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On My Mind

Let Bankers Be Bankers

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Forbes Magazine dated August 24, 2009

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In the good old days banks knew their customers.

Ben Bernanke has declared that a recovery is not going to happen "until the financial markets and the banks are stabilized."

But which ones? By favoring megabanks and the securitized assets that the behemoths profit from, the Fed and the Obama Administration have undermined a sustained recovery. In fact, regulators should focus on nurturing old-fashioned bank lending--and stop coddling the businesses that compete with commercial banking.

Banking demands careful regulation. Just as roads without rules would be chaotic and dangerous, unregulated banking in the 19th century was inherently unstable. In good times unfettered competition between banks encouraged a race to the bottom in lending. But at the first whiff of trouble, depositors rushed to withdraw funds before someone else emptied the till.

The Banking Acts of 1933 and 1935--in my view, the best of a large and uneven menu of New Deal initiatives--ended bank runs by creating a system of national deposit insurance, establishing strict rules to maintain lending standards and separating commercial and investment banking. Stabilizing banks and controlling their imprudence also did at least

as much to end recurring depressions as countercyclical monetary and fiscal policies did. In spite of fears of excessive conservatism, banks did meet the growing need for credit generated by an extended postwar economic boom. Apparently satisfying bank examiners rather than jittery depositors was, in the long run, liberating.

Poorly regulated "securitized" alternatives to traditional bank loans disrupted the steady increase in prudent lending. Starting with the launch of the Reserve Fund in 1970, money market funds stole away deposits from banks, investing the money in short-term instruments (like commercial paper) that substituted for bank loans. But unlike banks, money market funds didn't have to know their borrowers or set aside reserves. The funds were free riders, relying on rating agencies to certify borrowers. Traditional bank lending could not compete.

Losses on debt issued by Lehman Brothers felled the pioneering Reserve Fund last September. But meanwhile, faced with the eroding profitability of their traditional businesses, banks plunged into the lucrative new world of ever dodgier securitized debt and toxic derivatives based on this debt. For big banks like Citigroup, traditional lending became a sideshow.

Reviving prudent lending by banks who know their borrowers is now a must. That's at the heart of the two-tier system endorsed by Paul Volcker, the revered former chairman of the Fed: Tightly regulate commercial banks that take deposits and make loans, while giving considerable leeway to securities firms that engage in riskier activities such as trading. To protect banks from free-riding competitors, Volcker proposes subjecting money market funds to the same regulations as banks.

Unfortunately, the responses of the Fed and Treasury to the crisis are sabotaging the revival of good banking. Instead of promoting simpler, more easily regulated banks, the Fed helped turn Morgan Stanley, Goldman Sachs and GMAC into bank holding companies. Instead of protecting banks from free-riding money funds, the authorities did just the opposite by guaranteeing deposits in money market funds and backstopping the commercial paper market.

CIT, which made traditional loans to Main Street businesses, had to find private sources for a rescue. At the same time, the government program to revive the market for securitized packages of credit card receivables, automobile loans and the like is a travesty. If borrowers are creditworthy, why not let solvent banks, now flush with funds, make the loans? The argument that the program was necessary because banks would take too long to connect with borrowers is specious: The $1 trillion program announced in March has made, as of early July, loans of less than $25 billion.

Where are the reformers in the Obama Administration? Someone please give them Volcker's cell phone number.

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