America's Socialism for the Rich

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With all the talk of "green shoots" of economic recovery, America's banks are pushing back on efforts to regulate them. While politicians talk about their commitment to regulatory reform to prevent a recurrence of the crisis, this is one area where the devil really is in the details—and the banks will muster what muscle they have left to ensure that they have ample room to continue as they have in the past.

The old system worked well for the bankers (if not for their shareholders), so why should they embrace change? Indeed, the efforts to rescue them devoted so little thought to the kind of post-crisis financial system we want that we will end up with a banking system that is less competitive, with the large banks that were too big to fail even larger.

It has long been recognized that those of America's banks that are too big to fail are also too big to be managed. That is one reason that the performance of several of them has been so dismal. Because government provides deposit insurance, it plays a large role in restructuring (unlike other sectors). Normally, when a bank fails, the government engineers a financial restructuring; if it has to put in money, it, of course, gains a stake in the future. Officials know that if they wait too long, zombie or near zombie banks—with little or no net worth, but treated as if they were viable institutions—are likely to "gamble on resurrection." If they take big bets and win, they walk away with the proceeds; if they fail, the government picks up the tab.

This is not just theory; it is a lesson we learned, at great expense, during the Savings & Loan crisis of the 1980s. When the ATM machine says, "insufficient funds," the government doesn't want this to mean that the bank, rather than your account, is out of money, so it intervenes before the till is empty. In a financial restructuring, shareholders typically get wiped out, and bondholders become the new shareholders. Sometimes, the government must provide additional funds; sometimes it looks for a new investor to take over the failed bank.

The Obama administration has, however, introduced a new concept: too big to be financially restructured. The administration argues

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that all hell would break loose if we tried to play by the usual rules with these big banks. Markets would panic. So, not only can't we touch the bondholders, we can't even touch the shareholders—even if most of the shares' existing value merely reflects a bet on a government bailout.

I think this judgment is wrong. I think the Obama administration has succumbed to political pressure and scare-mongering by the big banks. As a result, the administration has confused bailing out the bankers and their shareholders with bailing out the banks.

Restructuring gives banks a chance for a new start: new potential investors (whether in equity or debt instruments) will have more confidence, other banks will be more willing to lend to them, and they will be more willing to lend to others. The bondholders will gain from an orderly restructuring, and if the value of the assets is truly greater than the market (and outside analysts) believe, they will eventually reap the gains.

But what is clear is that the Obama strategy's current and future costs are very high—and so far, it has not achieved its limited objective of restarting lending. The taxpayer has had to pony up billions, and has provided billions more in guarantees—bills that are likely to come due in the future.

Rewriting the rules of the market economy—in a way that has benefited those that have caused so much pain to the entire global economy—is worse than financially costly. Most Americans view it as grossly unjust, especially after they saw the banks divert the billions intended to enable them to revive lending to payments of outsized bonuses and dividends. Tearing up the social contract is something that should not be done lightly.

But this new form of ersatz capitalism, in which losses are socialized and profits privatized, is doomed to failure. Incentives are distorted. There is no market discipline. The too-big-to-be-restructured banks know that they can gamble with impunity—and, with the Federal Reserve making funds available at near-zero interest rates, there are ample funds to do so.

Some have called this new economic regime "socialism with American characteristics." But socialism is concerned about ordinary individuals. By contrast, the United States has provided little help for the millions of Americans who are losing their homes. Workers who lose their jobs receive only 39 weeks of limited unemployment benefits, and are then left on their own. And, when they lose their jobs, most lose their health insurance, too.

America has expanded its corporate safety net in unprecedented ways, from commercial banks to investment banks, then to insurance, and now to automobiles, with no end in sight. In truth, this is not socialism, but an extension of long standing corporate welfarism. The rich and powerful turn to the government to help them whenever they can, while needy individuals get little social protection.

We need to break up the too-big-to-fail banks; there is no evidence that these behemoths deliver societal benefits that are commensurate with the costs they have imposed on others. And, if we don't break them up, then we have to severely limit what they do. They can't be allowed to do what they did in the past—gamble at others' expenses.

This raises another problem with America's too-big-to-fail, too-big-to-be-restructured banks: they are too politically powerful. Their lobbying efforts worked well, first to deregulate, and then to have taxpayers pay for the

cleanup. Their hope is that it will work once again to keep them free to do as they please, regardless of the risks for taxpayers and the economy. We cannot afford to let that happen.

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