RSC Republican Study Committee

Financial Services Working Group

Congressman Scott Garrett (R-NJ), Chairman | Congressman Tom Price (R-GA), RSC Chairman

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"Systemic" Risk and Bailout Authority Bill

As this issue is going to be the main issue facing the Financial Services Committee over the next few weeks, I have provided a thorough outline of the bill, so you can see just how disastrous this will be if enacted. In general, this bill provides for: the creation of a systemic risk council; a list of systemically significant firms to be subjected to heightened prudential standards; a merger of the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC); a reform of industrial loan companies (ILCs) and other non-bank banks; a new regulatory framework for payment, clearing, and settlement facilities; a new risk retention standard for all asset-backed securities; a permanent bailout authority; and a reform of the Federal Reserve's 13(3) authority.

Summary of Subtitle A (Systemic Risk Council)
Subtitle A establishes an eleven-member Financial Services Oversight Council (the Council) to monitor the financial services marketplace to identify potential threats, including individual companies or activities that might threaten the stability of the financial system or pose systemic risk. The Council will advise Congress on regulation and issue formal recommendations to individual prudential regulators to mitigate systemic risk.

Summary of Subtitle B (Systemically Significant Financial Institutions)
This subtitle permits the Financial Services Oversight Council to identify financial companies to be subjected to heightened regulatory requirements if their size or activities pose a risk to the financial system. This subtitle also requires the Federal Reserve Board to issue heightened prudential standards for these companies, including risk-based capital requirements; leverage limits; liquidity requirements; concentration requirements; prompt corrective action requirements; resolution plan requirements; and risk management requirements. Section 1109 provides that the FDIC "may extend credit to or guarantee obligations of solvent" financial institutions or other firms predominantly engaged in financial activities. It is not clear from the legislative text whether section 1109 is intended to authorize "open-bank" assistance to failing institutions, is intended to create a lender-of-last-resort facility similar to the Federal Reserve's discount window, or is intended to replace the Federal Reserve's authority to provide funding under "unusual and exigent circumstances." Funding for this facility would come from financial firms with total assets above $10 billion (and possibly the taxpayer).

Summary of Subtitle C (Merger of the Office of Thrift Supervision (OTS) into the Office of the Comptroller of the Currency (OCC))
The OTS is merged into the OCC and the thrift charter is maintained. A new Deputy Comptroller is created to regulate thrifts. Thrift holding companies would be regulated in a similar fashion to bank holding companies, by the Federal Reserve. State-chartered thrifts would be regulated at the Federal level by the FDIC.

Summary of Subtitle D (ILC and other special purpose bank regulatory reform)
The subject of not a single Committee hearing in this Congress, this subtitle makes numerous changes to the Bank Holding Company Act. First, section 1301 alters the treatment of credit card banks, industrial loan companies, and identified financial companies and subjects them to higher prudential standards through the creation of a Section Six Holding Company ("SSHC"). Section 1314 requires the Federal Reserve to consider the stability of the financial system in its process for approving bank holding company mergers, acquisitions, or consolidations. This section also requires that financial holding companies (a form of bank holding company that has greater powers) to apply for Federal Reserve approval for acquisitions in excess of $25 billion; only notice is currently required. Section 1315 eliminates the investment bank holding company framework in which the SEC was a consolidated regulator. Section 1316 assesses examinations fees on bank holding companies with more than $10 billion in assets for all bank holding company examinations.

Summary of Subtitle E (Payment Clearing and Settlement Supervision)
The subject of not a single Committee hearing this Congress, this subtitle provides the Federal Reserve with authority to regulate certain market utilities and payment, clearing, and settlement systems. The Council shall, on its own initiative or at the request of the Federal Reserve, consider whether to identify a financial market utility or a payment, clearing, or settlement activity as systemically important or likely to become so. If so identified, the Federal Reserve will prescribe risk management standards governing the operations of those market utilities and institutions engaged in those payment, clearing, or settlement activities. The Federal Reserve is given authority to demand changes in operations, conduct examinations, bring enforcement actions in cooperation with the primary regulator, and demand reports and data if the primary regulator fails to do so.

Summary of Subtitle F (Risk-retention for asset-backed securities)
This title would require creditors and securitizers to hold up to 10 percent of the risk of loans that they sell off for securitization. It would apply to commercial as well as residential loans. The Federal banking agencies and the Securities and Exchange Commission would have the authority to increase or decrease the amount of risk retained and to roll back the bill's prohibition on hedging that retained risk.

Summary of Subtitle G (Permanent Bailout Authority)
This subtitle confers upon the FDIC the authority to take over and either wind down or act as a conservator for large, complex financial institutions that are in default or in danger of default, and whose failure would threaten the financial system, as determined by the Secretary of the Treasury upon written recommendation by the Federal Reserve Board and the appropriate regulatory agency. Section 1604(c) at pages 254-255 permits the FDIC to take the following actions:

- make loans to a failing firm;
- purchase the assets of a failing firm;
- guarantee the obligations of a failing firm to its creditors;
- acquire common or preferred shares in the failing firm;
- take a security interest in the assets of the failing firm; and/or
- sell or transfer assets that the FDIC has acquired from the failing firm.

Summary of Subtitle H (Reform of Federal Reserve's 13(3) authority)
This subtitle would reform the Federal Reserve's authority under section 13(3) of the Federal Reserve Act to provide assistance to firms under "unusual and exigent circumstances." Similar to a provision in the Republican regulatory reform plan (H.R. 3310), the Chairman's bill would require that any assistance provided under this authority be distributed broadly and not to any individual firm. The invocation of this authority would require the concurrence of the Secretary of the Treasury.

