March 6, 2014

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

**Subject: FEDERAL RESERVE SYSTEM 12 CFR Part 201 Regulation A; Docket No. R-1476 RIN 7100-AE08 Extensions of Credit by Federal Reserve Banks**

**From: Walker Todd, grantee, Institute for New Economic Thinking, and L. Randall Wray, Professor of Economics, University of Missouri—Kansas City**

This comment is in response to proposed language for Regulation A, Extensions of Credit by Federal Reserve Banks, that would implement Sections 1101 and 1103 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). These provisions of the Dodd-Frank Act amend the emergency lending authority of the Federal Reserve Banks under section 13(3) of the Federal Reserve Act (the "FRA"), 12 U.S.C. 343, and require the Board, in consultation with the Secretary of the Treasury, to establish by regulation certain policies and procedures with respect to emergency lending under that section.

We comment on the language concerning two of the Rule's provisions, plus a general set of overview comments:

1. Proposed Sections 201.4(d)(2)(i), 201.4(d)(2)(ii) and 201.4(d)(2)(iii): Lending to an insolvent institution, and for the purpose of assisting a specific company to avoid bankruptcy;
2. Proposed Section 201.4(d)(8): Credit extended under this provision may not be extended for a term exceeding 90 days, and that extensions be at a rate above the highest rate in effect for advances to depository institutions; and
3. General comments on the principles governing authorization for and use of Section 13(3) discounts or advances. Similar issues are addressed under Section 13(13).

## Background

In response to the Global Financial Crisis (GFC) that emerged in 2007-2008, various institutions of the Federal Reserve System (collectively "the Fed") mounted an unprecedented series of steps to rescue domestic and foreign financial institutions. The Fed invoked Section 13(3) of the Federal Reserve Act to justify much of its emergency lending to both particular institutions and general classes of the financial services industry after March 2008 under "unusual and exigent circumstances." A large number of special lending facilities was created to lend to financial institutions and to foreign central banks, and to prop up specific financial markets.[1] The total peak outstanding loans extended by the Fed reached over $1.7 trillion in December 2008.[2] However. over the next few years the Fed *originated* well over $29 trillion in loans.[3] A handful of institutions received most of the lending; indeed if we leave out the central bank

[1] See, e.g., Board of Governors, Federal Reserve Statistical Release H.4.1, *Factors Affecting Reserve Balances*, March 26, 2009, showing all or most of the new lending facilities created under Section 13(3): http://www.federalreserve.gov/releases/h41/20090326/ [hereafter cited as "Release H.4.1" with date and Internet link].

[2] Release H.4.1, January 2, 2009: http://www.federalreserve.gov/releases/h41/20090102/. For this purpose, "loans" include both discount window loans and advances and foreign exchange swap drawings of dollars by foreign central banks.

[3] See, L. Randall Wray, *Improving Governance of the Government Safety Net in Financial Crisis*, Research Project

liquidity swaps (loans to foreign central banks), a dozen huge banks (domestic and foreign) accounted for nearly 85 percent of all the borrowing from the Fed.[4] Some of these were "serial borrowers" who continually renewed loans, over periods exceeding two years. In many cases they paid interest rates as low as a few basis points.[5]

## Liquidity or Solvency Crisis?

It has been recognized for well over a century that the central bank must intervene as "lender of last resort" in a crisis. Walter Bagehot explained this as a policy of stopping a run on banks by lending without limit (albeit constrained at the time by the upper bound of a gold reserve), against good collateral, at a penalty interest rate. Such a policy allowed borrowing banks to cover withdrawals without forcing asset sales (which could create a Fisher-type debt deflation) so that irrational bank runs would stop. Once deposit insurance was added to emergency lending after March 1933, combined with official assurance that banks allowed to reopen after the bank holiday were solvent and sound, runs on ordinary deposit accounts essentially stopped. However, a banking model emerged after the 1960s in which banks increasingly financed their asset positions by issuing a combination of uninsured deposits (e.g., negotiable certificates of deposit in excess of $100,000) and short-term non-deposit liabilities (e.g., borrowings from parent bank holding companies that issued commercial paper to finance those borrowings). When it arrived, the GFC actually began as a run on banks' non-deposit liabilities, which were largely (and arguably improperly) held by other financial institutions.[6] Suspicions about insolvency led to refusal to roll over short-term liabilities, which then forced institutions to sell assets.

