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The good, the bad and the ugly in financial overhaul

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Our financial system has failed us. It's not a stretch to blame today's 10 percent unemployment rate on the trillions of dollars in loans made during the housing bubble that subsequently went bad. Financial institutions aren't solely to blame for this mess, but they were a big part of it, and they need substantive reform.

The reforms proposed by the Obama administration last year were roughly right. Giving the Federal Reserve responsibility for overseeing risk throughout the financial system, creating a new way to shut down troubled institutions, and establishing a new agency to advocate for consumer financial protection make sense. Even the president's new plan to tax the nation's largest banks to pay for the Troubled Asset Relief Program has merit. But the proposal made last week to effectively break apart the largest banks does not. More significantly, it suggests the administration is set to take overhaul efforts too far.

The good

The TARP tax is a good idea. Indeed, the administration's proposed levy on financial institutions should be made permanent to pay for the subsidy taxpayers provide those large and complex banks considered too big to fail.

The TARP was a success; without it, the system likely would have collapsed. Initial fears that the $700 billion allocated for TARP would vanish were misplaced; taxpayers will get back all but an estimated $117 billion. Much of the TARP money injected into financial institutions has been or will be repaid, with interest. Money the government won't get back includes the amount used to take over the insurer American International Group Inc. and to support the auto and housing industries.

Asking the banks to ante up to cover other TARP beneficiaries may seem odd, but it is appropriate. The institutions that survived the financial crisis benefited enormously from taxpayer largesse extending well beyond TARP. And given the industry's consolidation during the crisis, bank profits now flow to a much smaller group of shareholders, employees, and executives.

The TARP tax would also be a step in the right direction toward mitigating too-big-to-fail risk. Large, complex institutions can borrow more cheaply because, with the implicit backing of taxpayers, investors believe their money is safe. It is appropriate for taxpayers to be compensated for this subsidy.

True, bank shareholders and executives would not bear the full cost of the tax themselves: part would be passed through to consumers and businesses in the form of higher borrowing costs or tighter loan standards. This effect cannot be completely avoided, but it should be modest, as many of the country's 8,000 smaller banks would step up if big institutions were to raise rates or curtail lending too much.

The bad

On the other hand, breaking large institutions apart, as the president proposed last week, is a bad idea. If it were adopted, banks with deposits insured by the Federal Deposit Insurance Corp. would be barred from many kinds of trading and investment. The administration seems to believe that these activities are too risky and that without them, banks and presumably the entire financial system would be safer.

To be sure, banks' securities portfolios lost a boatload of money during the crisis, much of it from the kind of trading the president wants to prohibit. But the banks also lost a lot from traditional lending. Of the 140 banks that failed last year and the 550 currently on the FDIC's troubled list, nearly all stumbled because of bad residential and commercial mortgage lending, not because of risky trading.

The administration still would allow banks to trade for clients, but it won't be easy to tell which trades are for clients and which are not. If a hedge fund client of a bank wants to sell a security and the bank cannot find a ready buyer and instead buys the security itself, is that good customer service or inappropriate proprietary trading?

Security holdings also give banks an important way to keep their customers' money readily available, a feature known as liquidity. A sound bank is one that has sufficient capital and sufficient liquidity, and banks need to hold securities to manage liquidity prudently. Owning securities means being able to trade them when necessary; that in turn requires a healthy proprietary-trading operation.

The administration seems to believe that pushing trading activity outside the banks will make the entire financial system more stable. This is also questionable. It stands to reason that nonbank trading operations and global financial firms will grow bigger if the administration's proposal passes. Will the Federal Reserve and other regulators be better able to monitor and manage the risks taken by these very secretive, privately held institutions? It's hard to see how.

The ugly

The president's frustration with big banks is understandable; the financial system needs an overhaul, but financial institutions are using their substantial resources to prevent it. While it may be good politics to bash the banks - particularly in an election year when unemployment is in double digits - using voter anger to fuel change could get ugly. It is rare that good policy is made when politics trumps economics.

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