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GOVERNMENT SUPPORT FOR BANK HOLDING COMPANIES

Statutory Changes to Limit Future Support Are Not Yet Fully Implemented

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GAO-14-174T

Chairman Brown, Ranking Member Toomey, and Members of the Subcommittee:

I am pleased to be here today as you examine issues related to government support for large bank holding companies. The federal government maintains programs—frequently referred to as safety nets—to reduce the vulnerability of depository institutions to runs that could threaten the health of the banking system and the broader economy.[1] Two programs are generally considered to form the core of these safety nets: the Federal Reserve System's discount window and Federal Deposit Insurance Corporation (FDIC) deposit insurance.[2] By making emergency liquidity available to solvent depository institutions through the discount window and reducing incentives for depositors to withdraw their funds, these safety nets were intended to help ensure that depository institutions could continue to lend and provide other important services, even during turbulent economic conditions. In addition to these safety nets, the federal government extended unprecedented support to financial institutions to stabilize financial markets during the financial crisis.

My remarks today are based on our November 2013 report, entitled *Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented* (GAO-14-18). This report was the first of two reports we will issue on the economic benefits that the largest bank holding companies have received as a result of actual or perceived government support.[3]

Our November 2013 report examined (1) actual government support for banks and bank holding companies during the financial crisis, and (2)

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[1]This inherent vulnerability arises from the role of banks in using deposits that are available upon demand to fund long-term, illiquid loans.

[2]The Federal Reserve System consists of the Federal Reserve Board—a federal agency—and 12 regional Reserve Banks. The Federal Reserve Board has delegated some of its responsibilities for supervision and regulation to the Reserve Banks. The Federal Reserve Act authorizes the Reserve Banks to make discount window loans to the extent authorized by the Federal Reserve Board. Pub. L. No. 63-43, §§ 10B, 13, 38 Stat. 251 (codified at of 12 U.S.C. §§ 347b(a), 343).

[3]Perceived government support refers to support that market participants may expect the federal government to provide to these institutions in the event that they suffer large losses that threaten them with failure.

recent statutory and regulatory changes related to government support for banks and bank holding companies. To address the objectives for this report, we reviewed relevant statutes, regulations, agency documents, related studies, and prior GAO work; analyzed program transaction data; and interviewed regulators, representatives of financial institutions, academics, trade associations and others. While this report addressed benefits that bank holding companies and their subsidiaries received *during the crisis* from *actual* government support, our ongoing work on this issue includes a consideration of any benefits banks may have received from any *expectations of future* government support. Specifically, in a second report to be issued in 2014, we will examine any funding or other advantages the largest bank holding companies have received as a result of implied government support. Our work for the November 2013 report on which this statement is based was conducted in accordance with generally accepted government auditing standards. Further details on our scope and methodology are included in the November 2013 report.

Government Actions to Stabilize Markets Resulted in Significant Support to Bank Holding Companies

During the financial crisis of 2007-2009, the federal government extended unprecedented amounts of assistance to financial institutions to stabilize financial markets and the broader economy. This support included the creation of temporary programs that extended more than $1 trillion in loans, provided hundreds of billions of dollars of capital, and guaranteed hundreds of billions of dollars of other liabilities for participating financial institutions. While these government interventions helped to avert a more severe crisis, they raised questions about moral hazard and the appropriate scope of government safety nets for financial institutions.[4] In particular, extraordinary support for troubled financial institutions led to debate about how to decrease the likelihood of future rescues of failing institutions and limit the potential for federal safety nets intended for insured depository institutions to provide a backstop for activities conducted outside these institutions.

We found that from 2007 through 2009, the federal government's actions to stabilize the financial system provided significant funding support and other benefits to bank holding companies and their subsidiaries. The

[4]Moral hazard can occur when market participants expect similar emergency actions in future crises, thereby weakening their incentives to properly manage risks.

Board of Governors of the Federal Reserve System (Federal Reserve Board), the Department of the Treasury (Treasury), and FDIC introduced new programs with broad-based eligibility that provided funding support to eligible institutions, which included entities that were part of a bank holding company and others. Programs that provided the most significant support directly to bank holding companies or their subsidiaries included Treasury's capital investment programs, the Federal Reserve System's lending programs, and FDIC's guarantee programs. Some large institutions benefited from special assistance specific to their institution.

Isolating the impact of individual government interventions is difficult, but collectively these interventions likely improved financial conditions by enhancing confidence in financial institutions and the financial system overall.[5] Bank holding companies and their subsidiaries, in addition to the financial sector and the economy as a whole, benefited from improved financial conditions. Bank holding companies and their subsidiaries also experienced individual benefits from participating in particular programs, including liquidity benefits from programs that allowed them to borrow at lower interest rates and at longer maturities than might have been available in the markets.

