

## Why The Bailout Prevention Act May Be Unwise

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On May 13, 2015, Sens. Elizabeth Warren, D-Mass., and David Vitter, R-La., introduced a bill in the United States Senate aimed at limiting the authority of the Board of Governors of the Federal Reserve System (the “Federal Reserve”) to provide emergency lending to financial institutions seeking credit during a liquidity crisis.[1] This proposed legislation, known as the Bailout Prevention Act, has already proven to be a controversial measure, with supporters and critics speaking out from both sides of the aisle and across the public and private sectors.

While the issues raised by the bill merit vigorous debate, they must also be assessed in a realistic context and not merely as the application of abstract policy views. In particular, it may be a grave mistake to assume that private sector alternatives to Federal Reserve emergency lending will be as available as they have been in the past.

Private institutions are now less willing to serve as alternative sources of support for companies facing significant and immediate financial emergencies. This reluctance to assist in future crises principally is due to staggering liabilities that financial institutions have faced as a result of agreeing to acquire troubled institutions (or their assets) during the financial crisis — liabilities primarily arising from government enforcement actions attacking acquirers for conduct of the acquired institution before the transaction was consummated.

Congress should think twice before further limiting the availability of government-based solutions for struggling institutions in the absence of concomitant measures to address the simple fact that most sources of private capital, for good reason, will be unwilling to participate in resolving a future idiosyncratic failure of a major financial institution or in ameliorating a potential future systemic crisis.

### **Federal Enforcement Actions Discourage Private Sector Assistance**

As indicated by its title, a principal purpose of the bill is to limit the situations in which financial institutions can rely on the Federal Reserve for “bailout” credit in times of financial crisis. However, the success of this approach to financial reform is in no small part dependent upon the availability of alternate nongovernment sources of capital for struggling institutions. For example, in the recent crisis,



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large financial institutions worked with the government to provide capital where necessary by acquiring failing financial institutions or their assets on short time frames and with extremely limited due diligence efforts.

It would be a mistake for proponents of the bill to assume that similar sources of private capital will be available to distressed institutions in future crises. The private sector's reluctance to become involved in recapitalization efforts is primarily the result of multiple federal enforcement actions taken against the acquirers of institutions that failed in the 2007-2008 crisis for the alleged bad acts of those failed institutions prior to their purchase. Examples of such enforcement actions taken by the U.S. Department of Justice and other federal agencies include:

- Settlement between DOJ and Bank of America to resolve claims principally arising from misconduct at Countrywide and Merrill Lynch, which Bank of America acquired during the financial crisis.[2]
- Settlement between the Federal Housing Finance Agency and Bank of America to resolve claims principally arising from securities law violations at Countrywide and Merrill Lynch.[3]
- Settlement between DOJ and JPMorgan to resolve claims principally arising from misconduct at Bear Stearns and Washington Mutual, which JPMorgan acquired during the financial crisis.[4]
- Consent order between the Office of the Comptroller of the Currency and Wells Fargo assessing civil money penalty based on violations of law related to derivatives transactions at Wachovia, which Wells Fargo acquired during the financial crisis.[5]
- Deferred prosecution agreement between DOJ and Wells Fargo to resolve charges that Wachovia willfully failed to establish an anti-money laundering program.[6]

These matters alone resulted in payments of approximately \$40 billion, and many other examples can be cited. Given the potential for substantial liability arising from federal enforcement actions post-acquisition, major banks or other private financial institutions can no longer be expected to step forward in a future crisis as they have before without obtaining reliable liability protection. In effect, the federal government's enforcement policy of punishing institutions that assist in a time of emergency for misconduct they had no hand in has vastly diminished, if not practically removed, the most commonly used private-market alternative to a federal bailout.

### **Alternative to Private Assistance: The Federal Reserve's Emergency Lending Authority**

Currently, the Federal Reserve's lending authority offers an alternative to reliance on the private sector for institutions seeking emergency credit in a time of economic difficulty. While the Dodd-Frank Act limited this authority in some respects,[7] the Federal Reserve remains able to offer discounted notes, drafts and bills of exchange to financial institutions that are "unable to secure adequate credit accommodations from other banking institutions." [8]

For example, in 2007-08, as the financial crisis rapidly unfolded, the Federal Reserve relied on its lending authority to assist large, troubled financial institutions, including Bear Stearns and AIG.[9] During this time frame, the Federal Reserve also provided credit to other large institutions through nonpublic emergency lending programs.[10] The Federal Reserve's justification for exercising its lending authority

was the avoidance of the potentially catastrophic failures of systemically important companies, which it believed would have a broad negative economic impact.[11]

### **Bailout Prevention Act**

The bill is an attempt to limit the Federal Reserve's emergency lending authority beyond the measures taken in the Dodd-Frank Act and is based on a belief that additional reform is necessary to prevent financial institutions from relying on the availability credit from the federal government.[12] The proposed legislation contains provisions that would require the Federal Reserve to comply with the following requirements:

- Ensure that at least five institutions qualify for a given lending program. To qualify as a permissible "broad-based" program, at least five companies must be eligible to participate in the program in a significant manner.[13]
- Publicly certify that participating institutions are solvent. For all institutions participating in a Federal Reserve lending program, the Federal Reserve and any applicable prudential regulator(s) must certify that the company is solvent. Once the certification has been made, the Federal Reserve or regulator "shall issue a contemporaneous public statement providing a detailed explanation of the certification decision." [14]
- Provide credit at a penalty rate. The penalty rate offered to borrower institutions must be at least 500 basis points over the U.S. Treasury rate for a loan with similar terms.[15]
- Obtain congressional approval for noncompliant lending programs. To the extent that the Federal Reserve creates a program that does not comply with the penalty and/or broad-based eligibility requirements, the agency must submit a report on the program to Congress and seek a congressional joint resolution to permit the program to continue.[16]

