a good job of lifting the automatic stay or dismissing the case if the debtor is unlikely to reorganize. *See, e.g.,* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small Business Bankruptcies*, 50 J.L. & ECON. 381, 382 (2007)(concluding that "the Chapter 11 process appears to sort effectively between businesses that are viable and those that are not"); Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603, 614-15 (2009) (finding that the success rate for reorganizing businesses in chapter 11 is quite high when "dead-on-arrival" cases are omitted from the analysis). Failure to persuade the debtor's principal lender to extend DIP financing is likely to be the death knell for such a business, whether or not the business is viable.

118. The classic account of the role of bank financing for small businesses is Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

119. Seventy-eight percent of DIP financing is provided by banks. Eckbo. et al., *supra* note 31 (manuscript at 12). Eckbo, Li and Wang distinguish between insider-provided and new loans. We have combined the two.

120. Wang Email (June 21, 2020), *supra* note 33 (describing findings in a large dataset of 267 cases with DIP loans).

are, by far, the largest four banks in America. All ten of the top DIP lenders that were banks were very large banks.[121]

The structure of the DIP financing market is thus poorly designed to meet the needs of smaller businesses in bankruptcy. Under ordinary conditions, this means that some potentially viable businesses will fail due to their inability to obtain DIP financing. In the event of an economic disruption that caused previously healthy businesses to default, the costs of this flaw in the market could be significant unless local and regional banks that currently eschew DIP financing can be encouraged to enter the market. Such a tipping point, in the absence of a fiscal-monetary response similar to that of 2020, could have devastating consequences to the broader economy, far beyond the businesses themselves.

Congress has alleviated the difficulty faced by small firms in bankruptcy in one respect. In 2019, lawmakers enacted subchapter V, a new set of bankruptcy provisions that ease the requirements for confirming a reorganization plan for small businesses.[122] But the new provisions only apply to companies with $7.5 million or less of debt,[123] and they do not facilitate DIP financing.

Notice that the two structural flaws in the DIP financing market have very different implications for intervention. The optimal corrective for the excessive premia large corporate debtors are forced to pay for financing would be to render that market more competitive: that is, to loosen the stranglehold that these debtors' inside lenders have on them. With small firms, by contrast, the best solution is to give the debtor's current lender—the inside lender—a greater incentive to lend. For large firms, the inside lenders are, in a sense, the problem; for smaller firms, they are the solution.

A nuanced Fed intervention to correct the dysfunction in this market could thus aim at different targets in the two contexts and resolve these problems. The DIP Discount Window Facility we propose in the next part can accomplish precisely this task.

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121. *Id.* The top lenders were JPMorgan Chase and Bank of America, which each have several trillion dollars of assets. Number ten was Credit Suisse First Boston.

122. Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (codified as amended at 11 U.S.C. §§ 1181-1195). For a careful analysis of subchapter V and an argument that small business reorganizations can be facilitated even more by using the prepackaged bankruptcy strategy in subchapter V, see Christopher D. Hampson & Jeffrey A. Katz, *The Small Business Prepack: How Subchapter V Paves the Way for Bankruptcy's Fastest Cases*, 92 GEO. WASH. L. REV. (forthcoming 2024), https://ssrn.com/abstract=4595995 [https://perma.cc/2DSC-PT3M].

123. The original limit was $2,726,625, but this was raised to $7.5 million. 11 U.S.C. § 1182(1)(A) (2018). *See, e.g.*, Hampson & Katz, *supra* note 122, (manuscript at 15 n.61). As Hampson and Katz point out, the limit is a little misleading, because only debts that are liquidated and not owed to an affiliate count. *Id.* (manuscript at 15).

It is worth noting that it is at least possible that Congress will take action to counteract some of the sclerosis in the DIP financing market. The perception that insiders dominate the largest cases could prompt Congress to intervene, for instance.[124] Insider control of DIP financing is an important source of this dominance and would be an obvious target for reform. But there currently are not any serious proposals to break insiders' grip on the DIP financing market or to address other areas where insiders benefit to the exclusion of other constituencies.

E. The Stanford Proposal

We are not the first to advocate that the Fed turn its attention to the DIP financing market. In a widely cited policy brief posted to their websites at the onset of the 2020 pandemic, just as the fiscal-monetary response was taking root, Stanford economists Peter DeMarzo, Arvind Krishnamurthy, and Joshua Rauh argued for a "Debtor-in-Possession Financing Facility" under which the Fed would directly finance bankrupt entities.[125] They note that most systemic efforts, through conventional monetary policy, large-scale asset purchases, and market-level emergency lending facilities, however useful for economic stability, are too "diffuse" in their benefits to do much more than stabilize marginal firms. Instead, they argued for the creation of the DIP Financing Facility to intervene directly into these markets to "offer DIP financing at an interest rate equal to the Federal Reserve Discount Rate."[126] They also envisioned that the Treasury would participate in making an "equity investment" in the special-purpose vehicle designed to accomplish this purpose.[127] The authors also indicated that such a facility should be directed as part of the Fed's emergency authority, under section 13(3).

Many of the benefits of the Stanford proposal are the same for any emergency Fed intervention in these markets during a crisis: stabilization would permit far more firms to weather the crisis and emerge ready to participate in the macroeconomy as producers, consumers, and employers. There are three major problems with the proposal. First, and most basically, the Stanford proposal is illegal. As the proposal indicates, the authority under which it would putatively operate is section 13(3), the same provision that authorized nearly all of the Fed's emergency

124. For discussion of this perception, and of inside lenders' control of the DIP financing market, see David A. Skeel, Jr., *Bankruptcy's Identity Crisis*, 171 U. PA. L. REV. 2097 (2023).

125. Peter M. DeMarzo, Arvind Krishnamurthy & Joshua Rauh, *Debtor-in-Possession Financing Facility (DIPFF) Proposal*, STAN. GRADUATE SCH. OF BUS. (June 20, 2020), https://www.gsb.stanford.edu/sites/default/files/publication-pdf/dipff.pdf [https://perma.cc/U7NZ-XY85].

126. *Id.* at 2.

127. *Id.*

authorities.[128] But after the extensive use of this authority in 2008-2010, Congress substantially altered the basis on which the Fed may make emergency loans. As relevant here, the revised section 13(3) requires "a certification from the chief executive officer (or other authorized officer) of the borrower . . . that the borrower is not insolvent."[129] Lest there be any doubt whether a bankrupt entity is insolvent, the statute clarifies that "[a] borrower shall be considered insolvent for purposes of this subparagraph, if the borrower is in bankruptcy."[130]

The illegality of using section 13(3) to finance DIP financing isn't the only problem with the Stanford Proposal: we will discuss in more detail below why intermediated finance is a superior alternative. But for now, its most important virtue its legality: to use a section 13(3) facility is forbidden by law.

* * *

A Debtor-in-Possession lending facility must accomplish a number of tasks. It must be tailored the needs of the market dysfunction it is intended to address, it must be legally authorized by the Federal Reserve Act, and it must be designed such that there is reasonable incentive for participation. It must also fit within the traditions of the Federal Reserve and central banking, a proposition that requires some elaboration.

II. Federal Reserve Lending, Emergencies, and the Discount Window

Using the discount window as a tool of directed credit policy would admittedly be a change—potentially a large one—to the current operating system. The current system of Fed interventions in the financial markets consists of two extremes. In good times, the Fed sits above the financial system, using regulatory and supervisory tools to manage the government's role in the economy and monetary tools to intervene in the secondary markets of federal governmental debt with an eye to influencing the rates at which banks lend to each other on a short-term basis. This is "conventional monetary policy" that has been a relatively stable basis of Federal Reserve policy since the mid-1950s, albeit with several changes along the way.[131]

At the other end of the extreme, when crisis hits (as in 2008 and 2020) the Fed breaks the glass on a broad sweep of emergency lending

128. Federal Reserve Act § 13(3), 12 U.S.C. § 343(3) (2018).

129. 12 U.S.C. § 343(3)(B)(ii) (2018).

130. *Id.*

131. *See* CONTI-BROWN, *supra* note 76, at 131-35; Glenn D. Rudebusch, *A Review of the Fed's Unconventional Monetary Policy*, FED. RSRV. BANK S.F. (FRBSF Econ. Letter 2018-27, Dec. 3, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/december/review-of-unconventional-monetary-policy [https://perma.cc/K4CY-RXRZ].

facilities and unconventional monetary policies that have grown in complexity and creativity as crises wear on. The twin invocations of this emergency authority in a dozen years do not bode well for the proposition that the Fed will only resort to these tools rarely, but the political fallout of their usage suggests that these invocations are problematic, to say the least.

A storied mechanism for bank lending that, with a few exceptions, has mostly fallen into disuse, the discount window sits between these two extremes. In this Part, we explain what the discount window is, how it has evolved, and why it should be used as the foundation for the new credit channeling role we advocate for the Fed. As the historical analysis will show, there have been hints of this approach in the Fed's adaptation of the discount window to particular exigencies in the past. We are arguing, in a sense, that the mission be made more explicit. This Part also develops the details of a DIP Discount Window Facility design that would address the dysfunctional features of the market and explains how lending through that facility would work.

