Beware the Result of Outrage

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The biggest news story of last week?

O.K., maybe it was Oprah Winfrey announcing she was going to call it quits with her daytime show in 2011.

But it's a close call. Though Oprah sucked up a lot of the media oxygen, last Thursday was an important day in Washington, too, with a couple of Winfrey-worthy aha! moments that could shake up the world of finance.

Representative Ron Paul of Texas won committee approval of a far-reaching amendment that would give Congress vast new authority over the Federal Reserve. The Fed has long enjoyed Lone Ranger autonomy, but that will quickly end if the final bill passes.

Representative Brad Miller, Democrat of North Carolina, and Representative Dennis Moore, Democrat of Kansas, added their own bell-ringer for voters still outraged over bailouts: the next time the government has to step in and rescue a company, secured creditors will take a hit, too.

That would be a huge shift in the way bondholders are treated. Up to now, they've been kept whole, even as others have been asked to share the pain. Otherwise, some feared, creditors might get spooked, and lending might seize up.

The amendment, which also was approved by the committee, already has a nickname: "The Bair-Miller-Moore Haircut" (credit goes to Ira Stoll on his FutureOfCapitalism.com blog). The Bair reference is, of course, to Sheila C. Bair, chairwoman of the Federal Deposit Insurance Corporation.

One other amendment was added, as well. Representative Paul E. Kanjorski of Pennsylvania proposed giving regulators power to undo firms deemed to be too big to fail.

All of these amendments, which are part of a 300-page bill to reform the financial industry that is making its way around the House of Representatives, are intended to help quiet some of the outrage over the bailout.

The Federal Reserve, which has printed money in exchange for assets from the nation's banks, has long operated opaquely. It is virtually impossible to size up its balance sheet.

So on its face, the Paul amendment seems well intended. After all, who can argue with a little more sunlight?

But consider these words of caution from Senator Judd Gregg, Republican of New Hampshire: "Congress has demonstrated time and again its inability to manage the nation's fiscal policy, illustrated by our staggering national debt in excess of $12 trillion. So how can anyone think that its involvement in monetary policy would be good for the country?"

So any unintended consequences of the amendment -- what Senator Gregg calls "a dangerous move by this Congress to pander to the populist anger" -- could indeed lead to less independence for the Federal Reserve, and the result ultimately may not be good for the economy.

That has been Fed Chairman Ben Bernanke's line all along. He does not want the Fed to be a puppet of Congress. And on that score, he is probably right. Could Paul Volcker have raised interest rates in the early 1980s to nosebleed levels if Congress were pulling strings? What would happen in an election year? Interest rates would invariably go down, only to go up again later.

Representative Paul, of course, doesn't just want oversight of the Federal Reserve, he wants to dismantle it entirely. He has a dog in this fight and it is snarling: he has a book out called "End the Fed." In an interview with my colleague, Cyrus Sanati, Mr. Paul told him, "It's not pandering, it's listening."

"The people are angry because they are finding out what the Fed is doing," he added.

The other amendment, the Bair-Miller-Moore Haircut is potentially even more controversial.

It calls for secured creditors of banks -- the top creditors on the totem pole -- to be entitled to receive only 80 percent, not 100 percent, of the money they put up if a bank is taken over in receivership or a conservatorship by the government.

That is a hot-button idea because, for the last year, many critics have asked why bondholders were protected by the government. Again, at a gut level, it seems fair for secured creditors to take a haircut if the taxpayer if going to bail them out.

Again, not so simple in practice. Because of the new risk, banks would find it more expensive to raise money -- especially so when they run into problems.

Who wants to lend money to a bank when there is a chance the government is going to come in and take it over, so that even a secured creditor at the top of the food chain is going to lose something?

Joseph Abate, a Barclays Capital analyst, made this point in a research report, too: "In any situation where it appears that a large firm is about to fail, secured lenders will rapidly head for the exit and terminate as many of their repo transactions as possible. No secured lender will want to be left in a trade with a bank in receivership where the regulators have converted the transaction into an unsecured loan at 80 percent of the original amount."

In other words, Mr. Abate contends, "It would likely make secured funding to large institutions much more 'flighty.'"

Indeed, there is an argument that the amendment will make the system more risky, not less so.

"Large systemically important firms would become more vulnerable to liquidity runs -- of the sort seen last fall," the Barclays report said.

All these proposals are well intentioned, and with a bit of refining, they may ultimately be the right solutions. But as we learned with the bailouts, they may come with unintended consequences.