### **Limiting Options During a Crisis?**

The bill's proponents claim that these reforms are necessary to prevent financial institutions from assuming that the Federal Reserve automatically will make cheap credit available in a crisis.[17] They also applaud the idea that the Federal Reserve would be subject to increased accountability from Congress when exercising its lending authority.[18]

Certainly the practical effect of the bill if enacted would be to discourage institutions in a liquidity crunch from seeking emergency credit from the Federal Reserve, even if such credit were available and met the requirements of the proposed legislation. Whether in an individual or broad-based manner, the assistance regime the bill would establish almost assuredly would make exercise of the authority a practical impossibility. Borrowing institutions would be irreparably stigmatized by (1) the publicly disclosed solvency determinations, (2) the admission of the need to borrow at penalty rates of interest due to lack of alternatives, and (3) the marketplace knowledge that government credit is offered only on a short-term basis, the continuation of which is dependent on the political process.

Thus, should the bill succeed as currently written, the once-available option of seeking discounted, confidential credit from the Federal Reserve would effectively no longer exist. Likewise, for the reasons stated above, high-cost publicly disclosed credit under the bill's regime may be a real-world

impossibility. Consequently, despite the federal government's recognition that "recapitalization is the preferred method to resolve open troubled financial institutions,"[19] the only options practically available to institutions facing a future financial crisis in light of the unavailability of capital from the Federal Reserve and private sector may be through either traditional bankruptcy proceedings or the Dodd-Frank Act's orderly liquidation process.[20] However, even this latter option also may have been impaired by the enforcement environment, as orderly liquidation relies on private sector participants to be willing to purchase the assets of failed corporations.

## Looking Ahead

The Dodd Frank Act sought to end or limit "too big to fail" in a number of ways, including by removing some of the Federal Reserve's tools for addressing impending bank failures — tools that, in fact, were instrumental in the government's response to the financial crisis of 2007-2008. The proposed Bailout Prevention Act seeks to further reduce the utility and attractiveness of these tools. The wisdom of this course of action should be assessed in a realistic, post-crisis context, particularly in light of private sector reluctance to assist in times of emergency by offering to purchase companies and/or assets on a short time frame having performed limited due diligence. Congress and other policymakers would be wise to account for this important factor when considering the Bailout Prevention Act.

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[1] Section 2, Bailout Prevention Act of 2015, available at [http://www.warren.senate.gov/files/documents/Bailout\\_Prevention\\_Act\\_of\\_2015.pdf](http://www.warren.senate.gov/files/documents/Bailout_Prevention_Act_of_2015.pdf).

[2] Settlement Agreement (Aug. 21, 2014)

[3] Settlement Agreement (Mar. 26, 2014).

[4] Settlement Agreement (Nov. 19, 2013)

[5] Consent Order, AA-EC-11-97 (Dec. 7, 2011).

[6] Deferred Prosecution Agreement, Case No. 10-20165-CR-LENARD (Mar. 16, 2010).

[7] 12 U.S.C. § 343 (mandating that the Federal Reserve implement procedures to ensure that discounted credit is only offered through broad-based lending programs aimed at providing liquidity to the financial system generally, as opposed to directly aiding a failing or insolvent financial company, and requiring that the Federal Reserve report, either publicly or confidentially, the details of its emergency lending programs to a congressional committee). The Federal Reserve has published its proposed rules,

which have not yet been finalized. “Extensions of Credit by Federal Reserve Banks,” 79 Fed. Reg. 615 (Jan. 6, 2014).

[8] Federal Reserve Act § 13(3); 12 U.S.C. § 343 (2006).

[9] Speech of Federal Reserve Chairman Ben S. Bernanke at the Greater Austin Chamber of Commerce (Dec. 1, 2008) (“To avoid the failure of Bear Stearns, we facilitated the purchase of Bear Stearns by JPMorgan Chase by means of a Federal Reserve loan, backed by assets of Bear Stearns and a partial guarantee from JPMorgan. In the case of AIG, we judged that emergency Federal Reserve credit would be adequately secured by AIG’s assets.”), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>.

[10] Bob Ivry, et al., “Secret Fed Loans Gave Banks \$13 Billion Undisclosed to Congress,” Bloomberg News (Nov. 28, 2011), available at <http://www.bloomberg.com/news/articles/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income>.

[11] Speech of Ben S. Bernanke, *supra* n. 3 (“In each case, we judged that the failure of the institution in question would have posed substantial risks to the financial system and thus to the economy.”)

[12] Press Release, “Legislation would limit Federal Reserve’s lending authority to solvent companies during a financial crisis and close commodities” (May 13, 2015), available at [http://www.warren.senate.gov/?p=press\\_release&id=818](http://www.warren.senate.gov/?p=press_release&id=818).

[13] Section 2, Bailout Prevention Act of 2015, available at [http://www.warren.senate.gov/files/documents/Bailout\\_Prevention\\_Act\\_of\\_2015.pdf](http://www.warren.senate.gov/files/documents/Bailout_Prevention_Act_of_2015.pdf).

[14] *Id.* (emphasis added).

[15] *Id.*, Section 3.

[16] *Id.*

[17] Press Release, *supra* n. 12.

[18] *Id.*

[19] FDIC, “Failing Bank Acquisitions” (last updated May 8, 2015), available at <https://www.fdic.gov/buying/FranchiseMarketing/>.

[20] 12 U.S.C. § 5384.

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