JEB HENSARLING, TX , CHAIRMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

January 13, 2014

The Honorable Ben S Bernanke
Chairman
Federal Reserve Board of Governors
20th Street and Constitution Avenue N.W.
Washington, D.C 20551

Re: Docket Number R-1476

Dear Chairman Bernanke:

I am writing in response to the Federal Reserve's December 23, 2013 notice of proposed rulemaking and request for public comment entitled "Extensions of Credit by Federal Reserve Banks"[1] to implement the policies and procedures required by Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) (the "Dodd-Frank Act").

The Dodd-Frank Act amends the Federal Reserve's lender of last resort powers under section 13(3) of the Federal Reserve Act. Specifically, Section 1101 requires that emergency lending programs established under Section 13(3) have "broad-based eligibility," be designed to provide "liquidity to the financial system" rather than to "aid a failing financial company," be "designed to ensure . . . the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in an orderly and timely fashion," and will not be used to provide assistance to "borrowers that are insolvent."[2]

Section 1101 requires the Federal Reserve to "establish, by regulation, in consultation with the Secretary of the Treasury . . . policies and procedures governing emergency lending"

[1] *See* Federal Reserve System, 12 CFR Par 201, Regulation A; Docket No. R-1476, RIN 7100-AE08, "Extensions of Credit by Federal Reserve Banks," available at http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20131223a.pdf; hereinafter referenced as "Proposed Rule."

[2] See Federal Reserve Act § 13(3)(A) & § 13(3)(B).

under Section 13(3), and to do so "as soon as practicable" after the enactment of the Dodd-Frank Act.[3]

With more than three years having elapsed since the Dodd-Frank's enactment, I wrote to you on November 19, 2013, to inquire about the status of this required rulemaking. While these long overdue proposed regulations are therefore welcome, I am concerned that the proposal does little to remedy deficiencies that were anticipated in the Federal Reserve's implementation of Section 1101 of the Dodd-Frank Act and identified in hearings before the House Financial Services Committee.

These concerns were noted by President Lacker of the Federal Reserve Bank of Richmond and Carnegie-Mellon University Professor Marvin Goodfriend, a former economist at the Richmond Fed, in testimony before the Committee. Those concerns have focused on the extent of the Federal Reserve's flexibility under the provision to define the boundaries of its discretion using vague concepts.[4]

The proposed rule largely repeats the same phrases contained in the underlying legislation, leaving the Federal Reserve and the Treasury Secretary to interpret vague concepts like "insolvent" and "broad-based" on an ad hoc, case-by- case basis during the midst of a future financial crisis, the very problem that Section 1101 of the Dodd-Frank Act was intended to remedy. The Federal Reserve failed to suggest a clear methodology or criteria in the proposed rule to implement that congressional objective in adopting Section 1101, or provide specific parameters for its use of Section 13(3).

As part of its ongoing oversight of the Federal Reserve, the Committee has held multiple hearings examining the central bank's role as a lender of last resort, particularly its authority

[3] *See* Dodd-Frank Act § 1101(a)(6).

[4] *See* Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond, Testimony before the House of Representatives Committee on Financial Services hearing *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts,* June 26, 2013, available at http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-jlacker-20130626.pdf . *See also* Marvin Goodfriend, Testimony before the Subcommittee on Monetary Policy and Trade, House of Representatives Committee on Financial Services hearing *Lessons Learned From a Century of Central Banking*, September 11, 2013, available at http://financialservices.house.gov/uploadedfiles/hhrg-113-ba19-wstate-mgoodfriend-20130911.pdf.

under Section 13(3) of the Federal Reserve Act to make emergency loans to "any participant in any program or facility of broad-based eligibility" under "unusual and exigent circumstances."

If used inappropriately, Section 13(3) could result in enormous risks for American taxpayers. If the Federal Reserve sells Treasuries from its portfolio to finance future emergency support under Section 13(3), as it did in 2008 and 2009, it will forego a future stream of low risk interest payments it would otherwise return to the Treasury Department in the form of remittances.[5] That could represent billions of dollars in losses to the taxpayer.

