Earlier this week Senators Elizabeth Warren (D-Massachusetts) and David Vitter (R-Louisiana) introduced a bill they call the "Bailout Prevention Act of 2015." If enacted, the bill would further restrict the Federal Reserve's emergency lending powers in a financial crisis. That would be a mistake, one that would imprudently limit the Fed's ability to protect the economy in a financial panic.
During the 2007-2009 crisis, the Fed used its emergency lending authorities in two quite different ways. First, it made loans to help prevent the collapse of two systemically critical firms, Bear Stearns and AIG. The Fed took these actions, with the support of the Treasury, because it feared that the disorderly failure of a large, complex, and highly interconnected firm would greatly worsen the financial panic and damage the economy—a judgment confirmed by the aftermath of the bankruptcy of Lehman Brothers in September 2008. Second, the Fed created a variety of broad-based lending programs, to unfreeze dysfunctional markets and to help stem devastating runs that left whole sectors of the financial system without adequate funding. In providing this funding via short-term, fully collateralized loans, the Fed was fulfilling the traditional central bank role of serving as lender of last resort. This lending, all of which was repaid with interest, was essential for stabilizing the financial system and restoring the flow of credit.

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The Fed intervened in the cases of Bear and AIG with great reluctance, doing so only because no legal mechanism existed to safely wind down a systemic firm on the brink of failure. A key element of the Dodd-Frank financial reform bill, passed in 2010, was to provide just such a mechanism—the so-called orderly liquidation authority, which gives the Federal Deposit Insurance Corporation and the Fed the necessary powers to put a failing firm into receivership without creating financial chaos. (By the way, a great deal of progress has been made in implementing this authority and preparing for the possible failure of a systemic firm; see these recent remarks by FDIC chairman Martin Gruenberg.) With the creation of the liquidation authority, the ability of the Fed to make loans to individual troubled firms like Bear and AIG was no longer needed and, appropriately, was eliminated. As Fed chairman, I was delighted to see my institution taken out of the business of bailing out failing behemoths.

Dodd-Frank also cut back other emergency authorities, including those exercised by the FDIC and Treasury as well as by the Fed, while increasing disclosure and reporting requirements. I thought at the time that some of the additional restrictions on emergency powers went too far and were unwise, but I supported them as part of the deal that created the orderly liquidation authority. Moreover, Dodd-Frank preserved what I saw as the Fed's most essential power, namely, the authority in an emergency (with permission from the Treasury secretary) to set up broad-based lending programs in a financial panic, and thereby serve as lender of last resort.
The lender-of-last resort concept is centuries old. Walter Bagehot, the English economist, discussed the lender-of-last resort policies of the Bank of England in his famous 1873 tract *Lombard Street*. Bagehot famously advised that, in a panic, the central bank should lend freely, at a penalty rate, against good collateral. By providing liquidity—for example, to banks facing runs by their depositors—the central bank can help end a panic and limit the economic damage. Indeed, the Federal Reserve was founded in 1913 in large part to serve as a lender of last resort and thereby reduce the incidence of banking panics in the United States.

The Warren-Vitter bill would impose two additional requirements on the Fed's broad-based lending programs. First, it would require the Fed and any other supervisors of a firm receiving loans to certify the firm's solvency, and to make its solvency analyses public immediately. Second, it would require that the interest rate on any emergency loans be at least 5 percentage points above the Treasury rate. The Fed could suspend these

two conditions, but Congress would have to approve the suspensions within thirty days or the lending programs would have to be shut down. (Warren-Vitter also would define a "broad-based program" as one in which at least five borrowers are eligible to participate.)

Superficially, the two new conditions that Warren-Vitter would impose seem consistent with Bagehot's dictum, to lend freely at a penalty rate against good collateral. Unfortunately, in practice, they would eliminate the Fed's ability to serve as lender of last resort in a crisis.

The problem is what economists call the stigma of borrowing from the central bank. Imagine a financial institution that is facing a run but has good assets usable as collateral for a central bank loan. If all goes well, it will borrow, replacing the funding lost to the run; when the panic subsides, it can repay. However, if the financial institution believes that its borrowing from the central bank will become publicly known, it will be concerned about the inferences that its private-sector counterparties will draw. It may worry, for example, that its providers of funding will conclude that the firm is in danger of failing, and, consequently, that they will pull their funding even more quickly. Then borrowing from the central bank will be self-defeating, and firms facing runs will do all they can to avoid it. This is the stigma problem, and it affects everyone, not just the potential borrower. If financial institutions and other market participants are unwilling to borrow from the central bank, then the central bank will be unable to put into the system the liquidity necessary to stop the panic. Instead of borrowing, financial firms will hoard cash, cut back credit, refuse to make markets, and dump assets for what they can get, forcing down asset prices and putting financial pressure on other firms. The whole economy will feel the effects, not just the financial sector.

The stigma problem is very real, with many historical illustrations. When the BBC announced in 2007 that the British lender Northern Rock had received a loan from the Bank of England, for example, a severe run on the lender began almost immediately. Ultimately, the government had to take the firm over.

The Warren-Vitter legislation would create an insuperable stigma problem. (It has other drawbacks as well, but my focus here is on stigma.) First, the requirement that solvency analyses be released immediately (or quickly) would publicly identify any potential borrowers. No borrower would allow itself to be so identified, for fear of the inferences that might be drawn about its financial health. Second, the five percentage point penalty rate requirement would remove any doubt that those borrowing from the central bank had no access to other sources of funding, further worsening the stigma problem. (A penalty rate was not a problem in Bagehot's era, because, unlike today, all lending by the central bank was strictly confidential.) Moreover, because borrowers would know that the program could be terminated in thirty days if Congress didn't approve, the benefit of borrowing from the central bank would be limited. Because borrowers would not willingly participate, broad-based lending programs (which Dodd-Frank intended to preserve) would not work, and we
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would have lost a critical weapon against financial panics. Again, my concern is not for the borrowers, or potential borrowers, but for the broader economy. We have learned more than we would have liked about the damage a financial crisis can do to Main Street jobs and incomes.
I don't think Senators Vitter and Warren mean to stop broad-based emergency lending in all circumstances, although their bill would have that effect. Their goal, I assume, is to induce financial firms and market participants to be less reliant on possible government help, for example, by holding more cash to protect against possible runs and panics. But

their approach is roughly equivalent to shutting down the fire department to encourage fire safety; or—more relevant to the current context —eliminating deposit insurance so that banks will be more careful. Rather than eliminating the fire department, it's better to toughen the fire code. Dodd-Frank and the international Basel III Accord have already greatly increased the amount of cash that banks are required to hold, for example. This bill would not have any marginal effect on the behavior of banks or other financial firms. Senator Warren in particular has been a staunch defender of Dodd-Frank. It is puzzling that she would propose legislation to overturn one of the key legislative bargains in that bill—the trade of liquidation authority for reduced emergency powers—by further reducing the nation's ability to defend against financial panics.