A. The Discount Window: Evolution Toward Credit Policy

When the Fed was first organized in 1913, the discount window served as its primary mechanism for lending.[132] The Fed offers the discount window to depository institutions so that they can "manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress."[133] The Fed used the discount window as its principal strategy for intervening in banking markets to, in the words of the Federal Reserve Act, "furnish an elastic currency [and] to afford means of rediscounting commercial paper."[134] In jargon-free terms, a "discount" is just a collateralized loan to eligible banks. From 1914 to 1980, eligible banks had to be members of the Federal Reserve System, subject to Fed supervision and regulation. After the passage of the Monetary Control Act of 1980, any depository institution can access the Fed's discount window.[135]

Figure 2 shows the take-up (in billions) from the Fed's discount window from 1919 to 2007.

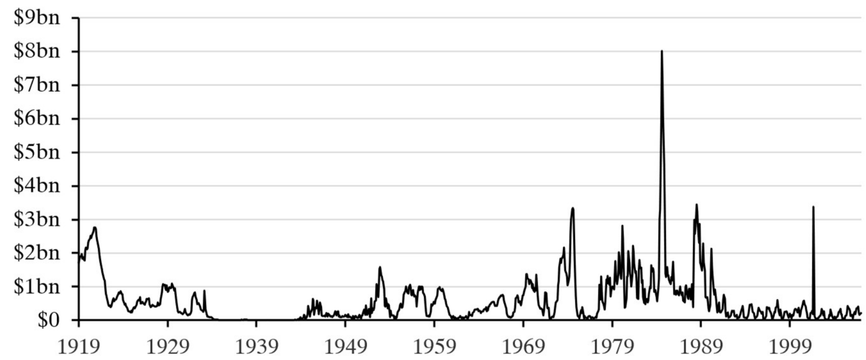
132. *See* Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, FED. RSRV. BANK ST. LOUIS REV., Sept./Oct. 1992, at 58, 60.

133. *Discount Window Lending*, BD. GOVERNORS FED. RSRV. SYS. (Dec. 31, 2020), https://www.federalreserve.gov/regreform/discount-window.htm [https://perma.cc/9JBC-PFD2].

134. Federal Reserve Act, ch. 6, 38 Stat. 251, 251 (1913).

135. Monetary Control Act of 1980, Pub. L. No. 96-221, sec. 103, 94 Stat. 132, 136 (amending Federal Reserve Act § 19(b)(7), 12 U.S.C. § 461(b)(7)).

Figure 2. Total Bank Borrowings from the Federal Reserve[136]



Shortly after the passage of the Federal Reserve Act the discount window began to decline in prominence (with some exceptions) in favor of the Fed's open-market operations, whereby the Fed buys and sells securities in the open market to influence their prices. Open-market operations constituted the dominant monetary regime from the 1930s through 2008.[137]

The impetus came from an intellectual change in the understanding of banking and finance and an appreciation for how different parts of the Federal Reserve Bank balance sheets operated. Indeed, the use of the discount window in 1970 and in the 1980s led several prominent economists—including Anna Schwartz,[138] Marvin Goodfriend and Robert G. King,[139] and Michael D. Bordo[140]—to call for its elimination because of perceived abuses. The basic critique is two-fold: (1) any reasonable macroeconomic function that the Fed needs to perform around the availability of money can be most efficiently accomplished through open-

136. Bd. of Governors of the Fed. Rsrv. Sys., *Total Borrowings from the Federal Reserve*, FRED (Nov. 28, 2023) [hereinafter *Monthly Total Borrowings*], https://fred.stlouisfed.org/series/BORROW [https://perma.cc/8P5A-9KLZ].

137. *See* Jane Ihrig & Scott A. Wolla, *The Fed's New Monetary Policy Tools*, FED. RSRV. BANK OF ST. LOUIS 1, 4 (Aug. 2020), https://files.stlouisfed.org/files/htdocs/publications/page1-econ/2020/08/03/the-feds-new-monetary-policy-tools_SE.pdf [https://perma.cc/5M8W-8YHA]. For a defense of the regime that succeeded it, interest on excess reserves, *see* Ben S. Bernanke & Donald Kohn, *The Fed's Interest Payments to Banks*, BROOKINGS INST. (Feb. 16, 2016), https://www.brookings.edu/blog/ben-bernanke/2016/02/16/the-feds-interest-payments-to-banks [https://perma.cc/5D8J-5LYK]. For a critical view, see GEORGE SELGIN, FLOORED!: HOW A MISGUIDED FED EXPERIMENT DEEPENED AND PROLONGED THE GREAT DEPRESSION (2018).

138. *See* Schwartz, *supra* note 132, at 58-68.

139. Marvin Goodfriend & Robert G. King, *Financial Deregulation, Monetary Policy, and Central Banking*, 74 FED. RSRV. BANK RICH. ECON. REV., May/June 1988, at 1, 11.

140. Michael D. Bordo, *The Lender of Last Resort: Alternative Views and Historical Experience*, FED. RSRV. BANK RICH. ECON. REV., Jan./Feb. 1990, at 18, 26.

market operations, and (2) discount-window lending invites strategic use by insolvent banks.[141]

Charles W. Calomiris argued that the discount window actually accomplished a different set of goals: to defuse "liquidity crises that occur in particular nonbank financial markets," especially in "periods of financial disruption."[142] In that way, Calomiris viewed the discount window as an answer to a collective action problem, a "mutually beneficial decision among depositors not to withdraw their deposits during panics."[143] The advent of deposit insurance rendered some of the need for this collective action moot, but not for those within the economic and financial system who operated outside the formal banking system, such as participants in the commercial paper market when the Penn Central railroad defaulted in the 1970s.[144]

Until the 2008 financial crisis, there were three primary mechanisms for borrowing through the discount window: primary credit, secondary credit, and seasonal credit. In that crisis, the Fed modified its primary credit facility to create a Term Discount Window Program that extended the maturities of discount-window lending beyond the overnight markets that had come to dominate this lending.[145] It also created a fourth facility, the Term Auction Facility (TAF), in December 2007. TAF, an auction with a large number of participants and a three-day lag between auction and settlement, was designed to resolve the so-called "stigma problem" associated with discount-window lending.[146] TAF carried the bulk of the Fed's discount-window lending during the crisis, reaching $700 billion at its peak. To put the point differently, between 2003 and 2006, discount-window lending across the system averaged $170 million per day; between 2007 and 2009, the number became $221 *billion*, or a 129,900% increase.[147]

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141. According to data released after the surge in discount-window lending in the Savings and Loan crisis, fully 60% of failed institutions had outstanding Fed loans from the discount window. *See* Schwartz, *supra* note 132, at 59.

142. Charles W. Calomiris, *Is the Discount Window Necessary? A Penn Central Perspective*, FED. RSRV. BANK ST. LOUIS REV., May/June 1994, at 31, 32 (emphasis omitted).

143. *Id.* at 33.

144. *Id.* at 41.

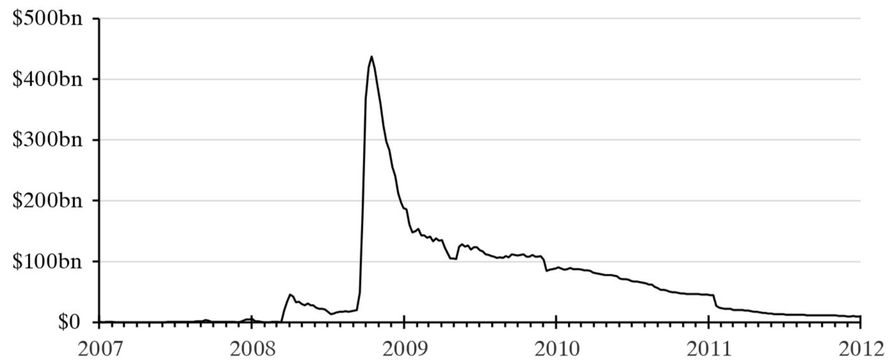
145. For an overview of the Term Discount Window Program and other discount window interventions, see Allen N. Berger, Lamont K. Black, Christa H.S. Bouwman & Jennifer Dlugosz, The Federal Reserve's Discount Window and TAF Programs: "Pushing on a String?" 7-9 (Jan. 2016) (unpublished manuscript), https://sc.edu/study/colleges_schools/moore/documents/finance/berger/federal-reserve-discount-window-taf-prog-pushing-on-a-string.pdf [https://perma.cc/A7LV-PBT9].

146. *See* Ben S. Bernanke, Chairman, Fed. Rsrv. Bd., Speech at the Federal Reserve Bank of Richmond 2009 Credit Markets Symposium: The Federal Reserve's Balance Sheet (Apr. 3, 2009), https://www.federalreserve.gov/newsevents/speech/bernanke20090403a.htm [https://perma.cc/6AF7-QDQN].

147. Berger et al., *supra* note 145 (manuscript at 1).

Figure 3 presents the Fed's total discount-window lending during the 2008 crisis.

Figure 3. Total Bank Borrowings from the Federal Reserve[148]



To be clear, as legal scholar Kathryn Judge has argued, the Fed's 2007-2009 discount-window lending, however massive, came nowhere near matching the liquidity demands that banks required. This caused them to turn to alternatives, such as deposits or loans from the Federal Home Loan Bank System.[149] Even so, the discount window was a key part of the crisis response. Taken together, the funds lent through the 2008 crisis through these four discount-window facilities constituted the single largest directed lending to banks in the Fed's history.[150] The results indicate something of an evolution of discount-window lending in two key ways. First, lender-of-last-resort theory would predict that discount-window lending would target weaker banks facing liquidity crises that they could not meet. Discount-window lending did indeed target smaller banks so constrained, but larger banks simply used discount-window funding strategically, whatever their strength.