For more information contact Chris Russell at 5-4465 or Brad Watson at 6-9719

The summary provided on this legislation courtesy of Congressman Spencer Bachus

What They Are Saying: Administration's Proposal Places Taxpayers On The Hook For Bailouts, Creates New Fannies And Freddies

(courtesy of the Financial Services Committee)

Democrats and Their Outside Allies:

Rep. Ed Perlmutter (D-CO): "…There is going to be a point where institutions we find insolvent or are systemically risky, and we take them down, we liquidate them, and **that's going to require federal funds**."

Rep. Brad Sherman (D-CA): "Now, the executive branch is empowered -- look at this from a constitutional perspective -- the executive branch is empowered to write the new tax law, so how much money is paid by a medium-sized financial institution in your district, whether it's $100,000 or $100 million, is totally at the whim of the executive branch and could go up or down by that factor, depending upon what the executive branch wants to do."

Rep. Paul Kanjorski (D-PA): "But what we're doing is allowing a board or council or organization to make determinations in a time of extremity -- no question about that -- that some of us may not agree that that authority rests in those entities or was -- or we even had the authority in this Congress to give that type of authority."

"I'm not a man that fears this administration or you. But I do fear the accumulation of power exercised by someone in the future that can be extraordinary."

Richard Trumka, President of the AFL-CIO: "We're also troubled by the provision in the discussion draft that would allow the federal government to provide taxpayer funds to failing banks and then bill other non-failing banks for the cost."

Financial Regulators:

FDIC Chairman Sheila Bair: "We would suggest changes that take away the power to appoint a conservator for a troubled firm, and eliminate provisions that could be interpreted to allow firm-specific support for open institutions. Ending too big to fail and the moral hazard it brings requires meaningful restraint from all types of government assistance, whatever its source. Any support should be subject, at a minimum, to the safeguards existing today in the systemic risk procedures."

"There is a suggestion of a conservatorship for failing institutions. We would think the process should be a receivership with the goal to be a prompt wind-down of the firm, breaking it up and returning it to the private sector."

Newspapers And Journals:

NYT Editorial: "The proposal is also weak on certain components of systemic risk management. It proposes to keep secret the name of institutions whose failures would be systemically dangerous, ostensibly to prevent them from enjoying lower financing costs and other advantages that come with implicit government backing. That would be silly if it wasn't so disturbing. Systemic regulation, done right, should not confer advantages."

"Its premise is that too-big-to fail institutions are an immutable fact of life. They are not.

"The proposal would concentrate much of the new power with the Federal Reserve, which is problematic for several reasons. Not only did the Fed fail in its responsibility to identify and stop several of the threats that led to the crisis, it has further damaged its credibility by failing to fully account for how and why those catastrophic lapses occurred. Before Congress grants new powers to the Fed, it needs a full accounting."

Washington Post Editorial: "Draft legislation before the House Financial Services Committee, which the Obama administration supports, rests on the assumption that too-big-to-fail is not only a reality but a reality that should be acknowledged in law. It seeks, in effect, to shape market perceptions by designating certain institutions, including not only banks but major players in the "shadow banking" sector, as eligible for government-led winding-down in a crisis."

Financial Times Editorial: "The clear winner [in the Frank bill] is a Federal Reserve with new powers: to foist higher capital standards on a company, halt its mergers or acquisitions; tell it to shed lines of business; or force it into bankruptcy. This is controversial: the Fed, already under heavy criticism for being unaccountable, would act at its sole discretion once the council (where other agencies would be represented) deemed an institution systemically important. The Fed is best placed to assess financial stability risks, but this approach is dangerous. Its risks an intellectual mono-culture – which the council looks too weak to remedy. What is more, unless the Fed takes special care to be open and transparent, it will become a football, punted around Congress for every decision about individual institutions."

Noam Scheiber, American Prospect: "But here's my concern: Almost by definition, you're going to be in the middle of a financial crisis (or at least a period of severe stress) if a megabank is on the verge of collapse. At a moment like that—think back to last fall—will Treasury and the Fed have the courage to only pay bondholders 60 cents on the dollar? After all, there's a very real risk they'll surprise the credit markets with their stinginess, which could lead bond investors to stop lending money and seize up the whole financial system—the very thing the federal government wanted to avoid.

And even if the feds did have the courage to give bondholders the hair cut they deserve, are the bondholders going to believe that ex ante—that is, at the time they're loaning money to these TBTF banks? If they don't believe it, then they're going to lend cheaply, which is going to help the TBTFs take outsized risks, which brings us right back to where we were. Now maybe all it takes is putting one megabank through receivership to show that the government is serious. But the soonest that would probably happen is several years from now (that is, during the next financial crisis; here's hoping it doesn't come sooner), which is a lot of time for TBTF banks to dine out on cheap credit and place ill-advised bets." (10/28/2009)

Tim Fernholz, The American Prospect: "The danger in the Obama administration's plan is that regulators, who are often too close to the banks, may not have the courage required to seize a failing institution -- it might always be easier to fund the bankers through another bailout. One simple solution to this problem would be to eliminate regulators' ability to provide capital for banks or guarantee their liabilities, making liquidation the only option. But that cuts down on regulatory flexibility and is strongly opposed in the Treasury Department." **(10/28/2009)**