The Clearing House[SM]
At the Center of Banking Since 1853

TCH WORKING PAPER | JANUARY 2014

Working Paper Series on the Value of Large Banks

Working Paper No. 2: Access to Deposit Insurance and Lender-of-Last-Resort Liquidity

2 I. INTRODUCTION

4 II. ACCESS TO DEPOSIT INSURANCE AND LENDER-OF-LAST-RESORT LIQUIDITY: EXECUTIVE SUMMARY

6 III. ACCESS TO DEPOSIT INSURANCE AND LENDER-OF-LAST-RESORT LIQUIDITY DOES NOT PROVIDE ANY UNFAIR, DISPROPORTIONATE, OR INAPPROPRIATE ECONOMIC BENEFITS TO LARGE BANKS

A. The discount window and deposit insurance have been lynchpins of banking system stability for nearly a century, and are designed to protect our system from destabilizing runs and financial panics, not to provide special benefits to banks of any size, large or small ... 7

B. Because access to both deposit insurance and discount window lending is *priced*, neither is a "gift" to banks ... 9

C. The discount window and deposit insurance are equally accessible to banks of all sizes on exactly the same terms—though larger banks are disproportionately taxed under the FDIC's deposit insurance assessment scheme ... 9

D. Deposit insurance benefits the largest banks less, given that they are disproportionately funded through means other than FDIC-insured deposits ... 10

E. The benefits that individual banks of all sizes derive from access to liquidity and deposit insurance are limited and circumscribed in law and practice ... 10

12 IV. THE FORMS OF GOVERNMENT FINANCIAL STABILITY SUPPORT THAT MAY BE PROVIDED TO THE BANKING SYSTEM UNDER CURRENT LAW DO NOT PROVIDE ANY UNFAIR, DISPROPORTIONATE, OR INAPPROPRIATE ECONOMIC BENEFITS TO LARGE BANKS

A. The ability to provide extraordinary, temporary support to stabilize the financial system during a crisis has long been a core feature of the U.S. financial system ... 13

B. To assess whether government policy in this area benefits the largest banks, a historical analysis of crisis-era actions reveals little, given the widespread legal and regulatory changes that have been enacted post-crisis ... 14

C. Extraordinary support designed to benefit any individual institution is now prohibited by law ... 14

D. Implementation of the Dodd-Frank Act and Basel III will substantially reduce the likelihood that even broad-based financial stability support may be necessary in a future crisis ... 15

E. Looking backward, many of the government financial stability facilities established during the crisis were designed to assist markets, not individual firms, and were equally accessible to banks regardless of size. To the extent that the largest banks disproportionately accessed these facilities, this was because these banks played unique market roles—only they could act as intermediaries to ensure that government liquidity reached financial markets and businesses and households that rely on markets directly or indirectly to meet their needs for credit ... 18

F. Looking backward, many of the emergency government facilities established during the crisis were disproportionately accessed by smaller banks, demonstrating that "uptake" varied by program and purpose ... 20

21 V. CONCLUSION

The Clearing House | 450 West 33rd Street | New York, NY 10001 | 212.613.0100 | theclearinghouse.org

I. Introduction

Notwithstanding ongoing implementation of recent financial regulatory reforms, some policymakers are once again questioning whether large banks play an essential role in the U.S. financial system or whether they exist in their current form in part because of competitive distortions resulting from government policies. Critics of large banks argue that there is an ongoing "too-big-to-fail" ("TBTF") problem, and contend that explicit or implicit government policies confer on large banks an unfair competitive advantage relative to smaller institutions or an unfair economic advantage more generally.[1] Some suggest that a competitive advantage stems from a lingering market perception that large banks are likely to be "bailed out" by the U.S. government should they become insolvent, despite the express statutory prohibition on government bail-outs introduced by the Dodd-Frank Act.[2] Other critics assert that large banks benefit disproportionately from federal deposit insurance and liquidity programs, or from the various types of extraordinary support provided by the U.S. government in response to the historic challenge facing the economy in 2008-2009.[3] Arguments along these lines have been invoked in support of aggressive proposals to "break up" large banks on account of their size, either directly or through indirect measures.

As a result, a renewed debate and new empirical research is underway on the role, activities, and function of large banks. Among the most prominent of these research efforts is the study to be conducted by the Government Accountability Office (GAO) to measure "the economic benefits that [large banks] receive as a result of actual or perceived government support."[4] In requesting this study, Senators Sherrod Brown (D-OH) and David Vitter (R-LA) expressed concern that an "implicit—and in some cases explicit—taxpayer-funded safety net provides subsidies to these large institutions" and that the recent financial reforms "may not be sufficient to eliminate government support for the largest bank holding companies."[5] In addition to its plans to issue a full report, which is expected in Spring 2014, the GAO released an interim report in November 2013 studying access to federal liquidity, deposit insurance, and emergency facilities established during the crisis.[6]

This second paper in The Clearing House's *Working Paper Series on the Value of Large Banks* examines access to deposit insurance and lender-of-last-resort liquidity (*e.g.*, the Federal Reserve's discount window) and analyzes whether the support that may be provided to the banking system under current law provides any unfair, disproportionate, or inappropriate economic benefits to large banks. The purpose of the *Working Paper Series* is to evaluate and address each key issue that must be considered in assessing whether large banks truly enjoy some "too-big-to-fail" ("TBTF") funding advantage and to correct any mischaracterizations about large banks. The first working paper in the series provided a necessary context to the policy debate by identifying the right questions for policymakers to consider.[7] This second working paper discusses whether large banks may experience any unfair advantage due to traditional or extraordinary government support to the banking system allowed under current law.

As we describe below, access to deposit insurance and lender-of-last-resort liquidity are the traditional lynchpins of banking system stability. Each of these programs benefits all depository institutions in certain ways, and they are equally accessible to all banks on the same terms. These programs confer no greater or special benefits on large banks relative to their smaller counterparts. Moreover, access to both deposit insurance and lender-of-last-resort liquidity is priced, and large banks in fact

1 *See* The Clearing House, *Working Paper No. 1: Identifying the Right Question,* Working Paper Series on the Value of Large Banks (Nov. 2013), *available at* https://www.theclearinghouse.org/~/media/Files/Association%20Documents/20131107%20TCH%20Working%20Paper%20Series%20on%20Value%20of%20Large%20Banks.pdf.

2 *See* 12 U.S.C. § 343 (prohibiting the Federal Reserve from using its authority under Section 13(3) of the Federal Reserve Act to assist a "single, specific company" in avoiding insolvency proceedings); 12 U.S.C. §§ 5384, 5386, and 5394 (imposing all financial institution losses under Title II of the Dodd-Frank Act on shareholders and creditors and flatly prohibiting taxpayer payments for such losses).

3 *See generally* Too Big Has Failed: Learning from Midwest Banks and Credit Unions, Hearing before H. Subcomm. on Oversight and Investigations (Aug. 23, 2010) (statement of Thomas M. Hoenig, President, Fed. Res. Bank of Kansas City), *available at* http://financialservices.house.gov/media/file/hearings/111/hoenig8.23.10.pdf.; Examining the GAO Report on Government Support for Bank Holding Companies, Hearing before S. Subcomm. on Financial Institutions and Consumer Protection (Jan. 8, 2014) (statement of Sen. Sherrod Brown, Chairman, S. Subcomm. on Financial Institutions and Consumer Protection), *available at* http://www.brown.senate.gov/newsroom/press/release/sen-brown-chairs-hearing-examining-government-subsidies-in-bailout-of-megabank-institutions.

4 Letter from Sen. Sherrod Brown & Sen. David Vitter to Gene L. Dodaro, Comptroller General of the U.S., at 1 (Jan. 1, 2013), *available at* http://www.fsround.org/fsr/dodd_frank/pdfs/Vitter-Brown-GAO-Study-Request-on-Megabanks.pdf.

5 *Id*.

6 *See* U.S. Gov't Accountability Office, GAO-14-18, Government Support For Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented 13 (2013).

7 *See* The Clearing House, *Working Paper No. 1: Identifying the Right Question,* Working Paper Series on the Value of Large Banks (Nov. 2013), *available at* https://www.theclearinghouse.org/~/media/Files/Association%20Documents/20131107%20TCH%20Working%20Paper%20Series%20on%20Value%20of%20Large%20Banks.pdf.

bear a disproportionately high burden in funding deposit insurance under the new assessment methodology imposed by the Dodd-Frank Act. This is particularly noteworthy since deposit insurance protections are relatively less significant to large banks, which rely far less on insured deposits as a percentage of their overall funding than smaller institutions.

As we explain, in addition, the limited forms of lender-of-last-resort emergency liquidity that the government can use to assure financial stability (*i.e.*, only provided to the financial system in times of severe crisis) do not provide any special or disproportionate economic benefit to large banks. Current reforms have drastically altered the landscape in this area—strictly limiting the terms and availability of extraordinary financial stability support the government may provide in times of crisis. Extraordinary support designed to benefit an individual institution is now prohibited by law, and implementation of the Dodd-Frank Act and Basel III will dramatically reduce the practical likelihood that even "broad-based" financial stability support for the banking system will be necessary.

