A Case Study: The Wall Street Bailout

By Congressman J. Randy Forbes
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In the last ten days, I have heard from thousands of constituents who are both scared and outraged at the financial crisis facing our nation and the subsequent response by legislators in Washington. These taxpayers are worried about their retirement accounts, personal and business investments, and college investment accounts - money and financial security they have worked hard to secure all their lives. At the same time, they are outraged that taxpayers are being asked to pick up the tab for the irresponsible actions of businesses and the government that have led to our current economic crisis. People know things need to change.

As I am sure you are aware, the House failed to pass a Wall Street bailout package on Monday by a vote of 228-205. In the hours following the vote both Republicans and Democrats cited partisan speeches, constituent pressure, and the upcoming campaign as reasons for why the package failed to garner the necessary support for passage. While I cannot explain the votes of other Members of Congress, I can share with you how I decided to cast this difficult vote and what solutions I believe we should be considering that will protect our citizens' life savings, keep them in their homes, sustain their businesses, and help to determine the root causes of this crisis in order to reform Wall Street and Washington to prevent us from being here again.

In the midst of great partisanship in Washington and throughout the country, I believe we witnessed a powerful bipartisan statement yesterday from 133 Republicans and 95 Democrats. While Members undoubtedly arrived at this conclusion for differing reasons, 228 bipartisan Members agreed that the American taxpayers should not take a $700 billion gamble on a stopgap failure of government and private corporations. While decisive action is undoubtedly needed to address problems in our financial sector, there was a clear message sent that this should not be in the form of a Wall Street bailout that gives short-term relief at the expense of long-term economic security.

In the wake of the failure of Monday's bill, it is imperative that Congress continue to work on alternative legislation which will have a greater likelihood of improving our economy as a whole – and that will provide taxpayer protection at less taxpayer cost. On Monday, I voted against the House adjournment so that we would continue to work on Tuesday and Wednesday so that the House might continue consideration of an alternative proposal to address problems within our financial sector. While a majority voted to adjourn, the House will reconvene this Thursday.

Over the last ten days, many of you took the time to send me your comments, concerns, and suggestions on this important issue. The e-mails, phone calls, and letters poured into my office, and I appreciate each person that shared with me where they stood on this tough issue. As your Representative in Congress, I consider your comments and opinions to be one of my most valuable decision-making tools, and I hope you will continue to share your thoughts with me on this issue. With kind personal regards, I am

Yours truly,

J. Randy Forbes
Member of Congress

Why Did I Vote Against the Bailout?

The bill that I voted against on Monday was, without question, an improved bill in comparison to the one presented by Secretary Paulson a week and a half ago. The bill phased in the $700 billion rather than authorizing a lump sum requiring separate approval from Congress on additional funds. It required oversight from every major government oversight agency, including the Government Accountability Office, a special Inspector General, and an independent bipartisan oversight board. The bill also put limits on executive compensation for companies that rely on the bailout and requires the President to propose a plan to recoup taxpayer dollars if it does not pay for itself within five years. However, I could not support this legislation for three key reasons:

First, I was not confident that the proposed bailout bill would work. Over the past several days, I have had countless meetings with economic experts on this topic and have spoken personally with senior Treasury officials and the Former Chairman of the FDIC and others. Each of the individuals I spoke with cautioned that this plan might not work. Further concerning was that many of the basic questions I laid out in my letter to Secretary Paulson could not be answered and many economists felt that a $700 billion federal government commitment would leave the government crippled to take any secondary actions if and when the plan did not succeed. Without the confidence of economic experts, I too was not confident that the proposal would work the way it was intended.

Second, there were not enough protections for American taxpayers. This bailout bill put taxpayers on the line first, rather than using an insurance plan that would have financial firms putting up funds first through insurance premiums. In addition, while the bill did include some taxpayer protections, they were tentative at best. Even if the President proposes a plan to recoup the losses after five years, it requires a future Congress to vote to adopt those proposals. However, Congress has repeatedly demonstrated that similar budget balancing mechanisms lack the teeth to produce action. For example, there is a required vote on a presidential proposal to save Medicare and Medicaid every year that they have serious projected shortfalls. So far, the proposal has never passed despite the fact that Medicare and Medicaid have long had serious projected shortfalls. I could not support a bill that did not give adequate consideration to taxpayers.