You have also indicated that interest payments by the Federal Reserve on excess reserves held by banks will be a primary policy tool of the Federal Reserve in the future.[6] As the Federal Reserve uses 13(3) in the future to create new bank reserves, it would make that policy tool increasingly costly for the Federal Reserve, which would again diminish its remittances to the Treasury Department and also risk costing taxpayers billions of dollars annually.

Another reason for concern about the extent of the Federal Reserve's discretion under Section 13(3) is that its use risks exacerbating moral hazard costs. Traditionally the risk of moral hazard was contained by the fact that the Federal Reserve limited its role as lender of last resort to providing support to commercial banks. The Federal Reserve's use of Section 13(3) during 2008, however, represented an unprecedented expansion of the Federal Reserve's safety net, extending it far beyond commercial banks to encompass non-bank institutions, such as investment banks and broker-dealers, like Goldman Sachs and Merrill Lynch, the insurance company American International Group (AIG), and industrial companies like General Electric.

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[5] See Testimony of Marvin Goodfriend, *Lessons Learned from the Financial Crisis for Federal Reserve Policy*, Testimony before the House Committee on Financial Services Committee hearing *Reexamining the Federal Reserve's Many Mandates*, December 12, 2013, available at http://financialservices.house.gov/uploadedfiles/hhrg-113-ba00-wstate-mgoodfriend-20131212.pdf.

[6] See Joshua Zumbrun and Steve Matthews, Bernanke Says Interest on Excess Reserves Will Be Main Tightening Tool, Bloomberg News, April 8, 2013, available at http://www.bloomberg.com/news/2013-04-09/bernanke-says-interest-on-reserves-would-be-main-tightening-tool.html.

Disappointingly, the proposed rule does not provide any real or binding constraints on the Federal Reserve's discretion to conduct bail-outs of failing financial firms and their creditors and counterparties like those that took place during the financial crisis.

I am therefore writing to request that you consider a list of potential policy options in your consideration of this rulemaking. I am also writing to request that you respond in writing with your view of each of these policy options prior to the close of the comment period for this proposed rulemaking.

The following list of options is not provided to suggest that all of those options must be included in order for the rule to accomplish its stated purpose, nor is it offered to endorse any single option as an essential element for the rule to perform its intended function. Each of these items does, however, deserve serious consideration by the Board of Governors, and a failure to consider any one of them will render the resulting rule ineffective.

1) **Create a financial metric to determine whether a firm is insolvent.** The rule does not establish any financial metric to determine whether a firm is "insolvent" and thus ineligible for support pursuant to Section 13(3). The proposed rule erroneously assumes that only firms already a part of a bankruptcy or receivership proceeding should be considered insolvent, which excludes potential firms that are insolvent but not yet in such a proceeding. While the proposed rule purports to prohibit use of Section 13(3) to assist a "specific firm" in avoiding such a proceeding, that provision shares the same flaw as the "broad-based eligibility" criteria it purports to implement under the Dodd-Frank Act. The proposed rule effectively permits aid to a specific firm if other firms are granted assistance as well, which would permit the Federal Reserve to mask its intent to aid that specific insolvent institution. If the history of the Federal Reserve over the last 40 years is any guide, it will be strongly tempted to provide support to insolvent institutions under the guise of a program featuring "broad-based eligibility" requirements.[7]

[7] *See* Michael D. Bordo, *The Lender of Last Resort: Alternative Views and Historical Experience*, Federal Reserve Bank of Richmond Economic Review January/February 1990; *See also* Marvin Goodfriend and Jeffrey M. Lacker, *Limited Commitment and Central Bank Lending*, Federal Reserve Bank of Richmond Economic Quarterly (1999);

2) **Specify whether bridge financial companies created pursuant to Title II authorities under the Dodd-Frank Act can be beneficiaries of the Federal Reserve's emergency lending facility.** The rule does not specify whether a bridge financial company created pursuant to an Orderly Liquidation proceeding under Title II of the Dodd-Frank Act, or pursuant to a bankruptcy or receivership process, shall also be considered insolvent for the purposes of Section 13(3).