Given the widespread legal and regulatory changes that have been enacted post-crisis, a historical analysis of actions taken during the crisis is of little use in assessing whether government policy benefits large banks. Nevertheless, this working paper, which presents a balanced retrospective analysis, demonstrates that large banks did not enjoy an unfair benefit during the crisis. Many of the emergency government facilities were designed to assist markets in which large banks played unique market roles, accounting (along with their size) for their greater use of certain facilities. Other facilities benefitted smaller institutions, demonstrating that "uptake" varied by program and purpose. In sum, large banks have not—and will not in the future—enjoy any disproportionate economic benefit from extraordinary government support. ■

The Clearing House[SM]
At the Center of Banking Since 1853

Access to Deposit Insurance and Lender-of-Last-Resort Liquidity: Executive Summary

II. Access to Deposit Insurance and Lender-of-Last-Resort Liquidity: Executive Summary

- Access to liquidity and deposit insurance are fundamental components of the banking system that are equally accessible to all banks regardless of size. Large banks do not receive any meaningful economic advantage from these programs, and in fact, they pay significantly more for deposit insurance under the new post-crisis assessment methodology despite the fact that they rely much less on insured deposits for their overall funding than their smaller counterparts.

- Under current law, the types of extraordinary support the government may provide to the banking industry during times of crisis will not—and cannot—confer a disproportionate economic advantage on large banks. Bail-outs of individual institutions are prohibited by law, and other post-crisis regulatory reforms further reduce the likelihood that *any* government support will be needed in a future crisis.

- A historical analysis of crisis-era actions to assess whether government policy benefits large banks reveals little given the widespread legal and regulatory changes that have been enacted post-crisis. Many of the extraordinary support programs employed during the crisis are now prohibited by law, and regulatory changes have substantially reduced the likelihood that support might be needed in the future.

- Nevertheless, even a retrospective analysis fails to show that large banks unfairly benefited from the emergency facilities established during the crisis. Facilities that supported particular markets in which large banks engage may have been accessed principally by large banks, but other facilities also supported smaller banks and their market roles as well. ■

The Clearing House℠
At the Center of Banking Since 1853

Access to Deposit Insurance and Lender-of-Last-Resort Liquidity Does Not Provide Any Unfair, Disproportionate, or Inappropriate Economic Benefits to Large Banks

III. Access to Deposit Insurance and Lender-of-Last-Resort Liquidity Does Not Provide Any Unfair, Disproportionate, or Inappropriate Economic Benefits to Large Banks.

The stability of the U.S. banking system in large part depends upon several long-standing governmental authorities established during the first half of the 20th century. The core authorities—namely access to the Federal Reserve's discount window and the provision of deposit insurance—represent the long-recognized fact that the savings and lending functions of banks sustain nearly all commercial activity and economic growth, and that banks must retain the confidence of their communities and customers to carry out these functions. Both liquidity and deposit insurance function to prevent the adverse systemic consequences of "runs" on individual depository institutions as well as the erosion of overall confidence in the U.S. banking system.

These authorities, while necessary, are only a small part of the foundation on which the stability of the U.S. banking system rests. Every bank, and nearly every other financial company controlling an insured depository institution ("IDI"), is subject to a robust regulatory and supervisory regime, made even stronger through recent developments such as the Dodd-Frank Act and Basel III.[8] In addition, transactions between any bank with access to deposit insurance and an affiliate or subsidiary is subject to strict quantitative and qualitative requirements under Sections 23A and 23B of the Federal Reserve Act. Subsidiaries and affiliates are also subject to consolidated capital requirements. Furthermore, all IDI holding companies subject to consolidated supervision have historically been looked to, and are now explicitly required by law, to be a "source of strength" to their depository institution subsidiaries.[9] Such measures help ensure that individual banks and the banking system remain resilient, lessening the need for dependence on access to liquidity and deposit insurance by all U.S. banks—large and small.

Consequently, neither large banks' access to the discount window nor their affiliation with IDI subsidiaries provides them with any meaningful unfair economic benefit or competitive advantage over smaller banks. Furthermore, the fact that large banks might utilize these programs more than others is no proof of competitive or undue economic advantage since these programs are equally accessible to all banks on the same terms. Indeed, deposit insurance often places a disproportionately greater burden on large banks. And the size, competition, and financial stability factors in banking applications and notices make it significantly more difficult for large banks—relative to their smaller counterparts—to expand the scale and scope of their activities. Moreover, the evidence suggests that large banks are least likely to benefit, particularly as insured deposits comprise a far lesser percentage of their liabilities.

8 Certain holding companies of depository institutions, including industrial loan corporations, limited-purpose credit card banks, municipal deposit banks, and trust banks, are not subject consolidated supervision and regulation. *See* 12 U.S.C. §1841(c)(2)(F); 12 U.S.C. §1841(c)(2)(H); 12 U.S.C. §1841(a)(5)(E); 12 U.S.C. §1841(c)(2)(D).

9 *See* Dodd-Frank Act § 616(d).

A. THE DISCOUNT WINDOW AND DEPOSIT INSURANCE HAVE BEEN LYNCHPINS OF BANKING SYSTEM STABILITY FOR NEARLY A CENTURY, AND ARE DESIGNED TO PROTECT OUR SYSTEM FROM DESTABILIZING RUNS AND FINANCIAL PANICS, NOT TO PROVIDE SPECIAL BENEFITS TO BANKS OF ANY SIZE, LARGE OR SMALL.

Banks engage in the business of maturity transformation, taking short-term deposits and lending them over the longer term.[10] This function is critical to the economy, enabling businesses to grow and consumers to finance their longer-term expenditures for life staples such as homes and cars.[11] However, as a result of their role in

10 *See* Bipartisan Policy Center, *Too Big to Fail: The Path to a Solution* (May 2013) at 36, *available at* http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf ("Maturity transformation is the process by which banks and other financial institutions fund themselves with short-term credit, including demand deposits and other money-like instruments such as repos, asset-backed commercial paper, interest-rate swaps, foreign-currency swaps, and other operating liabilities. They use these funds to make long-term loans or invest in asset-backed and other debt securities and other assets that are or can become quickly illiquid.").

11 *See id.* at 37 ("Maturity transformation is socially beneficial because it intermediates between savers and investors, giving savers the option to invest their cash in money-like or other short-term claims against financial institutions while giving investors the ability to obtain longer-term loans or issuing longer-term asset-backed or other debt securities. The process also provides households, businesses and institutional investors with claims against financial institutions that can be used as money to make payments and securities deliveries more efficiently by electronic transfer rather than by physical deliveries of cash or physical securities. Indeed, the Federal Reserve has from time to time included demand deposits, time deposits, checks, repos, and other similar claims against financial institutions in various components of the money supply. Without maturity transformation, our modern economy would grind to a halt.").

maturity transformation, banks are inherently susceptible to destabilizing losses if they must sell longer-term assets, such as business loans, when short-term depositors choose to "run" because of a loss of confidence in individual institutions or the banking system as a whole.[12]

To avoid this result, central banks have long acted as a lender-of-last-resort by providing banks with an emergency source of fully-secured liquidity, allowing banks to borrow cash fully secured by assets rather than selling them at fire sale prices in markets that tend to be illiquid, especially during periods of financial stress. In this way, lender-of-last-resort activities "relieve liquidity strains for individual depository institutions and for the banking system as a whole by providing a source of funding in a time of need."[13] While the provision of liquidity is important to individual institutions, it is critical to maintaining functional markets in illiquid assets commonly held by banks. Without lender-of-last-resort liquidity, banks would not renew loans as they matured, forcing borrowers to engage in fire sales of their assets. Fire sales of those assets can cause their prices to fall, often dramatically, and impede economic recovery. Margin requirements and general market uncertainty can cause financial problems to spread to other institutions that are not experiencing liquidity problems.[14] As a consequence, access to liquidity and deposit insurance is crucial to the smooth functioning of the financial system.

1. The Federal Reserve's Discount Window

Fundamental to nearly every central bank in the developed world is the capacity for "discounting notes" presented by banks in exchange for legal tender. As commentators have noted, discount window lending is essential to secure the banking system and the economy at large when circumstances arise, "such as bank runs and panics, when even fundamentally sound banks cannot raise liquidity on short notice."[15]

The Federal Reserve's discount window lending authority has been a key feature of the U.S. banking system for a century, and indeed the primary purpose of the Federal Reserve's creation was to stop runs on solvent banks. In practice, the discount window serves as a means by which IDIs may pledge their high quality assets in return for an interest-bearing loan from a regional Federal Reserve Bank.

The vast majority of banks' liquidity needs are met by private sector sources, for example the interbank lending market. What makes the discount window unique—and at certain points vital to the stability of the U.S. banking system—is that it remains open during times of acute stress, when private sector credit is dramatically reduced. Government facilities are crucial in times of liquidity runs particularly because private investors in a time of crisis are not as well-equipped as central banks to assess whether a bank is actually solvent even though it needs liquidity. In this way, the Federal Reserve functions as the "lender of last resort" to IDIs.[16] In so doing, the Federal Reserve, through the discount window, helps to relieve liquidity strains for individual depository institutions, for the banking system as a whole, and for the economy as a whole by providing a reliable backup source of funding for solvent institutions.[17] It "also helps ensure the basic stability of the payment system more generally by supplying liquidity during times of systemic stress."[18] In short, the very presence of the always-open discount window and the knowledge that the Federal Reserve stands ready to supply liquidity to solvent IDIs (large and small) in periods of market distress bolsters confidence in the U.S. banking system and the stability of the broader financial system and the U.S. economy.

