FAIR GAME

Trying to Slam the Bailout Door

By Gretchen Morgenson, *New York Times*
Published: April 27, 2013

THERE'S a lot to like, if you're a taxpayer, in the new bipartisan bill from two concerned senators hoping to end the peril of big bank bailouts. But if you're a large and powerful financial institution that's too big to fail, you won't like this bill one bit.

The legislation, called the Terminating Bailouts for Taxpayer Fairness Act, emerged last Wednesday; its co-sponsors are Sherrod Brown, an Ohio Democrat, and David Vitter, a Louisiana Republican. It is a smart, simple and tough piece of work that would protect taxpayers from costly rescues in the future.

This means that the bill will come under fierce attack from the big banks that almost wrecked our economy and stand to lose the most if it becomes law.

For starters, the bill would create an entirely new, transparent and ungameable set of capital rules for the nation's banks — in other words, a meaningful rainy-day fund. Enormous institutions, like JPMorgan Chase and Citibank, would have to hold common stockholder equity of at least 15 percent of their consolidated assets to protect against large losses. That's almost double the 8 percent of risk-weighted assets required under the capital rules established by Basel III, the latest version of the byzantine international system created by regulators and central bankers.

This change, by itself, would eliminate a raft of problems posed by the risk-weighted Basel approach. Under those rules, banks must hold lesser or greater amounts of capital against assets, depending on the supposed risks they pose. For example, holdings of United States government securities are considered low-risk and require no capital to be held against them. Securities or loans that are riskier require more of a buffer against loss.

There are many problems with this arrangement. First, the risk assessments on various types of assets rely heavily on ratings agency grades. In the housing boom, toxic mortgage securities carrying triple-A ratings were considered low-risk, too. As such, they didn't require hefty capital set-asides.

We all know how disastrous that was. So chalk up this plus for Brown-Vitter: Eliminating risk-weights as part of a capital assessment means less reliance on unreliable ratings.

Risk-weighted asset calculations also give bankers a lot of freedom to understate the perils in their institutions' holdings.

The bill prevents another type of fudging by requiring off-balance-sheet assets and liabilities and derivatives positions to be included in a bank's consolidated assets. In addition, the capital cushion that a bank would hold under the bill is liquid and can absorb losses easily. This capital measure would be more transparent than the current system and could not be manipulated.

In a truly courageous move, Brown-Vitter would require United States financial regulators to abandon Basel III. An earlier version of Basel did nothing to prevent the financial crisis and encouraged banks to binge on leverage.

Taxpayers would not be the only beneficiaries in the Brown-Vitter bill. Community banks, which weren't responsible for bringing the nation's economy to the brink, would be operating on a more level playing field with the jumbo banks. These large institutions have lower financing costs than community banks because the market understands that regulators will never let them fail.

"This bill will inject more market discipline on the financial services industry," Mr. Brown said in an interview on Thursday. "The megabanks have a choice to make: they can increase their capital or bring down their size."

Brown-Vitter has other attributes as well. It would bar bank regulators from giving nondepository institutions access to Federal Reserve lending programs. And it would make it harder for bank holding companies to move assets or liabilities from nonbanking affiliates, like derivatives bets held at a brokerage unit, to the protective umbrella of the parent company that might be rescued by taxpayers in a financial disaster.

Thomas M. Hoenig, the vice chairman of the Federal Deposit Insurance Corporation, supports the bill. "It's finally taking the discussion in the right direction toward improving the stability of banks and the financial system more broadly," Mr. Hoenig said in an interview on Friday. Brown-Vitter would also put the United States in a leadership position on financial soundness, he added, which other countries could emulate.

Both Mr. Brown and Mr. Vitter acknowledge, of course, that they will have to wage war with the financial services machine to move the bill forward. And last week, right on cue, the big-bank protection team went to work, warning of economic mayhem that would result if Brown-Vitter became law.

Standard & Poor's, for example, published a report forecasting a possible credit crisis resulting from passage of the bill, "further reducing economic growth prospects." With more money in a capital cushion, there would be less money to lend, the banks say.

And Tony Fratto, a strategist who represents the large banks, called the bill's capital requirements "a penalty rate." He added in an e-mail: "This bill is being introduced in the context of significant improvements to the safety of the financial sector. By historical and international standards, large U.S. banks are very safe."

Mr. Brown and Mr. Vitter are also up against the Obama administration, which continues to argue, in lock step with the banks, that the Dodd-Frank legislation has already eliminated the threat of big and risky enterprises.

But Mr. Vitter told me that risks remained in the banking system, and that he wasn't the only one making that judgment. "There is a growing bipartisan concern that 'too big to fail' is still unfortunately alive and well," Mr. Vitter said. "I'm not trying to suggest passing this bill will be a cakewalk, but it's a completely different landscape than it was a year ago."

Now comes the hard work of getting support for their bill from Senate colleagues.

A little over a month ago, the Senate held a nonbinding vote on the problems posed by megabanks. Its members voted 99 to 0 to "to end 'too big to fail' subsidies or funding advantage for Wall Street megabanks."

Brown-Vitter would achieve those goals while also protecting taxpayers. As such, it will be interesting to see which senators retreat from their earlier positions by refusing to support the bill. Constituents on the alert for hypocrisy, take note.