Financial Services Management

FRB Restrictions

Cite
S. 1320
Bailout Prevention Act of 2015

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Website
http://www.warren.senate.gov/files/documents/Bailout_Prevention_Act_of_2015.pdf

Impact Assessment

- The FRB would be severely constrained from providing emergency-liquidity support, reducing buffers that could prove critical in financial crises. However, it is possible that crises—at least those with their origins in high-risk, very large banks—will be deterred because counterparties will not expect central-bank intervention.
- Two U.S. BHCs would gradually need to eliminate some of their physical-commodity activities, but others at these BHCs and those at other BHCs could continue.

Overview

Sens. Elizabeth Warren (D-MA) and David Vitter (R-LA) have introduced legislation that would sharply curtail the Federal Reserve's ability to provide emergency-liquidity support to financial institutions, going well beyond provisions in Dodd-Frank intended also to do so.[1] The bill would also limit the ability of some large BHCs to engage in certain physical-commodity activities.

[1] See **RESCUE65,** *Financial Services Regulation & Legislation*, August 3, 2010.

Impact

This legislation was introduced by bipartisan senators who rarely agree with each other outside of financial-policy matters, doing so in advance of legislative action in the Senate. As discussed below, House Members, especially in the GOP, agree with aspects of the legislation, although concerns there go considerably beyond these issues, and legislation specific to the matters in the Warren-Vitter bill has thus not yet taken place.

As noted, Dodd-Frank places significant restrictions on the FRB's ability to extend emergency-liquidity support. Although the law does so also for the FDIC, public attention has generally focused on the FRB and this bill is also limited to the central bank. It is therefore possible that the FDIC could read its authority broadly during a crisis and extend support along the lines of the unrestricted debt and deposit guarantees provided during the 2008 crisis, although its ability to do so is potentially constrained by other language in Dodd-Frank related to FDIC powers in a crisis.[2] Regardless, the FRB has the greatest capacity to support global financial markets in a crisis and, thus, the limits in this bill may not only address the too-big-to-fail (TBTF) protection feared by its sponsors, but also sharply constrain the central bank's ability to prevent a looming financial crisis.

Reflecting the importance of TBTF, the FRB was charged in Dodd-Frank with defining the "financial-stability" criteria that would lead it to provide support for solvent, but illiquid, financial institutions. Under pressure during the Yellen confirmation hearings and in other contexts, the Board several years ago released this proposal.[3] It is, however, almost a verbatim repeat of the statute and includes no indication of any potential procedures, restrictions, or other steps the FRB might use to ensure its support did not provide undue support.

The lack of a final and clear rule is cited by Sens. Warren and Vitter as among the reasons for the measure. Should the bill fail, the FRB will nonetheless remain under pressure to finalize this rule and make it more prescriptive.

The provisions related to physical commodities reflect growing concern that this line of business is inappropriate for companies that also control insured depositories. The Gramm-Leach-Bliley Act (GLBA) in 1999 not only authorized a broader range of financial activities, but also authorized the grandfathering of any that were still impermissible should a non-bank decide to become a bank holding company (technically called a "financial holding company" under GLBA).[4]

Following questions in Congress on this issue,[5] the Federal Reserve issued an advance notice of proposed rulemaking (ANPR) in 2013.[6] It promised action on the

[2] See **SYSTEMIC30,** *Financial Services Management,* July 22, 2010.

[3] See **RESCUE67,** *Financial Services Management,* January 2, 2014.

[4] See **FSM112999,** *Financial Services Management*, November 29, 1999.

[5] See *Client Reports* in the **COMTRADE** series.

[6] See **COMTRADE4,** *Financial Services Regulation & Legislation*, January 22, 2014.

ANPR by early 2015, but has not yet issued any new proposals. In part, this is because it remains unsure of the extent to which it could remove the authority some believe required by GLBA. This bill would settle the matter and mandate FRB action. However, it would do so only for the two BHCs—Goldman Sachs and Morgan Stanley—that became BHCs in the financial crisis. At the time, each had significant physical-commodity activities that have been allowed to continue under this grandfather provision and, where reduced, have been altered largely due to business considerations even as these BHCs defended their grandfathered powers in this sector. This protection would be removed by the bill and, as a result, any remaining activities permitted solely by the grandfather would need to be terminated.

The bill does not, however, bar any physical-commodity activity the FRB might choose to approve generally for BHCs in the course of the rulemaking noted above. In the ANPR, the FRB laid out some concerns related to these activities as well as some possible benefits and a regulatory framework that might apply. The OCC, which has allowed certain physical-commodity activities in national banks, has taken no action at all, likely looking to the FRB's standards to determine if and how to proceed.

These regulatory actions are not halted by the Warren-Vitter bill. As a result, the scope of physical-commodity operations that the FRB finds to be within the scope of the BHC Act, regardless of the grandfather and those permitted in national banks, could be little altered even if this measure were to pass.

What's Next

S. 1320 was introduced on May 13 in advance of the mark-up scheduled for May 21 by Senate Banking Committee Chairman Shelby (R-AL). There is no direct House companion bill, but several House GOP Members have, in both the previous and current Congress, introduced sweeping bills to reform the central bank generally in concert with provisions here to limit FRB liquidity support.[7]

Analysis

A. Emergency-Liquidity Support

1. Procedures

The FRB would be required to establish procedures to ensure that liquidity support is only provided to solvent firms. This restriction would apparently not apply to ordinary discount-window advances, but only to emergency-liquidity facilities or similar support. Funds or other support could

[7] See Client Reports in the **FEDERALRESERVE** Series.

be extended only if the FRB and all federal banking regulators with jurisdiction over the borrower certify that the borrower is not insolvent. This would be determined by analysis of the last four months through a finding that the fair value of assets exceeds the borrower's liabilities following temporary adjustments. Insolvency would have to be found if the borrower is:

- in bankruptcy;
- in resolution under Title II of Dodd-Frank[8] or any other federal or state insolvency proceeding; or
- a bridge financial company under Dodd-Frank.

2. Disclosures

Any regulator making a solvency determination would need to make a detailed public disclosure to this effect.

3. Emergency-Liquidity Programs

To meet the Dodd-Frank standard for "broad" application, at least five firms would need to be likely to use the emergency support in a "significant manner."

4. Penalty Rate

Emergency FRB support would need to bear an interest rate at least five percent above comparable Treasury rates.

5. Congressional Approval

Any decision by the FRB to create an emergency-liquidity program that does not meet the broad-eligibility or penalty rates described above would have to be submitted to Congress within three days. The submission would have to describe why the facility is structured in this fashion, terminating thirty days after Congress receives this report unless a joint resolution is enacted into law authorizing it. Any support outstanding at any such termination would then have to be repaid in thirty days. The bill specifies the procedure and structure of any such joint resolution and also that Congress would need to be called back into session if it is in recess or otherwise adjourned in order to ensure that a joint resolution authorizes the emergency-liquidity support. If the resolution is vetoed, then aspects of this calendar are extended subject to an expedited procedure also specified in the bill.

B. Physical-Commodity Activities

As noted, provisions in the GLBA that grandfather activities in newly-formed financial holding companies are repealed. This would take effect five years after enactment, presumably giving adequate time for divestiture.

[8] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.