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It's time to lay off the bank-bashing


By Mark Zandi, April 26, 2015

The nation's big banks have no friends. The political parties don't agree on much, but they agree that the big banks are a big problem. Bank-bashing is in vogue.

This has become counterproductive and should stop.

There is no argument that the banks, and the financial system more broadly, badly needed reform after the housing bubble burst. When millions of faulty mortgage loans defaulted, the system was brought to its knees. Without a taxpayer bailout, it would have collapsed, ensuring economic depression.

The most important reform has been to make it much more difficult to make bad loans. The subprime mortgage loans at the heart of the financial collapse are now all but impossible to make.

Reform also requires banks to hold a lot more capital - the financial cushion banks need to absorb the losses they suffer if loans they make default. Banks fail if their bad loans are greater than their capital.

Today, the banks have more capital than they have ever had, enough to withstand something much worse than the housing bust. Their capital cushion is also still growing, particularly for the biggest banks.

And regulators now have more tools to deal with troubled financial institutions that run out of capital. Regulators were unsure of how they should deal with failing institutions during the crisis. Or whether they even had the authority to deal with those that weren't banks.

Indeed, most of the financial institutions that faltered badly during the crisis weren't banks at all. Lehman Bros. and Bear Stearns were more like hedge funds, Fannie Mae and Freddie Mac are behemoth mortgage companies, Countrywide was a nonbank mortgage lender, and AIG is an insurance company.

At the behest of regulators, the nation's biggest banks took over many of these failing institutions. The hope was that if the banks took them over, regulators, and by extension taxpayers, wouldn't have to. Ironically, these banks are now getting bashed mostly for the bad lending by the institutions they took over.

Yes, the banks made plenty of mistakes, and reform was necessary, but it is time to stop the bank-bashing. It is counterproductive, as banks remain reticent to provide the credit the economy needs to perform well.

This is clearest with mortgage loans. Potential first-time home buyers, in particular, are having a tough time qualifying for a loan. First-timers generally have lower incomes and less for a down payment, and are more likely to stumble on their loan payments.

Banks, nervous about getting hammered if they make a loan to someone who ultimately has a problem, have become overly cautious. Many would-be home buyers who could make timely payments can't get a loan. Yet housing - and thus the economy - won't kick into full gear without more first-time home buying.

Bank-bashing also threatens to manifest itself in regulators requiring the banks to hold too much capital. Think of it this way: It makes sense to require that homes be built so they don't get flooded more than once every hundred years, but it makes little sense to require that homes be built to withstand a thousand-year flood. That would be prohibitively costly.

The same principal applies to bank capital. We want banks to hold enough capital so that they could withstand a financial crisis like the one we just went through, but much more than that and it becomes too costly. Banks will charge onerously high interest rates and make it too difficult to get a loan.

Requiring the banks to hold too much capital also means that more credit will be provided by the shadow banking system. This part of the financial system is made up of a mélange of non-bank financial institutions and global investors.

There is nothing wrong with the shadow system per se, but as its name implies, what goes on in the shadow system can be opaque. Moreover, there is a lot more risk-taking in the shadow system and it is only lightly regulated. Parts of it are like the Wild West of the financial system, where almost anything goes and the regulatory sheriff can't do much.

The banks have an overflow of capital and appear on safer financial ground, but the shadow system and thus the entire financial system probably isn't.

Most bank-bashers also advocate breaking up the big banks with the goal of ending too-big-to-fail. That is, no bank should be so large that it would require taxpayer support if it faltered or the entire financial system would be at risk.

This is a laudable goal, but it should be considered against the potentially considerable benefits big banks provide. In a global economy, big banks supply the financial services required by large multinational corporations. Big banks also have the heft needed to make financial markets work efficiently. Stock, bond, foreign-exchange, and commodity prices would likely be more volatile without the liquidity big banks provide.

It is also worth considering that in nearly all other countries, the financial system is dominated by a few too-big-to-fail financial institutions. These foreign institutions are already big players in our financial system, and could become bigger without the counterweight provided by large U.S. banks.

It is politically expedient to beat up on the big banks. That was perhaps understandable in the immediate aftermath of the financial crisis. It no longer is.

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