Second, lender-of-last-resort theory is not specifically about credit policy in the real economy, but about stabilizing the financial system in a panic. Thus, window lending has not historically been viewed as the appropriate mechanism for encouraging bank lending to credit-deficient entities in the economy. In 2008, however, the Fed used discount-window lending for precisely that purpose. In its Monetary Policy Report in 2009,

148. Bd. of Governors of the Fed. Rsrv. Sys., *Total Borrowings of Depository Institutions from the Federal Reserve*, FRED (Dec. 22, 2023) [hereinafter *Weekly Total Borrowings*], https://fred.stlouisfed.org/series/TOTBORR [https://perma.cc/PNP4-F8CV].

149. Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795, 797 (2014).

150. *See Monthly Total Borrowings*, *supra* note 136 (showing that the total borrowings of depository institutions from the Federal Reserve reached its peak in 2008).

the Fed reported to Congress its justification for the dramatic expansion of the discount window: "By increasing the access of depository institutions to funding, the TAF has supported the ability of such institutions to meet the credit needs of their customers."[151] In this effort, they succeeded: according to the most comprehensive analysis of discount-window lending in the crisis, increased discount-window usage was "associated with increased lending by both small and large banks during the crisis."[152]

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

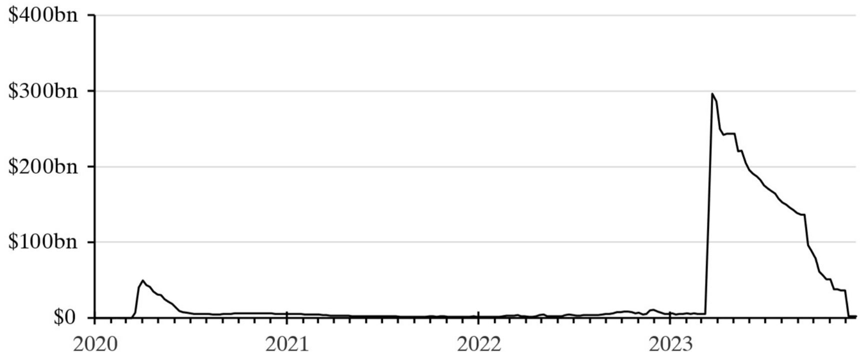
In 2020, the Fed once again deployed the discount window for credit purposes. On March 15, 2020, the Fed announced that its primary credit discount-window rate would drop to 0.25%, to match the target rate for its open market operations. It also extended the maturity of the loans to 90 days, consistent with the statute, "prepayable and renewable by the borrower on a daily basis" (thus providing much more stability than the 90-day maturity suggests).[153] Figure 4 shows the usage of the discount window from January 2020 through November 2023.

151. Monetary Policy Report to the Congress, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 47 (Feb. 24, 2009), https://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf [https://perma.cc/F5ZA-LUCE].

152. Berger et al., *supra* note 145, at 5.

153. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Actions to Support the Flow of Credit to Households and Businesses (Mar. 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm [https://perma.cc/FW5X-FERQ].

Figure 4. Total Bank Borrowings from the Federal Reserve ($bn)[154]



Once again, the Fed viewed the discount window not in the traditional lender-of-last-resort frame for preventing panic in the financial system, but as a mechanism to influence credit policy, as exemplified by the first sentence of its press release issued four days after its announced changes to the discount window: "The Federal Reserve Board is encouraged by the notable increase in discount window borrowing this week with banks demonstrating a willingness to use the discount window as a source of funding to support the flow of credit to households and businesses."[155]

B. The DIP Discount Window

As discussed earlier, several prominent scholars advocated the use of the Fed's section 13(3) powers to facilitate DIP financing during the pandemic, a proposal that would violate the law.[156] Our discount-window strategy, by contrast, would not be limited to emergencies and would be governed by a separate provision of the Federal Reserve Act, section 10B, which does not forbid bankruptcy lending.[157] This solution is not only legal; it also is superior from policy and institutional perspectives, since it would not require the Fed to be a party to a bilateral lending arrangement, would not impose interest rate requirements, and would not need Treasury approval. It would also avoid the temptation for the

154. *Weekly Total Borrowings*, *supra* note 148.

155. Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Encouraged by Increase in Discount Window Borrowing to Support the Flow of Credit to Households and Businesses (Mar. 19, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200319c.htm [https://perma.cc/YA62-Q4JD].

156. *See supra* Section I.E.

157. Federal Reserve Act § 10B, 12 U.S.C. § 347b (2018).

Fed to use emergency lending as the solution to all market failures. And it would be available even if the political heat for fiscal and monetary experimentation meant that such experimentation was not in the offing.

To be clear, our application of the discount window to DIP financing is important in two ways. First, it is meant to address genuine problems endemic to the DIP markets, as described below. Resolving these issues for small- and medium-sized enterprises would be an important policy triumph in itself. Second, we mean to place the discount window into more direct conversation with credit policy generally. If the Federal Reserve and the banks that rely upon it master the intricacies of lending in times of intermediate stress, a new avenue of lending opens up that can preserve and protect the Fed's arsenal of other tools for more extreme situations. In the absence of these developments, we fear that the Fed and the public will only know one register for macroeconomic intervention: the all-out approach that has characterized its efforts in its most recent interventions in the last fifteen years.

Our approach to addressing structural flaws in the credit markets through the discount window builds on two historical and theoretical insights about the discount window discussed above: first, the Fed's evolution of the discount window toward credit policy and away from emergency lending policy, and second, the insight (from Calomiris) that, post-deposit insurance, the discount window is best justified for its ability to provide relief not only to banks, but to their fragile customers and counter-parties.[158]

1. Structuring the Facility

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

The first approach would be designed to mirror the existing discount-window facilities with some modifications. The law governing the permissible design of such facilities is found in section 10B of the Federal Reserve Act and Regulation A, the regulation that the Fed promulgated to implement this authority.[159] The counterparty must be a depository institution, which means that hedge funds, investment funds,

158. *See* Calomiris, *supra* note 142.

159. Federal Reserve Act § 10B, 12 U.S.C. § 347b (2018); Regulation A, 12 C.F.R. § 201 (2023).

and other entities outside the regulatory and supervisory apparatus of banking cannot participate.[160] The maturity of discount-window lending is limited to four months, but can be renewed at the Fed's discretion.[161] The counterparty depository institution must not be "undercapitalized" at the time of the advance, with exceptions for "viable" depository institutions as certified by the relevant federal banking agency.[162] These restrictions are largely statutory and would apply whether the Fed structured a DIP facility as primary, seasonal, or DIP-specific credit.

The Fed treats seasonal credit slightly more flexibly by permitting lending to occur "for periods longer than those permitted under primary credit."[163] Seasonal credit has historically been available for those banks whose customers truly face "seasonal" demands—in agriculture, primarily, but not exclusively.[164] But a "seasonal" wave of bankruptcies associated with recessions and the steep financing that is imposed on otherwise viable entities in a recession could be enough on its own to trigger a discount-window facility. Structuring it in this way would not necessarily require the Fed to alter Regulation A, even as it tailored DIP lending to meet these regulatory requirements.

These two alternatives notwithstanding, the far superior approach would be to issue an amendment to Regulation A. In the quieter times that the Fed faces, it should make such a proposed rulemaking subject to usual notice-and-comment procedures; but even if it did not do so, it could issue such an amendment under the emergency provisions of the Administrative Procedures Act that permit a "good cause" exception to notice-and-comment rulemaking when those procedures are "impracticable, unnecessary, or contrary to the public interest."[165] This approach also permits the Fed to be more deliberate about structuring a DIP facility for purposes unique to the DIP financing.

The most important regulatory decisions the Fed will face in determining the scope of DIP financing as a separate category of

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160. 12 U.S.C. § 347b(a) (2018); *id.* § 461(b)(7).

161. *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., *supra* note 145 ("[D]epository institutions may borrow from the discount window for periods as long as 90 days, prepayable and renewable by the borrower on a daily basis."); *cf.* Federal Reserve Act § 10B(b)(4), 12 U.S.C. § 347b(b)(4)(2018) ("A Federal Reserve bank shall have no obligation to make, increase, renew, or extend any advance or discount under this chapter to any depository institution.").

162. Federal Reserve Act § 10B(b), 12 U.S.C. § 347b(b) (2018).

163. 12 C.F.R. § 201.4(c) (2023).

164. Federal Reserve Act § 19(b)(7), 12 U.S.C. § 461(b)(7) (2018). *See* Michelle A. Clark, *Are Small Rural Banks Credit-Constrained? A Look at the Seasonal Borrowing Privilege in the Eighth Federal Reserve District*, FED. RSRV. BANK ST. LOUIS REV., May/June 1992, at 52, 53-57; Bd. of Governors of the Fed. Rsrv. Sys., *Assets: Liquidity and Credit Facilities: Loans: Seasonal Credit: Week Average*, FRED (Dec. 22, 2023), https://fred.stlouisfed.org/series/WSB [https://perma.cc/36AX-T8PU] (showing seasonal credit lent by the Federal Reserve from 1986 to 2023).

165. 5 U.S.C. § 553(b)(3)(B) (2018).

discount-window lending will be (1) eligibility, to the extent that specific capital standards will apply for depository institutions that participate; (2) acceptable collateral, which will likely differ from traditional collateral presented for discount-window lending; and (3) incentives, positive and negative, for bank participation. We also consider (4) how central banks can use suasion, as a strategy for encouraging bank participation.