Third, this bill would have significantly increased our federal debt, potentially handicapping our nation's economic future. We increased the national debt to $10.6 trillion less than two months ago when Congress passed, without my support, a housing bill that was supposed to restore confidence to the markets. The bailout bill would have raised the debt limit for the second time in less than two months, to a limit of $11.3 trillion. To this respect, we must remember that the government has to borrow money from somewhere, and it is unclear where that money is going to come from. There is a chance that the money will be provided by foreign countries. However, senior Treasury officials that I spoke with last week could not tell me what the long-term impacts of foreign-owned federal debt would be. China, which has one the largest shares of the debt owned by a foreign country, is buying a growing percentage of our national debt. If they choose to finance this $700 billion, it could give China undesired leverage over our domestic or foreign policy choices.

What Solutions Would Get Our Economy Back on Track?

Prior to Monday's vote, very little consideration was given to any alternative to the Administration's $700 billion bailout plan. In the rush to approve the Administration's plan, many Americans assumed that the Wall Street Bailout was our only solution. This is not true. There were many options available to us, supported by some of our nation's leading economists, that will help our struggling economy and that would not put $700 billion of hard-earned American tax dollars on the line. Here are just a few ideas that should be on the table:

Pay for the Bailout With Investment Insurance Before Using Taxpayer Dollars

A mandatory insurance program would direct the government to provide companies with a guarantee in the form of insurance for mortgage-backed securities – with a much smaller cost to the taxpayer. The cost of the insurance would be paid for by the companies receiving the assistance by charging them premiums based on the risk of the assets. This principle is similar to that of car insurance: if you have a good driving record, you pay less because you are less of a risk; if you have a bad driving record, you pay more because you are more of a risk to insure.

Q: What will this do to improve our economy?

A: By guaranteeing these assets and providing an accurate assessment of their risk, the bad assets – mortgage backed securities -- become more attractive to potential buyers. In addition, insurance will require some way to put an assigned value to these assets, which will create a market to actually buy and sell these assets. Right now, there is no market for them because investors are too afraid to buy them because no one knows what they are worth. This "price discovery" will unfreeze billions of private dollars currently sitting on the sidelines in safe, government backed bonds. A mandatory insurance program would also ensure that taxpayers and companies who made good financial decisions are not forced to foot the bill to bail out institutions that made risky investments.

The current bill includes an insurance program, but it doesn't require Treasury to use that option first. As my colleague Eric Cantor put it, "The Treasury asked for a Cadillac, and we gave them a Cadillac and a 1988 Yugo…They're never going to use the Yugo." The Yugo is the insurance plan because it requires financial firms to pay for the insurance plan rather than just getting cash in return for bad assets. Companies would have no incentive to opt-in when they could instantly get rid of all their worst assets by selling them to the government.

Increase Capital by Getting Rid of Mark-to-Market

Fair value accounting, or "mark-to-market" rules, force financial firms to keep track of the current market value of their long-term assets, even if they don't plan to sell them for a while. Because mortgage-backed securities have fallen in value in the short-term because of the decline in the housing market and because their values are assigned based on mark-to-market, falling prices in mortgage-backed securities has led to a largely unprecedented shortfall in capital. As the capital, and therefore the assets, of a bank decrease, their ability to lend money to new investors decreases. This impacts the free flow of credit to consumers and businesses alike. Getting rid of mark-to-market will increase capitol and allow the free flow of credit to consumers and businesses. The bailout bill as written allows the SEC to adjust this rule, but there is no requirement to do so. I sent a letter yesterday to SEC Chairman Chris Cox, along with other Members of Congress, urging him to make this change immediately.

Q: What will this do to improve our economy?

A: Federal rules, like the mark-to-market rule, are driving companies to unnecessary bankruptcy and contribute to a downward spiral as firms have to evaluate their assets not on the basis of their long-term investment, but rather on a short-term mania. The SEC should suspend the mark-to-market regulatory rules and issue new guidelines that will allow firms to account for the true economic value of their assets. This will help banks and firms that are low on capital to recapitalize, which will infuse more capital into the credit market at no cost to taxpayers.

