Joint Economic Committee
Republicans Senator Sam Brownback *Ranking Member*
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Republican Staff Commentary

Financial Regulatory Reform: Oops! I did it again.

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Do you remember back in March 2008 when Timothy Geithner was President of the New York Fed and he used the Federal Reserve's special bailout powers to bail out creditors of Bear Stearns? Do you know where the Fed got that power to bail out the big Wall Street investment firms?

The authority for the Federal Reserve's action came from Senator Chris Dodd's last minute 1991 amendment inserting Section 473 to the FDIC Improvement Act (FDICIA). The amendment widened the Federal Reserve's bailout powers. And the Congressional Record includes Senator Dodd boasting that his amendment would "give the Federal Reserve greater flexibility."

Protects Taxpayers?

- *Senator Dodd's 1991 Amendment to the Federal Deposit Insurance Corporation Improvement Act widened Federal Reserve's bailout powers.*
- *Senator Dodd's 2010 Legislation leaves room for future bailouts and fails to address significant moral hazard problems that were broadened by his 1991 FDICIA Amendment.*

Soon after passage of the FDIC Improvement Act of 1991, none other than famed economist and scholar Anna Schwartz along with others warned that the expanded Fed power would lead to moral hazard and bailouts like what we just saw in the past couple of years. Senator Dodd may not have had bailouts in mind back in 1991, but the big banks were likely comforted with the Fed having flexibility to issue bailouts.

Now, it looks like the Federal Reserve and the big financial institutions want to have even broader bailout authority for the Fed in Senator Dodd's newest bill, the "Restoring American Financial Stability Act of 2010." And Senator Dodd once again is arguing for greater flexibility for the Fed.

The Bailout of Bear Stearns (Maiden Lane, LLC): In March 2008, the Federal Reserve Bank of New York (FRBNY) provided funding to facilitate a merger between the Bear Stearns Companies Inc. and JPMorgan Chase & Co. The transaction was authorized by the Federal Reserve Board under Section 13(3) of the Federal Reserve Act. The transaction was structured as follows: the FRBNY extended credit to a Delaware limited liability company, called "Maiden Lane LLC," to partially fund purchases of mortgage-related securities, residential and commercial mortgage loans, and complex derivatives ("hedges") from Bear Stearns. Maiden Lane LLC borrowed $28.8 billion from the New York Fed which, together with funding of around $1.15 billion from JPMorgan Chase, was used to purchase an asset portfolio which had an estimated fair value of approximately $30 billion. The Fed has reported losses on its funding of the Bear Stearns and JPMorgan Chase merger. Thus, the Federal Reserve bailout of Bear Stearns imposed risks and losses upon innocent taxpayers who had nothing to do with losses generated by Bear Stearns.

Legal Authority for the Bailout: The legal authority for the Bear Stearns bailout came from an expansion of authority, under FDICIA, for emergency lending by the Federal Reserve under Section 13(3) of the Federal Reserve Act. That section allows Federal Reserve Banks "in unusual and exigent circumstances," and when authorized by the Board of Governors of the Federal Reserve System, to make discount loans "for any individual, partnership, or corporation" when it "is unable to secure adequate credit accommodations from other banking institutions."

Prior to its use in the Bear Stearns case, the powers under Section 13(3) had not been used since the Great Depression in 1936, although its use was considered in the case of New York City in 1975, among others. One practical effect of Section 13(3) lending is to shift a portion of the risk of loss from private creditors onto the books of the Federal Reserve, and therefore the taxpayers.

Senator Dodd and 13(3) Bailout Authority: In an amendment of the Federal Reserve's lending authorities, the FDICIA permitted all nonbank firms, financial or otherwise, to obtain emergency Federal Reserve loans at the Fed's discount window under the same collateral terms afforded to banks. Specifically, Section 473 of FDICIA, amending Section 13(3) of the Federal Reserve Act, was inserted at the ending stages of Congressional deliberations over FDICIA—by Senator Christopher Dodd—to broaden the Federal Reserve's ability to make loans to nonbank firms and thereby extend the government safety net.

Section 473 of FDICIA removed a restriction on the kinds and maturities of "notes, drafts, and bills of exchange" against which the Fed can offer discount loans to individuals, partnerships, or corporations under Section 13(3). Before Senator Dodd's change to 13(3), the Federal Reserve could discount only when the notes, drafts, and bills of exchange were endorsed or otherwise secured to the satisfaction of the Federal Reserve and, when endorsed, were "of the kinds and maturities made eligible for discount from member banks." The change made by FDICIA eliminated the requirement that loans be of the kinds and maturities made eligible for discount from member banks, thereby easing collateral requirements on emergency Fed lending to nonbank firms, such as securities firms.

The changes made to the Federal Reserve's emergency lending powers by Senator Dodd in the final hours of debate surrounding FDICIA expanded emergency discount window access for nonbanks of all types, not merely securities firms, because any assets that the Fed finds to be "satisfactory" may be pledged to secure a borrower's own note.