2. Eligibility

Eligibility for participation is limited to depository institutions, a broad category that requires a banking charter and excludes financial institutions such as mortgage banks and credit unions. Eligible depository institutions cannot be "critically undercapitalized,"[166] but otherwise the Fed retains the discretion, in practice and by rulemaking, to choose its counterparties: there is no legal "obligation to make advances" through the discount window.[167]

We see no need to alter that level of eligibility and discretion for specialized discount-window facilities. One of the primary benefits to this system outlined below is the marriage of exigent lending and bank supervision. Initially, participation in discount-window facilities will likely require incentives, so the Fed should avoid imposing barriers to eligibility in the beginning. In the event that take-up of the program succeeds, and demand introduces questions about risk management for the Fed, further restrictions linked to supervisory ratings or other metrics may be appropriate.

The final eligibility requirement is not as straightforward. Recall that the structural flaws in the DIP financing market manifest themselves quite differently with the largest and smaller corporate debtors.[168] In large corporate bankruptcies, the problem is the near monopoly enjoyed by the debtor's inside lenders, which has led to an unusually high cost of credit. At the other end of the size spectrum, the principal problem is the absence of funding. The eligibility requirements of the DIP Discount Window would need to be different in the two contexts.

Start with lenders to the largest corporate debtors. In addition to setting a size threshold to distinguish this market from smaller firms—we would suggest $50 million of assets as the dividing line—the program should only be available to outside lenders, so that it would facilitate competition in this market. Giving inside lenders access to the DIP Discount Window subsidy would simply reinforce the competitive advantage inside lenders already have.

166. Federal Reserve Act § 10B(b)(3), 12 U.S.C. § 347b(b)(3) (2018).
167. *Id.* § 10B(b)(3), 12 U.S.C. § 347(b)(4).
168. *See supra* notes 108-124 and accompanying text.

Given the dearth of competition, a key question with the large-firm facility would be whether to give access to non-bank lenders such the hedge funds and equity funds that current provide roughly 22% of DIP financing.[169] Although broader access would further increase the universe of outside lenders, we believe the facility should be limited to banks. The positive regulatory externalities of the DIP Discount Window that we discuss below arise from the Fed's existing bank regulatory role, and banks already provide most DIP financing.[170] This restriction would not be locked in stone, however, and could be revisited if a bank-only facility proved insufficient.

As several commentators have pointed out to us, it is possible that inside banks would try to circumvent the outsiders-only stricture of the facility by coordinating with another, ostensibly outside bank to tap the program. The Fed would need to be alert to this possibility, of course, but we think it is unlikely manipulation would be pervasive. Even if an inside bank were tempted engage in such behavior, they would be likely to think twice, given that they are subject to continuous Fed oversight and would be subject to draconian penalties. This is another benefit of limiting the facility to banks.

Shift now to the facility for smaller corporate debtors—that is, debtors with less than $50 million in assets. Here, an outsiders-only restriction could be disastrous. Given the absence of financing for these debtors, it is important to entice local and regional banks into this credit market. The debtor's current lender is the most promising lender in this context. By subsidizing loans made by debtors' principal bank lenders as well as those made by outside banks, the facility not only could encourage lenders to make DIP loans; it might also encourage them to do so at reasonable rates.

3. Collateral

The Federal Reserve Act provides ample discretion for the Fed to determine the value and nature of collateral presented to the discount window, so long as the loans offered are "secured to the satisfaction" of the lending Federal Reserve Bank.[171] This phrase has become important, used as it was to justify the failure to prevent the bankruptcy of Lehman Brothers in 2008. It lacks statutory definition and had no meaning in common law.[172]

169. Eckbo et al., *supra* note 31 (manuscript at 12).
170. *Id.*
171. Federal Reserve Act § 10B(a), 12 U.S.C. § 347b(a) (2018).
172. Peter Conti-Brown, Yair Listokin & Nicholas R. Parrillo, *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REGUL. 1, 68-70 (2021).

The critical question with collateral arises from the fact that most of the businesses that need access to DIP financing already have lenders to which the debtor has pledged all of its assets as collateral. This is not likely to be a problem if the existing lender will be making the new DIP loan, as will often be the case under the small-debtor facility. Under the large-debtor facility, by contrast—which would be available only for new, outside lenders—the collateral requirement is more problematic. It is not immediately clear how a loan by a new lender could be "secured to the satisfaction" of the Fed. Bankruptcy's DIP financing provision provides a potential solution to this problem—the "priming lien," discussed earlier and discussed in more detail in Section II(C) below.[173]

The only other restriction on collateral by statute is that such collateral must not have maturities longer than four months.[174] At first glance, this restriction appears to be a major impediment to the facility we propose. In reality, it is not. The time restriction is easily avoided, since the Fed, by regulation, can commit to roll over debt on these maturities during the pendency of the bankruptcy proceedings. Moreover, given that DIP loans often do not have a long duration—they usually are paid off or refinanced when the debtor emerges from bankruptcy—the maturities usually would not have to be rolled over numerous times.

4. Program Incentives

A very real concern with creating a discount-window facility for credit policy, rather than emergency financial policy, is that banks will simply boycott the process because the economics are not favorable. There is some concern that, in credit-policy facilities aimed at the real economy via section 13(3) during the recent pandemic, banks did just this.[175] The Main Street Lending Program (MSLP) is a primary example.[176] The MSLP was open to banks on behalf of other counterparties. There were no clear eligibility requirements for banks; the secondary counterparties were required to be relatively small (no

173. *See supra* notes 110-111 and accompanying text; *infra* Section II(C).

174. Federal Reserve Act § 10B(a), 12 U.S.C. § 347b(a) (2018).

175. Paul Kiernan, *Fed's $600 Billion Main Street Lending Program Sees Lukewarm Interest*, WALL ST. J. (July 1, 2020, 9:00 AM ET), https://www.wsj.com/articles/feds-600-billion-main-street-lending-program-sees-lukewarm-interest-11593608400 [https://perma.cc/SP2B-VSBR].

176. For a cogent critique of the program, see William B. English & Nellie Liang, *Designing the Main Street Lending Program: Challenges and Options*, (Brookings Inst., Hutchins Ctr. Working Paper No. 64, 2020), https://www.brookings.edu/research/designing-the-main-street-lending-program-challenges-and-options [https://perma.cc/QQE5-SK55].

more than 15,000 employees or less than $5 billion in annual revenues).[177] The Fed's explanations for the MSLP were hardly a model of clarity—the Frequently Asked Questions sheet is 105 pages long and full of jargon.[178] It appears, though, that loans had "a five year maturity, deferral of principal payments for two years, and deferral of interest payments for one year."[179] Banks had to retain 5% of the loans, which were priced uniformly at LIBOR + 3%.[180]

A DIP Discount Window Facility should avoid some of the mistakes of the MSLP. First, the credit availability should be more highly subsidized, perhaps even beyond the levels of the generic discount-window facilities. The fact that the specialized facility would have a rate different than the primary discount window is not itself remarkable: the three main discount-window facilities—primary, secondary, and seasonal—are also priced differently.[181] Additionally, the Term Auction Facility had a rate set by auction.[182]

The subsidy is appropriate for the aims of this discount window and for others that might follow. The point of Fed intervention in DIP financing markets is to prevent the liquidation of viable companies for which efficiently priced DIP financing would mean the difference between survival and liquidation.

Another approach would be a form of regulatory subsidy that would reclassify the liquidity requirements for discount-window loans obtained for credit-policy purposes. Following the attacks on the United States on September 11, 2001, the Fed issued a statement that the discount window was available for all liquidity needs that banks might have in an effort to remove the stigma often associated with discount-window lending.[183] In 2003, the Fed amended Regulation A, the implementing regulation for

177. *Main Street New Loan Facility*, BD. OF GOVERNORS OF THE FED. RSRV. SYS. 1 (June 8, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200608a1.pdf [https://perma.cc/B8SC-5YY6].

178. *Main Street Lending Program Frequently Asked Questions,* BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Dec. 29, 2020), https://www.bostonfed.org/mslp-faqs [https://perma.cc/R6H2-F3VP].

179. *Main Street Lending Program*, BD. GOVERNORS FED. RSRV. SYS. (Oct. 11, 2023), https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm [https://perma.cc/A6QL-C3DE].

180. *Main Street New Loan Facility*, *supra* note 177, at 1-2.

181. *The Discount Window and Discount Rate*, BD. GOVERNORS FED. RSRV. SYS. (Oct. 17, 2023), https://www.federalreserve.gov/monetarypolicy/discountrate.htm [https://perma.cc/PHT7-UMQX].

182. *Term Auction Facility*, BD. GOVERNORS FED. RSRV. SYS (Feb. 12, 2016), https://www.federalreserve.gov/regreform/reform-taf.htm [https://perma.cc/RG84-V2S2].

183. *See* James J. McAndrews & Simon M. Potter, *Liquidity Effects of the Events of September 11, 2001*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., Nov. 2002, at 59, 69-70; Christopher J. Neely, *The Federal Reserve's Response to the Sept. 11 Attacks*, FED. RSRV. BANK ST. LOUIS: REG'L ECONOMIST (Jan. 1, 2002), https://www.stlouisfed.org/publications/regional-economist/january-2002/the-federal-reserves-response-to-the-sept-11-attacks [https://perma.cc/B8QY-CZSE].

direct Fed lending, to turn the discount window into a "no questions asked" facility.[184] But there remains an important impediment: loans obtained through the discount window count against a bank's liquidity requirements.[185] If this treatment were removed, as we believe it should be, the cost of borrowing would plummet with little consequence for financial stability. So long as underwriting remains robust and banks retain skin in the game, this simple regulatory change would increase incentives for participation and eliminate the stigma problem associated with discount-window lending, without creating significant new risks to bank stability.

