Bank Regulation For Dummies

The United States Senate is currently wheeling and dealing over another gargantuan bill with over one thousand pages of legal gobbledygook that no legislators will bother to read. Even if they took the time to read it, they would not understand it—which is the point of the lawyers who wrote it. Intentional confusion is the only way politicians can pass a law that does one thing while they tell the public it does something else. *"No, there are no taxpayer bailouts of financial firms included in our financial reform legislation!"* they intone to the television cameras when, in fact, the whole purpose of the bill is perpetual taxpayer bailouts of financial firms.

"We need to do something" to protect American citizens from banks that are *"too big to fail!"* is a great sound bite that makes the average voter believe his Senator is working to "protect the little guy," but that voter is being sold a bill of goods. The pending financial reform legislation dumps enough rules and regulations on small banks to make many of them fail under the sheer weight of the bureaucracy. It encourages them to be swallowed up by the larger banks, which will then become all the more "too big to fail."

Granted, a small bank can fail even without the assistance of burdensome bureaucracies. Let's take a look at just one example:

On April 23 federal authorities closed Chicago's Broadway Bank after it missed a deadline to raise $85 million in sorely needed capital. The bank is owned by the family of Alexi Giannoulias, one of Obama's slimy pals—who happens to be running for his former U.S. Senate seat in Illinois. Obama, his now-jailed Syrian money man Tony Rezko, and his Pentagon-bombing buddy William Ayers have all used the mob-tied Broadway Bank.

Giannoulias was elected Illinois State Treasurer in 2006 largely because of Obama's endorsement (and because he is a Democrat in Illinois). Obama supported Giannoulias even though powerful Illinois Democrats like House Speaker Michael Madigan refused to be seen with him. Obama called Giannoulias *"…one of the most outstanding young men I could ever hope to meet"*—despite the candidate's youth, lack of experience, mob connections, and Broadway Bank's financing of Chicago crime figure Michael "Jaws" Giorango. (Obama's statement might seem outrageous on its face, but considering that he hangs around with people like Tony Rezko, William Ayers, Andy Stern, Rahm Emanuel, David Axelrod, Reverend Jeremiah Wright, and Louis Farrakhan. Giannoulias may indeed look outstanding by comparison. After all, it is difficult not to compare favorably against domestic terrorists, anti-Semites, anti-Americans, racists, and con artists.)

Of course, Obama's over the top endorsement of Giannoulias was payback for an earlier favor. Obama's first home in Chicago, a townhouse, was bought in 1993 with a loan from Broadway Bank—in a complicated deal which for several years left various names other than Obama listed as the owner. Giannoulias donated $10,000 to Obama's political campaign.

Broadway Bank failed partly because of numerous bad investments. ("Why give a high-interest loan to a responsible businessman who plans on paying it back when you can make a low-interest loan to a gangster who doesn't plan on paying it back?") The bank also failed because its owners gave themselves over $100 million in dividends, rather than keep that cash inside the vault.

The failure of Broadway Bank has cost the Federal Deposit Insurance Corporation (FDIC)—also called "the taxpayers"—$394.3 million. Not surprisingly, Giannoulias has not offered any of his millions to compensate customers for their losses. (He's putting the blame on George W. Bush, probably because he doesn't dare blame "Jaws"—there's no telling what he might do if angered.)

Giannoulias and members of his family paid themselves a hefty $47.8 million in dividends in 2007. In 2008, even though the bank was then losing money, they took an additional $34.5 million in dividends—*a whopping 46 percent of the bank's equity*. They knew the bank was failing and took out as much as they could, knowing that the FDIC would foot the bill when it finally collapsed. In 2009, when the bank lost another $75 million, "the family" still felt it deserved another $4 million.

The shameless Giannoulias said in a recent press conference, "…the knowledge that what has happened tonight is just a sliver of the hardship which has become endemic in our society strengthens my resolve." Congressman Mark Kirk (R-IL), Giannoulias' opponent in the U.S. Senate race, states, "While years of risky lending schemes, hot money investments and loans to organized crime led to today's failure, it's a sad day for Broadway Bank employees who may lose their jobs due to Mr. Giannoulias' reckless business practices." (Obama's personal banking and campaign fund accounts have been with Broadway Bank; effective April 24 his accounts—and all others at Broadway Bank—were transferred to MB Financial Bank.)

The fact that Republican Kirk leads Democrat Giannoulias in the polls shows that even in Illinois the voters can sometimes get tired of holding their noses when they punch their ballots. (Of course, November is a long way off, and ACORN may still be able to resuscitate a few hundred thousand dead Chicagoans to put Obama's basketball buddy over the top. There has, after all, been a history of back scratching between Obama, ACORN, and Giannoulias.)

It is unclear whether MB Financial Bank, which inherited the remains of Broadway Bank, has now become "too big to fail," but it is clear that Giannoulias is still a millionaire—while the taxpayers happily covered the accounts of Obama and his other customers with $394.3 million.