To discourage excessive risk-taking and excess demand, the discount window is now designed to be priced at a higher rate during normal periods than alternative sources of liquidity.[19] Moreover, the discount window

12 *See id*. at 38-40 ("If the public loses confidence in [banks'] solvency or liquidity a panic will ensue. Depositors, repo lenders and other holders of money-like or other short-term claims against financial institutions will demand immediate conversion of their claims into currency and the institution will not be able to liquidate their assets fast enough to satisfy those demands. This is what is known as a *run on a bank* or *other financial institution* engaged in maturity transformation . . . . A run on one bank or other financial institution can undermine the public's confidence in other financial institutions engaged in maturity transformation. A *contagious panic* is characterized by a sudden, strong and unexpected preference for cash or other central bank money rather than claims against private-sector financial institutions. [M]ass withdrawals of cash—also known as *liquidity runs* or just *runs*—force financial institutions to liquidate their illiquid but valuable assets at *fire-sale prices*, . . . [which] can result in contagious panics that can cause otherwise solvent financial institutions to fail. (emphases added)).

13 Board of Governors of the Federal Reserve System, Lending to depository institution (last updated July 30, 2012), *available at* http://www.federalreserve.gov/monetarypolicy/bst_lendingdepository.htm.

14 *See* Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System. Remarks at the 2011 Credit Markets Symposium, Charlotte, North Carolina on Regulating Systemic Risk (Mar. 31, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm#fn2.

15 Joao Santos & Stavros Peristiani, *Why Do Central Bank Have Discount Windows?* (Mar. 30, 2011), *available at* http://libertystreeteconomics.newyorkfed.org/2011/03/why-do-central-banks-have-discount-windows.html.

16 The Federal Reserve System also has tools available to lend to entities other than IDIs in times of market turmoil. *See infra*.

17 *See* Board of Governors of the Federal Reserve System, *Discount Window Lending* (last updated Sept. 30, 2013), *available at* http://www.federalreserve.gov/newsevents/reform_discount_window.htm.

18 Federal Reserve Discount Window (last updated Mar. 18, 2012), *available at* http://www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtlID=43.

19 *See* Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Remarks at the Federal Reserve Bank of Atlanta Financial Markets Conference: Liquidity Provision by the Federal Reserve (May 13, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm.

has an associated stigma for banks because using this facility conveys a negative signal about a bank's health to regulators, other banks and investors, further mitigating any moral hazard associated with discount window use.[20]

Finally, the terms of the Federal Reserve's discount window facility include very specific and robust collateral requirements that ensure that all lending is fully secured, in order to minimize any risk of loss to governments or taxpayers. As a result, the Federal Reserve has reported that since its establishment in 1913 it "has never lost a cent on its discount window loans to banks."[21]

2. Federal Deposit Insurance

A second governmental authority critical to the U.S. banking system is deposit insurance. The deposit insurance regime was established in 1933 to prevent future runs by instilling confidence—particularly among retail customers—that individual banks of all sizes as well as the entire banking system could be relied on as a safe place for savings. As a direct result of the bank runs that contributed significantly to the Great Depression, the FDIC was established in 1933 to insure all traditional bank deposits up to a maximum specified amount (now $250,000 per account).[22] All banks in turn pay premiums to the FDIC, thus funding the U.S. Deposit Insurance Fund without the support of taxpayers. Deposit insurance substantially reduces the likelihood and prevalence of bank runs "and thus prevents liquidity problems that could lead banks to insolvency (through fire-sale of assets)."[23] Deposit insurance also "provides a degree of protection for retail depositors who, for social and political reasons, are not expected to bear the entire burden of a bank failure."[24] Finally, "because deposit insurance is a way of allowing banks to fail with minimal socio-political costs, it can be seen as a mechanism for facilitating the exit of poor banks from the banking industry."[25]

B. BECAUSE ACCESS TO BOTH DEPOSIT INSURANCE AND DISCOUNT WINDOW LENDING IS *PRICED*, NEITHER IS A "GIFT" TO BANKS.

Large banks pay, quite significantly, for the benefits conferred by the discount window and deposit insurance regime. Banks that receive FDIC deposit insurance must pay quarterly assessments into the Deposit Insurance Fund.[26] A bank's assessment rate is determined quarterly,[27] and as described in detail below, the current FDIC insurance assessment scheme disproportionately taxes large banks due to changes implemented by the Dodd-Frank Act.

Similarly, banks must pay for discount window lending. In order to encourage banks to first seek funding from market sources before accessing the discount window, "the Federal Reserve lends at a rate that is higher, and thus more expensive, than the short-term rates that banks could obtain in the market under usual circumstances."[28]

C. THE DISCOUNT WINDOW AND DEPOSIT INSURANCE ARE EQUALLY ACCESSIBLE TO BANKS OF ALL SIZES ON EXACTLY THE SAME TERMS—THOUGH LARGER BANKS ARE DISPROPORTIONATELY TAXED UNDER THE FDIC'S DEPOSIT INSURANCE ASSESSMENT SCHEME.

Primary credit from the discount window is available to generally sound depository institutions regardless of size. Eligibility for primary credit at the discount window is determined by Reserve Banks on an ongoing basis using supervisory ratings and capitalization data.[29] Criteria are the same for daylight credit as set in the Board of Governors' Payment System Risk Policy. An institution assigned a composite CAMELS rating of 1, 2, or 3 (pursuant to the Uniform Financial Institutions Rating System or equivalent) that is at least adequately capitalized is eligible for primary credit unless supplementary information indicates that the institution is not generally sound. Institutions assigned a composite CAMELS rating of 4 (or its equivalent) are not eligible for primary credit unless an ongoing examination or other supplementary

20 *See* Renee Courtois & Huberto M. Ennis, *Is There Stigma Associated with Discount Window Borrowing?*, The Federal Reserve Bank of Richmond (May 2010), *available at* http://www.richmondfed.org/publications/research/economic_brief/2010/pdf/eb_10-05.pdf. Indeed, a number of large banks were encouraged to step up to the discount window during the crisis, even though they did not want to in order to demonstrate stability and lack of stigma to those that actually did borrow.

21 Board of Governors of the Federal Reserve System, Frequently Asked Questions: *Why Does the Federal Reserve Lend Money to Banks?* (last updated June 17, 2011), *available at* http://www.federalreserve.gov/faqs/banking_12841.htm.

22 *See* 18 U.S.C. § 1821(a)(1)(E).

23 Indrek Sapaar & Farouk Soussa, *Financial Consolidation and Conglomeration: Implications for the Financial Safety Net*, *in* Financial Stability and Central Banks: Selected Issues for Financial Safety Nets and Market Discipline 87 (2000). Deposit insurance is widely employed around the globe. "The adoption of explicit deposit insurance systems around the world has steadily increased since the 1960s. By 1970 there were 10 countries with explicit deposit insurance systems, by 1980 there were 18, by 1990 there were 36, and by 2000 there were 70. Today, over 100 countries either have, or are considering or planning, deposit insurance schemes." Martin J. Gruenberg, Vice Chairman, Federal Deposit Insurance Corporation, Remarks at the 2007 Annual Meeting of the European Forum of Deposit Insurers, Istanbul, Turkey (Nov. 26, 2007), *available at* http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spnov2607.html.

24 *Id.* at 87.

25 *Id.*

26 12 U.S.C. § 1817.

27 *See* Federal Deposit Insurance Corporation, The Deposit Insurance Fund (last updated Nov. 26, 2013), *available at* http://www.fdic.gov/deposit/insurance/.

28 Board of Governors of the Federal Reserve System, Frequently Asked Questions: *Why Does the Federal Reserve Lend Money to Banks?*

29 *See* Regulation A, 12 C.F.R. § 201.4(a).

information indicates that the institution is at least adequately capitalized and that its condition has improved sufficiently to be deemed generally sound by its Reserve Bank. Institutions assigned a composite CAMELS rating of 5 (or its equivalent) are not eligible for primary credit. These eligibility criteria make no reference to size; discount window access is based exclusively on financial data assessing a given bank's stability and creditworthiness.

Similarly, FDIC deposit insurance is available to all IDIs, regardless of their size. The insured deposits of all banks are insured in exactly the same manner and to the same extent.[30] The Dodd-Frank Act required the FDIC to change its assessment system for deposit insurance coverage from one based on domestic deposits to one based on consolidated total assets.[31] This change has shifted much of the cost of deposit insurance from small and mid-sized banks that rely heavily on deposits for funding to large banks that often have diverse sources of funding. The change results in IDIs with $10 billion or more in assets bearing approximately 80% of the burden for deposit insurance, despite holding only 72% of deposits. [32] Thus, the post-Dodd-Frank assessment scheme for the pricing of deposit insurance disproportionately taxes large banks, and effectively makes them pay premiums on some liabilities that are not actually insured by the government.