5. Suasion

Although the economics of a DIP Discount Window Facility should be favorable for bank participation—whether through subsidy or the nudge that the facility's institutional design would offer to first-time DIP financers—the Fed has an additional, often underappreciated option to spur additional interest if needed: the informal leverage that the Fed has as bank supervisor. Bank supervision is a unique and uniquely powerful set of institutional practices distinct from regulatory authority. The Fed has in the past often invoked its supervisory authority, a kind of "moral suasion," to put pressure on market participants to act in pro-social ways.[186] Given the importance of the banks to the implementation of credit, financial, and monetary policy, it may be appropriate for supervisors to advocate for banks' participation in these programs as part of the supervisory process.

Bank participation in the Fed's credit policies is an important part of the debate about emergency relief. Some scholars conceive of banking as essentially a public function, using sovereign control over money creation to accomplish public ends.[187] Banks themselves, however, have tended to act very differently. The banks' lack of participation in the Main Street Lending Program has many reasons, but one concern, as with some failures of participation in the Payroll Protection Program, is that banks simply don't see the upside to their shareholders in participating.

184. Bill Nelson, *The Discount Window is Available to Meet Liquidity Needs*, BANK POL'Y INST. (Feb. 24, 2020), https://bpi.com/the-discount-window-is-available-to-meet-liquidity-needs [https://perma.cc/N5LH-9PY9].

185. *Id.*

186. Examples of suasion in supervision to accomplish pro-social goals are legion. *See* CONTI-BROWN, *supra* note 76, at 219-25. More recently, the borrowing from the discount window by eight major banks was effectively an answer to this same problem. *See* Kate Kelly, Andrew Ross Sorkin & Jeanna Smialek, *As Market Convulses, Big Banks Plan to Borrow Funds from Fed*, N.Y. TIMES (Mar. 16, 2020), https://www.nytimes.com/2020/03/16/business/fed-discount-window.html [https://perma.cc/YB9X-7CZ9].

187. *See, e.g.*, Morgan Ricks, *Money as Infrastructure*, 2018 COLUM. BUS. L. REV. 757, 760.

Banks—and their supervisors—should rethink this shareholder-only commitment. The Fed has backstopped these instruments of credit policy such that even if they are not profitable, participants will not incur losses. This kind of encouragement should not be altruism, but rather reflect part of the bargain of deposit insurance and the benefits associated with bank supervision.[188]

More concretely, the banks have *already* benefitted from supervisory suasion in their favor through supervisory forbearance.[189] As part of the Fed's response to COVID-19, it issued statements and emergency regulations that mitigated the accounting and regulatory capital impact of nonperforming assets.[190] This is a commitment to let banks ride out their clients' challenges, even if the consequence would be, in better times, the deterioration of bank capital and other increased supervisory penalties (as well as the risk of failure). For banks to take advantage of these benefits, especially during a period of surprising resiliency, suggests that bank supervisors have more space to condition some of that supervisory flexibility on participation in other aspects of their credit policy.

C. The Priming Lien

The Fed's obligation to be "secured to [its] satisfaction" in its discount-window facilities is both vague (since neither Congress nor the Fed has ever defined these terms) and ambiguous (since security need not necessarily be collateral).[191] The term therefore does not serve as a useful legal limitation on Fed lending. But it is practically very important: we take for granted that the Fed will not create specialized discount-window facilities without the banks who receive the loans receiving priority in bankruptcy.

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188. In December 2020, Harvard, Wharton, and the Federal Reserve co-hosted a conference on bank supervision that yielded substantial literature reviews of scholarly and policy engagement for this growing subject. *See* Beverly Hirtle & Anna Kovner, *Bank Supervision*, FED. RSRV. BANK N.Y. (Staff Rep. No. 952, 2020), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr952.pdf [https://perma.cc/67W2-K7FN]; Julie Andersen Hill, *Bank Supervision: A Legal Scholarship Review*, (Univ. of Ala., Legal Stud. Rsch. Paper No. 2627472, 2021), https://ssrn.com/abstract=3777580 [https://perma.cc/Q4NY-Z2Z3]; Sean H. Vanatta, Histories of Bank Supervision (Dec. 15, 2020) (unpublished manuscript), https://ssrn.com/abstract=3749116 [https://perma.cc/T52L-6S4A].

189. *See* Hirtle & Kovner, *supra* note 188, at 16.

190. *See Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)*, BD. OF GOVERNORS OF THE FED. RSRV. SYS., FED. DEPOSIT INS. CORP, NAT'L CREDIT UNION ADMIN., OFF. OF THE COMPTROLLER OF THE CURRENCY & CONSUMER FIN. PROT. BUREAU (Apr. 7, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200407a1.pdf [https://perma.cc/5H6J-982P].

191. Federal Reserve Act § 10B(a), 12 U.S.C. § 347b(a) (2018); *see* Conti-Brown et al., *supra* note 172, at 68-70.

This security requirement is the most significant potential complication for a DIP Discount Window Facility. The assets of businesses that file for bankruptcy are usually fully encumbered by the lien of an existing lender or lenders.[192] If the incumbent lender provides the DIP loan, the concern is not serious, because the lender can simply rely on its existing collateral as security. But an outside lender does not have this luxury. If the debtor has few or no unencumbered assets, it may be very difficult to secure a loan by an outside lender "to the satisfaction" of the Fed. This is a particular concern for the large-debtor facility, since its principal objective is to attract outside lenders. The small-debtor facility is designed encourage inside lenders to provide DIP financing, so the concern is less serious with the small debtor facility.

Bankruptcy law provides a potential solution to this problem: the priming lien. The bankruptcy financing provision permits the court to "authorize the obtaining of credit . . . secured by a senior or equal lien on property of the estate that is subject to a lien," so long as the pre-bankruptcy lender is given "adequate protection."[193] The prospect of a superior lien would give a new lender a significantly greater incentive to provide bankruptcy financing.

In practice, bankruptcy judges often approve consensual "self-priming" liens—that is, a lien given to the insider loan that is deemed to prime the insider's prebankruptcy loan secured by the same collateral, but they rarely authorize nonconsensual priming liens for the benefit of new, outside lenders.[194] To some extent, this reluctance is invited by the statute, which makes clear that the debtor has the burden of proof to demonstrate that the pre-bankruptcy lender will be "adequately protected."[195]

For a truly effective DIP Discount Window Facility, bankruptcy courts would have to adopt more flexible standards for approving priming liens (or, alternatively, Congress could amend the financing provision to require them to do so). Absent Congressional intervention,[196] a key factor is outside lenders' willingness to challenge inside lenders by offering alternative financing. Currently, few outsiders do. But there is some basis for optimism that this may change as the

192. *See, e.g.*, Tung, *supra* note 32, at 658 ("A pre-bankruptcy lender . . . typically has pre-bankruptcy liens on all the debtor's assets by the time bankruptcy approaches . . . .").

193. 11 U.S.C. § 364(d) (2018).

194. *See* Ayotte & Morrison, *supra* note 36, at 1591.

195. 11 U.S.C. § 364(d)(2) (2018).

196. The principal limitation on Congress's flexibility in authorizing priming liens is the Takings Clause, U.S. CONST. amend. V, which requires an existing lender's property rights be protected. For an argument that this is a less significant constraint than is often believed, see Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765, 766.

range of financing options for debtors increases.[197] In 2020, for example, a lender group led by Mudrick Capital challenged the favored, insider loan in the Neiman Marcus bankruptcy. The court unfortunately rejected the challenge, but an uptick in the number of challenges may lead to greater willingness to approve nonconsensual priming liens.[198]

It is worth emphasizing that the adequate protection requirement is not nearly so daunting an obstacle as bankruptcy judges seem to think. Even if a debtor's assets are fully encumbered, a priming lien could be deemed to attach to value created from operations during the bankruptcy case. This is precisely how receiver's certificates, the precursor to DIP financing, functioned in the nineteenth century.[199] Restoring that legal standard would facilitate the functionality of the DIP Discount Window Facility and would make good economic sense, too.

Bankruptcy courts could further incentivize competition through the simple expedient of deeming the adequate protection requirement to be met by an outside lender if the inside lenders have asked for a priming lien themselves. By requesting a priming lien—as inside lenders routinely do—the inside lenders are conceding that the value of the debtor's assets is greater than the original lien.

The existence of a DIP Discount Window Facility would itself help alleviate the problem of insider control. The benefits of the facility should induce many outside banks to offer alternative financing conditioned on the court granting a priming lien. This increase in opportunities to consider the parameters of adequate protection could create a virtuous loop. As courts develop clearer—and one suspects, more flexible—standards for authorizing priming liens, more outside lenders will be willing offer alternative financing, increasing the competitiveness of the DIP financing market.

III. Benefits and Costs of a DIP Discount Window Facility

A resurgent discount window as a tool for credit channeling by the Fed has important benefits. It is also costly. In this Part, we present a clear-eyed accounting of both the costs and the benefits and defend the idea that it is, on balance, cost-beneficial as an alternative to both private

197. For an argument that the increasing fragmentation of firms' capital structures is likely to prompt more challenges to insider DIP loans from other lenders that are already within the debtor's capital stack, see Skeel, *supra* note 111, at 317-18.

198. *Id.* at 325-26.

199. Based on this reasoning, two bankruptcy scholars have recently offered a strategy for expanding the use of priming liens, inspired by this historical practice. Under their proposal, a court would "require a temporary period at the outset of the case (perhaps 60-90 days) in which a DIP loan can prime . . . even secured . . . creditors." After this initial period, the court would then "consider a more expansive set of DIP loan proposals in the usual way." Ayotte & Ellias, *supra* note 112, at 48.