Of course, "too big to fail" has virtually no meaning if the FDIC stands ready with taxpayer dollars (or, even worse, money borrowed from China) to bail out any bank that goes under. The pending financial reform legislation purportedly attempts to address the problem by giving the federal government and the Federal Reserve Board enormous new powers over financial institutions. Of course, the federal government and the Federal

Reserve Board are inarguably more ineptly run than even Broadway Bank, so anyone with an ounce of common sense may wonder why they should be trusted with anything having to do with other people's money. *("Broadway Bank is $394.3 million in debt! Gee, who can solve that problem? How about the federal government… which is only $12 trillion in debt! Surely the folks in Washington, D.C. know how to handle big sums of money!")*

What the nation certainly does not need is another bill that is thicker than five New York City telephone books, gives the federal government more power, burdens banks with red tape (the cost of which will necessarily be passed on to customers), sticks the taxpayers with the cost of still more federal bureaucrats, and doesn't solve the problems it has been portrayed as solving.

Accordingly, here is a proposal for simple legislation that will address the issue, will take only one page, cannot be misrepresented by the mainstream media, and can be readily understood by all Americans:

"The Federal Deposit Insurance Corporation (FDIC) will insure individual accounts in financial institutions, up to $100,000, with the provision that, effective January 1, 2011, the total amount insured by the FDIC will not exceed $100 million per bank. In the case of banks with assets in excess of $100 million, individual deposits will be insured based on a ratio of $100 million to the bank's assets. All banks are required to inform their customers of the amount of the total assets of the bank, and the current level of FDIC coverage based on those assets."

Here's how it would work:

Situation A:

You have $100,000 in an account at Bank A. The total assets of Bank A are $95 million. The bank fails. Because the bank's assets are less than $100 million, the FDIC insures your account for the full $100,000.

Situation B:

You have $100,000 in an account at Bank B. The total assets of Bank B are $150 million. The bank fails. Because the bank's assets are greater than $100 million, the FDIC insures only a portion of each of its accounts. The portion is based on the $100 million maximum divided by the bank's total assets. In this example, $100 million divided by $150 million is 66.67 percent. As a result, each depositor's account is inured at only 66.67 percent. Your $100,000 account is insured for only $66.666.66. Someone with $10,000 in the bank is insured for $6,666.67. Someone with $100 in the bank is insured for $66.67. The FDIC will pay out $100 million in total. Every account holder is guaranteed 66.67 percent of his deposits, and every account holder loses 33.33 percent.

In other words, the bigger the bank, the less safe your deposit. If such a law were passed, what would the result be?

- No bank failure would cost the taxpayers more than $100 million. (Instead of $394.3 million, the failure of Broadway Bank would cost the FDIC only $100 million.)

- As is the case now, few customers would put more than $100,000 in any one bank. If you have $200,000 to deposit, you would divide it among two or more banks.

- Many banks would have an incentive to keep their assets at or under $100 million. That is, they would be encouraged *not* to become "too big to fail." Customers of those banks would have their deposits (of up to $100,000) guaranteed at 100 percent.

- Many banks, of course, already have assets greater than $100 million, and some smaller banks might still want to grow larger than $100 million. Neither would be prohibited by the legislation. But the more the bank exceeds $100 million in assets, the more it would lose customers. To retain those customers, the bank would have to pay them a higher rate of interest on their deposits. Some customers would still prefer the safety net of the FDIC's $100,000 insurance, and move their accounts to a smaller bank. But many customers would be willing to *voluntarily* accept the risk of less coverage from the FDIC in exchange for the higher interest rate.

The law would consist of a single paragraph. Even Senator Roland Burris (D-IL)—who has never read a bill in his life and simply votes as he is told by the Democrat leadership—could understand it.

The proposal eliminates the problem of lawmakers asking "*Are Bank of America and CitiGroup too big to fail?"* and wondering what to do about it. It would be improper for the government to force large firms to be broken into smaller units or sold off. Why should some Senators and Congressmen be given that power? What would their decision be based on—other than who donates the most to their election campaign? And why give that power to one bureaucrat, such as Treasury Secretary Timothy Geithner—who can't even be trusted to pay his income taxes?

This simple proposal leaves the "too big to fail" judgment to the *consumer*—which is where it *should* be in a free market. There is, after all, no God-given right to insurance on one's bank deposit. The taxpayers can certainly collectively agree that it is desirable to have an institution like the FDIC rescue individual depositors in the unlikely event of a bank failure *("There but for the grace of God go I")*, but there is no justification for 1,300-page legislation that does more to protect Wall Street millionaires—so they can continue to fund the campaigns of politicians—than it does to protect the taxpayers from having to bail out more banks.

The proposal *encourages* banks to be managed responsibly. It also *allows* them to be run irresponsibly—*but everyone would be aware of the risk going in*. If Bank C will pay you a higher interest rate than Bank D, you are free to move your money to Bank C. But as you walk through the door you will see a sign that reads, *"Based on this bank's total assets your deposits are currently insured at 84.53 percent."* As the saying goes, *"You pays your money and you takes your chances."*

Is anyone harmed by this proposal? No. If your deposits are in a small bank, you maintain the same $100,000 in FDIC insurance. If you have deposits in a larger bank, you can freely move them to one or more smaller banks. If you choose to accept the risk of reduced FDIC insurance, you can keep your money in a large bank and expect to be rewarded for that risk with higher rate of interest. The proposal saves the taxpayers money with lower anticipated payouts from the FDIC. (The $100 million cap in the proposal could be higher, of course. That amount was chosen for the sake of providing examples.)

