Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

Barnett Sivon & Natter P.C.
ATTORNEYS at LAW
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The Law of Unintended Consequences*

Donald Lamson

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It is a commonplace that people often want to have things both ways, to have their cake and eat it, too. Legislators are no different, and an oft-cited example of Congress' conflicting goals is the Dodd-Frank Act. Commentators frequently cite increased restrictions on banks that were adopted by Congress (e.g., increased capital requirements and restrictions on proprietary trading) that already have led, or in future could lead, to unintended consequences, such as anemic economic growth or more limited liquidity in certain markets. Another example of unintended consequence is Congress' tampering with an obscure provision that lies tucked away in the Federal Reserve Act, section 13(3), that previously had permitted the Federal Reserve, in effect, to pick winners and losers in the financial industry during a period of market tumult through the extension of emergency credit normally available only to banks.

Before Dodd-Frank, section 13(3) allowed the Fed to provide emergency credit to any person and on security of anything. This was consistent with the classic understanding of a central bank's function, the well-known role of the "lender of last resort," and the Fed seldom resorted to such lending. The Federal Reserve did extend such credit in the last crisis and we may never know with precision whether such lending in fact prevented an outright meltdown of our economy or whether a more limited or even a different response would have done more good. It seems, however, that every potential economic recovery is dependent on the identification and punishment of villains and Congress enthusiastically took up this cudgel during enactment of Dodd-Frank. Rather than accept on mere faith that the Federal Reserve had acted effectively given the conditions that then existed, Congress instead vilified the recipients of emergency lending and vowed never to permit such conduct to recur. As a result, section 13(3) was "strengthened" and rather than continue to allow the Fed the discretion to act quickly to prevent the spreading of contagion in a future crisis, the Fed now must go through a detailed and complicated procedure before it may make any emergency loans. Congress may later come to regret its actions.

Congress clipped the Fed's wings in several ways. Dodd-Frank amended section 13(3) to limit Federal Reserve emergency lending only to "participants in any program with broad-based eligibil-

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ity" rather than to any one person or corporation. The premise, of course, is that a large program by definition is preferable to a more tailored response. The Fed also must lengthen its decision process by consulting with Congress and the Treasury Department before creating any new emergency lending program. Given the propensity of observers to pass judgment and lay blame on participants in emergency lending situations, sometimes in haste and anger, one wonders just how Congress will embrace its new responsibility as a before-the-fact overseer of an emergency lender in the face of a different and new crisis. Last, the Fed must adopt rules to implement the amended section 13(3) and provide added detail on how this circumscribed authority is to work in practice. More than five years after enactment, in late November 2015, the Federal Reserve adopted final implementing rules for emergency lending.

With the benefit of fewer than a dozen comments from the public, the Federal Reserve tightened the requirements of the revised statute even more. Commenters still do not trust the Fed to exercise its considerable expertise and sound discretion to oversee emergency lending. Commenters wanted the Fed to tie itself down further, by suggesting: the inclusion of a provision defining how a program can be "broad-based," the imposition of a "penalty rate" on all borrowers under any program, a limitation on the types of collateral that would be acceptable, and a requirement that the Fed seek a joint resolution from the Congress before finalizing a program. The Fed largely obliged and adopted several of those suggestions. In some instances the Fed wisely chose not to adopt suggestions where impractical or simply inappropriate, for example, by recognizing that it is for Congress, not the Federal Reserve, to adopt a requirement for a joint resolution of Congress approving an emergency lending program. It is understandable that there has been such a lengthy hiatus between enactment of Dodd-Frank and adoption of implementing rules, since, on reflection and consideration of the historical record, the imposition of tight restrictions on the Federal Reserve may not be in the public interest, and certainly not in Congress' interest.

As one observer noted, history may not repeat itself, but it certainly can rhyme. Students of central banking have seen more than one instance in which a central bank, when confronted with a financial crisis, faces a choice of how best to save the financial system and whether in that effort it makes sense to aid (or, as critics might prefer, bail out) one or more industry participants. Regardless of the choice taken, bail out or not, the central bank invariably will face an angry public outcry and possibly an effort to curtail the central bank's powers.

Over the last two centuries, and before, asset bubbles have frequently developed and then led to crisis. Periods of excessively low interest rates can arise for a variety of reasons, including when a government reduces its debt. Investor dissatisfaction with low yields on safe assets can lead to a migration in pursuit of higher yields on riskier assets. If this persists, the yields on less safe assets will fall and tighten relative to the safe yields. The speculation ultimately results in a bust and asset prices collapse.

Long before the creation of the Federal Reserve System, the Bank of England (BOE) was the world's dominant central bank. The BOE has had to navigate a number of crises in its long history and the Crisis of 1836-9 is particularly instructive. That crisis, like our recent crisis, was international in character and also followed a speculative boom. In that early crisis, the BOE acted just as the Fed did in our own, acting as the lender of last resort and providing liquidity to the system it oversaw. Today, commenters on the Fed proposal lamented that the Fed should provide liquidity to the system but not save persons from bankruptcy. That sounds laudable but ignores that there are both asset and liquidity insolvencies. The Fed should not bail out an asset insolvency,

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but it should prevent a liquidity insolvency. That is just what the BOE did, lending to crippled firms on varied types of security.

In response to the public outcry that followed, Parliament predictably recoiled with dismay at the BOE's "excessive" actions and enacted the Act of 1844, which severely restricted the BOE's authority to repeat its emergency lending. The measures taken by Parliament differed from those recently taken by Congress, but the effects were intended to be similar. No more bailouts.

The Act of 1844 did not repeal the economic cycle, and as night follows day the economy again tanked, shortly after its enactment. The British government pressed the BOE to open the credit spigot, and the BOE refused, choosing not to violate a law that Parliament could not politically afford to repeal. The government pressed and quietly reassured the BOE. The tap opened and once credit again became available, the crisis passed. A later inquiry found that the Act of 1844 did nothing to prevent the next crisis, or the speculation that fueled it. Even so, Parliament would not repeal the law, leading to a conclusion that laws have two possible effects, one of which is to respond to a public outcry, the other to effect sound policy. The Act of 1844 accomplished the first, but not the second, as witnessed by its failure.

Armed with this history, one might wonder whether there are similarities to be found in comparing the Act of 1844 with Dodd-Frank. Like the British law, we can agree that Dodd-Frank was effective, at least in part, at quelling the public's desire that Congress should do something to address the causes of the recent crisis and prevent a recurrence. As witnessed in recent news stories and reflected in the Fed's comment letters described above, there still is a thirst for retribution against those who caused the recent crisis. We cannot predict whether Congress' attempt to restrict the Fed in its section 13(3) authority will be any more effective in preventing or curing a downturn than was the Act of 1844. We can conclude that revisions to section 13(3) and its own implementing rules will not make the Fed's job any easier in the event of the next crisis.

Donald Lamson is a partner with the law firm of ***Barnett Sivon & Natter, P.C.***

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