D. DEPOSIT INSURANCE BENEFITS THE LARGEST BANKS LESS, GIVEN THAT THEY ARE DISPROPORTIONATELY FUNDED THROUGH MEANS OTHER THAN FDIC-INSURED DEPOSITS.

Large banks enjoy no disproportionate economic benefit or competitive advantage resulting from deposit insurance. In fact, highly-rated large banks may be distinctly disadvantaged. At least one study has concluded that these institutions enjoy only a minimal benefit from deposit insurance.[33] Institutions with the highest supervisory and capital ratings are "least likely to receive a material subsidy from deposit insurance and from the discount window."[34]

30 *See* 12 U.S.C. § 1815 (applications for deposit insurance); 12 U.S.C. § 1816 (factors considered for continuation of deposit insurance); *see also* 12 U.S.C. § 1821(a) (setting forth the uniform provision of insurance and maximum limits for "the deposits of *all* insured depository institutions." (emphasis added)).

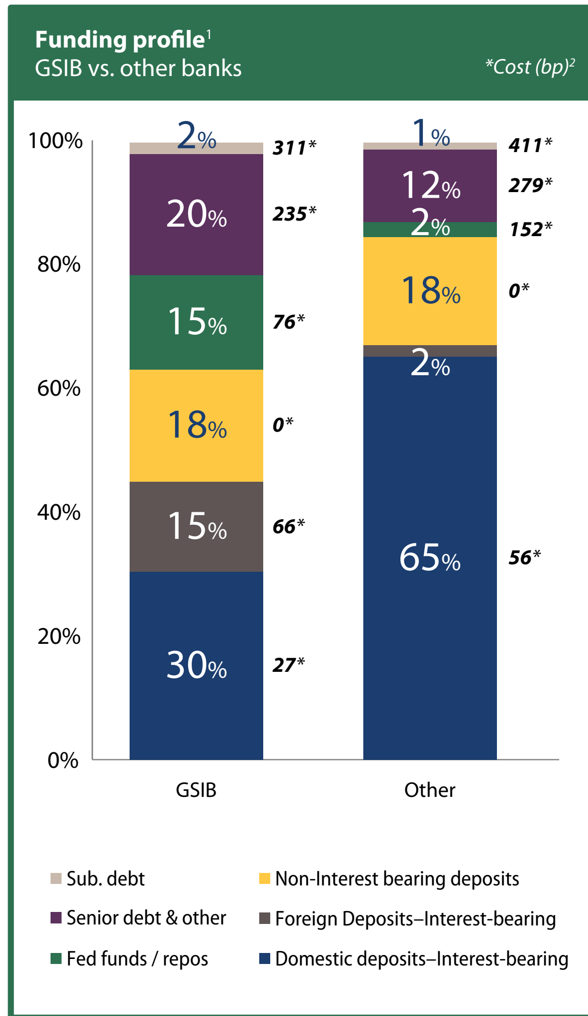
31 *See* Dodd-Frank Act § 331 ("assessment base" is equal to "the average consolidated total assets of the insured depository institution during the assessment period; minus . . . the sum of . . . the average tangible equity of the insured depository institution during the assessment period").

32 *See* The Clearing House, Comments Re: RIN 3064-AD66: Notices of Proposed Rulemaking — Deposit Insurance Assessment Base and Rates and Large Bank Pricing (Jan. 3, 2011) (using data current as of 2011), *available at* http://www.theclearinghouse.org/index.html?f=071406.

33 *See* Kenneth Jones & Barry Kolatch, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, FDIC Banking Review, Vol. 12, No. 1 (May 1999).

34 *Id.* at 8.

Likewise, because of the different funding profiles of large and small banks, deposit insurance protections are much less beneficial to large banks, which rely far less on insured deposits for their overall funding (approximately 32%) as compared to their smaller counterparts (approximately 59%).



Notes:

1. 4-quarter averages volumes, for 2012Q2 – 2013Q1
2. Calculated as rolling 4Q sum of interest expense / rolling 4Q average liability volumes for 2012Q2 – 2013Q1; interest expenses for foreign interest-bearing deposits excluded for smaller banks due to limited observations
3. Includes data for domestic US bank holding companies, savings and loan holding companies and financial holding companies

Source: Randy Kroszner, *A Review of Bank Funding Cost Differentials* (Oct. 2013), available at http://faculty.chicagobooth.edu/randall.kroszner/research/pdf/Kroszner%20Bank%20Funding%20Cost%20Difs%20Oct%202013.pdf.

E. THE BENEFITS THAT INDIVIDUAL BANKS OF ALL SIZES DERIVE FROM ACCESS TO LIQUIDITY AND DEPOSIT INSURANCE ARE LIMITED AND CIRCUMSCRIBED IN LAW AND PRACTICE.

Both deposit insurance and discount window access are limited in law and in practice to depository institutions alone. They are not available to nonbank affiliates of depository institutions, nor are they available to

nonfinancial companies. Specifically, Section 5 of the Federal Deposit Insurance Act limits deposit insurance to "depository institutions,"[35] and Section 10B of the Federal Reserve Act and the Federal Reserve's Regulation A also limit Federal Reserve discount window loans and advances to "depository institutions."[36]

As a further restriction on benefits received from the discount window and deposit insurance, banks are significantly restricted in the activities in which they are permitted to engage. Similarly, the activities of affiliates and subsidiaries of banks are significantly limited, and affiliates and subsidiaries are permitted only to engage in activities that are generally financial in nature.[37] Moreover, even if a bank, affiliate, or subsidiary is permitted to engage in an activity, it is subject to regulations by both its functional regulators (*e.g.*, OCC, SEC, CFTC, etc.) and under the comprehensive consolidated supervisory framework of the Federal Reserve, which imposes key capital and other prudential requirements (*e.g.*, liquidity, supervision, and enhanced standards on a consolidated basis under the Dodd-Frank Act discussed further below). All requirements that apply to small bank holding companies apply to large bank holding companies, but certain enhanced requirements apply only to larger banks, such as the G-SIFI surcharge.[38]

Even if the bank, affiliate, or subsidiary is permitted to engage in an activity, and has complied with all the regulatory requirements, regulators nevertheless impose significant restrictions on transactions associated with that activity between banks and their affiliates that have the purpose and effect of preventing depository institutions from transferring the benefits of the discount window and deposit insurance to a nonbank affiliate. For example, Sections 23A and 23B of the Federal Reserve Act impose strict quantitative limits, collateral requirements, market terms requirements, and other restrictions on transactions between a depository institution and its affiliates that

- significantly circumscribe the types of affiliate transactions in which a depository institution may engage, and
- fully protect the depository institution against the risk of loss from such affiliates.[39]

For further protection, Section 23A contains an "attribution rule" that similarly captures any transaction with a third party that may benefit a nonbank affiliate—helping to ensure that the benefits of discount window access and deposit insurance are not indirectly transferred to such affiliates. Additionally, in response to criticism that certain pre-crisis elements of the 23A/23B framework may have been insufficiently protective, Section 608 of the Dodd-Frank Act significantly strengthened limits on affiliate transactions by

- broadening the definition of affiliate,
- requiring collateral values to be marked to market,
- capturing more fully and specifically potential risks arising out of derivatives and securities lending/borrowing transactions, and
- requiring multiple agency approvals before any exemption may be granted.[40]

Finally, the Dodd-Frank Act recently codified the Federal Reserve's longstanding prudential requirement that any bank holding company—regardless of its size—serve as a "source of strength" for any affiliated IDIs.[41] Consequently, the larger the bank, the more support the holding company must provide.

Large bank and small banks access deposit insurance and the discount window on exactly the same terms, and a comprehensive legal framework is in place to make sure that any benefits from these programs are limited to depository institutions, and not transferred to their nonbank affiliates. The depository institutions that are permitted access may only engage in a limited set of activities under the supervision of functional and consolidated regulatory schemes, and the terms and conditions of the transactions they may conduct with their affiliates are significantly limited. This framework ensures that nonbank affiliates of depository institutions do not indirectly benefit from these important programs that are lynchpins of banking system stability. ■

35 12 U.S.C. § 1815.

36 12 U.S.C. § 347b; 12 C.F.R. § 201.

37 *See* 12 U.S.C. § 24.

38 Further discussion of such enhanced requirements will be included in a subsequent Working Paper.

39 *See* 12 U.S.C. §§ 371-c, 371-c1.

40 *See* Dodd-Frank Act § 608.

41 *See* Dodd-Frank Act § 616.

The Clearing House[SM]
At the Center of Banking Since 1853

The Forms of Government Financial Stability Support That May Be Provided to the Banking System Under Current Law Do Not Provide Any Unfair, Disproportionate, or Inappropriate Economic Benefits to Large Banks

IV. The Forms of Government Financial Stability Support That May Be Provided to the Banking System Under Current Law Do Not Provide Any Unfair, Disproportionate, or Inappropriate Economic Benefits to Large Banks.

The financial crisis prompted unprecedented government intervention to support and to stabilize the financial markets. Hundreds of U.S. banks received government support of varying degrees notwithstanding their individual size and financial strength, as the overriding policy goal was to shore up market stability and confidence.[42] Indeed, the ability to provide extraordinary temporary support to the banking system during a crisis has long been a critical feature of the U.S. financial system.