Government entities generally sought to set prices for assistance through these programs to be less expensive than prices available during crisis conditions but more expensive than prices available during normal market conditions. Based on our analysis, we found that emergency lending and guarantee programs were generally priced below estimated market alternatives that may have been available during the crisis.[6] This result is consistent with the programs' policy goals, which were to stabilize

[5]In prior work, we found that the Troubled Asset Relief Program (TARP), along with other efforts by the Federal Reserve System and FDIC, made important contributions to helping stabilize credit markets. For example, the TED spread—a key indicator of credit risk that gauges the willingness of banks to lend to other banks—had narrowed to precrisis levels within a year of the October 2008 announcements of TARP, the Temporary Liquidity Guarantee Program (TLGP), the Commercial Paper Funding Facility (CPFF), and other government actions.

[6]The market rates used in this analysis provide a general indication of market alternatives that could have been available to participants, but for a number of reasons the rates are unlikely to reflect available alternatives for all participants at all points in time during the crisis and cannot be used to produce a precise quantification of the benefits that accrued to participating financial institutions. See appendix III in GAO-14-18 for more details on our methodology and limitations for these analyses.

financial markets and restore confidence in the financial sector. The pricing of emergency assistance below estimated market alternatives is also evidenced by the significant participation in these programs. In addition, based on analyses of emergency equity support programs we reviewed, Treasury purchased equity in financial institutions at prices that were higher than estimated market prices. For specific programs, we were able to estimate the extent to which participants may have benefited from program pricing as well as the extent to which this pricing became unattractive in comparison to market pricing during normal and more stable credit conditions.

We also found that programs generally were made available to institutions of various sizes, and differences in the use of programs by institutions of various sizes were driven in part by differences in how institutions funded themselves.[7] For example, compared to smaller bank holding companies, larger bank holding companies relied less on deposits as a source of funding and more on short-term credit markets and participated more in programs created to stabilize these markets. In addition, large bank holding companies were significant users of Federal Reserve System programs targeting repurchase agreement markets. At the end of 2008, program use—measured for each institution as the percentage of total assets supported by the programs—was higher on average for banks and bank holding companies with over $50 billion in total assets than for smaller firms. For example, total loans outstanding from selected Federal Reserve System programs combined were at least 2 percent of assets on average for banking organizations with $50 billion or more in assets and less than 1 percent of assets on average for smaller organizations.[8] The six largest bank holding companies were

[7]To compare the extent to which banking organizations of various sizes used emergency programs, we calculated the percentage of banking organization assets that were supported by emergency programs—either through capital injections, loans, or guarantees—at quarter-end dates for 2008 through 2012. Capital provided by emergency programs includes capital investments by Treasury under the Capital Purchase Program and the Targeted Investment Program. Loans provided by emergency programs include Term Auction Facility (TAF), Term Securities Lending Facility (TSLF), Primary Dealer Credit Facility (PDCF), and CPFF loans from the Federal Reserve System. Funding guaranteed by emergency programs includes deposits guaranteed by FDIC through TLGP and debt guaranteed by FDIC through the Debt Guarantee Program. Our analysis of institutions receiving support included banking organizations receiving government support through these emergency programs for which we could reliably calculate consolidated assets. See GAO-14-18 for more information on our analysis.

[8]Selected Federal Reserve System programs included CPFF, PDCF, TAF, and TSLF.

significant participants in several emergency programs but exited most of the programs by the end of 2009. Differences in program use across banking organizations of various sizes diminished as institutions exited the programs.

In addition to these programs, the Federal Reserve Board granted several regulatory exemptions to requirements under Section 23A of the Federal Reserve Act for a range of purposes, such as allowing banks to provide greater liquidity support to the nonbank sector.[9] The number of exemptions granted increased significantly during the crisis, and the majority of these exemptions were granted to U.S. bank holding companies and other firms with $500 billion or more in total assets.

Beyond broad-based programs and regulatory exemptions, federal government agencies took special actions with respect to individual financial institutions on several occasions in 2008 and 2009. While these actions were intended to benefit a range of market participants and the broader financial system, some large U.S. bank holding companies received substantial direct benefits from these actions. Such actions included (1) assisting individual troubled financial firms or facilitating the acquisition of troubled financial firms whose failures posed significant risks to the financial system, and (2) the Federal Reserve Board granting bank holding company status to several nonbank financial companies, which provided these firms with greater access to emergency government funding support.

[9]Section 23A of the Federal Reserve Act imposes quantitative limits on certain transactions between an insured depository institution and its affiliates, prohibits banks from purchasing low-quality assets from their nonbank affiliates, and imposes collateral requirements on extensions of credit to affiliates. 12 U.S.C. § 371c. In letters documenting its approval of exemptions to Section 23A, the Federal Reserve Board has indicated that the twin purposes of Section 23A are (1) to protect against a depository institution suffering losses in transactions with its affiliates, and (2) to limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net. In other words, these restrictions are intended to protect the safety and soundness of banks and to prevent them from subsidizing the activities of nonbank affiliates by passing on any benefits they may receive through access to deposit insurance and the discount window.

