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The FDIC Needs to Address the Moral Hazard of TBTF

It appears that it is FDIC Chairman Sheila Bair who is making the misinformed criticisms ("Beyond Bankruptcy and Bailouts," op-ed, April 5). Critics of the Dodd or Frank financial reform bills do not oppose these bills in order to protect the funding advantage of the largest firms. It's quite the opposite. Critics recognize that if creditors believe they will be bailed out, then the funding advantage for larger institutions will not only remain, but will increase. While these bills may impose losses on creditors, they are just as likely not to. One need only look at Ms. Bair's FDIC, which regularly pays off uninsured creditors. Remember WaMu's uninsured nondeposit creditors? Had Citigroup acquired Wachovia instead of Wells Fargo, it is likely that Wachovia's uninsured debt would have been rescued also.

Ms. Bair's analysis gives insufficient attention to the moral hazard of guaranteeing unsecured creditors. While protecting the taxpayer should rank at the top of any list, reducing moral hazard should rank as high. Extending an FDIC-like g uarantee to debtholders, even funded by the banking industry, would greatly increase moral hazard. Does anyone truly believe that insured depositors act now as effective monitors? Of course not. So why would we want to extend that same system to cover other creditors? At the end of the day, creditors do not care if it is the taxpayer or banks bailing them out. Any rescue reduces their due diligence.

The debate is not simply about protecting the taxpayer. It is also about protecting the financial system. It is well accepted within the banking literature that while deposit insurance reduces the likelihood of bank runs, it also reduces the monitoring of bank behavior by depositors. Some serious thought should occur before we blindly extend this system to nondeposit creditors. Ms. Bair's misrepresentation of the reform debate only makes effective reform all the harder to achieve.

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We need legislative changes so that government regulators aren't performing like fire departments—arriving only after the damage has been done. Financial authorities need to be more like police departments: detecting, deterring and preventing fraud, abuse and manipulation in critically important markets. When the next Bernie Madoff scandal happens—and it will—we shouldn't be coming in with fire hoses to water down charred remains; we should be there on the front end with sophisticated law-enforcement tools at our disposal and stop the damage beforehand.

The simple answer is that stopping something in Washington is much easier than getting something

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done. This is compounded by the fact that there are over 22,000 registered lobbyists who have access to members of Congress. Many of these lobbyists represent various financial-sector concerns that have found reasons to oppose or slow down one or more sections of the financial regulatory reform bill. As it's cynically and succinctly put in Washington: If you aren't part of the solution, there's plenty of money to be made being part of the problem.

Let's hope that the powerful interests don't win on this one.

Bart Chilton

Commissioner

Commodity Futures

Trading Commission

Washington

Nowhere in her article does Ms. Bair own up to the fact that the FDIC is itself technically bankrupt. The FDIC is being bailed out by the U.S. government under similar circumstances to those of AIG, namely lack of foresight by regulators and precautionary and concomitant enforcement actions.

Throughout the federally insured banking system local and regional banks are being hung out to dry while the big banks and the FDIC are bailed out by Congress because, like AIG, they are too big and important to fail. In other words, the FDIC despite its oversight failures will be given eternal life-support at taxpayer expense, in no less manner than AIG. The obvious hypocrisy of pointing toward another catastrophe to blur the disaster at hand can be disguised on the surface, but like rotting meat the overpowering stench cannot be concealed.

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