To assess whether government policies relating to extraordinary support benefit the largest banks, a historical analysis of crisis-era actions reveals little due to recent and widespread legal and regulatory reforms. Most notably, the Dodd-Frank Act now prohibits regulators from providing assistance to individual firms and severely limits the ability of regulators to support insolvent firms as part of any broader facility. Furthermore, recent and impending regulatory changes, such as those embodied in both the Dodd-Frank Act and the Basel III Liquidity Framework, have articulated requirements intended to substantially reduce the need for such extraordinary support in the future.

No one can dispute that many banks received extraordinary taxpayer-backed support during the crisis. The legal basis for much of that support—and for all of that support for the nation's largest banks—has long since been repealed. Moreover, those programs—designed to assist markets and not individual firms—were equally accessible to banks regardless of size. To the extent that the largest banks disproportionately accessed certain facilities, this was because—in addition to their size—these banks played unique market roles. In particular, they play a vital role as intermediaries to ensure that government liquidity reaches financial markets as well as the businesses and households that rely directly or indirectly on market sources of credit. And the government has been repaid all of the extraordinary liquidity support directed to the large banks, at a profit of $13 billion.[43]

A. THE ABILITY TO PROVIDE EXTRAORDINARY, TEMPORARY SUPPORT TO STABILIZE THE FINANCIAL SYSTEM DURING A CRISIS HAS LONG BEEN A CORE FEATURE OF THE U.S. FINANCIAL SYSTEM.

The ability of central banks and governments to provide lender-of-last resort liquidity and other forms of temporary, extraordinary support for the purpose of preserving financial stability is a core feature of any modern financial system and is critical for markets and credit availability. This kind of government financial stability support has historically included (i) emergency liquidity programs provided by the Federal Reserve under Section 13(3) of the Federal Reserve Act, (ii) FDIC debt guarantees and open bank assistance under the Federal Deposit Insurance Act, and (iii) unique statutory authorization of particular measures (*e.g.*, equity investments made under the Troubled Asset Relief Program pursuant to the Emergency Economic Stabilization Act of 2008).

The need for governments to provide emergency liquidity or other support in the event of a sudden loss of funding has been widely recognized and practiced in the United

42 *See* Letter from Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, to The Honorable Tim Johnson, Chairman, Committee on Banking, Housing, and Urban Affairs, United States Senate, The Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, United States Senate, The Honorable Spencer Bachus, Chairman, Committee on Financial Services, House of Representatives, and The Honorable Barney Frank, Ranking Member, Committee on Financial Services, House of Representatives (Dec. 6, 2011).

43 *See* Michael Fleming & Nicholas Klagge, *Income Effects of Federal Reserve Liquidity Facilities*, Fed. Reserve Bank of N.Y. Current Issues in Economics and Finance, Vol. 17 No.1 (2011), *available at* http://www.newyorkfed.org/research/current_issues/ci17-1.pdf.

States and abroad for over a century.[44] As Federal Reserve Chairman Bernanke has explained, "the notion that a central bank should provide liquidity to the banking system in a crisis has a long intellectual lineage."[45] Before the creation of the Federal Reserve "the availability of liquidity depended on the discretion of firms and private individuals," but since its creation "the Federal Reserve fulfilled the role of liquidity provider, consistent with the classic prescriptions of Walter Bagehot."[46] Accordingly, the Federal Reserve's response during the crisis demonstrated its responsibility to "eas[e] . . . monetary policy [and] reduc[e] funding pressures for depository institutions and primary securities dealers [to] improve[e] overall market liquidity and market functioning."[47]

B. TO ASSESS WHETHER GOVERNMENT POLICY IN THIS AREA BENEFITS THE LARGEST BANKS, A HISTORICAL ANALYSIS OF CRISIS-ERA ACTIONS REVEALS LITTLE, GIVEN THE WIDESPREAD LEGAL AND REGULATORY CHANGES THAT HAVE BEEN ENACTED POST-CRISIS.

No one can dispute that many banks received government financial stability support during the crisis. However, many of those crisis-driven actions are no longer in operation and will not be repeated in light of significant legal changes that now render illegal any institution-specific liquidity and other extraordinary support, as discussed further below.

Equally important, and also as detailed below, the widespread regulatory changes stemming from the Dodd-Frank Act, Basel III, and other reforms will substantially reduce the likelihood that even broad-based extraordinary support may be necessary in a future crisis, thereby further reducing the relevance of a retrospective analysis. Indeed, the vulnerabilities to which large banks were exposed under prior funding models are being addressed through a variety of comprehensive regulations, including the Basel III liquidity framework and reforms to the tri-party repo market and other short-term funding.[48] These requirements essentially mandate that large banks self-insure against severe and protracted liquidity shocks to key funding markets. Accordingly, large banks' use of these liquidity facilities nearly five years ago is not relevant to evaluating whether these institutions may receive any benefit from government financial stability support today or in the future.

C. EXTRAORDINARY SUPPORT DESIGNED TO BENEFIT ANY INDIVIDUAL INSTITUTION IS NOW PROHIBITED BY LAW.

Nearly all of the Federal Reserve's emergency financial stability programs during the 2008 financial crisis were established under the authority granted in Section 13(3) of the Federal Reserve Act. However, as amended by Title XI of the Dodd-Frank Act, Section 13(3) eliminates the Federal Reserve's authority to provide emergency credit to individual institutions; now only "broad-based" facilities and programs are permitted.[49] In particular, Section 13(3) prohibits any facility that is:

- Structured to remove assets from the balance sheet of a "single, specific company"; or
- Designed to assist a "single, specific company," to avoid insolvency proceedings, such as bankruptcy, Title II resolution, or any other state or federal insolvency proceeding.[50]

Consequently, it is now illegal for the Federal Reserve to "bail out" individual firms.

The Dodd-Frank Act also restricts the FDIC's ability to provide extraordinary support in times of crisis. The Act eliminates the FDIC's authority to provide assistance to insolvent depository institutions through a widely-available debt guarantee program. The guarantee cannot take the form of an equity infusion. The Act also limits the FDIC's ability to provide open bank assistance and guarantees to specific firms, circumscribing the existing "systemic risk exception" of the Federal Deposit Insurance Act and prohibiting the FDIC from providing any form of support other than through widely-available guarantee programs pursuant to a "liquidity event determination" requiring a joint resolution of approval by Congress.[51]

Finally, the Treasury Department's authority to fashion its own ad hoc emergency measures also has been

44 A liquidity crisis occurs when individuals and firms lose confidence in financial institutions' short-term liquidity positions, resulting in a bank run. The excess demand of liquid assets reduces the available supply so that there are adverse real effects on production and employment. In this way a liquidity crisis can induce and/or exacerbate a recession. The prime examples in the U.S. are the liquidity crises that occurred in 1930 and 2008. *See* Robert E. Lucas & Nancy L. Stokey, *Liquidity Crises: Understanding Sources and Limiting Consequences*, Federal Reserve Bank of Minneapolis (May 2011), *available at* http://www.minneapolisfed.org/pubs/eppapers/11-3/eppaper11-3_liquidity.pdf ("In the event of a bank run or a run on the repo market, the Fed can always add liquidity to the system, and there will be occasions—as in 1930 and in the fall of 2008—when it would be irresponsible not to do so.").

45 Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Remarks at the Federal Reserve Bank of Atlanta Financial Markets Conference, Sea Island, Georgia (May 13, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20080513.htm.

46 Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, Remarks at the Fourteenth Jacques Polak Annual Research Conference, Washington, D.C. (Nov. 8, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20131108a.htm.

47 *Id.*

48 *See infra* Part D.

49 12 U.S.C. § 343; Dodd-Frank Act § 1101.

50 *Id.*

51 *See id.* §§ 1106, 1105.

curtailed. Most notably, the Treasury Department's use of the Exchange Stabilization Fund to support its money market mutual fund guarantee program during the crisis was directly abrogated by Congress in the subsequent TARP legislation. Under current law, "[t]he Secretary is *prohibited* from using the Exchange Stabilization Fund for the establishment of any future guaranty programs for the United States money market mutual fund industry."[52]

D. IMPLEMENTATION OF THE DODD-FRANK ACT AND BASEL III WILL SUBSTANTIALLY REDUCE THE LIKELIHOOD THAT EVEN BROAD-BASED FINANCIAL STABILITY SUPPORT MAY BE NECESSARY IN A FUTURE CRISIS.

Implementation of the Dodd-Frank Act and the comprehensive capital and liquidity reforms within the Basel III framework are substantially enhancing the resiliency of both individual banks and the banking system on the whole, making it less likely that broad-based, extraordinary government support will be needed to manage and limit systemic risk in a future crisis. Below are eight examples of post-crisis regulatory reforms that will help ensure the continued safety and soundness of large banks.

1. Enhanced Capital Requirements

The Dodd-Frank Act and Basel III capital reforms require large banking organizations to maintain higher levels and a better quality of capital. These capital improvements include both increased amounts of risk-weighted capital and decreased leverage. As a result of (and in anticipation of) these reforms, U.S. banks currently hold substantially more and higher capital than pre-crisis levels, and these capital levels are expected only to increase as the Basel III reforms are implemented.