In truth, the GFC was not simply a liquidity crisis but rather a solvency crisis brought on by risky and, in many cases, fraudulent or other unsustainable practices. This conclusion increasingly is recognized by a large number of analysts.[7] As evidence, we note that all of the Fed's lending did not resuscitate

---

Reports | April 2012, Levy Economics Institute; Anna J. Schwartz and Walker F. Todd, "Commentary: Why a Dual Mandate Is Wrong for Monetary Policy," *International Finance*, vol. 11, no. 2 (Spring 2008), pp. 167–183.

[4] Just three banks accounted for about a third of all of the loans made by the Fed to private institutions through its special facilities: Citigroup, Merrill Lynch, and Morgan Stanley.

[5] See Nicola Matthews, "How the Fed Reanimated Wall Street: The Low and Extended Lending Rates that Revived the Big Banks," Working Paper No. 758, Levy Economics Institute of Bard College (March 2013). For example, the Fed set up the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) to lend at rates as low as 5 basis points. JP Morgan would borrow from the FRBB 144 times at that rate, while State Street borrowed 35 times and Citigroup eleven times at 5 basis points.

[6] The argument is not that such funding devices were illegal or unauthorized; rather, the argument is that financial institution cross-holdings of other institutions' paper in large quantities is unsound because such holdings are unsustainable without Fed assistance in a large-scale crisis. Traditional bank accounting in the United Kingdom required financial institutions to net out holdings of other banks' capital issues before reporting their own capital positions, for example.

[7] See L. Randall Wray, *The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention after 2007*, Research Project Reports, April 2013, Levy Economics Institute. See also Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown,* Vintage Books (2010). Some might argue that the general public resentment of bankers in the aftermath of the crisis is derived from the perception, whether warranted or not, that bankers engaged in shady practices in an atmosphere of supervisory nonfeasance and were bailed out. In general, the public's perception is that Section 13(3) loans amount to a particular form of corporatist or quasi-corporatist favoritism for the financial services industry while the general public received few or no identifiable benefits from the same bailouts.

the markets. A liquidity crisis—even a very serious one—should be resolved quickly by lender of last resort intervention in affected markets. In fact, however, the Fed found itself creating loan facility after loan facility, originating over $29 trillion in loans (aggregate of daily loans), much of that amount at heavily subsidized (below market) rates to serial borrowers. Five and one-half years later, the Fed's balance sheet is still about 4.5 to 5 times larger than it was when the crisis arrived, and it is still growing.[8]

Government response to a failing, insolvent bank is supposed to be much different than its response to a liquidity crisis: In traditional banking practice, government is supposed to step in, seize the institution, fire the management, and begin a resolution.[9] Indeed, in the case of the United States, there is a mandate to minimize bank resolution costs to the Treasury (the FDIC maintains a fund to cover some of the losses so that insured depositors are paid dollar-for-dollar) as specified by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.[10] Normally, stockholders lose, as do the uninsured creditors—which ordinarily would have included other financial institutions. It is the Treasury (through the FDIC) that is responsible for resolution. However, rather than resolve institutions that probably were insolvent, the Fed, working with the Treasury, tried to save them during the GFC—by purchasing troubled assets, recapitalizing the banks, and providing low interest rate loans for long periods.[11] While some policy makers have argued that there was no alternative to propping up insolvent banks, President Tom Hoenig insists that the "too big to fail" doctrine "failed", and argues that policy-makers should have—and could have—pursued orderly resolution instead.[12]

**The Proposed Rules**

[8] Release H.4.1, September 10, 2008, the last balance sheet before the failure of Lehman Brothers, showed total Fed assets of $924.9 billion. The most recent release in the same series, for February 26, 2014, shows total Fed assets of $4,160.0 billion, with a great expansion of Fed open-market purchases of various securities having replaced nearly all the lending facilities of 2008-2010. Total loans and foreign exchange swaps are now less than $2.0 billion, of which nearly all are legacy loans from the ongoing emergency period. Only $5 million are loans originated in the current period.