Ban Abusive Short Sells That Make Bad Situations Worse

Short selling has been on the rise in recent months as the market has taken a downturn. Short-sellers try to profit from an expected decline in the price of a security, such as a stock or a bond. This is in contrast to ordinary investment practice, where an investor purchases a stock in the hope the price will rise. If the stock, or any other security, falls in price, the short-seller profits. In recent years, the SEC has lifted restraints on short sellers of stocks to allow "naked short selling" (shorting a stock without actually possessing it). The problem with short selling is that it is "pro-cyclical," in other words, it magnifies the swings in the market, which increases instability and can lead to the collapse of companies.

Q: What will this do to improve our economy?

A: Short selling accelerates the rate at which the market falls. On top of this, some short sellers are engaged in abuses such as purchasing "credit default swaps" on corporate bonds, which is a bet that a borrower will default. Again, just like short-selling, this action further lowers the price of corporate bonds, and in some cases it causes the price of a company's stock to decline further and can lead to credit ratings agencies reducing the ratings of a company. Once these two things happen, a company can have a very difficult time raising new capital, which leaves it little choice but to file for bankruptcy. If the SEC acts immediately to eliminate these and other potential abuses by short sellers, it will afford companies and the economy as a whole time to react to liquidity and capital shortfalls. In the current climate, companies can be targeted by short-selling investors that can erode businesses chance for successfully recovering.

Increase Confidence in Banks and Markets by Raising FDIC Insurance Limits

The Federal Deposit Insurance Corporation (FDIC) protects individuals and businesses against the loss of your bank deposits if an FDIC-insured bank or savings association fails up to $100,000 (joint accounts up to $200,000) and most retirement accounts such as IRAs are insured up to $250,000. (Visit www.myfdicinsurance.gov to find out if your accounts are insured).

By increasing the current coverage limit to keep up with inflation, it will send a message to families, to small businesses whose accounts often exceed $100,000, and to others to know that the failure of investment institutions on Wall Street does not mean that their bank account is in any way jeopardized. No FDIC account holder has ever lost a penny to due a bank failure.

Q: What will this do to improve our economy?

A: The greatest challenge in our economy today is a crisis of confidence. Most institutions remain sound, yet some individuals have begun taking money out of their community bank accounts out of fear that they won't be there in the future. Increasing FDIC limits should reverse this unhelpful trend, which hurts banks by reducing their assets and further restricts their ability to lend to their customers. Increasing the limits of this time-tested guarantee will help instill confidence and calm the fears of those who wisely keep their money in banks. The FDIC Chairwoman requested this authority yesterday from the House Financial Services Committee.

Issue Net Worth Certificates to Banks

One alternative is a "net worth certificate" program similar to what Congress enacted in the 1980s for the savings and loan industry. Using such a program, the FDIC resolved a $100 billion insolvency in the savings banks for a total cost to the federal government of less than $2 billion. The FDIC purchased net worth certificates in troubled banks that the agency determined could be viable if they were given more time. Banks entering the program had to agree to strict supervision from the FDIC, including oversight of compensation of top executives and removal of poor management. The FDIC paid for the net worth certificates by issuing FDIC senior notes to the banks. The end result required no cash outlay. This was greatly successful then and could work in the current climate.

Q: What will this do to improve our economy?

A: If such a program were enacted today, the capital position of banks with real estate holdings would be enhanced, giving those banks the ability to sell and restructure assets and get on with their rehabilitation. No taxpayer money would be spent, and the asset sale transactions would remain in the private sector where they should be.

Closing Thoughts...

I hope you will continue to stay in contact with me and my office as the House moves forward in considering new alternatives to solving our nation's economic situation. It seems very likely Congress will pass some form of legislation on this matter soon. Unfortunately, many of those supporting this bailout of Wall Street have now created a self fulfilling prophesy of doom which will have enormous negative repercussions if no action is taken. They have been wrong on many of their proposed solutions so far. I will continue to seek the solution that will best help our economic crisis with long-term stability and not merely be a short-term fix with a long term price tag. For more information on this issue, or to read my Wall Street Bailout primer, please visit my website at: www.forbes.house.gov.