2. Capital Surcharges

Large banks are subject to additional capital surcharges that are intended to reduce their likelihood of failure and to discourage large banks from growing in size and complexity. Under the Dodd-Frank Act, large banks are subject to capital requirements that are more stringent than those imposed on smaller banks, and these requirements increase in stringency based on size and other factors.[53] The largest banks will face a Common Equity Tier 1 (CET 1) surcharge of between 1% and 2.5% (and possibly as high as 3.5%) based on their size and complexity.[54] As a result, large banks subject to these surcharges will hold minimum capital levels that are 14% to 36% higher than the required minimum for smaller banks.[55]

3. Stress Testing

The Federal Reserve now conducts semi-annual capital stress tests of the largest banks to ensure they hold sufficient loss-absorbing capital to weather severe financial stress. In the recent round of stress tests, the Federal Reserve subjected the balance sheets of the 18 largest bank holding companies to stressed and severely stressed macroeconomic scenarios—the results of which were published in March 2013. Key assumptions for this severe stress included

- 5% decline in GDP (Q3 2012-Q4 2013),
- 12% unemployment (Q3 2012-Q4 2013),
- 50% decline in equity prices (Q3 2012-Q4 2013), and
- 20% decline in home and commercial real estate prices (Q3 2012-Q4 2014).

Even under these scenarios, aggregate capital ratios (including the leverage ratio) remain well above levels seen during the crisis.[56]

4. Liquidity

a. Liquidity Coverage

The Liquidity Coverage Ratio (LCR under Basel III) requires internationally active banks to maintain high-quality liquid assets to cover liquidity demands during a 30-day period of severe liquidity stress.[57] The rules include numerous ways to test liquidity, including mandatory consideration of stresses such as a ratings downgrade, market volatility, and rapid drawdown of liquidity facilities. The LCR standard requires that the value of the ratio be no lower than 100% (*i.e.*, the stock of high-quality liquid assets should be at least equal to total net cash outflows). Banks and supervisors also are expected to be aware of any potential mismatches within the 30-day period and to require that sufficient liquid assets are available to meet any cash flow gaps.

The U.S. banking agencies introduced a proposed rule in

52 Emergency Economic Stabilization Act of 2008 § 131(b) (emphasis added).

53 *See* Dodd-Frank Act § 165(b).

54 *See* Basel Committee on Banking Supervision, *G-SIB Assessment Methodology* (Nov. 2011).

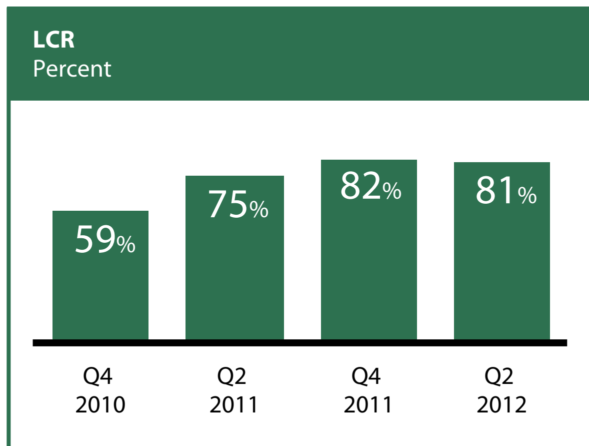
55 Smaller banks are subject to a 7% minimum requirement. The capital surcharge for large banks will sit on top of the 7% minimum requirement.

56 *See* Board of Governors of the Federal Reserve System, *Dodd-Frank Act Stress Tests 2013: Supervisory Stress Test Methodology and Results* (Mar. 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/dfast_2013_results_20130314.pdf.

57 *See* Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013), *available at* http://www.bis.org/publ/bcbs238.htm.

October 2013 to implement the LCR in the United States.[58] The proposed U.S. LCR—as applicable to advanced approaches banks—is more stringent than the Basel III LCR, with a stricter transition timeline, definition of high-quality liquid assets, and treatment of maturity mismatch within the 30-day period.[59]

Since 2010, U.S. banks have substantially increased their holdings of liquid assets, and implementation of the LCR will reinforce this trend.



Graphic: The Clearing House, *U.S. Banking Industry Liquidity Update* (Dec. 14, 2012).

b. Funding Stability

The Net Stable Funding Ratio (NSFR under Basel III) establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of a bank's assets and off-balance sheet (OBS) activities over a year horizon under stress (defined for the NSFR to include a broader range of events than under the LCR).[60] The NSFR is defined as the amount of available stable funding compared with the amount of required stable funding. This ratio must be above 100%. "Stable funding" is the amount of equity and liability financing expected to be reliable sources of funds under extended stress over a one-year horizon. Available stable funds include the bank's capital, long-term liabilities, and some wholesale funding sources. The amount of required funding is a function of the liquidity characteristics of various types of assets held, OBS contingent exposures incurred, and the activities pursued by the institution. Different run-off factors are assigned to various forms of deposit liabilities. The NSFR metric is designed to act as a minimum enforcement mechanism to complement the LCR and to reinforce other supervisory efforts by promoting structural changes in banks' liquidity-risk profiles away from short-term funding mismatches toward more stable, longer-term funding of assets and OBS business activities.

Large banks in the United States have significantly improved their funding stability since the end of 2010. Wholesale funding reliance has decreased by 3.6%, or about $248 billion, and net short-term funding has decreased by 4.6%, or about $584 billion. At the same time, demand deposits (historically a stable funding source) increased by 2.1%, or about $308 billion. Implementation of the NSFR is expected to begin in 2018.[61]

c. Governance and Risk Management

Buttressing the quantitative ratios of Basel III, the Dodd-Frank Act imposes specialized governance and risk management requirements for large banks that would address liquidity. The boards of directors of large banks must now establish risk committees, which would document and monitor enterprise-wide risk management practices based on banks' capital structures, risk profiles, complexity, and sizes.[62] In addition, liquidity stress tests are being conducted on the largest banks by the Federal Reserve.[63]

5. Tri-party, MMF, and Short-term Funding Capital Surcharge

In addition to the Dodd-Frank Act and Basel III, the Federal Reserve is imposing reforms on markets that serve as a source of short-term funding and on the institutions that rely on this type of funding. For example, the Federal Reserve Bank of New York has devoted considerable resources to reforming the tri-party repo market in an attempt to address credit concerns that caused contagion during the financial crisis.[64] Further, the Federal Reserve has been a vocal leader of efforts to impose additional regulatory standards on money market funds to ensure greater stability of this funding source in

58 *See* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (proposed Oct. 24, 2013) (to be codified at 12 C.F.R. pt. 329) *available at* http://www.federalreserve.gov/aboutthefed/boardmeetings/FR-notice-lcr-20131024.pdf.

59 *See* Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Opening Statement at Federal Reserve Board Meeting (Oct. 24, 2013), *available at* http://www.federalreserve.gov/mediacenter/files/open-board-meeting-transcript-20131024.pdf.

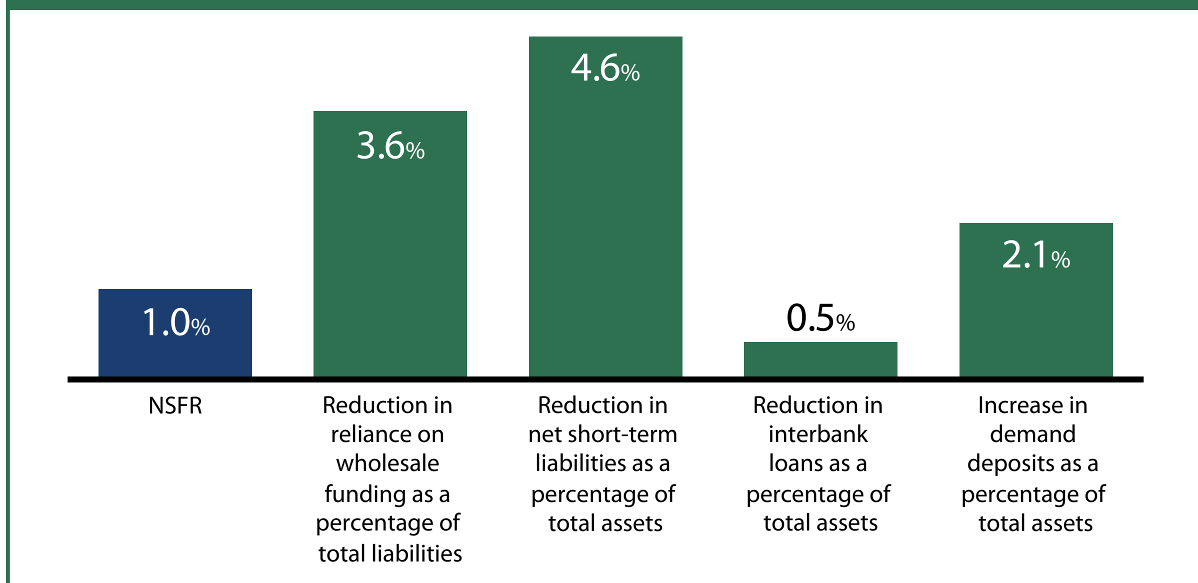
60 *See* Basel Committee on Banking Supervision, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 2010), *available at* http://www.bis.org/publ/bcbs188.pdf; Basel Committee on Banking Supervision, *Basel III: The Net Stable Funding Ratio* (Jan. 2014), *available at* http://www.bis.org/publ/bcbs271.pdf.