[9] An innovation of the 1930s that was misinterpreted in the various banking crises since the mid-1980s is the appointment of conservators for failing banks with the intention of possibly recapitalizing them and continuing their operation. The largest conservatorships in recent years were those for Fannie Mae and Freddie Mac created in July 2008, still ongoing while aiming for their sixth anniversaries. See, e.g., Walker F. Todd, "Receivership and conservatorship for Fannie Mae, Freddie Mac, and failing banks," submitted for posting on website of American Institute for Economic Research, July 23, 2008, www.aier.org.

[10] FDICIA required the resolution of insolvent banks to be conducted by the *least costly* method available. See, Bernard Shull, "Too Big To Fail in Financial Crisis: Motives, Countermeasures and Prospects," Working Paper No. 601, Levy Economics Institute of Bard College (June 2010).

[11] In traditional corporate finance, emergency loans that remain outstanding after five or six years raise at least threshold questions about whether the accounting for such loans should treat them as equity positions instead of debt. The Fed still has $96 million of Term Asset-Backed Securities Lending Facility (TALF) loans outstanding after more than five years, as well as Maiden Lane LLC loans (usually related to Bear Stearns or AIG) still outstanding in excess of $1.5 billion. See Release H.4.1 for February 26, 2014. But the Fed has no clear and unambiguous statutory mandate to hold equity positions in any entity other than, for example, a holding company designed to hold its own real estate interests.

[12] See Thomas Hoenig, "Too Big Has Failed", March 6 2009, speech given in Omaha, Nebraska, http://www.kc.frb.org/speechbio/hoenigpdf/omaha.03.06.09.pdf

1. Proposed Section 201.4(d)(2)(iii) provides that a Reserve Bank must not extend credit through a program or facility established under section 13(3) of the FRA to any person or entity that is in bankruptcy, resolution under Title of the Dodd-Frank Act, or any other Federal or State insolvency proceeding. Proposed Section 201.4(d)(2)(iii)(B) provides that a Reserve Bank may rely on a written certification from a designated senior person, apparently intended to be the chief executive officer or another authorized officer of the entity, at the time that person or entity initially borrows under a program or facility, stating that the person or entity is not in bankruptcy or in a resolution or other insolvency proceeding. These provisions, as worded currently, would provide sufficient scope for the Fed to lend to conservatorships. If that is what the Fed intends, it should say so explicitly and offer Congress the chance to change the relevant statutory language if Congress objects to loans to conservatorships, which it might do after due deliberation. Also, as provided in Section 1101 of the Dodd-Frank Act, the proposed rule provides that a person or entity that submits such a written certification immediately must notify the lending Reserve Bank if the information in the certification changes. Section 201.4(d)(2)(iii)(C) of the proposed rule provides that a participant that is or has become insolvent would be prohibited from receiving any new extension of credit under the program or facility. Language clarifying congressional intent about Fed loans to conservatorships would be helpful in that context.

2. As under the current rule, the proposed rule would authorize any Reserve Bank to extend credit under section 13(13) of the Federal Reserve Act (the "FRA") in unusual and exigent circumstances, after consultation with the Board, if the Reserve Bank has obtained evidence that credit is not available from other sources and that failure to obtain credit would affect the economy adversely. As set forth in section 13(13) of the FRA, section 201.4(d)(8) of the proposed rule also provides that credit extended under this provision may not be extended for a term exceeding 90 days. Section 201.4(d)(8) retains the provision in current section 201.4(d) of Regulation A that extensions of credit under this section be at a rate above the highest rate in effect for advances to depository institutions. Section 13(13) covers extensions of credit secured by full faith and credit obligations of the United States or issued or guaranteed by any agency of the United States.