Dodd-Frank Aims to Restrict Future Government Support, but Implementation Is Incomplete and Effectiveness Remains Uncertain

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) includes provisions intended to restrict the ability of regulators to provide support to financial institutions, among other things.[10] Nevertheless, market observers have continued to debate whether some of the largest and most complex financial institutions—including bank holding companies with more than $500 billion in total consolidated assets—may continue to benefit from expectations of extraordinary government support that could potentially give them funding and other economic advantages relative to smaller institutions.

The Dodd-Frank Act contains provisions that aim to modify the scope of federal safety nets for financial firms, restrict future government support, and strengthen regulatory oversight for the banking sector, but implementation is not yet complete and the effectiveness of some provisions remains uncertain. Agencies have finalized certain changes to traditional safety nets for insured banks, but the impacts of provisions to limit the scope of transactions that benefit from these safety nets will depend on how they are implemented. The act also places restrictions on emergency authorities used by regulators during the crisis to assist financial firms. For example, the act effectively removes FDIC's authority to provide assistance to a single, specific failing bank outside of receivership and grants FDIC new authority to resolve a large failing institution outside of bankruptcy.[11] FDIC has made progress toward implementing its new resolution authority and continues to work to address potential obstacles to the viability of its resolution process as an alternative to bankruptcy, such as challenges that could arise when resolving more than one large institution concurrently. For example, experts have questioned whether FDIC has sufficient capacity to use its new authorities to handle multiple failures of systemically important firms and thus prevent further systemic disruption. The act also places new restrictions and requirements on the Federal Reserve Board's emergency lending authority. While the act allows the Federal Reserve Board to continue to use its authority under Section 13(3) of the Federal Reserve Act to authorize programs with broad-based eligibility, it sets forth new restrictions and requirements for such programs, including a requirement that lending not assist insolvent firms.

[10] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[11] §§ 204, 210, 124 Stat. at 1454-56, 1460.

While the Dodd-Frank Act requires the Federal Reserve Board to establish policies and procedures governing future actions under Section 13(3) authority, at the time of our report's issuance the Federal Reserve Board had not yet completed its process for drafting these policies and procedures and had not set time frames for doing so. A Federal Reserve Board official indicated that the Board of Governors has focused first on completion of other required regulations that have statutory deadlines and the regulations that are specifically directed at enhancing the safety and soundness of the U.S. financial system. While the act did not set a specific deadline, our report noted that setting time frames could help ensure more timely completion of these policies and procedures. Moreover, finalizing these procedures could help the Federal Reserve Board to ensure that any future emergency lending does not assist insolvent firms and complies with other new requirements.

Finally, the Dodd-Frank Act also introduced a number of regulatory changes designed to reduce the risks that the largest financial institutions pose to the financial system. A notable change is a set of new prudential requirements and capital standards designed to strengthen the regulatory oversight and capital base of large financial institutions. The Federal Reserve Board has made progress towards implementing these enhanced regulatory standards, which cover areas such as risk-based capital requirements and leverage limits, stress testing requirements, and debt-to-equity limits.

In our November 2013 report, we recommended that the Chairman of the Board of Governors of the Federal Reserve System set time frames for completing its process for drafting policies and procedures governing the use of emergency lending authority under Section 13(3) of the Federal Reserve Act. This recommendation is intended to better ensure that the design and implementation of any future emergency lending programs comply with Dodd-Frank Act requirements in a timely manner. The Federal Reserve Board accepted this recommendation and noted that it has made progress toward completing draft policies and procedures governing the use of its emergency lending authority under Section 13(3) of the Federal Reserve Act. On December 23, 2013, the Federal Reserve Board issued a notice of proposed rulemaking and a request for public

comment on a rule designed to establish the required policies and procedures.[12]

Chairman Brown, Ranking Member Toomey and members of the Subcommittee, this concludes my prepared remarks. I would be happy to answer any questions that you or other members of the Subcommittee may have.

For future contacts regarding this statement, please contact Lawrance L. Evans, Jr. at (202) 512-4802 or at evansl@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Other GAO staff who made key contributions to this statement and the report it is based on include: Karen Tremba, Assistant Director; Jordan Anderson, Bethany Benitez, Stephanie Cheng, John Fisher, Michael Hoffman, Risto Laboski, Courtney LaFountain, Jon Menaster, Marc Molino, Robert Rieke, and Jennifer Schwartz.

[12] *Extensions of Credit by Federal Reserve Banks*, Notice of Proposed Rulemaking by Board of Governors of the Federal Reserve System, http://federalreserve.gov/newsevents/press/bcreg/201312223a.htm (Fed. Reg. publication pending) (Dec. 23, 2013).

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