Joint Economic Committee
Republicans
Senator Sam Brownback *Ranking Member*
Representative Kevin Brady *Senior House Republican*

Republican Staff Commentary

Despite Claims, the Dodd Bill-

- *Does not end "Too Big to Fail"*
- *Does authorize future taxpayer guaranteed bailouts without approval from Congress.*
- *New authorities = TARP on steroids.*
- *Provides implicit subsidies that will give large financial institutions a competitive advantage over smaller competitors.*

Financial Reform Legislation and Bailouts *Myth vs. Reality*

April 26, 2010

As the Senate moves closer to floor consideration of legislation to reform the financial services industry, advocates and opponents have traded charges over the extent to which the legislation does or does not institutionalize future bailouts of large failing financial institutions. In addition, there has been much debate over whether any such bailouts would be paid for by the U.S. taxpayer or funded by the financial services sector.

Bailouts, Taxpayer Backed Bailouts, or Neither?

The correct answer -- BOTH. Proponents of the legislation are quick to point out that it provides for a $50 billion fund to be funded by the largest institutions in order to pay for the cost of winding down large failed financial institutions. What they do not discuss, or even seem to appreciate, is that the mere existence of such a fund provides a significant competitive advantage to the largest financial institutions compared to smaller institutions.

Perhaps the simplest way to explain the subsidy involved is to use a very simple example. Consider Luke and Sarah who are looking for financing to expand their business. They have a very strong credit profile. Similarly, Harry and Nancy are looking to expand their business. Their credit risk profile is also strong. The major distinction is that Harry and Nancy belong to "The Club". Members of "The Club" were forced by their parents to contribute into a fund to help pay off all or part of a member's debts in the event that their business failed.

Both couples approach investors seeking to borrow funds for their very similar ventures. As potential investors evaluate their nearly identical proposals to decide to which couple they will lend, they look to the likelihood that their funds will not be repaid. Harry and Nancy emerge from the meeting with smiles on their faces; their project will be funded. Devastated, Luke and Sarah inquire as to why the investors chose Harry and Nancy's proposal over their own.

Not surprisingly, Luke and Sarah learn that the deciding factor was the lenders' perception as to who represented the lowest risk for non-repayment. The lenders explained that because Harry and Nancy were members of "The Club", the lenders could count on "The Club's" fund to make them whole in the event of a business failure by Harry and Nancy.

Undeterred, Luke and Sarah ask what, short of them belonging to "The Club," they could do to secure funding for their almost identical venture. The lenders confer. They decide that Luke and Sarah could get funding, but since they didn't belong to "The Club," they would have to pay a higher interest rate on their loan.

Far from imposing a significant cost on major financial institutions, the existence of such a fund will serve to provide them with a significant competitive advantage over their competitors who are not members of "The Club". For large financial firms whose sizes are in the hundreds of billions or more, even a small funding advantage over time leads to billions of undeserved profits and to unfair advantages over their smaller potential competitors.

Taxpayer Funded Bailouts

In his speech on April 22 in New York, President Obama proclaimed that "a vote for reform is a vote to put a stop to taxpayer-funded bailouts."

As with healthcare legislation, proponents of the current financial reform legislation must not be reading their own bill to make the argument that the legislation puts an end to taxpayer backed bailouts. In fact, the legislation amounts to TARP on steroids. One only need review the language of the Dodd legislation's 1,408 pages to find the permanent sanction of taxpayer funded bailouts.

First, § 1155 expands the Federal Reserve's emergency lending authority. In other words, the legislation expands the authority the Federal Reserve used to prop up AIG. Second, § 1155 grants authority to the FDIC and to Treasury to enable them to provide debt guarantees in times of "severe economic distress" if financial institutions face a "liquidity event." However, if a depository or depository holding company receiving guarantees defaults on its obligations, there is *no* requirement that the FDIC take the defaulting company into receivership, bankruptcy, or resolution. Thus, in a crisis, the FDIC and Treasury would have the power to prop up, as unproductive zombie institutions, any failing company they so choose.

Bottom line: Taxpayers are on the hook. The FDIC's function has been to insure the deposits of bank customers. This provision of the Dodd bill uses the FDIC as a vehicle to guarantee other liabilities of financial institutions and their holding companies. The legislation essentially creates an authorization for the Administration to initiate the next TARP-like program without the inconvenience of having to secure Congressional approval.

Conclusion

While advocates of the proposed legislation might like to claim that it ends "Too Big to Fail" and will prevent future taxpayer funded bailouts, they can only make such claims if they are willing to dismiss or ignore the very legislative language they seek to pass. From an economic perspective, the provisions that are supposed to address the issue of "Too Big to Fail" actually provide competitive advantage (subsidies) to large financial institutions. Similarly, the back-up guarantee authority provided Treasury and FDIC, as well as the Federal Reserve's expanded emergency lending authority, not only put taxpayers at risk without future Congressional approval, but represent a further implicit subsidy to large financial institutions at the expense of their smaller competitors