

March 6, 2014

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Re: Docket Number R-1476
Regulation A - Extensions of Credit by Federal Reserve Banks

To Whom It May Concern:

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").

There was perhaps no bigger force pushing the Dodd-Frank Act to passage than the public's anger with the various financial rescues. Sections 1101 and 1103 of the Dodd-Frank Act attempt to address the public's concerns by limiting the Federal Reserve's ability to engage in arbitrary assistance. Section 1101 clearly intends to limit the authorities under the Federal Reserve Act paragraph 13-3 lending to broad-based liquidity programs, and to exclude assistance to either insolvent and/or individual entities. Accordingly the Federal Reserve's implementation of Section 1101 must by construction limit the choices available to the Federal Reserve. Anything that preserves the flexibility

¹ See Federal Reserve System, 12 CFR Part 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/bcreg20131223a1.pdf>; hereinafter referenced as "Proposed Rule."

of the Federal Reserve to assist insolvent and/or individual firms would directly conflict with the clear intent of Section 1101. As a general matter the regulations promulgated under Section 1101 should clearly distinguish between entities that would be eligible for assistance and those that would not be. I believe it would also greatly assist market participants if clear lines were visible before a crisis hits. While there are many who believe it would be best for the Federal Reserve to maintain maximum flexibility under its 13-3 powers, Congress rejected such a view.

While there are a number of the most important issues raised in the proposed rule, I will focus upon those which I believe are most important in carrying out Congress' intent to eliminate the assistance of insolvent and/or single entities.

1. **Insolvency determination** – the proposed rule's definition of insolvency is exceedingly narrow and does not appear to actually limit Federal Reserve discretion beyond what is already included in Title II of the Dodd-Frank Act. The notion that a firm is only insolvent once it is already in a bankruptcy, resolution or receivership contradicts both common sense and historical practice. Bankruptcy does not trigger insolvency, insolvency triggers bankruptcy. Dodd-Frank Section 1101 attempts to limit Federal Reserve assistance to firms experiencing liquidity issues, not solvency issues. To shed some light on this question, what follows is the definition of "insolvent" from Merriam-Webster's dictionary²:

- a. (1): unable to pay debts as they fall due in the usual course of business; (2): having liabilities in excess of a reasonable market value of assets held
- b. insufficient to pay all debts <an insolvent estate>.

² See <http://www.merriam-webster.com/dictionary/insolvent>

By stating, under Section 1101(a)(6), that a “borrower shall be considered insolvent...if the borrower is in bankruptcy, resolution under title II...or any other Federal or State insolvency proceeding” Dodd-Frank sets a floor for the definition of insolvency, not a ceiling, as would appear to be the case under the proposed rule. Section 1101(a)(6) states the “Board shall establish procedures to prohibit borrowing from programs and facilities by borrowers that are insolvent.” Said section continues to note that the Federal Reserve *may* include a certification from the company as to that effect, which is reflected in the proposed rule. The structure of Section 1101(a)(6), however, suggests that such a certification is in addition to, and not a substitute for, the Board’s own procedures for determining insolvency. The company certification and Board determination of insolvency would appear to be two separate processes, not one. At a minimum the Board should require a determination of solvency from the primary regulator of the entity in question, if that entity has a primary regulator. The Board could also require a written determination by the independent auditor most recently responsible for the entity’s financial statements. Certifications should also state if they are conducted on a fair value basis. Certifications of solvency should also explicitly state whether they incorporate any existing or governmental assistance or the expectation of such. Ideally the Board should establish its own independent procedures for determining the solvency of entities to which it provides assistance.

In developing procedures for the determination of insolvency, the Board should also bear in mind that accounting measures of net worth are generally lagging indicators. Reliance on for instance a quarterly financial statement that is weeks old would likely lead to an inaccurate determination. I believe the intent of Section 1101(a)(6) is quite clear: assistance should only be available for entities that are solvent at the time when assistance is being provided, not some days or weeks earlier. The procedure most consistent with Section 1101(a)(6) would be for the Board to establish a real time financial metric of insolvency.

2. **Pass-through assistance from solvent to insolvent firms** – While it is generally agreed that Bear Stearns was insolvent at the time of its purchase by J.P. Morgan, we should not forget that the actual assistance was to J.P. Morgan, even if an intended beneficiary was the creditors (and shareholders) of Bear Stearns. The rule is silent on in this area. No doubt it is a difficult issue to address. But if Federal Reserve could simply pass assistance to insolvent firms via solvent firms, then the entire purpose of Dodd-Frank’s Section 1101 would be nullified. I would encourage the Board to place into its final rule a clear prohibition against the pass-through of assistance under Section 1101 to any entity that is insolvent. Of course sound business practice would dictate that any entity receiving 13-3 assistance not provide lending to another entity which is insolvent. At a very minimum, the company certification required should include a statement by the company that such any assistance received is not intended for assistance of any other entity.

3. **Definition of Broad-based** – While I am personally against any rescues, individual firm or broad-based, the intent and language of Section 1101 is to only provide assistance to classes of firms, not individual firms. At the time of creating any assistance facility, the Board should provide a public estimate of the number of entities which it believes would be eligible and the number which it expects to participate in said facility. A narrow range might also be appropriate. If the Board believes that such could “unsettle” the markets, then this estimate can be privately provided to the Chairs and Ranking Members of Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services and after a reasonable amount of time, no more than 6 months, made public. The Board should also make public, after a reasonable length of time, any denial of assistance to any established lending facility.

4. **Classes of assets eligible 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. Appropriate “hair-cuts” for different classes of assets should also be considered and to the extent feasible determine ex ante. I believe at a minimum any type of equity should be excluded from being eligible as collateral.

5. **Penalty rate for assistance.** - 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.

I appreciate your consideration of the submitted comment. If there is need for any elaboration, I would be happy to provide such. I can be reached at 202.789.5222.

Sincerely,

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