Fed proposal to end bailouts falls short

By Marcus Stanley and Mark Calabria
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At the heart of public anger with Wall Street is the sense that accountability is lacking. The largest banks seem to live in a 'heads I win, tails you lose' world in which they keep their gains but receive a bailout to prevent their failure.

The most publicized bailout of the financial crisis was the TARP bill that provided capital injections to a wide range of banks. But most of the assistance to financial firms was provided through a less publicized set of emergency lending programs authorized by Section 13(3) of the Federal Reserve Act. This emergency lending authority supported the Fed's rescue of AIG, a massive set of guarantees for Citibank, which would have failed without them, and an alphabet soup of lending 'facilities' that supported a small set of Wall Street dealers with almost unlimited cheap credit for a period of years.

When Congress examined this issue during the Dodd-Frank Act, they placed new limits on emergency lending that are contained in Section 1101 of the legislation. These limits are clearly intended to limit 13-3 lending to programs that are truly broad based (as opposed to bailing out a small set of insider Wall Street institutions), and to exclude the use of the program for 'bailouts' of institutions that are actually insolvent. While Americans for Financial Reform and the Cato Institute disagree on many questions about Dodd-Frank, we do agree these new limitations are important steps forward in improving the accountability of both Wall Street and the Federal Reserve.

We also agree that the Federal Reserve's implementation of these new limits on emergency lending is totally unsatisfactory and inadequate. Despite a requirement to issue rules detailing the new limits 'as soon as possible,' the proposal was released just days before Christmas in 2013, over three years after the passage of Dodd-Frank. The board and staff must have been in a hurry to leave for the holidays, as the notice largely repeats language from the statute and fails to address the law's intent to limit Federal Reserve discretion. It is impossible to read the proposal and see how it limits Federal Reserve discretion. With the exception of a few actions aimed at single institutions, it appears that the actions taken in 2008, which so angered the public would still be feasible under the proposed rule.

It would also greatly assist market participants if clear lines were visible before a crisis hits. Yet the proposal sets no such clear lines. Elements of the rules that preserve the flexibility of the Federal Reserve to assist insolvent and/or individual firms would directly conflict with the clear statutory intent. But the only definition of 'insolvency' in

the rules is that a firm cannot currently be in a bankruptcy process – meaning the Federal Reserve could literally meet an institution 'on the courthouse steps' with a check to prevent bankruptcy.

In order to faithfully fulfill the objectives on Dodd-Frank's Section 1101, we propose the Federal Reserve consider the following changes to their proposed rule:

- Establish a process for determining insolvency. Congress has decided that the Fed's assistance should be limited to illiquid but solvent firms. Companies that are basically bankrupt are to be excluded from assistance. The Fed's current definition of insolvency is too narrow and inconsistent with both generally accepted accounting standards and common sense.
- Define "broad-based". Congress has decided that one-off rescues of individual firms are no longer allowed. Assistance programs must be limited to broad categories of institutions. The Fed should detail its process for determining what is "broad-based." Additionally, 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.
- Set a time limit for dependence on such emergency lending programs. Firms should not be able to rely on Federal Reserve emergency lending for a period of years, as they did during the crisis. A firm which requires years of large-scale lending assistance to recover was likely not solvent in the first place. Should a crisis period continue for an extended time, then Congress will have time to take independent action, or other authorities in Dodd-Frank can be relied on, such as FDIC loan guarantee programs or the new authority to resolve failing financial firms.

These are just a few suggestions to help conform the Fed's proposal to the clear intent of Congress. Further suggestions are included in comment letters we have individually submitted. Congress has said "never again" to the ad hoc and arbitrary rescues that characterized the financial crisis. To make this a reality, the Federal Reserve must bind its own hands. If it is unwilling to do so, Congress must revisit the scope of the Fed's assistance powers.

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