During the Senate floor debate on FDICIA, Senator Dodd discussed his amendment [Section 473] and argued in first person that:

"It also includes a provision I offered to give the Federal Reserve greater flexibility to respond in instances in which the overall financial system threatens to collapse. My provision allows the Fed more power to provide liquidity, by enabling it to make fully secured loans to securities firms in instances similar to the 1987 stock market crash." [Congressional Record (1991), p. S18619].

Dodd Assures Full Security; Bear Gives Pause: Loans by the Federal Reserve under 13(3) authority to Maiden Lane LLC, to facilitate the JPMorgan Chase takeover of Bear Stearns, were examples of Fed provision of "fully secured loans" to a securities firm. However, those loans have generated losses. A loss on the Bear Stearns transaction, would be directly counter to an expressed intent of Senator Dodd in 1991 that Section 13(3) lending be done to security firms only as "fully secured loans." This gives caution in interpreting repeated claims in current regulatory reform legislation that emergency authorities provided variously to the Federal Reserve, the FDIC, and Treasury all contain ample provision ensuring that there will only be allowed emergency loans and support to "solvent" firms and on "full security." However pure are the intentions for loans to be fully secured and for support to be given only to solvent firms, unless those intentions are matched in the legislation with strict language, the intentions may never be realized in actions.

Moral Hazard: While undoubtedly well intentioned, Senator Dodd's expansion of the Federal Reserve's emergency lending authority served, according to scholars, to introduce moral hazard into nonbanks' behavior and injected a new element, previously not present, of taxpayer risk. Before Dodd's FDICIA changes to the Fed's emergency lending authority, nonbanks lacking collateral that would have been necessary to obtain Fed loans under pre-FDICIA collateral requirements would have to have managed their affairs, including relations with creditors and clients, so as to be able to survive market emergencies. After Dodd's changes, with increased potential for assistance from government during emergencies, nonbanks' managers have less incentive to avoid recourse to the Federal Reserve. Potential access to the

Fed as an emergency funding source during financial crisis alters business decisions of the nonbanks so as to make their reliance on that funding even more likely in a crisis.

Prescient Warnings: There were two prescient warnings about moral hazard, risk taking, and crisis building implications of Senator Dodd's amendment in FDICIA. Walker F. Todd, then Assistant General Counsel and Research Officer at the Federal Reserve Bank of Cleveland warned of the increased moral hazard introduced by Dodd's amendment, and concluded that: "…greater potential access to the federal financial safety net could boost the risk-taking incentives for nonbanks, thereby increasing the probabilities that they will request discount window lending during financial emergencies." He argued, also, that: "It is important to keep in mind that nonbanks' behavior depends in part on how they expect the Federal Reserve to manage its emergency lending powers." [See "FDICIA's Emergency Liquidity Provisions," by Walker F. Todd, Federal Reserve Bank of Cleveland Economic Review 1993 Quarter 3, Vol. 29, No. 3, available at http://www.clevelandfed.org/research/Review/1993/93-q3-todd.pdf].

A second warning came from National Bureau of Economic Research scholar Anna J. Schwarz who, identifying the FDICA of 1991, stated that Senator Dodd's amendment: "…eliminated the requirement that the notes, drafts or bills tendered by nonbanks be eligible for discount by member banks…this provision enables the Fed to lend directly to security firms in emergency situations…" She concludes that: "In my view, the provision in the FDIC Improvement Act of 1991 portends expanded misuse of the discount window. To this date, the Fed has apparently been a reluctant participant in loans and loan guarantees to nonbanks. The question must be asked whether it will be firm in the future in resisting pressures to fund insolvent firms that are politically well-connected." [See "The Misuse of the Fed's Discount Window," by Anna J. Schwartz, Federal Reserve Bank of St. Louis Review September/October 1992 Vol. 74, No. 5, available at http://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf].

Growing Risks May Take Time to Fester: Senator Dodd relaxed collateral requirements on emergency Fed lending and expanded the scope of possible Fed lending to nonbanks with a last minute and little-noticed amendment to FDICIA in 1991. Warnings of the consequences of increased moral hazard, increased risk taking, reduced due diligence, and increased odds that Fed emergency lending would be tapped following Dodd's amendment presciently foresaw the recent financial crisis. Dodd's amendment was put in place in 1991 and it took a few episodes of testing the Fed's resolve to not use emergency lending authority, including the Long Term Capital Management test and the dot-com bubble burst test, before the Fed finally failed the test in March 2008 when then New York Fed President Timothy Geithner and Federal Reserve Board Chairman Ben Bernanke broke the glass and invoked 13(3) powers.

Dodd Assures Again: We are now being comforted by Senator Dodd that his bill ends too big to fail and allows government loans or guarantees only for solvent firms that are based on sound collateral and that taxpayers are protected. History suggests that Senator Dodd's assurances will lead to another large crisis in the future and ability for him to proclaim: oops, I did it again.