Vitter, Warren Introduce Bailout Prevention Act

Legislation would limit Federal Reserve's lending authority to solvent companies during a financial crisis and close commodities loophole

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(Washington, D.C.) – U.S. Senators David Vitter (R-La.) and Elizabeth Warren (D-Mass.), members of the Senate Banking Committee, today introduced the Bailout Prevention Act, legislation to halt megabank bailouts during a financial crisis by responsibly limiting the Federal Reserve's lending authority. It would also close a loophole that creates risk-taking exemptions for megabanks Goldman Sachs and Morgan Stanley.

"It's no secret that Too Big to Fail is still around. If another financial crisis happened tomorrow – and that's still a real risk – nobody doubts that megabanks would be calling on the federal government to bail them out again," Vitter said. "Our legislation makes common sense reforms to the Fed's emergency lending powers to protect taxpayers the next time the megabanks lead us into another crisis."

"If big financial institutions know they can get cheap cash from the Fed in a crisis, they have less incentive to manage their risks carefully – which further increases the chance of another financial crisis," said Warren. "This bill would make our financial system safer and help level the playing field between the megabanks and their smaller competitors."

"The Bailout Prevention Act makes a great improvement in reestablishing Congressional oversight and approval of Federal Reserve bailouts of distressed banks. It restores the role of Congress by requiring a vote of both houses to appropriate public money. The legislation also halts any subsidies to banks and financial institutions by requiring that all such loans must carry an interest rate that is 5 percentage points above the relevant Treasury securities rate. This reform is highly desirable and long overdue," said Allan Meltzer, Professor of Political Economy at Tepper School of Business, Carnegie Mellon University.

"I, like many Americans, was shocked and dismayed at the ad hoc nature of Federal Reserve assistance programs during the financial crisis. Even in retrospect the Fed's interventions appear to lack consistency and accountability. I commend Senators Vitter and Warren for their efforts to ensure future Federal Reserve assistance is limited and that such assistance is not given to firms that are truly bankrupt," said Mark Calabria, Director of Financial Regulation Studies at the Cato Institute.

"Despite a directive in the Dodd-Frank Act to limit emergency lending assistance to healthy banks, the Federal Reserve's proposed procedures on emergency lending have been completely unsatisfactory and fail to place any real limits on the Fed's ability to engage in indiscriminate bailouts in the future. The Warren-Vitter bill takes a crucial step in preventing future bailouts by ensuring that future interventions by the Fed are truly limited to assisting solvent banks, and are provided at a 'penalty rate' that does not improperly subsidize the bank. The common-sense limits in this legislation align not only with the intent of the Dodd-Frank Act, but with traditional principles of central bank lending that go back centuries," said Marcus Stanley, Policy Director of Americans for Financial Reform

"This bill proposes a major improvement to the emergency powers of the Federal Reserve System. The ability of the Fed to react to systemic danger remains strong. But in this proposal, under certain circumstances, the Fed would need not to just explain its actions but also seek congressional approval. It makes sense to fast track

the approval process – so the Fed will get a fair hearing and Members of Congress must vote on whether to support what the Fed has done. We retain sufficient flexibility and fire-fighting capacity for the Fed, along with significantly more democratic accountability. This is the best way to safeguard our financial system while also ensuring that the Fed retains its political legitimacy," said Simon Johnson, Professor of Entrepreneurship at the MIT Sloan School of Management and Former Chief Economist of the International Monetary Fund

The Bailout Prevention Act would:

• Improve market discipline by responsibly limiting the Fed's emergency lending authority. During the 2008 financial crisis, the Fed used its emergency lending authority to provide long-term, low-cost loans to massive financial institutions. In Dodd-Frank, Congress directed the Fed to impose meaningful restrictions on its lending authority, but the Fed's proposed rule did little to limit its discretion. Last August, Senators Warren and Vitter – along with 13 of their colleagues – sent a letter to the Fed asking it to strengthen the restrictions in the final rule. But the Fed is yet to act, and Congress should not wait any longer to address this important issue.

Accordingly, the Bailout Prevention Act limits emergency lending by:

o Requiring lending programs to be truly broad-based: The Fed may only create facilities or programs that allow five or more institutions to participate in a significant manner.

o Restricting lending to only those institutions that are not insolvent: The Fed and all other banking regulators with jurisdiction over an institution that wishes to participate in a lending program must certify – based on analysis of assets and liabilities over the preceding four-month period – that the borrower is not insolvent, and must provide a contemporaneous written explanation of their analysis.

o Requiring lending to be provided at a penalty rate: The Fed may only offer loans that are 500 basis points or more above the cost of borrowing for the US Treasury for a similar loan term.

The Act explicitly permits the Fed to create a program that does not satisfy the broad-based requirement or the penalty rate requirement, but the Fed must obtain congressional approval for that program within 30 days under expedited procedures spelled out in the Act. If the Fed fails to obtain congressional approval within that time period, it must terminate the program.

• Reduce the risk of future bailouts and market manipulation by closing the loophole that allows two megabanks to engage in nearly unrestricted activities with physical commodities. The Bailout Prevention Act safeguards taxpayers from bailing out large financial institutions by repealing section 4(o) of the Bank Holding Company Act, a grandfather clause that allows two firms – Goldman Sachs and Morgan Stanley – to conduct a wide array of commodities-related activities that other financial holding companies cannot. Repealing section 4(o) will level the competitive playing field and reduce systemic risk.

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