United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510–6075

March 25, 2010

The Honorable Timothy F. Geithner
Secretary of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Dear Mr. Secretary:

In recent remarks to the American Enterprise Institute on financial reform, you referred to a speech that I delivered last year to the Oxford Union. I appreciate that you read my speech and referred to it in your public remarks. I take issue, however, with a number of the points you made.

Apparently, we agree that we should construct a credible resolution regime which can make liquidity available to reduce the likelihood of panics and runs. Such liquidity, however, must come at a cost to those receiving the funds, and not at a cost to taxpayers. We also agree that we must eliminate the problem of "too big to fail" and the associated moral hazard. These two areas of agreement can serve as a basis for further discussions. Where we differ, however, is on your conclusion that "[t]he bill the Senate Banking Committee is considering…meets those objectives."

While Senate Banking Committee Chairman Dodd's most recent financial reform bill represents an improvement over the bill you sent to Congress last year, it does not end the problem of "too big to fail" and will not end the associated moral hazard. Also, it does not ensure that taxpayers are protected from the costs of bailing out failing financial institutions.

Chairman Dodd's bill provides the Federal Reserve with enhanced emergency lending authority that is far too open to abuse. For example, because the Federal Reserve would determine whether collateral is satisfactory, the Federal Reserve could provide widespread bailouts by making emergency loans against bad collateral. Continuing to allow the Fed to have the authority to prop up failing institutions is unacceptable to me as well as many Federal Reserve officials based on their publicly expressed views.

The bill also grants emergency authority to the FDIC and Treasury to provide broad debt guarantees in times of "economic distress" when firms face a "liquidity event." Because defaulting guarantee recipients are not required to be placed into FDIC receivership, bankruptcy, or resolution, this broad authority would give the FDIC and Treasury a backdoor way to prop up failing institutions. A resolution regime can be credible only if the government does not have the authority to bail out failing firms.

The bill reported out of Committee sets up a $50 billion slush fund that, while intended for resolving failing firms, is available for virtually any purpose that the Treasury Secretary sees fit. Nonetheless, the mere existence of this fund will make it all too easy to choose a bailout over bankruptcy. This can only reinforce the expectation that the government stands ready to intervene on behalf of large and politically connected financial institutions at the expense of Main Street firms and the American taxpayer. Therefore, the bill institutionalizes "too big to fail."

Finally, the language charges the Federal Reserve with special oversight of the top 35 to 50 firms with assets over $50 billion as well as other "systemically significant" financial firms. The market will view these firms as being identified by the Federal Reserve as "too big to fail" and implicitly backed by the government. This is akin to setting up dozens of new government-sponsored enterprises that will inevitably receive funding advantages. This only will exacerbate moral hazard in our financial markets.

I am pleased that you share my goal of ending the problem of "too big to fail." While Chairman Dodd's most recent bill takes some promising and useful steps, it does not end the problem. Trillions of taxpayer dollars and the stability of the financial system are at stake; we must get this right. I remain committed to achieving our shared goal and I believe that we can do so with broad bipartisan support. I look forward to working with you and the President on this very important legislation in the coming weeks.

Sincerely,

Richard Shelby

Richard Shelby