61 *See id*. at 2.

62 *See* Dodd-Frank Act § 165(h).

63 *See* Shahien Nasiripour, *Fed Begins Stress Tests on Bank Liquidity*, Financial Times, Dec. 13, 2012.

64 *See* Task Force on Tri-Party Repo Infrastructure, *Final Report* (Feb. 15, 2012). The Task Force on Tri-Party Repo Infrastructure operates under the auspices of the Payments Risk Committee, a private sector body sponsored by the Federal Reserve Bank of New York.



Source: The Clearing House, *Assessing the Basel III Net Stable Funding Ratio in the Context of Recent Improvements in Longer-TermBank Liquidity* (August 2013).

the future.[65] Finally, the Federal Reserve has announced its intention to implement additional requirements to address excessive short-term funding by bank holding companies.[66] The Federal Reserve is considering several policy options, including higher capital for large firms that rely substantially on short-term wholesale funding, increased capital charges applicable to securities financing transaction ("SFT") matched books or modified liquidity standards to require firms to hold larger liquidity buffers against SFT assets, and a market-wide system of haircuts and margin requirements for SFTs.[67]

6. Counterparty Exposure Limits

The Federal Reserve is required to establish a comprehensive credit exposure limit as part of enhanced prudential standards required for large banks under the Dodd-Frank Act. The Act imposes a 25% limit on aggregate single-counterparty credit exposures for firms with at least $50 billion in assets.[68] For exposures between firms with at least $500 billion in assets, the Federal Reserve has authority to impose a limit below 25%[69] (and has proposed by rule a more stringent 10% limit[70]). Rules will be finalized after completion of an ongoing quantitative impact study by the Federal Reserve.[71]

The Dodd-Frank Act ensures that all credit exposure limits (including Section 23A affiliate transaction limits) cover traditional exposures (*e.g.*, loans), as well as exposures arising from derivatives, repo, and securities lending transactions.[72] The Basel Committee has also issued proposed international standards for limits on large counterparty credit exposures.[73] Finally, under the LCR, as mentioned above, credit lines between financial institutions are subject to more conservative assumed drawdown and inflow rates designed to limit interconnectedness and contagion risk.

7. Other Enhanced Prudential Standards

Large banking organizations are subject to other stringent enhanced prudential standards and early

65 *See, e.g.*, Janet L. Yellen, Vice Chair, Board of Governors of the Federal Reserve System, Remarks at the International Monetary Conference, Shanghai, China (June 2, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/yellen20130602a.htm.

66 *See* Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Remarks at the Americans for Financial Reform and Economic Policy Institute Conference, Washington, D.C. (Nov. 22, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

67 *Id.*

68 *See* Dodd-Frank Act § 165(e).

69 *See id.* § 165(a)(2)(b).

70 *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 613 (proposed Jan. 5, 2012).

71 *See* Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. (July 11, 2013), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm.

72 *See id.* §§ 165(e), 608-610.

73 *See* Basel Committee on Banking Supervision, *Supervisory Framework for Measuring and Controlling Large Credit Exposures* (Consultative Document) (Mar. 2013), *available at* http://www.bis.org/publ/bcbs246.pdf.

remediation requirements that do not apply to smaller banking organizations. The Dodd-Frank Act requires the Federal Reserve to establish enhanced prudential standards for risk-based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, and resolution plan and credit exposure reporting.[74] In addition, the Act authorizes the Federal Reserve to establish additional standards regarding contingent capital, enhanced public disclosures, short-term debt limits, and any other prudential standards the Federal Reserve determines to be appropriate.[75] The Act further directs the Federal Reserve to establish requirements to provide for the early remediation of financial distress of a large financial institution in order to minimize the possibility that the company will become insolvent and pose a risk to U.S. financial stability.[76]

The Dodd-Frank Act also empowers the Federal Reserve to prohibit bank transactions that would increase systemic risk. In considering whether to approve any M&A transaction, the Federal Reserve must consider the extent to which the transaction would result in greater or more concentrated risks to financial stability.[77] Relatedly, the Act limits the aggregate size of any one banking institution. Specifically, it prohibits a financial company from acquiring or merging with another company if consolidated liabilities of the resulting organization would exceed 10% of consolidated liabilities of all financial companies.[78] Alongside the statute, the Federal Reserve has a *de facto* prohibition against any sizeable acquisitions by the largest banks. These restrictions supplement an existing law prohibiting any single bank from controlling 10% or more of total U.S. deposits.[79]

8. Systemic Risk Monitoring

The Financial Stability Oversight Council (FSOC) was established by the Dodd-Frank Act to identify and monitor systemic risk. The FSOC is charged with identifying risks to the financial stability of the United States, promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.[80] Among other things, the FSOC is authorized to facilitate regulatory coordination, facilitate information sharing and collection, recommend stricter standards, and break up institutions that pose a "grave threat" to financial stability.[81] The FSOC can provide direction to, and request data and analyses from, the Office of Financial Research (OFR).[82]

The OFR was established by the Dodd-Frank Act to facilitate the monitoring of systemic risk. It is a unit within the Treasury Department that is funded separately via the Financial Research Fund.[83] The primary function of the OFR is to support the FSOC and its member agencies in fulfilling their duty to promote financial stability and monitor systemic risk.[84]

E. LOOKING BACKWARD, MANY OF THE GOVERNMENT FINANCIAL STABILITY FACILITIES ESTABLISHED DURING THE CRISIS WERE DESIGNED TO ASSIST MARKETS, NOT INDIVIDUAL FIRMS, AND WERE EQUALLY ACCESSIBLE TO BANKS REGARDLESS OF SIZE. TO THE EXTENT THAT THE LARGEST BANKS DISPROPORTIONATELY ACCESSED THESE FACILITIES, THIS WAS BECAUSE THESE BANKS PLAYED UNIQUE MARKET ROLES—ONLY THEY COULD ACT AS INTERMEDIARIES TO ENSURE THAT GOVERNMENT LIQUIDITY REACHED FINANCIAL MARKETS AND BUSINESSES AND HOUSEHOLDS THAT RELY ON MARKETS DIRECTLY OR INDIRECTLY TO MEET THEIR NEEDS FOR CREDIT.

As the Federal Reserve and other commentators have noted, the various emergency liquidity facilities established during the crisis were not intended to address credit concerns or capital shortages at individual banks, but rather to mitigate the liquidity disruptions in financial markets by providing collateralized, short-term loans to creditworthy institutions at an interest rate higher than the normal cost of funds.[85] Because these facilities were established to stabilize and support specific key markets and those markets provided credit to a very wide range of borrowers, the fact that some banks availed themselves of these programs more than others is no proof of competitive advantage or other special economic benefit for large banks.[86] Even Federal Reserve programs geared toward particular markets, such as the Term Asset-Backed

74 *See* Dodd-Frank Act § 165 (b), (f), (h), (j).

75 *See id*. § 165(c), (f), (g).

76 *See id*. § 166.

77 *See id*. § 604(d).

78 *See id*. § 622.

79 *See* 12 U.S.C. § 1842(d); *see also* Dodd-Frank Act § 623 (applying the 10% limit to interstate merger transactions and to acquisitions by bank holding companies and savings and loan holding companies).

80 *See id*. § 112(a)(1).

81 *See id*. §§ 115, 119, 120, 121.

82 *See id*. § 112(a)(2).

83 *See id*. §§ 152, 155.

84 *See id*. § 153.

85 *See* Michael J. Fleming, *Federal Reserve Liquidity Provision during the Financial Crisis of 2007-2009*, Fed. Reserve Staff Report No. 563 (July 2012), at 11, *available at* http://www.newyorkfed.org/research/staff_reports/sr563.html.

86 *See* U.S. Gov't Accountability Office, GAO-14-18, Government Support For Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented 13 (2013) (stating that "[t]he Federal Reserve System designed its emergency programs to address disruptions to particular credit markets and to assist participants in these markets").

Securities Loan Facility and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, were explicitly and equally accessible to banks and other eligible entities of all sizes.

In addition, even those few programs that were accessible to a smaller group of institutions were based on activity profile, not size. These include the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF) and TSLP Options Program, the Term Auction Facility (TAF), and the Commercial Paper Funding Facility (CPFF). Large banks had a significant presence in the market activities that these facilities were intended to support such as the government securities and commercial paper markets. Indeed, these markets cannot function effectively in the absence of large bank support of these particular activities. Without large banks, government efforts to support these markets would be highly diffuse and not nearly as effective as the concentrated support of a few large institutions.

