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Warren, Vitter Team Up to Take on Wall Street's 'Too Big to Fail' Megabanks

Natalie Johnson

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Sens. Elizabeth Warren, D-Mass., and David Vitter, R-La., have merged in an unlikely pairing to reign in the Federal Reserve's emergency lending powers to Wall Street's biggest banks.

The two introduced bipartisan legislation in the spring that would hinder megabank bailouts should another financial crisis hit the U.S.

"It is time to end too big to fail," Warren said Wednesday during an event at the Cato Institute. "It is still a serious issue in this economy and more importantly, it is a serious issue in politics. We're trying to find a way to beat it back and to get us back to an economy that works better, not just for those at the top, but for everyone."

When the 2008 financial crisis hit the U.S., the bailouts under Congress' $700 billion TARP package dominated headlines and political debate. But Warren noted the lesser-known $9 trillion in overnight loans the Federal Reserve was quietly "shoveling out the backdoor" that primarily funneled into just three financial institutions.

Those loans, allotted under the Federal Reserve's emergency lending authority, were issued below market interest rates, effectively giving those three big banks subsided loans at the expense of the taxpayer.

Warren and Vitter's bill would require the Federal Reserve to loan at a penalty rate of interest five points above the Treasury's lending rate at the time the loan is issued.

"The point here is not to give you below market rates so that we can subsidize you, the point is to say if you're having to turn to the Fed for help in a crisis, then the Fed in that sense should be like other market lenders," Warren said.

The legislation would retain the Federal Reserve's role as a lender of last resort, but it would require big banks that take a loan to pay a price for it.

The bill also restricts the Federal Reserve from lending money to financial institutions during times of economic distress unless the problem is deemed "system-wide" and is the result of the market itself freezing, rather than the outcome of a poor business decision.

Though Dodd-Frank—passed in 2010 as a response to the 2008 financial crisis—had a system-wide requirement, it was not explicitly defined, leaving the Federal Reserve broad flexibility in interpretation. The haziness led to the Federal Reserve counting just two financial institutions as satisfying the system-wide condition.

Warren and Vitter's legislation would increase that threshold to five financial institutions.

Another problem with the Federal Reserve's emergency lending powers is its measure for insolvency, Warren said.

According to Warren, the Federal Reserve currently considers a financial institution insolvent solely if it has explicitly filed for bankruptcy.

She added that this allows the Federal Reserve to "intercept" large financial institutions that may be on their way to bankruptcy, but because they have not officially filed as such the Federal Reserve can extend them a loan.

"If you advertise to the market that the Fed is here and no need for any large financial institution ever to have to go to the bankruptcy court house or to declare itself insolvent, but instead having trillions of dollars available to backup these giant institutions, I think that changes fundamentally the behavior of the big banks themselves, the behavior of those who lend the money and the behavior of those investing."

Vitter said this has created a market advantage for those "too big to fail" banks, forcing smaller and midsized banks to compete for capital and investments against those big banks that have the government to fall back on.

"The ultimately irony is that we've come out of the crisis too big to fail, and I think mostly what we've done is created a greater disadvantage to the small players who essentially had nothing to do with the crisis," he said. "So we've titled the playing field even further in favor of megabanks against smaller community banks and credit unions."

Vitter said to move the bill forward in the Senate, broad-based public debate needs to overcome the string of banking interests that have lobbying arms across Capitol Hill.