Banks Should Be For Banking

January 21, 2010 - Since the beginning of the downward spiral of financial markets in late 2008, there have been calls emanating from Washington for new banking regulations. The primary aim of those new regulations would be to prevent companies in the financial sector from engaging in risky activities that could lead to another collapse; especially if those activities are being backed up by taxpayer dollars. This morning, President Obama put forth a series of proposals that he wants included in a broader financial services bill being considered on Capitol Hill. While there are significant issues associated with the overall bill, the suggestions made this morning warrant serious consideration.

Prior to 1999, commercial banks (those that take individual deposits) were regulated under a 1933 law known as Glass-Steagle. That law limited the legal activities of banks toâ€¦ wellâ€¦ banking. But near the end of the Clinton Administration, banks were deregulated and allowed to purchase other businesses within the financial services industry. For instance, Bank of America now owns the brokerage firm Merrill Lynch; a full service brokerage.

Under the current law, banks cannot only own brokerages, but they can use those brokerage firms to make trades in their proprietary accounts (accounts that belong to the bank rather than to brokerage clients). And therein lies the rub. Because commercial banks have the benefit of being able to borrow from the government at a discount, and because their depositors are federally insured, if they make securities trades that lose money they are actually being backed up by taxpayer dollars. Under the new proposals, that would come to an end.

The rules that the President proposed this morning would force banks to decide if they are commercial banks or something else. If they are commercial banks, they would be barred from using brokerage firms - including those that they own - from trading their own accounts. Any bank that does trade its own accounts would be barred from using the FED's discount window for borrowing funds. Banks that own brokerage firms would still be able to use those firms to make securities trades for their customers. Commercial banks would also be barred from owning or investing in hedge funds and private equity funds.

The proposal would not be a complete return to Glass-Steagle, but it would erect a shield to protect taxpayers from some of the abuses that they have been subjected to. In the days after Congress approved the bank bailout bill known as TARP, there was a rush by investment banks to change their status and become commercial banks. This allowed them to take money from the TARP fund while continuing to function largely as they had in the past. Companies that include Goldman Sachs and Morgan Stanley - traditional investment banks - would have to give up their commercial bank status if the proposal becomes law.

There is already partisan opposition to the proposal coming largely from the Republican Party. Rep. Scott Garrett, R-N.J. said, "The American people have rejected extreme government expansion into the private sector, be it in the health care, financial services or auto industry." As evidence, he used Tuesday's Republican upset in Massachusetts.

But Garrett's statement is only partially true. Tuesday's election results were actually a rejection of both party's big government, big spending activities. It is doubtful that most citizens would support the current deregulated banking environment, regardless of party affiliation, after being made aware that taxpayer dollars are being put at risk needlessly. Politicians that don't understand this might be better served by retiring. The President's proposal this morning appears to be a common sense approach to put up a firewall between tax dollars and risky trading activity.

Even so, there are other aspects of the proposed bill which rightfully warrant opposition. One of the items that the President wants included in the bill is a tax on large banks to help repay TARP funds. But that proposal would actually tax banks that didn't participate in TARP. And any tax levied against banks would eventually be passed down to consumers in the form of higher fees. The end result for citizens would be the same as an across the board income tax hike and would have little if any affect on the banks themselves.

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