The Government Accountability Office explained the nature of these programs in its November 2013 report:

> Agencies made these programs available to specific types of institutions regardless of their size, and institutions of various sizes participated in these programs. Differences in the level of program use by institutions of various sizes were driven in part by differences in how institutions funded themselves. For example, compared to smaller bank holding companies, larger bank holding companies relied to a greater extent on short-term credit markets that were the most severely disrupted during the crisis and participated more in programs intended to address disruptions in these markets. Smaller banking organizations relied more on deposits to fund their activities.[87]

Accordingly, it is not surprising that the following facilities were disproportionately used by large banks:

- *Primary Dealer Credit Facility*: The Federal Reserve created the PDCF to respond to liquidity pressures on primary dealers and the markets to which primary dealers provide liquidity.[88] "[W]hen strains in financial markets escalated sharply, the PDCF was established to improve the ability of primary dealers to provide financing to participants in securities markets, and to promote the orderly functioning of financial markets more generally."[89]

- *Term Securities Lending Facility*: Similarly, the Federal Reserve established the TSLF to address "the pressures faced by primary dealers in their access to term funding and collateral,"[90] and a smaller number of dealers were especially important to market functioning. The TSLF "supported the liquidity of primary dealers and fostered improved conditions in financial markets more generally."[91] The TSLF Options Program was established "to offer additional liquidity during periods of heightened collateral market pressure, such as quarter-end dates."[92]

- *Term Auction Facility*: Despite the Federal Reserve's changes to discount window access to ease pressures in term funding markets, many banks remained reluctant to borrow from the discount window. "The TAF enabled the Federal Reserve to provide term funds to a broader range of counterparties and against a broader range of collateral than it could through open market operations. As a result, the TAF helped promote the distribution of liquidity when unsecured bank funding markets were under stress. It also provided access to term credit without the stigma that had been associated with use of the discount window."[93] The ability and willingness of banks to use TAF avoided what might have been a very damaging pullback by those banks from lending to businesses and households.

- *Commercial Paper Funding Facility*: "[T]he Federal Reserve established the [CPFF] to provide liquidity to U.S. issuers of commercial paper in the event that credit was not available in the market. By providing liquidity to the commercial paper market, the CPFF encouraged investors to resume lending in the market."[94] Only borrowers with outstanding commercial paper were eligible, meaning the facility was predominantly geared toward larger institutions. "The commercial paper that was eligible for purchase was highly rated, U.S. dollar-denominated, unsecured and asset-backed commercial paper with a three-month maturity."[95]

Large banks did not enjoy any unfair competitive or economic advantage from these facilities; instead, they accessed programs designed to support markets in which large banks play a central and critical role. Moreover, consumers benefited from increased competition in

87 *Id.* at 30.

88 *See* Board of Governors of the Federal Reserve System, Primary Dealer Credit Facility (PDCF) (last updated Aug. 2, 2013), *available at* http://www.federalreserve.gov/newsevents/reform_pdcf.htm.

89 *Id.*

90 Board of Governors of the Federal Reserve System, Term Securities Lending Facility (TSLF) and TSLF Options Program (TOP) (last updated Aug. 2, 2013), *available at* http://www.federalreserve.gov/newsevents/reform_tslf.htm.

91 *Id.*

92 *Id*.

93 Board of Governors of the Federal Reserve System, Term Auction Facility (last updated Aug. 2, 2013), *available at* http://www.federalreserve.gov/newsevents/reform_taf.htm.

94 Board of Governors of the Federal Reserve System, Commercial Paper Funding Facility (last updated Aug. 2, 2013), *available at* http://www.federalreserve.gov/newsevents/reform_cpff.htm.

95 Board of Governors of the Federal Reserve System, Commercial Paper Funding Facility.

the marketplace and from the fact that these programs successfully restored confidence and liquidity.

In addition, none of these facilities has resulted in any cost to taxpayers. The result is clear: taxpayers did not lose money and the government made a return of $13 billion.[96] As the Federal Reserve has emphasized, "Credit provided under these programs was fully collateralized to protect the Fed—and ultimately the taxpayer—from loss."[97] Accordingly, "the Federal Reserve did not incur any losses in connection with its lending programs, especially since the programs came at a price to banks. In fact, the Federal Reserve has generated very substantial net income since 2007 that has been remitted to the U.S. Treasury."[98] Moreover, "[m]ost of the Fed's lending facilities were priced at a penalty over normal market rates so that borrowers had economic incentives to exit as market conditions normalized."[99]

F. LOOKING BACKWARD, MANY OF THE EMERGENCY GOVERNMENT FACILITIES ESTABLISHED DURING THE CRISIS WERE DISPROPORTIONATELY ACCESSED BY SMALLER BANKS, DEMONSTRATING THAT "UPTAKE" VARIED BY PROGRAM AND PURPOSE.

Upon closer examination, the evidence reveals that certain of the emergency facilities established during the crisis particularly benefitted smaller banks. For example, as part of the government's response during the crisis, deposit insurance protections were expanded to address the primary source of funding for smaller institutions, and the Transaction Account Guarantee Program (TAGP) was created to provide support to non-interest-bearing transaction accounts. The FDIC has emphasized that "[t]he TAGP brought stability and confidence to banks and their business customers by removing the risk of loss from deposit accounts that are commonly used to meet payroll and other business transaction purposes. . . . The temporary coverage allowed institutions, *particularly smaller ones*, to retain these accounts and maintain the ability to make loans within their communities."[100] Other examples, such as the Community Development Capital Initiative, were special emergency facilities established using TARP funds to serve the funding markets of smaller community development financial institutions.[101] In light of the government's overarching aim of providing broad market support through varied programs, it is misleading to argue that large banks were favored recipients of these extraordinary measures. ■

96 *See* Michael J. Fleming & Nicholas Klagge, *Federal Reserve Liquidity Provision during the Financial Crisis of 2007-2009*.

97 Board of Governors of the Federal Reserve System, Frequently Asked Questions, *Why did the Federal Reserve lend to banks and other financial institutions during the financial crisis?* (last updated Aug. 2, 2013), *available at* http://www.federalreserve.gov/faqs/why-did-the-Federal-Reserve-lend-to-banks-and-other-financial-institutions-during-the-financial-crisis.htm.

98 *Id.*

99 *Id.*

100 Federal Deposit Insurance Corporation, Temporary Liquidity Guarantee Program (last updated Feb. 27, 2013), *available at* http://www.fdic.gov/regulations/resources/TLGP (emphasis added)

101 *See* United States Department of the Treasury, Community Development Financial Institutions Fund, *available at* http://www.cdfifund.gov.

The Clearing House[SM]
At the Center of Banking Since 1853

Conclusion

V. Conclusion

In the continuing debate over the role of large banks in the U.S. financial system and whether they benefit from competitive distortions resulting from government policies, critics have asserted that large banks benefit disproportionately from federal deposit insurance and liquidity programs, or from the extraordinary support provided by the U.S. government in 2008-09. This working paper makes clear that access to deposit insurance and lender-of-last-resort liquidity—traditional lynchpins of banking system stability— do not provide any special or disproportionate economic benefit to large banks. This paper also demonstrates that the limited tools available to the government during the crisis were aimed at critical markets serving a wide variety of stakeholders and not simply saving individual institutions, nor did actions taken during the crisis unfairly benefit large banks in particular.

With respect to liquidity access and deposit insurance, it is clear that large banks do not enjoy any unfair, disproportionate, or inappropriate economic benefits from these programs. Access is priced, and the programs are equally accessible to all banks regardless of size. Indeed, banks pay quite significantly for discount window lending and deposit insurance. Further, large banks benefit less from these programs given smaller banks' greater reliance on insured deposits as a percentage of their overall funding. Post-crisis reforms have disproportionally raised large banks' contributions to the Deposit Insurance Fund and have also restricted the activities in which all banks are permitted to engage by imposing increased requirements for inter-affiliate transactions in order to prevent the transfer of benefits from these programs to nonbank affiliates.

Moreover, the kinds of emergency support that may be provided to the banking industry in times of crisis do not provide a disproportionate economic benefit to large banks, and a retrospective analysis of actions taken during the crisis contributes little to the present debate in light of significant statutory and regulatory changes that have since been enacted. These changes include the limitations on the Federal Reserve's 13(3) authority imposed by the Dodd-Frank Act, as well as numerous other legal and regulatory developments specifically designed to enhance the safety, soundness, and resiliency of large institutions and the banking system as a whole.

In forthcoming papers in the *Working Paper Series*, The Clearing House will further explore large banks' role in the financial system in order to thoroughly and thoughtfully address other complex issues that must inform the TBTF policy debate. ■

ABOUT THE CLEARING HOUSE

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over two million people and hold more than half of all U.S. deposits.

The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of important banking issues.

Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer and check-image payments made in the U.S. See The Clearing House's web page online at www.theclearinghouse.org.

Paul Saltzman
President of The Clearing House Association, EVP and General Counsel of The Clearing House Payments Company
212.613.0138 | paul.saltzman@theclearinghouse.org

Jeremy Newell
Executive Managing Director and Head of Regulatory Affairs
202.649.4622 | jeremy.newell@theclearinghouse.org

Jill Hershey
Executive Managing Director and Head of Government Affairs
202.649.4601 | jill.hershey@theclearinghouse.org

John Van Etten
Vice President, Government Affairs and Legislative Counsel
202.649.4617 | john.vanetten@theclearinghouse.org

Kristin Richardson
Vice President, Government Affairs and Legislative Counsel
202.649.4616 | kristin.richardson@theclearinghouse.org

NEW YORK | 450 West 33rd Street | New York, NY 10001
WASHINGTON, D.C. | 1001 Pennsylvania Avenue | Suite 720 - North Tower | Washington, DC 20004
TEL 212.613.0100 | www.theclearinghouse.org