Congress Is Wasting a Good Crisis

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By Peter Eavis
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Has anyone in Congress actually explained to taxpayers how much they could be on the hook for if the banking system were to crater again?

Compromises are being struck in the Senate that could soon clear the way for the passage of financial-system-overhaul legislation. That would seem a cause for celebration, given the need for reform and the many sensible proposals in draft legislation.

However, the overhaul could be undermined by parts that aim to construct enormous government backstops for banks. Indeed, if Congress gets its way, the taxpayer may soon have to stand behind some of the riskiest parts of banks' balance sheets.

Before the credit crisis, government support to the banks looked sensibly limited. Through the Federal Deposit Insurance Corp., the taxpayer effectively guaranteed deposits up to a certain size. In theory, other bank liabilities, like bonds, interbank loans and derivatives claims, weren't backed. But when the credit crisis hit, the government rushed in to make sure all manner of bank liabilities could be repaid, including even "repo" obligations, short-term loans whose collateralized nature was supposed to make them super-safe.

Now, in the overhaul legislation, Congress effectively wants to formalize much of that emergency support. Creditors to banks could gain protection that lenders to other sectors will likely never enjoy, creating even more moral hazard. The two main proposed backstops are a program to guarantee bank debt and a $4 trillion Federal Reserve repo facility for banks to tap, both of which would be made available in shaky times.

Granted, these provisions contain features that aim to protect the government and the taxpayer. But this would be difficult in practice. The draft legislation would make it possible for the government to lend to a large financial firm it had seized because it was unstable. The rationale for this is that some debts need to be honored to prevent financial contagion. But that standard could easily lead to the government once again paying out on the sort of derivatives obligations that nearly sank American International Group. As government defenders of the AIG bailout repeatedly say, those were done to prevent contagion.

What should Congress have done instead? First, instead of enshrining a system for backstopping liabilities like market debt, legislation should have put defined limits on it—and forced firms that use a lot of it to hold more capital. Second, the advantageous treatment derivatives counterparties enjoy under bankruptcy law should have been reversed. These perks undermine market discipline and can actually increase systemic instability when a firm fails, says Harvard University law professor Mark Roe.

Congress is highly unlikely to insert such changes. In January, President Obama said he would send back an overhaul bill that doesn't contain "real reform." The backstops are reason alone to do just that.