**General comment on Rule 1:** This rule establishes a lax standard for solvency, requiring only that an institution not be already in bankruptcy or insolvency proceedings. The rule appears to rely on a statement of an authorized officer of the institution that the institution is not yet in such proceedings. And if the institution receiving a loan should then be forced into such proceedings, the Fed relies on the authorized officer for notification, with a prohibition on further lending in such case. Again, this is a lax standard. One could imagine a situation in which a fatally insolvent institution were "saved by the bell" by Fed lending to the bank just before its officers faced a bankruptcy filing for the parent bank holding company. Given the Fed's (and the Treasury's) actions in 2008-2009 to save institutions that certainly were insolvent (brought on in some cases by reckless and even fraudulent practices), one should not dismiss the possible recurrence of such actions out-of-hand.

The Fed should adopt a more stringent rule requiring that the Fed itself examine (with the help of the FDIC, the OCC, state banking supervisors, and any other relevant supervisory authority) financial institutions for solvency before extending loans. The Fed should also consult the examination reports, which should be available to the Fed, to check the condition of a financial institution seeking loans. If there were any question of solvency, the Fed could make very short-term loans (overnight, over-holiday, or over-weekend) to stop a bank run and then work with the FDIC to place the institution into receivership

or conservatorship.[13] The goal should be to resolve insolvent institutions, not to prop them up through loans, emergency or otherwise. If there were loans to nonfinancial institutions under Section 13(3), the Fed should examine the books and records of those institutions also, perhaps with the assistance of their principal bank lenders.

**General comment on Rule 2:** This rule establishes a 90-day limit to emergency lending, but it is ambiguous on the number of times a troubled institution can roll over loans. As we know from the experience after 2008, the Fed can continue to renew short-term loans for months and even years on end. The Rule needs to clarify whether short-term loans can be rolled over indefinitely.

The 90-day limit itself is much too generous in normal circumstances except possibly for emergency advances secured by agricultural or ocean shipping loans. An institution that is merely illiquid should be able to return to market funding in much less time. An institution suspected of insolvency would not be able to go to the markets, but the Fed should not lend to insolvent institutions (see Rule 1). A more reasonable time limit would be measured in not more than a few weeks, including loan renewals. Any institution that cannot return to market funding in a matter of a few weeks (e.g., 45 days) should be resolved, finally and officially.

There will be exceptions to this rule—during natural disasters or in the case of seasonal loans that might be renewed several times. However, the biggest issue is continued roll-overs in the case of an institution that is insolvent. While the Fed's call for comments as well as the Dodd-Frank Act emphasizes the importance of protecting taxpayers from losses due to bad loans, there is another important principle involved: lending to insolvent institutions provides perverse incentives.[14] While the Fed wants to preserve flexibility, it should not subvert good banking practices by supporting failing institutions.

---

[13] If a conservator is appointed, then the Fed should require segregation of old from new (post-conservatorship) loans and deposits so that the new assets and liabilities can be protected fully while assessing any future losses from prior activity to pre-existing depositors and borrowers. This was the procedure roughly followed from 1933 until conservators began to reappear in bank insolvencies in the 1980s. See, e.g., Walker F. Todd, "Bank Receivership and Conservatorship," *Economic Commentary*, Federal Reserve Bank of Cleveland, October 1, 1994.

[14] See interview with Thomas Hoenig: "In some ways it [lender of last resort intervention] is the larger part of the safety net as it involves lending against the assets of the institution that is under pressure and therefore affords the bank ultimate liquidity. It was originally intended for commercial banks to provide them liquidity and ensure the payments system remained viable, and it was for solvent but illiquid institutions. Solvency was defined by a bank examination process that actually looked at the assets and found out what the value was. Support was to be afforded only to solvent firms. When you extend that support by lending to insolvent firms, then the moral hazard multiplies by some factor and it is much more difficult to handle. That is really the danger we have now encountered by lending to nearly all financial firms, including market funds in the US during the last crisis. So I am worried about that. I would constrain it to make sure our lending activities are only to solvent commercial banks and not every financial institution that might get into trouble." http://www.centralbanking.com/central-banking-journal/interview/2266696/fdic-s-thomas-hoenig-on-bank-separation-safety-nets-and-basel-iii