Some might suggest that the proposal can be improved to better protect bank customers. The problem with using a bank's total assets in the FDIC insurance formula is that assets consist of both good and bad assets. If a bank approves a $200,000 mortgage, is that a $200,000 asset? That depends, of course, on the likelihood of it being paid back. If the mortgage was approved based on an inflated appraisal of the property and a too-optimistic judgment of the buyer's ability to repay the loan, one might call it a bad asset on the bank's balance sheet.

But the legislation can get around that problem by focusing not on the bank's total assets but it's ratio of cash reserves to total assets. Banks function by paying interest on deposits and charging a higher rate of interest on those deposits when the cash is distributed in car loans, business loans, and mortgages. If a bank's customers have $100 million on deposit "in the bank," the bank doesn't actually have $100 million locked inside a vault. The bank may have only $10 million in available reserves, while the other $90 million is in the economy in the form of new cars, new businesses, and new homes. If 100 percent of the deposits were held in the bank's vault, there would be no car loans or mortgages. Anyone who has seen the Jimmy Stewart film *It's a Wonderful Life* understands that.)

The legislation can instead consider the ratio of the bank's reserves to total assets. The greater the bank's reserves, the less risk there is of a bank failure. The lower the reserves, the greater the risk of failure. The law can base FDIC coverage on the bank's *reserves to assets ratio*. The higher the ratio, the greater the level of FDIC coverage. That would give the customers an incentive to favor less risky banks. If a bank chooses to approve tens of millions of dollars in subprime mortgages, its ratio of reserves to total assets would fall. It would then lose customers as their level of FDIC coverage decreases. The bank can retain customers by paying them a higher interest rate, but it cannot do that for long if it is approving risky subprime mortgages that are not being paid back. Thus, there is a built-in incentive for banks to make less risky loans. Banks would still be free to make higher-risk loans, but those actions would have consequences. If they are good loans that are

repaid, the bank earns a profit. If they are bad loans that are not repaid, the bank loses money on those loans—and the deposits of customers who decide to take their cash elsewhere.

What about Government Sponsored Entities (GSE) like Fannie Mae and Freddie Mac, which buy mortgages from banks and then hold them as investments or resell them to other investors? The GSEs contributed in large part to the economic meltdown of 2008. The federal government had been encouraging—and even forcing—banks to give mortgages to almost anyone with a pulse, in an effort to guarantee everyone “the American dream” of home ownership. Many banks did not want to make those risky subprime loans, but they were pressured by the government to do so—with the threat of discrimination fines and lawsuits if they did not comply. The banks naturally acted in self-defense; they approved the mortgages, and then quickly sold them to Fannie Mae and Freddie Mac—which then resold them to investors like AIG and hedge funds. Too many investors naïvely believed the loans were safe because they thought home values would always rise and Americans were dumb enough to forever pay $400,000 for houses worth only $250,000. Eventually the bubble burst, as buyers defaulted on loans and investors realized their bundled mortgages were not worth anywhere near what they had thought they were worth.

How is *that* problem solved? First, disconnect Fannie Mae and Freddie Mac from the federal government. Entities like that simply should not exist. Remove the government connection and, with it, the assumption that Fannie and Freddie will be bailed out. Knowing that you will be bailed out if you make a risky investment encourages risky investments. Cut the umbilical cord, and let them sink or swim on their own. If they sink, so be it.

Without the backstop of federal bailouts, Fannie and Freddie would have to act more responsibly. Acting more responsibly means they will not buy as many risky mortgages from individual banks. Without Fannie and Freddie to buy those loans, the banks will stop approving them. Banks will return to common sense practices and lend money only to people who are likely to pay it back. If hedge funds want to buy risky subprime loans, let them do so. But do not bail out those investors—ever.

If this proposal were implemented, banks would be encouraged to make wiser investments, while Fannie Mae and Freddie Mac would be discouraged from making risky investments. Granted, there may be less opportunity for investors to “get rich quick”—*but that was what caused the problems in the first place*. It is unrealistic to expect that the value of your home will increase by 10 percent per year. If it does, it’s a signal that something is *wrong* with the economy, not the opposite. It is unrealistic to expect the value of your 401(k) to go up 10 percent per year. If it does, it’s only because the government is printing money and *inflation* is causing the increase—*not* brilliant investment decisions. Earning 10 percent on your house or your investments year after year is an aberration that cannot continue; it’s a signal of unwise practices somewhere in the economy or (more likely) in government, and an indication that it will all eventually come crashing down.

It is better to follow common sense practices that encourage wise investments and discourage risky investments, but which also leave Americans free to choose between them as they see fit. Granted, that concept may be too overwhelming for Senator Roland Burris, but he will soon be replaced by Giannoulias or Kirk. I'll leave it to the reader to decide which of those two is more likely to place the interests of the bank customers ahead of the bank owners.

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