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Trump will perpetuate bailouts by signing bank reform bill

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THE HILL

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BY DAVID SCHOENBROD, OPINION CONTRIBUTOR — 03/16/18 01:45 PM EDT
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Like President Barack Obama, President Donald Trump vows the government will never again bail out "too-big-to-fail" (TBTF) firms yet supports arrangements that will lead to more bailouts. He should do better, but the banking bill that the Senate passed Wednesday is so far a missed opportunity.

In contrast to Obama and Trump, President Franklin Roosevelt discouraged bailouts. He did so through the statute establishing the Federal Deposit Insurance Corporation (FDIC) during a banking crisis in 1933. The FDIC's guarantees would cover only small deposits, originally no more than $2,500.

Big depositors and others who might lend to banks, having no government guarantee, would thus demand higher interest rates from banks that took more risks and refuse to lend to those that took much more risk.

So, the government could protect little depositors yet give banks a cash incentive to control their appetite to take on too much risk. This would help avert systemic financial crises and bailouts.

Subsequent decades without any such crises emboldened officials to implicitly guarantee even the largest debts of financial titans. For

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example, the statute that made the mortgage giant Fannie Mae into a private corporation in 1968 implied to sophisticated investors that the government guaranteed all its debts.

Similarly, Washington covered all debts during the collapse of Continental Illinois in 1984 and other banking failures that did not amount to a systemic crisis.

With investors reassured by implicit guarantees, the financial titans could borrow at lower interest rates. That increased their profits by hundreds of billions of dollars. The guarantees also increased their profits by loosening the constraints on risky behavior imposed by risk-averse investors.

So, the titans could still borrow on reasonable terms even though they borrowed more and made riskier but more lucrative investments. Thus, they got bigger and more likely to fail. Some of them started to fail during the financial crisis that began in 2007, but Washington rescued them.

The presidents and legislators of both parties who made Washington into a guarantor long before 2007 got hefty campaign contributions from the executives of the firms that profited from the guarantees. The politicians avoided blame from voters by promising the guarantees implicitly rather than explicitly. Besides, most of these politicians were out of office before the unpopular bailouts began in 2007 and 2008.

The blame fell on the officials in office in those years, but they felt they had no real choice. As the current Minneapolis Federal Reserve president Neel Kashkari explains, they were "forced to bail out failing institutions ... The risks to the U.S. economy and the American people were simply too great not to do whatever we could to prevent a financial collapse."

Trying to distance himself from such behavior, President Barack Obama stated in signing the Dodd–Frank Wall Street Reform and Consumer Protection Act: "Because of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes."

The basis for this promise is that the statute establishes an Orderly Liquidation Authority with the power to take money from solvent firms to pay debts of a failing firm.

Notice, however, that Dodd-Frank still guarantees debts, just hopefully not at the public's expense. Yet, in the last financial crisis, the cost to the public of the bailouts was trivial in comparison to the harm to the public from guarantees encouraging firms to take risks that led to the financial crisis.

It triggered the Great Recession that cost millions of people their homes, jobs or retirement savings. Besides, as Stanford's Peter Conti-Brown has shown, experts with diverse political affiliations believe that, in a systematic financial crisis, government would still end up using taxpayers' money to pay off most or all the debts of the giant firms.

In 2017, a month after taking office, President Trump issued an executive order stating it "shall be the policy of my Administration to ... prevent taxpayer-funded bailouts" and directing the treasury secretary to report what changes are needed to do so.

The secretary's report, issued last month, argues that Dodd-Frank is insufficient to keep Obama's promise and proposes creating a new chapter of the bankruptcy law to deal with failures of financial giants.

Bankruptcy may well be an improvement over the Orderly Liquidation Authority, but Treasury undercuts its own proposal by suggesting that the Orderly Liquidation Authority be kept as “an emergency tool for use under only extraordinary circumstances.”

The upshot is that bailouts will still be available in a financial crisis because, given the experience in the U.S. and elsewhere, Washington can’t convince the financial giants’ creditors that it won’t rescue them when a financial crisis threatens the economy.

The solution is to charge the financial giants a market-based fee for the debt guarantees. Financial experts have shown how to charge such a fee even though no private insurer is big enough to provide the insurance alone.

Require each TBTF firm to buy from a private insurer a guarantee for a small fraction of its debt. Then, the government would guarantee the rest at a multiple of the cost of the private insurance. That way, TBTF firms that borrow more or make riskier loans would have to pay higher fees.

Making the financial titans pay for their guarantees would not preclude alternatives such as reducing their size or requiring them to be better capitalized. Indeed, the fees would facilitate such alternatives because cheap guarantees would no longer subsidize these firms to be big and thinly capitalized.

Donald Trump would insist upon a market-based fee before his firm gave a guarantee, but as president, he states that he would sign the Senate bill as is, even though it lacks such fees. So, Jane Q. Public will still subsidize Wall Street. The House now has a chance to put the American people first.

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