3) **Prohibit beneficiaries of 13(3) from acting as conduits to provide support to insolvent firms.** The proposed rule does not provide specifications to ensure that a business entity obtaining support under Section 13(3) does not itself act as a conduit to support a separate insolvent firm, as was the case with support provided by the Federal Reserve to AIG pursuant to 13(3).

4) **Establish a timetable for withdrawal of emergency lending facility support.** The proposed rule provides no detail concerning how the Federal Reserve will determine an appropriate timetable for withdrawal of a Section 13(3) support program.

5) **Establish a penalty rate to be applied for funds from the emergency lending facility.** The proposed rule provides no detail or specified method for determining the appropriate penalty rate to be applied to loans extended pursuant to Section 13(3), such as for instance a minimum spread above the prevailing discount rate at the time of the 13(3) support, nor does it specify a penalty that would increase over time to encourage a prompt unwinding of support provided pursuant to 13(3).

6) **Determine whether certain classes of assets should be excluded from being offered as collateral.** The proposed rule does not exclude any class of assets from being offered as collateral, nor does it specify a method for obtaining third-party appraisals of the value of collateral pledged to secure 13(3) lending.

See also Government Accountability Office, *Review of Federal Reserve System Financial Assistance to American International Group, Inc.* (2011); See also Robert L. Hetzel, *The Great Recession: Market Failure or Policy Failure?*, Cambridge University Press (2012).

7) **Determine whether CEO certification is appropriate.** The proposed rule does not require the CEO of a firm seeking support to certify that the firm is unable to obtain support from banking institutions or other funding sources.

8) **Determine whether a joint resolution from Congress would be appropriate.** The proposed rule does not provide a procedure to seek a joint resolution from Congress to determine whether a lending program is consistent with Congress's intent in adopting the new restrictions on 13(3). Professor Goodfriend has suggested in testimony before the Committee that it would be appropriate for the Federal Reserve to do so.[8]

9) **Specify the metrics the Federal Reserve will use to determine whether the use of the emergency lending facility will be "broad-based."** The proposed rule provides no method to establish that a 13(3) program is "broad-based" and not intended to benefit a specific institution, such as a maximum amount or percentage of support under a 13(3) program that will be available to any one firm, or a maximum percentage of appropriate balance sheet variables that will constitute a ceiling for 13(3) support to an individual firm.

10) **Specify whether the Federal Reserve has the ability to claw back support from an institution that has received support from the emergency lending facility that is subsequently determined to have been in violation of Section 13(3), and if so, whether such authority would be used.** The proposed rule provides no method or legal authority for the government to demand immediate repayment of a loan extended pursuant to Section 13(3) that is subsequently determined to have violated the statute. Please state whether the new limitations placed on the Federal Reserve's 13(3) authority will be effective if a firm receiving support in violation of 13(3) cannot be required to return the proceeds of that support upon a determination that the lending was unlawful. If it is your position that the Federal Reserve is unable to include such a provision in the

[8] See Testimony of Marvin Goodfriend, Hearing Before the Subcommittee on Monetary Policy and Trade, Committee on Financial Services, U.S. House of Representatives, September 11, 2013.

rule without additional amendment to the statute please elaborate on what form of amendment would be required.

This list of items not addressed in the proposed rule — and the failure to even solicit comment from market participants about these matters — suggests that the proposal is designed to ensure that the Federal Reserve retains maximum discretion pursuant to Section 13(3) to carry out the same kinds of bail-outs of large financial institutions that characterized its crisis response in 2008 and 2009.

Please provide a response prior to the close of the comment period for this proposed rulemaking.

If you have questions regarding this request, please contact J.W. Verret of the Committee staff at (202) 225-7502.

Sincerely,

JEB HENSARLING
Chairman

cc: The Honorable Maxine Waters, Ranking Member