ISSUE BRIEF | No. 3 April 2010

MANHATTAN INSTITUTE FOR POLICY RESEARCH

PROTECTING THE ECONOMY FROM WALL STREET:
Can the Financial Industry Pay for Its Own Bailout?

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EXECUTIVE SUMMARY

As part of Washington's plan to fix Wall Street regulations, lawmakers, supported by President Obama, want financial firms, rather than taxpayers, to pay for future bailouts of their industry.

Such a suggestion is impractical. In a future crisis, the financial industry would need more than $20 trillion up front to cover unknowable losses if it were to avoid turning to government, the current crisis shows. That's the amount that would keep investors from deserting the financial system and causing a depression. This price tag is far beyond what the industry could afford.

"MOVES TO TAX BANKS TO PAY FOR BAILOUTS GAIN STEAM" —headline, *Wall Street Journal*, March 29, 2010

It's become a piece of global conventional wisdom: the financial industry should fund its own rescues. As the *Journal* reported in March, "U.S. and European governments are moving toward a consensus on taxing large banks to cover the cost of any future bailouts rather than asking taxpayers to foot the bill, as happened in past banking crises."[1] In the United States, the White House and Congress are consid-

Published by the Manhattan Institute

ering such proposals. The German government is mulling a similar levy, while in Britain, both the Labour government and its Tory rivals agree on this principle.

The idea seems a way to temper public anger. As President Obama said in his State of the Union Address, "…if there's one thing that has unified Democrats and Republicans, and everybody in between, it's that we all hated the bank bailout. I hated it. You hated it. It was about as popular as a root canal." Voters have consistently voiced outrage over the unfairness of the bailouts that Washington has effected since the Federal Reserve, offering nearly $30 billion in loan guarantees, engineered the purchase of the failing investment firm Bear Stearns by JPMorgan Chase in March 2008. Outrage reached a crescendo six months later with the federal government's $182 billion rescue of failing insurance giant AIG.

Anger is strong despite the fact that the government had no choice but to act as it did. If Washington had not enacted programs such as the Troubled Asset Relief Program (TARP) to pump money into financial firms and stem losses in the industry, investors would have fled banks, investment firms, and insurers—killing off credit and forcing the economy to slash millions more jobs than it has.

The idea of requiring financial firms to pay to protect themselves also seems rooted in precedent. After all, if the Federal Deposit Insurance Corp (FDIC) can use the proceeds of a bank fee to guarantee small deposit accounts against losses in bank failures, the thinking goes, the government can create a broader fund through which the financial industry "insures" itself against all financial-industry failures.

President Obama laid the groundwork earlier this year. In January, he proposed a ten-year, $117 billion "financial crisis responsibility" assessment on large financial firms to pay for bailouts that occurred in 2008 or later, calling it a "modest fee to pay back the taxpayers who rescued them in their time of need."[2] Looking toward the future, Treasury Secretary Timothy Geithner said in a March speech that "reforms would put in practice the principle that large institutions should bear the costs of any losses to the taxpayer."[3]

Congress has taken the concept further, proposing a permanent fund for future rescues. The financial-reform bill that Sen. Chris Dodd (D-Conn.) proposed in March would require large financial firms to pay for an "orderly-liquidation fund." The government could use the fund's resources to help wind down financial firms it deems unable to go through normal bankruptcy procedures.

The FDIC, which would be in charge of such liquidations, could tap into the fund to rescue uninsured lenders to the financial industry, a form of extraordinary support similar to what the U.S. government has done for the financial industry since 2008 through TARP and other programs.[4]

WHY INDUSTRY-FUNDED BAILOUTS CAN'T WORK

Pre-funded bailouts, though, sound too easy to be true—and they are.

The comparison to the FDIC, for one, is inapt. FDIC insurance protects the economy only against public panics, not against the kind of massive panic *within* the financial industry that we saw in 2008. FDIC insurance draws on all banks to protect small depositors, who are but a small subset of financial-industry lenders. FDIC insurance does not prevent bank failures; rather, in quelling public fear, it enables orderly liquidations of failed banks, through which uninsured lenders do take their losses.

FDIC insurance, then, does *not* protect against the type of systemic financial-industry risk that nearly killed Wall Street in the fall of 2008. That systemic financial-industry risk comes not from public panics, but from the panicking of sophisticated investors —itself the result of inadequate limits on debt as well as inadequate rules for trading financial instruments such as "exotic" derivatives.

Inadequate regulations can cause investor panics by allowing bubbles to distort asset prices and credit markets to an irrecoverable extent. When bubbles burst, they leave behind so much debt that the financial industry is unable to repay it. Investors know that business failures are inevitable. But they don't know which financial firms will go under, so they pull their money from every firm, just in case.

In the current crisis, for example, AIG, putting no consistent level of cash down, issued tens of billions of dollars' worth of unregulated credit default swaps to guarantee mortgage securities against losses. These promises made the debt seem safe – increasing lending and pushing up asset prices. But when AIG could not make good on its promises, no one knew who would be left unpaid, and who, in turn, would be bankrupted by AIG's default.

The financial industry will never have enough money to protect itself and the economy from such fear. The true tab for such rescues is not the retroactive cost, as the White House and regulators intimate when they say they'll make the financial industry pay back net losses from TARP's financial bailouts—estimated, as Obama notes in his bank-fee proposal, to be around $100 billion.