DIP financing and Fed 13(3) emergency lending, especially in the absence of widespread fiscal stimulus to prevent the economic collapse of small- and medium-sized businesses. Discount-window facilities targeted at other structural flaws in the credit markets would produce analogous benefits.

A. Benefits of Intervention

In this Section, we discuss four key benefits of creating and deploying a DIP Discount Window Facility: (1) improvements to the bankruptcy process by spurring more competition for the financing of large corporate debtors and better access to DIP financing for smaller debtors; (2) improvements to the bank regulatory and supervisory environment by pushing more DIP financing into depository institutions; (3) benefits for monetary policy and central banking functions generally; and (4) a more tailored approach to crisis response that is more than the usual Fed lending and less than the sweeping 13(3) interventions in 2008 and 2020.

1. Improvements to Bankruptcy Process

The DIP Discount Window Facility would improve the bankruptcy process in three important respects. First, it would help introduce more competition into the market for financing large corporate debtors. As we have seen, the vast majority of financing comes from inside lenders, at noncompetitive rates that increase the cost of credit and undermine the efficiency of the bankruptcy process.[200] The large-debtor facility would entice more outside lenders to offer to provide DIP financing, would only be available to outside lenders, and would enhance the competitiveness of the market and efficiency of the reorganization process. Second, the small-debtor facility would make bankruptcy financing available for companies that might not otherwise have access to it. As we have discussed, smaller companies struggle to obtain DIP financing even under ordinary circumstances.[201] This gap in the market for financing is of particular concern during a crisis or other disruption of liquidity, since otherwise viable businesses are much more likely to be forced into bankruptcy if there has been a liquidity shock.

Third, the facility could expand the range of institutions that provide DIP financing. DIP financing currently is provided almost entirely by the largest banks, along with hedge funds and equity funds. As noted earlier, the top ten providers of DIP financing are all large banks (led by

200. *See supra* notes 106-112 and accompanying text.
201. *See supra* notes 113-121 and accompanying text.

JPMorgan Chase and Bank of America), and only 21 banks made more than 5 DIP loans in the past several decades.[202] Although local banks would seem to be logical participants in the DIP financing market, they currently play a very small role. The DIP Discount Window Facility might induce both incumbent and new lenders to participate, increasing access to DIP financing, especially for smaller corporate debtors.

2. The Mitigation of Shadow Banking in a Key Credit Sector

The 2008 crisis was, in many important ways, a shadow banking crisis—that is, nonbank financial institutions and financial instruments lay at the heart of the crisis.[203] The extraordinary lengths the Fed went through with its emergency lending authority to stabilize non-bank financial markets during the 2020 crisis suggests that crisis had important shadow banking elements, too.[204]

The introduction of a Fed facility for DIP financing limited to depository institutions would expand the banking regulatory and supervisory footprint at the expense of nonbank entities, at a time when alarming amounts of financial activity take place outside of regulatory oversight. Pushing more maturity transformation and financial intermediation back into the bank supervisory, regulatory, and insurance framework would be an important benefit of the DIP Discount Window Facility.

3. Supervisory Benefits

Every decade or so, there is a debate about whether to strip the Fed of its bank-supervisory role.[205] The Fed's primary defense is that bank supervision provides key insights that enhance the Fed's ability to conduct monetary policy. As former Fed Chair Ben Bernanke said in 2010, "[T]he Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the

202. Wang Email (June 21, 2020), *supra* note 33 (describing findings in a large dataset of 267 cases with DIP loans).

203. *See* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2010, at 261, 261.

204. Some of these interventions were discussed earlier. *See supra* Section II(A).

205. For an overview of these debates, see Elizabeth F. Brown, *Prior Proposals to Consolidate Federal Financial Regulators*, VOLCKER ALLIANCE (2015), https://www.volckeralliance.org/sites/default/files/attachments/Background%20Paper%201_Prior%20Proposals%20to%20Consolidate%20Federal%20Financial%20Regulators.pdf [https://perma.cc/X6JP-4NSR].

information, expertise, and powers that it has as both a bank supervisor and a central bank . . . ."[206]

Facilitating greater oversight over DIP financing would provide precisely this benefit to the Fed by giving great insights into the real economy. Recognizing when bankruptcy spikes occur, how sensitive those spikes are to the availability of efficiently priced credit, and the quality of outcomes associated with different kinds of funding mechanisms would all inform and improve the quality of the Fed's monetary policies. As Kathryn Judge argued in criticizing the relative lack of take-up from the discount window in 2008, alternatives to traditional discount-window lending—be they through 13(3) facilities or the Federal Home Loan Banks—"lack a meaningful check on the solvency of the bank receiving the funds" and prevent the flow of supervisory information and the development of regulatory expertise to handle the systemic consequences of these credit flows.[207] Discount-window lending for the purposes of credit policy can alleviate those concerns.

4. Less Fed Reliance on Emergency Lending Powers

The Fed's formerly once-in-a-century use of its emergency authority under 13(3) has become a once-in-a-decade phenomenon. This authority is deeply controversial, even as most experts regard its ongoing availability as vital to financial stability. Even so, there are essential questions about the overuse of such significant authority that some scholars have already begun to evaluate.[208] These questions will set the agenda for discussions about Fed legitimacy, independence, and accountability for years to come.

A DIP Discount Window and other credit-market interventions will encourage the Fed to develop tools that, even if used sparingly, need not await the "unusual and exigent circumstances"[209] that open floodgates of Fed creativity in providing emergency support. An intermediate standard—call it the "usual but exigent," or "unusual but non-exigent" circumstances—can be invoked to permit Fed liquidity to address temporary or more stubborn flaws in the credit markets without having to wait for a full-blown emergency.

206. *Examining the Link Between Fed Bank Supervision and Monetary Policy: Hearing Before the H. Comm. on Fin. Servs.*, 111th Cong. 8 (2010) (statement of Hon. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Rsrv. Sys.).

207. Judge, *supra* note 149, at 838-40.

208. *See, e.g.*, Menand, *supra* note 4.

209. Federal Reserve Act § 13(3), 12 U.S.C. § 343(3) (2012).

B. Costs of Intervention

Although use of the discount window to correct distortions in the credit markets offers major benefits, as we have seen, it also has several real and some imagined downsides. These need to be taken into account as well. The potential costs of a DIP Discount Window Facility include (1) compromising Fed independence by forcing the Fed into politically embarrassing situations when DIP-financed firms must take actions that will be unpopular, such as firing employees, closing plants, or even liquidating; (2) institutionalizing Fed interventions that distort otherwise-functioning markets; (3) manipulating the discount window beyond its traditional purposes; and (4) exploiting a legal loophole to finance firms—i.e., those in bankruptcy—that Congress has explicitly restricted from participating in the Fed's emergency lending facilities.

1. Fed Independence and Bankruptcy

The dramatic increase in Fed financing for the bankruptcy process would associate Fed lending with decisions that can be politically toxic. Firms will have to restructure, including by closing plants, restructuring debt, firing employees, etc.[210] When they do so with Fed financing, the public may come to associate the Fed with these actions. Such a public association could decrease public confidence in the Fed to perform core central banking policies that require political independence.

However valid these concerns may be, they are equally applicable to nearly every emergency intervention that the Fed has *already* undertaken. Indeed, the only difference is that permitting banks to undertake the underwriting process means that the banks, not the Fed, will be the counterparties to restructuring entities. This will present a buffer between the Fed's actions and the actions of private parties.

Furthermore, the restructuring process is a highly judicialized one. This stands in stark contrast to the Fed's other activities, which are almost completely immune to judicial oversight.[211] By adding the Fed into such a process, there would be more accountability for Fed participation, not less.

2. The Risk of Crowding Out

Some fear governmental support could "crowd out" private financing, pointing to evidence that the DIP market was robust during

210. For evidence of the detrimental effects of bankruptcy on employee wages and employment, see John R. Graham, Hyunseob Kim, Si Li & Jiaping Qiu, *Employee Costs of Corporate Bankruptcy*, 78 J. FIN. 2087, 2089 (2019).

211. *See* Steffi Ostrowski, Note, *Judging the Fed*, 131 YALE L.J. 726, 733-58 (2021).

the recent pandemic.[212] Although this is indeed a risk whenever the Fed intervenes in a market, there are important countervailing considerations with both large and smaller corporate debtors. For large corporate debtors, the financing market is highly noncompetitive, and the new entrants would be private banks, not the government. As for small- and medium-sized businesses, most do not have access to bankruptcy financing. There currently is not a significant market to crowd out. Moreover, intervention would bring a new class of lenders—smaller banks—into the DIP financing market, another important benefit that needs to be weighed against any crowding out effect. In an important sense, then, Fed support for banks to develop their own DIP financing operations will add to market vitality, not detract from it.

3. Manipulating the Discount Window

Another concern, echoing the 1990s critique of Anna Schwartz, is that explicitly directing funds through banks to non-bank counterparties is an abuse of the discount window.[213] But as discussed above, the discount window has been a tool of credit policy, not emergency lending, since at least 2008, if not in fact in the 1980s (giving rise to Schwartz's original critique). It is also consistent with the Fed's raison-d'être, as articulated in the original statute.[214] While we do not disagree with the idea that this represents something of an expansion to that conception, especially as it has evolved, the most novel parts of the DIP Discount Window Facility reflect an evolution that has already occurred.

