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Break the Banks

Why don't any of the Obama administration's financial reforms help middle-class Americans?

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The Obama administration, which has spent much of the past year bailing out banks and protecting the markets, has done shockingly little to help the middle class that has borne the brunt of the financial meltdown. Two acts are particularly revealing. First, the administration failed to go to the mat to give judges the power to reform mortgages in the bankruptcy context. The administration barely winced as the Senate caved to the banks on this critical issue, risking no political capital to protect one of the few reforms that could have totally transformed the mortgage crisis. As the foreclosure wave continues, and as adjustable-rate mortgages hit reset points that are going to cause havoc for millions of additional families, this failure of political leadership by the administration stands as one of the early warning signs that things were amiss.

The second act is the recent—equally difficult to understand—concession to the banks, allowing them not to be required to offer what are called "plain vanilla" mortgages and other products to consumers. These products are simpler, more understandable, less ridden with fees, and less prone to long-term risk than most of what banks try to sell consumers on a regular basis. These are the very products consumers need.

Trillions of dollars of taxpayer infusions—direct cash, loan guarantees, capital purchases, policies to keep banks' cost of capital at virtually zero—have kept the banks afloat. It is amazing that the administration didn't leverage these infusions to negotiate these two simple policies that would have made banking more sensible for the middle-class Americans whose tax dollars have bailed out the banks.

The administration's failure on these two policies is symptomatic of its larger failure of vision when it comes to banking reform. The administration has spent more time worried about the musical chairs of regulatory jurisdiction than it has asking fundamental questions about what banks should be doing, what we should expect in return for the vast sums we have invested in the banks, and how discomforting it is that the banks—in an effort to forestall these very questions—are already trying to assert that things have reverted to normal. It's worth recalling that the greatest impact of the New Deal was not the money spent on particular programs but, rather, the fundamental restructuring of the banking and securities sector that President Roosevelt imposed over the objections of business leaders.

Among the advisers to the White House, only Paul Volcker appears to be asking the tough questions. Volcker is asking what banks should be permitted to do if they want to have explicit federal guarantees on deposits and implicit guarantees that they are too big to fail. Unfortunately, Volcker does not seem to have a central role in any of the critical decisions.

The administration also hasn't asked whether the banks are using the capital we have given them in ways that will generate the economic recovery we need. The administration may believe that guiding bank

investment through limits or obligations would not be good policy. Yet most thoughtful observers agree that even if a precise return to a Glass-Steagall separation of investment and commercial banking may not be wise, some constraints on how banks with federal support deploy their capital are absolutely necessary.

Too many banks refuse to reform mortgages and refuse to lend to midsize companies yet simultaneously pursue the activities that do little to create jobs but do much to generate the type of paper profits that fueled the last bubble: proprietary trading, highly leveraged private-equity deals, and foreign investment. These activities are not the fuel for domestic job growth that federal dollars and guarantees should provide. They are also more likely to lead to significant losses that will once again require taxpayer intervention.

For 50 years, under a regime of careful constraints on how and to whom banks lent, we avoided a meltdown of the sort we have just suffered though. The least we should now expect is a serious conversation about where banks should be active and how we can avoid rebuilding the same system that just collapsed.

The message we should be sending is clear: If banks want to participate in the high-risk activity that generates outsize bonuses but also outsize risk, they must do so only with their own capital, separated from guaranteed deposits and a taxpayer backstop to their debt and borrowing capacity. Unfortunately, this message is *not* being sent. If, after all the fuss of supposed banking reform, we do not redefine the relationship between banks and their customers and redefine what banks do with our capital, we will have failed. We will get neither the real economic recovery we need nor the assurance that another round of bailouts will not be necessary in the near future.

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