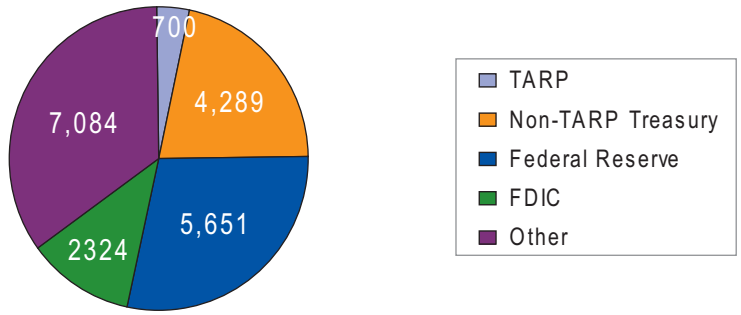
Rather, the true upfront cost of future financial-industry bailouts is what investors demand *at the time* of an acute crisis for refraining from pulling all their funds from the financial system, as well as the amount that Washington thinks the financial system needs at that time to avoid an economic depression. Those costs, in the present crisis, have exceeded $20 trillion (see graph, attached data[5]).

The figure includes the cost of the measures that the government has taken to prop up markets directly (TARP injections of capital into banks) as well as indirectly (Federal Reserve purchases of securities to keep prices high and avoid financial-industry bankruptcies).

For example, the figure includes the Federal Reserve's purchase of $1.25 trillion in mortgage-backed securities, which prop up the prices of similar mortgage securities that financial firms still hold on their books. It also includes the FDIC's extraordinary guarantee of up to $940 billion in financial-firm bonds, which allowed the firms to borrow in the midst of an investor panic and avoid selling off assets at crisis-level prices. The figure does *not* include the economic stimulus or the auto-industry bailouts, even though these measures, too, likely have averted immediate financial-industry bankruptcies.

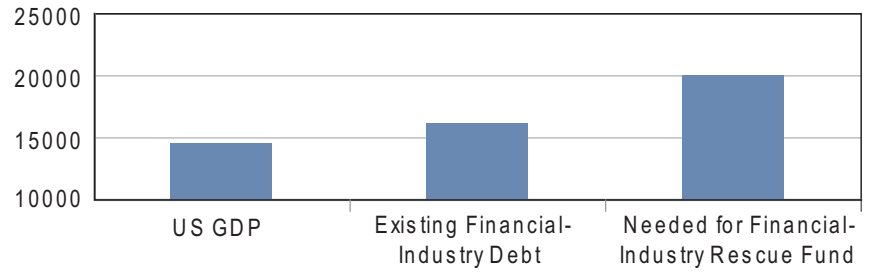
True, the government and the financial industry decided not to tap some of these programs in the end and didn't use others to the maximum extent.

Extraordinary Government Support of the Financial Industry Has Exceeded $20 Trillion Since 2008. (In Billions of Dollars)



Source: Author's calculations based on data from the Troubled Asset Relief Program Inspector General.

A Credible Financial Industry Rescue Fund Would Exceed US GDP and Existing Financial-Industry Debt. (In Billions of Dollars)



Source: Author's calculations based on data from the Bureau of Economic Analysis, Federal Reserve, and TARP IG.

But markets didn't know those things when the government first made its promises to step forward, if necessary.

HOW MUCH IS $20 TRILLION?

Twenty trillion dollars is far more than the financial industry could ever pay. It is 39 percent more than the gross domestic product (GDP) of the United States. It's 24 percent more than America's financial industry explicitly owed to existing creditors before the 2008 bailouts began.[6]

Even if the financial industry could make a modest down-payment on this bailout fund—say, $2 trillion—*that* amount would pose a systemic risk to the economy of the type the government hopes to avoid. The government could not invest $2 trillion in any financial markets—Treasury bond markets, global stock markets, real estate, or some combination—without distorting them. Moreover, in a crisis, global investors would expect the bailout fund to dump some assets to pay for its rescues. This expectation would itself exacerbate price declines.

BACK TO THE FINANCIAL-REFORM DRAWING BOARD

In the future, as now, the financial industry won't be able to bail itself out before financial panic results in a depression. The only protection for the economy is a set of predictable regulations—including consistent borrowing limits and trading rules applied to all financial firms and instruments.

Such rules would have avoided the disasters that started in 2008. With consistent cash-down requirements on the promises it made with credit-default swaps, for example, AIG, it is likely, never would have made such a large volume of promises; fewer such promises, in turn, would have tempered the bubble. If the company had failed anyway, the economy would have had a cash cushion with which to withstand hefty losses.

For more information on how such rules have worked in the past and can work again, see *After The Fall: Saving Capitalism From Wall Street and Washington* (Encounter Books, 2009).

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[1] Davis, Bob, "Move to Tax Banks for Bailouts Gains Steam," *Wall Street Journal*, March 29, 2010.
[2] Calmes, Jackie, "Taxing Banks for the Bailout," *The New York Times*, January 14, 2010; State of the Union Address, January 27, 2010.
[3] Remarks before the American Enterprise Institute on Financial Regulatory Reform, March 22, 2010.
[4] "Restoring American Financial Stability Act of 2010," Senate draft, March 15, 2010.
[5] SIGTARP, Quarterly Report to Congress, July 21, 2009.
[6] Flow of Funds report, Federal Reserve, March 11, 2010.