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

4. Exploiting a Legal Loophole

Finally, there is a concern that using section 10B—not section 13(3)—for lending to bankrupt entities exploits a legal loophole, since Congress clearly limited emergency lending under section 13(3) to non-bankrupt entities.[215]

212. *See, e.g.*, Elliot Ganz & David Smith, *It's Not Time for a Government Bankruptcy Facility*, REALCLEAR MKTS. (June 15, 2020), https://www.realclearmarkets.com/articles/2020/06/15/its_not_time_for_a_government_bankruptcy_facility_496152.html [https://perma.cc/2ELV-YDU3].

213. *See* Schwartz, *supra* note 132.

214. *See supra* note 134 and accompanying text.

215. *See supra* notes 128-130 and accompanying text.

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

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

C. Alternative Approaches

We have advocated Fed intervention to correct the structural flaws in the DIP financing market under the Fed's discount-window authority, but one can easily imagine other possible strategies for achieving this objective. In this part we consider three—Treasury oversight, use by the Fed of its emergency lending powers in section 13(3), and a National Investment Authority. None, we argue, is an adequate alternative to a DIP Discount Window Facility or to other credit market interventions that follow this template.

1. Would Treasury Be Preferable?

Two of the signature interventions of the 2008-2009 crisis—the Troubled Asset Relief Program (TARP)[216] and the new resolution framework for systemically important financial institutions in Title II of the Dodd-Frank Act of 2010[217]—provided for Treasury oversight of bankruptcy or bankruptcy-like funding by the U.S. government. Under TARP, Treasury was the sole overseer, and with Title II it shares

216. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, div. A, §§ 101-136, 122 Stat. 3765, 3767-3800 (codified as amended at 12 U.S.C. §§ 5211-5241).

217. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. II, 124 Stat. 1376, 1442-1520 (2010) (codified as amended at 12 U.S.C. §§ 5381-5394). Title II is also referred to as the "Orderly Liquidation Authority" or "OLA.".

responsibility with the Federal Reserve and Federal Deposit Insurance Corporation (FDIC).[218] These interventions provide a helpful perspective on the question how a Treasury program might compare with our proposed discount-window facility.

Start with TARP. Enacted in October 2008, TARP gave Treasury the authority to provide up to $700 billion of assistance to "financial institutions" during the 2008-2009 crisis.[219] Of particular relevance for our purposes, Treasury used this program to provide financing to Chrysler and General Motors both before and during their bankruptcy cases.

Use of TARP money to assist the carmakers began at the end of the Bush administration. Under then Treasury Secretary Henry Paulson, Treasury provided initial rescue funding to General Motors in Fall 2008. After President Obama assumed office, he created an Auto Task Force which designed a bankruptcy solution for the two carmakers. In each case, a new entity was created, and the carmaker sold its assets to the new entity shortly after filing for bankruptcy. Treasury made large DIP loans to Chrysler and General Motors to fund their bankruptcies, and it also lent money to the new, non-bankrupt entities that purchased the carmaker's assets in each case.[220] The bankruptcies were highly controversial at the time.[221] Some of the criticism reflected a general hostility to bailouts. Other critics complained about how the bankruptcies were handled, and still others complained that political objectives such as promoting the production of environmentally friendly cars were incorporated into the terms of the transactions.[222]

218. The details of this sharing of authority are discussed below. *See infra* notes 223-225 and accompanying text.

219. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, div. A, § 115(a), 122 Stat. 3765, 3780; *id.* § 101(a)(1), 122 Stat. at 3767 (codified at 12 U.S.C. § 5211) (authorizing the Treasury Secretary to "establish the Troubled Asset Relief Program (or 'TARP') to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary").

220. For details on the government lending to the two carmakers before and after their bankruptcy filings—totaling $81.8 billion in all—see STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY 297 (2010).

221. The auto bailouts were more popular in retrospect, as Republican presidential nominee Mitt Romney learned to his great chagrin during the 2012 presidential campaign. An op-ed he had written arguing against bailouts was used against him during the campaign. Jon Healey, *Romney Swings at Obama's Auto Bailout, Hits Himself*, L.A. TIMES (Oct. 30, 2012, 12:00 AM PT), https://www.latimes.com/opinion/la-xpm-2012-oct-30-la-ol-mitt-romney-auto-bankruptcy-commercial-20121029-story.html [https://perma.cc/ZMG6-9S3G] (discussing Mitt Romney, *Let Detroit Go Bankrupt*, N.Y. TIMES (Nov. 18, 2008), https://www.nytimes.com/2008/11/19/opinion/19romney.html [https://perma.cc/UT6S-WLPD].

222. For scholarly criticism of the auto bankruptcies, see, for example, Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010); and Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375. For defenses, see Stephen J. Lubben, *No Big Deal:*

For our purposes, the carmaker bailouts have two especially salient features. First, they were ad hoc—since only two companies were involved—which made the decision whether and how to intervene inevitably political. Second, they did not involve financial institutions overseen by bank regulators, subject to bank supervision. Together, these factors weigh strongly in favor of Treasury rather than Federal Reserve oversight. As an executive branch agency whose head is removable by the president, Treasury is much more politically accountable than the Federal Reserve. Nor do the Federal Reserve or other bank regulators have any special oversight expertise with carmakers that would give them unique insight into the resolution of their financial distress.

The other legislation involving bankruptcy-like funding is Title II of the Dodd-Frank Act of 2010.[223] Title II gives Treasury, the Fed, and the FDIC joint authority to initiate a receivership for a systemically important financial institution that has fallen into financial distress. If the three regulators agree the institution is in default or danger of default—the "three keys turn," in lingo that arose at the time of Dodd-Frank's passage—a Title II proceeding is commenced and the FDIC becomes the receiver.[224] Title II gives the FDIC access to substantial amounts of funding—very similar to a DIP loan from the government—if Treasury agrees to its use.[225] Treasury approval is thus required both at the outset of the Title II case, and as a prerequisite to receiving funding.

In our view, this power sharing arrangement among Treasury, the Fed and the FDIC generally makes sense. Unlike with the carmaker bankruptcies, exclusive Treasury oversight would not be optimal, given that the Fed and FDIC have special expertise in regulating financial institutions. The benefits of this expertise would be sacrificed, at least to some extent, if Treasury had complete control.[226] Treasury also brings important attributes to the oversight framework, however. Because the decision to take over (or not to take over) a systemically important financial institution is likely to be politically charged—much more than with an ordinary, non-systemically important financial institution—

The GM and Chrysler Cases in Context, 83 AM. BANKR. L.J. 531 (2009); and Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271 (2012).

223. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. II, 124 Stat. 1376, 1442-1520 (2010) (codified as amended at 12 U.S.C. §§ 5381-5394). For an overview of the basic details of Title II, see SKEEL, *supra* note 10, at 129-42.

224. 12 U.S.C. § 5383 (2018).

225. The FDIC is authorized to borrow up to 10% of the book value of the institution as of the time it is taken over, and 90% of its value in resolution, if the Treasury approves. 12 U.S.C. § 5390(n) (2018).

226. Treasury might consult informally with the Fed and FDIC even if it had exclusive authority, but this would not make nearly as much use of the bank regulators' regulatory expertise as giving them a formal role.

Treasury involvement is appropriate. Treasury's role ensures the presence of a democratically accountable decision maker.

What implications do these two funding programs from the 2008-2009 crisis have for addressing structural flaws in the DIP financing market? The first thing to note is that a Treasury-run program does not seem optimal for addressing such a crisis. Unlike TARP, which was used for targeted interventions with particular firms, regulatory intervention in the DIP financing market would be broader—it could be used by any qualifying bank for any business in bankruptcy. As a result, the DIP Discount Window Facility would not be as politically charged as loans to systemically important financial institutions and General Motors and Chrysler. Nor would Treasury have particular expertise in administering the loans. Not only is the Fed a more logical overseer, but a Treasury-led program would sacrifice the additional benefits promised by our DIP Discount Window Facility, such as the synergy between the lending program and the Fed's oversight of the banking system.

To be sure, one can imagine a program that provided both for Treasury and Fed oversight, as with the CARES Act during the recent pandemic. But the credit channeling function advocated in this article is more targeted than the sweeping CARES Act funding programs. Indeed, CARES Act lending appears to have been highly inefficient, providing funding for businesses that could survive without it and failing to provide funding for firms that did need help.[227] Moreover, such a program would be far less nimble than the Fed's ordinary discount-window authority, requiring legislation from Congress.[228] And, as noted above, Treasury does not have any particular comparative advantage in this context.

Our conclusion that unilateral Fed oversight is preferable to a Treasury program assumes that the facility is in fact non-political—that the rules for inclusion are standardized and applied consistently. If this were not the case, the Fed would find itself making unavoidably political decisions. In our view, this argues for minimizing the range of discretion in the facility, and for avoiding features that are inevitably political where possible.

This removal from politics—procedurally and substantively—also supports the DIP Discount Window Facility's purpose to provide an alternative to the fiscal-monetary consensus of 2020, should that

227. According to the lead author of one study of the Paycheck Protection Program under the CARES Act, "[a] very large chunk of the benefit went to a very small share of the firms, and those were probably the firms least in need." Ben Casselman & Jim Tankersley, *$500 Billion in Aid to Small Businesses: How Much Did It Help?*, N.Y. TIMES (Aug. 17, 2021) (quoting M.I.T. economist David Autor), https://www.nytimes.com/2021/02/01/business/economy/ppp-jobs-small-business.html [https://perma.cc/8NME-2KFL].

