The Honorable Paul Ryan
Speaker of the House of Representatives
House of Representatives
Washington, DC 20515

The Honorable Nancy Pelosi
Democratic Leader
House of Representatives
Washington, DC 20515

November 18, 2015

RE: H.R. 3189, the Federal Reserve Oversight Reform and Modernization (FORM) Act

Dear Speaker Ryan and Democratic Leader Pelosi:

The Committee on Capital Markets Regulation (the "**Committee**") is concerned that the FORM Act, scheduled for a vote on November 19, 2015 by the House of Representatives, would severely constrain the Federal Reserve's ability to preserve the financial stability of our country by performing its role as lender of last resort to the financial system, a power that was already limited by the Dodd-Frank Act of 2010. The bill would thus increase the likelihood and severity of another financial crisis and the Committee therefore strongly opposes the proposed legislation.

The Committee does not advocate "bailouts" or the moral hazard created by financial institutions that are too big to fail ("**TBTF**"). We strongly believe that financial institutions that are insolvent due to bad business decisions, whatever their size, should be allowed to fail. Shareholders and creditors should experience haircuts commensurate with the losses of the firm.

However, this bill does not address "government bailouts," which involve capital injections into insolvent firms. Instead, due to its onerous requirements, the bill effectively eliminates the Federal Reserve's ability to *lend* to non-banks, which is a crucial tool for the Federal Reserve to effectively reduce market stress. Some non-banks, like money market mutual funds, experienced runs by investors in the 2008 crisis, and Federal Reserve lending helped stall the resulting panic in short-term credit markets. We therefore emphatically agree with Federal Reserve Chairman Yellen, "the FORM Act would essentially repeal the Federal Reserve's remaining ability to act in a crisis."[1]

Our financial system needs a strong lender of last resort to prevent market-wide contagion. Contagion occurs when short-term creditors run on *solvent* financial

[1] Janet Yellen, Chair of the Board of Governors of the Federal Reserve, letter to the Honorable Paul Ryan and the Honorable Nancy Pelosi, November 16, 2015.

institutions or, to put it another way, financial institutions that would be solvent but for the fire sale of assets that accompanies contagion. The lender of last resort through its very lending restores these asset prices and prevents the insolvency of these institutions. History has taught us that contagion is an unavoidable risk of financial intermediation (creating credit for the U.S. economy by borrowing short and lending long) and that a strong lender of last resort is therefore necessary to protect our financial system.

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-five leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Description of the Bill

Section 11 of the bill has three key provisions that would restrict the Federal Reserve's lender of last resort authorities. First, it would revise Section 13(3) of the Federal Reserve Act so that the Federal Reserve could only lend to non-banks if at least nine of the 12 Presidents of the Federal Reserve Banks vote in the affirmative. Second, *all Federal banking regulators with jurisdiction over the borrower* must certify that the borrower is solvent. Third, the bill would preclude Federal Reserve lending to entities that are not "financial institutions."

Analysis of the Bill

The bill may make 13(3) lending impossible in practice. Indeed, the mandatory solvency certification requirement is extremely dangerous to the financial stability of the country. First, it would require lender of last resort by "committee," which would increase uncertainty in the marketplace and slow the Federal Reserve's ability to respond to an emerging crisis. In the real world, decisions to lend to avoid financial panics need to be taken quickly. Second, by precluding non-financial institutions from borrowing from the Federal Reserve during a crisis, it would prevent the Federal Reserve from buying the commercial paper of non-financials such as McDonalds, Caterpillar Inc., Harley-Davidson, Ford, Toyota, Verizon Communications, Syngenta AG, Georgia Transmission Corp., COFCO Ltd. and Baxter International Inc. as it did in the 2008 crisis, when private financing seized up entirely.[2] This provision could greatly imperil Main Street during a crisis.

[2] Bloomberg Business, "The Fed's Secret Liquidity Lifelines," Available at: www.bloomberg.com/data-visualization/federal-reserve-emergency-lending/#/overview

Lender of Last Resort by Committee

Even with Treasury approval, already required by Dodd-Frank, the bill would go much further by requiring that nine of the 12 Presidents of the Federal Reserve Banks vote in the affirmative before the Federal Reserve can make a 13(3) loan. This is likely to slow the approval process for 13(3) loans, as the Presidents of the Federal Reserve Banks are unlikely to be well positioned to assess the solvency of non-banks.

Even worse, in order for the Federal Reserve to make a 13(3) loan, the bill would require that all federal banking regulators with jurisdiction over the borrower certify its solvency. The term federal banking regulator is not defined but it could include a broad group of regulators, some of which have experience regulating banks and some of which do not, such as the Consumer Financial Protection Bureau ("CFPB"), the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Financial Stability Oversight Council. However, at the same time, it would not include what are traditionally thought of as federal banking regulators, such as the Federal Deposit Insurance Corporation or the Comptroller of the Currency, because these banking regulators do not have jurisdiction over non-banks. Requiring multiple regulators to make a solvency determination would prevent the Federal Reserve from responding quickly to a run at a non-bank, like a broker-dealer or bank holding company, and would introduce substantial uncertainty in the marketplace thereby exacerbating any panic by short-term creditors. Further, it would place solvency determinations in the hands of agencies that do not generally monitor non-banks for solvency and therefore have limited expertise in making such determinations, compared to the Federal Reserve.

For example, this provision, as noted, could provide the CFPB—an agency responsible for consumer finance--with veto authority over 13(3) lending to non-banks, including broker-dealers or bank holding companies. This is because Dodd-Frank provides the CFPB with very broad jurisdictional authority, including over banks of any size and non-banks that are "engaged in conduct that poses risk to consumers with regard to the offering or provision of consumer financial products or services."[3] The definition of consumer financial products or services is left open to the CFPB's interpretation. The CFPB has no experience assessing the solvency of a non-bank.

Do we really want to provide "federal banking regulators" without any experience assessing the solvency of a large non-bank with this crucial authority in a crisis?

Timing of the Solvency Determination

Whether an institution is deemed solvent or insolvent will of course depend on how the Federal Reserve values the firm's assets, and whether the Federal Reserve uses pre- or post-fire sale valuations. Because the purpose of a lender of last resort is to prevent panic-driven fire sales of assets, the Federal Reserve should clearly value assets at pre-fire sale prices. The Federal Reserve, or other federal regulators, will be hesitant to use such valuations because the bill requires them to make a solvency determination as of

[3] Dodd Frank Act Section 1024

the time of the loan. For this reason and others, the Federal Reserve should have discretion regarding how to value assets when assessing solvency.

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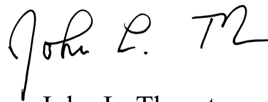
Thank you very much for your consideration of our views. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu), or the Executive Director of Research, John Gulliver (jgulliver@capmktsreg.org), at your convenience.

Respectfully submitted,

R. Glenn Hubbard
CO-CHAIR



John L. Thornton
CO-CHAIR

Hal S. Scott
DIRECTOR

Cc: The Honorable Jeb Hensarling
The Honorable Maxine Waters