Congress of the United States
Washington, DC 20510

August 18, 2014

The Honorable Janet Yellen
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chair Yellen:

We write to express our concern with the Federal Reserve Board's (the Board) proposed rule implementing Section 1101 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[1] Section 1101 was intended to restrict the Board's emergency lending authority under Section 13(3) of the Federal Reserve Act – authority the Board used during the financial crisis to provide trillions of dollars in low-cost loans to a handful of massive financial institutions. But the Board's proposed rule places no meaningful restrictions on its emergency lending powers and, in a time of crisis, invites the same sort of backdoor bailout we witnessed five years ago. We urge the Board to strengthen these restrictions in its final rule.

During the financial crisis, the Board invoked its emergency lending authority for the first time in 75 years. The scope of the Board's program was staggering. Between 2007 and 2009, the Board's emergency lending facilities provided over *$13 trillion* in loans to large domestic and foreign financial institutions.[2]

These loans were another bailout in all but name. Of the nearly $9 trillion the Board provided through its largest facility – the Primary Dealer Credit Facility – over two-thirds went to just three institutions: Citigroup, Merrill Lynch, and Morgan Stanley.[3] Those institutions and others had access to the Board's credit facilities for an average of 22 months.[4] And the interest rates the

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[1] Docket No. R–1476; RIN 7100–AE08; Extensions of Credit by Federal Reserve Banks.
[2] James Felkerson, *$29,000,000,000,000: A Detailed Look at the Fed's Bailout by Funding Facility and Recipient* (Dec. 2011), at 32 (Tbl. 16), *available at* http://www.levyinstitute.org/pubs/wp_698.pdf. This figure excludes roughly $10 trillion in lending to other central banks through Central Banks Liquidity Swaps, and another $6.5 trillion in lending through facilities – the Term Auction Facility, the Single Tranche Open Market Operation, and the Agency Mortgage-Backed Security Purchase Program – that did not require the Fed to use its emergency lending authority under Section 13(3) of the Federal Reserve Act.
[3] Id. at 20 (Fig. 11).
[4] Levy Economics Institute of Bard College, *The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention After 2007* (Apr. 2013), at 61, *available at* http://www.levyinstitute.org/pubs/rpr_4_13.pdf.

Board offered were typically very low – in many cases, under 1%.[5] By lending to a select group of large financial institutions at below market rates for nearly two years, the Board was essentially propping up institutions that were viewed as "Too Big to Fail."

Congress enacted Section 1101 of Dodd-Frank to stop those kinds of bailouts from happening again. Congress directed the Board to establish firm limitations on its emergency lending authority so that "any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company." Among other specific mandates, Congress required the Board to set rules "to prohibit borrowing from programs and facilities by borrowers that are insolvent," and to ensure that any lending program allowed for "broad-based eligibility."

In short, Congress sought to eliminate the moral hazard associated with allowing the largest financial institutions to avoid bankruptcy by obtaining long-term emergency lending from the Board instead. As Dr. Allen Meltzer testified before the Senate Banking Committee, a true lender-of-last-resort policy – permitting emergency lending on "good collateral" at a penalty rate during financial turmoil – would create market discipline because banks that lack good collateral would be able to fail without disrupting the economy.[6] By directing the Board to establish a clear lender-of-last-resort policy, where both policymakers and the marketplace know the rules of the game beforehand, Congress sought to ensure that banks fully internalized both the risks and the rewards of their decisions.

The Board's proposed rule does not achieve that end. Accordingly, we recommend that the Board adopt the following changes in its final rule:

- <u>Establish a clear time limit for a financial institution's reliance on the Board's emergency lending and provide a concrete limit on the duration of each lending facility or program</u>: Under the proposed rule, an institution could rely on the Board's emergency lending indefinitely. The rule thus permits the kind of multi-year assistance programs the Board provided during the financial crisis. In its final rule, the Board should require an institution that obtains a loan through an emergency lending program to pay back that loan in full within a set period of time, with no rollover permitted beyond that period. Such a time limitation would prohibit the kind of lending we observed during the crisis, while still giving genuinely solvent institutions the opportunity to address a temporary interruption in liquidity and find private counterparties willing to lend against the true value of their assets.

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[5] Id. at 41-56.

[6] Allen H. Meltzer, Testimony on Regulatory Reform and the Federal Reserve, U.S. Senate Committee on Banking, Housing and Urban Affairs (July 23, 2009), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=729bdf90-bb15-4717-844e-3c1a300b9af8. Dr. Meltzer echoed that testimony at a Banking Subcommittee hearing this January. *See also* Allen H. Meltzer, Testimony before the U.S. Senate Subcommittee on Financial Institutions and Consumer Protection (Jan. 8, 2014), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9943329a-2a61-4507-9817-b9ff4cf79789.

- Establish procedures for the orderly unwinding of any emergency lending program or facility, including how the Board will cover any associated losses: Such procedures will reinforce that these emergency facilities are truly temporary. Failure to establish these procedures will erode public confidence in the Board's ability to manage its balance sheet and leave the market susceptible to reading tea leaves of statements made by Board officials.

- Adopt a broader definition of "insolvent": The proposed rule defines an "insolvent" institution as one that is in bankruptcy or any similar insolvency proceeding. While Section 1101 of Dodd-Frank requires the Board to define such institutions as insolvent, it does not prohibit the Board from including other institutions within its definition. The Board should use that discretion to adopt a broader definition of "insolvent" – one that might examine the relative value of an institution's assets and liabilities – so that the Board could not use its emergency lending program to save an institution that is on the verge of bankruptcy. The purpose of Section 1101 of Dodd-Frank was to ensure that banks that would be insolvent absent emergency lending assistance from the Board would be put into bankruptcy or Title II resolution, rather than receiving extended liquidity support.

- Expand the definition of "broad-based": The proposed rule defines a program with "broad-based eligibility" as one that is available to two or more institutions. That narrow definition still permits emergency lending that is plainly intended to help a handful of financial institutions or a particular industry, rather than to inject liquidity into the financial system broadly, as Section 1101 of Dodd-Frank requires. The Board staff has told the Government Accountability Office (GAO) that the Board "could re-launch emergency programs to assist the repurchase agreement, commercial paper, and other credit markets" – markets whose very nature benefits a limited set of large financial institutions.[7] The Board should expand its definition of "broad-based" so that it reflects congressional intent.

- Establish limitations, and a penalty rate, on lending terms: During the crisis, the Board offered loans at interest rates that were well below market rates (though, of course, those rates still exceeded the Board's extremely low short-term rates for interbank lending). To reduce the moral hazard associated with the emergency lending program, the Board should make clear that any lending it provides through the program will be at a "penalty rate."

Although these are not the only changes we would each like to see to the Board's proposed rule, we believe that these changes would substantially strengthen the rule.

If the Board's emergency lending authority is left unchecked, it can once again be used to provide massive bailouts to large financial institutions without any congressional action. The Board's proposed rule fails to strike the appropriate balance between promoting financial

[7] GAO, Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented 53 (Nov. 14, 2013), *available at* http://www.gao.gov/products/GAO-14-18.

stability and mitigating moral hazard among the largest financial institutions. We urge the Board to revise its proposed rule so that it reflects Congress' intent in enacting Section 1101 of Dodd-Frank, and forecloses the kind of extended multi-trillion dollar bailout we observed during the financial crisis.

Sincerely,

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