228. Congress's frequent inability to respond quickly in a crisis is one of the themes of Posner and Vermeule's work on executive power. *See* ERIC A. POSNER & ADRIAN VERMEULE, THE EXECUTIVE UNBOUND: AFTER THE MADISONIAN REPUBLIC (2011).

consensus not be available. This does not mean that the work of banking and bank-intermediated finance is somehow apolitical—it means simply that it is political in the ways that it has always been.

2. Statutory Amendments to Section 13(3)

Some commentators have proposed structuring fiscal responses to crisis—such as the CARES Act of 2020—so that lending under that authority need not comply with section 13(3)'s prohibitions on lending to bankrupt firms.[229] Alternatively, section 13(3) might be amended to remove the bankruptcy prohibition. After all, this proviso was only added in 2010, as part of the Dodd-Frank Act; the Fed's previous authority was untrammeled and key to interventions that many still regard as vital to the crisis response in 2008 (for example, in lending to the abundantly insolvent AIG[230]). Would the latter approach—returning to the pre-2010 structure, and relying on the Fed's use of its emergency lending authority—be superior to a DIP Discount Window Facility?

The ostensible benefits of reverting to the pre-2010 model of emergency lending are twofold. First, as just stated, Treasury participation offers some kinds of political legitimacy for thorny issues of distribution that the Fed would rather avoid. Second, the Fed itself—not the depository institutions—would act as counterparty to bankrupt entities. This would give the Fed the ability to control underwriting, loan portfolio management, and other factors that would otherwise have to be intermediated through the banks.

These two concerns are related, but we think they counsel strongly in favor of keeping 13(3) as amended in Dodd-Frank and not reverting to the broader, pre-2010 authority. A bank-intermediated discount-window facility sidesteps the potential politicization of the Fed's role caused by its direct involvement in 13(3) as a counterparty to the recipient of the loans. Because banks would be the ones making the DIP loans, the Fed would be insulated from decisions about whether a particular debtor qualifies for a DIP loan. This is one of the reasons why our discussion of eligibility, above, is limited to the eligibility of banks, not bankrupt firms: the latter decision is for the banks to make. Were the Fed to stand in the place of banks to direct loans according to its own underwriting standards, the

229. David Skeel, *Bankruptcy and the Coronavirus*, ECON. STUD. AT BROOKINGS 10 (Apr. 2020), https://www.brookings.edu/wp-content/uploads/2020/04/ES-4.21.2020-DSkeel-2.pdf [https://perma.cc/R6UK-Y48Z]; David Skeel, *Bankruptcy and the Coronavirus: Part II*, ECON. STUD. AT BROOKINGS 9 (July 2020), https://www.brookings.edu/wp-content/uploads/2020/07/ES-6.6.20-Skeel-1.pdf [https://perma.cc/4XJ8-JFVZ]. For a similar proposal, see George Selgin, *Catch-11*, CATO INST. (May 13, 2020), https://www.cato.org/blog/catch-11 [https://perma.cc/8J7Q-GPFV].

230. *See Actions Related to AIG*, FED. RSRV. BANK N.Y., https://www.newyorkfed.org/aboutthefed/aig [https://perma.cc/3S2E-N65A].

line-drawing problems it would face would necessarily invite political scrutiny.

3. National Investment Authority

Crises such as COVID-19 have prompted some scholars, such as Robert C. Hockett and Saule T. Omarova, to propose an alternative structure to Fed interventions: a National Investment Authority.[231] The NIA is patterned in part after the Reconstruction Finance Corporation (RFC), the U.S. government agency proposed by Eugene Meyer at the Federal Reserve in 1931 and adopted by Herbert Hoover as the cornerstone of his response to the Great Depression. The RFC was in turn modeled after the War Finance Corporation.[232] The RFC far outlasted the Great Depression and New Deal and was only shuttered in 1957, after disbursing more than $40 billion in loans (for reference, GDP in 1932 was $60 billion).[233]

The general idea for an NIA is the same: a permanent investment authority with a "long-term national view in charge of managing investments" in assets and projects primarily anchored in infrastructure.[234] Other similar proposals for "greening" the economy have also been offered.[235]

Although we are not familiar with proposals for using a National Investment Authority to provide DIP financing, the idea is not difficult to grasp. A permanent, public (or public-private) investment facility would be deployed explicitly for credit policy. Given the importance of DIP financing in an exogenous crisis with minimal moral hazard, deploying

231. Robert C. Hockett & Saule T. Omarova, *Private Wealth and Public Goods: A Case for a National Investment Authority*, 43 J. CORP. L. 437 (2018). Adam J. Levitin, Lindsay Owens, and Ganesh Sitaraman have suggested another approach, which also would use a standing facility. *See* Adam J. Levitin, Lindsay Owens & Ganesh Sitaraman, *No More Bailouts: A Blueprint for a Standing Emergency Economic Resilience and Stabilization Program*, GREAT DEMOCRACY INITIATIVE (June 2020), https://rooseveltinstitute.org/wp-content/uploads/2021/08/GDI_No-More-Bailouts_202006.pdf [https://perma.cc/5YTB-SDGZ].

232. *See* DAVID M. KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929-1945, at 84-86 (1999); JAMES STUART OLSON, SAVING CAPITALISM: THE RECONSTRUCTION FINANCE CORPORATION AND THE NEW DEAL, 1933-1940, at 13-14 (1988).

233. *Final Report on the Reconstruction Finance Corporation*, U.S. DEP'T OF THE TREASURY, at v, 2 (1959), https://fraser.stlouisfed.org/files/docs/publications/rcf/rfc_19590506_finalreport.pdf [https://perma.cc/85CK-VGAF]; *Table 1.1.5. Gross Domestic Product*, U.S. BUREAU OF ECON. ANALYSIS (Dec. 21, 2023) https://apps.bea.gov/iTable/?reqid=19&step=3&isuri=1&select_all_years=1&nipa_table_list=5&series=a&first_year=2016&scale=-6&last_year=2020&categories=survey&thetable=x [https://perma.cc/ZZ8P-U7F8].

234. Hockett & Omarova, *supra* note 231, at 439.

235. *See, e.g.*, Lisa Friedman, *What is the Green New Deal? A Climate Proposal, Explained*, N.Y. TIMES (Feb. 21, 2019), https://www.nytimes.com/2019/02/21/climate/green-new-deal-questions-answers.html [https://perma.cc/V683-58UP].

the balance sheet of such an entity looks similar to using the central bank for the same purpose.

Indeed, Omarova envisions using a "New Discount Window" in a world where the Fed also accepts deposits from the general public as a mechanism to "efficiently and effectively replace deposit funding for banks and enable a broad range of nonbank credit institutions to access this reliably 'patient,' stable, and affordably priced capital."[236] In Omarova's proposal, then, the discount window becomes a dramatic expansion of the Fed's balance sheet, to replace funding for banks that would have occurred through their deposit-taking.

We envision no such expansion. We see instead the DIP Financing Discount Window Facility as narrowly tailored to a specific purpose consistent with the Fed's existing statutory mandates. Even if it became a model for other credit intermediation efforts, that model is not to displace banks but to encourage them.

Importantly, the DIP Financing Discount Window facility would not be a permanent expansion of the discount window, but seasonal. The entire point of the exercise is to provide an intervention between open-market operations and conventional regulatory and supervisory tools on the one hand and break-the-glass emergency lending on the other. That means some twilight mechanism after which private markets are restored and banks can continue to make these loans and even use the permanent discount window for appropriate support, under that permanent framework. As with a Treasury program, bank intermediation is key: private entities bear at least some of the risk and responsibility such that they make decisions about capital allocation, rather than having the government perform that role.

Conclusion

This Article has joined a growing conversation about the government's role in correcting structural flaws in the credit markets. The Fed has edged in this direction during the last two crises of 2008 and 2020, often by construing broadly its lender-of-last-resort authority to make emergency loans in ways that have drawn to it sincere and partisan questions about the appropriateness of the institution to its tasks.

The Fed, to date, has conceptualized its actions as fitting within one of its two traditional roles: conventual monetary policy and lender-of-last resort intervention in crises. We have argued instead that the Fed is uniquely well-positioned to take on a new role that is intermediate between its two traditional tasks: channeling credit policy in the event of

236. Omarova, *supra* note 26, at 1271.

a temporary or more entrenched disruption in the proper functioning of the credit markets.

To show how the credit channeling function might work, we have identified and focused on the market for credit in bankruptcy. This market is undermined by structural problems that manifest differently in different parts of the market. For the largest corporate debtors, DIP financing is available but it is extremely costly, due to the near monopoly held by debtors' inside lenders. Smaller debtors, by contrast, have very little access to bankruptcy financing. To address these issues, we have proposed that the Fed create a DIP Discount Window Facility with eligibility requirements tailored to the specific flaws in the DIP financing market. With large corporate debtors, the facility would only be available to outside lenders, so that the facility could inject more competition into the market. With small debtors, the debtor's current lender would be eligible; indeed, the program would be designed to draw these lenders into the DIP financing market. In each context, the facility would be limited to banks.

In addition to improving the DIP financing market, the DIP Discount Window facility would bring a variety of other benefits as well. It would shift more lending from the shadow banking to the formal banking sector, for instance, and would enhance the Fed's visibility into the participating banks.

The DIP financing market is only one area in the credit markets that would benefit from Fed intervention. We have used it to make the benefits of the novel credit channeling role we advocate in this Article concrete. In future work we intend to identify and explore other structural flaws in the credit markets that would benefit from this approach.