WHY BANK BASHING IS BAD FOR THE COUNTRY-Money Marathon August 2010

Recently a good friend of mine who is a regular reader of my column emailed me with political questions and concerns. This friend and I are of different political persuasions, and we decided to have lunch together to discuss the issues. At our luncheon, we discussed almost all of the current issues, but the interesting point was that we basically agreed on what we thought were the solutions to these issues. Additionally, we concluded that most of the country is somewhere in the middle on the majority of the issues, and therefore it is only the extreme sides from both parties causing most of the main differences of opinion.

Shortly after our luncheon, he emailed me a recent blog bashing banks and asked for my opinion. After emailing him my response I thought this would make a good subject for my column. This column will try to explain the misinformation that is out there and why I think bank bashing is bad for the country.

Public Perception # 1: <u>Banks are primarily responsible for the current "Great Recession</u>". Banks were only a part of the overall real estate bubble that burst. Very few people expected home prices to drop in value, and almost no one expected the crash in home prices. Government policy played a huge role in the real estate bubble by requiring by law that banks make home loans to many people that could not afford them (Community Reinvestment Act). Then by law the government required that the quasi government agencies, FNMA and Freddie Mac, make 40% of all their real estate loans to borrowers with low and moderate income, most of which were made without a down payment and were therefore subprime in nature. Additionally, many experts believe interest rates were left low for too long a period in this last decade which further expanded the perception that homes were affordable for everyone without risk. Obviously banks and mortgage brokers and Wall Street brokers participated in making and packaging loans, but most of the bubble and subsequent crash was a direct result of the government induced, huge volume of subprime loans (little or no down payment loans made to borrowers who couldn't afford them). When the market started to drop these low equity loans were the ones that crashed that caused the subsequent panic. The bottom line: Banks played a role but poor government policies created the majority of the bubble.

Public Perception # 2: <u>Banks and "fat cats" were bailed out; banks are getting rich at everyone else's expense and therefore they should pay with punitive taxes and restrictions on their income.</u> The reality is that many banks have been crushed in value more than almost any other industry from the crisis. Some major banks have seen their stock values drop by two thirds and have nearly eliminated their dividends to shareholders. I told my friend who is a farmer, imagine that the value of his farm dropped in value by two thirds and there was no farm income to distribute. If that were the case, a farmer wouldn't feel very good about repeatedly being told he was given a bailout. Losing two thirds of their

2007 stock value for many of the large banks is hardly a bailout. Yes many banks were given TARP money but the vast majority of TARP money was given to large banks, most of which did not want to take it. Most all of these large banks have since paid back the TARP in full along with a profit for the government.

Public Perception #3: Banks are gouging customers with overdraft fees and credit and debit card fees which need to be restricted by the government. Banks, like other businesses must earn a reasonable return on investment or equity will not be available or will go to other industries. Overdraft fees are a source of their income, about 10% of their income on average. Banks pay for the cost of free checking a least partially by overdraft fees. This could be considered a penalty fee and processing fee for people who don't manage their accounts in the most prudent way. I suppose this is similar to taxes on cigarettes and alcohol. If a person doesn't drink or smoke, then others are paying taxes for them they don't have to pay. Without these "sin" taxes others would have to pay more regular taxes. The same is true with overdraft fees. If the fees are restricted, banks will have to charge more people for their accounts. As a result of the new legislation just passed, it has been estimated by some analysts that 12 million low income households will end up losing their checking accounts as account charges are increased to offset the lost overdraft income, which these low income people will not be able to afford. As credit and debit card fees are restricted by law, banks will have to raise loan rates or something else to offset this loss of income. Bank America, as an example has estimated that the cost of the new legislation on their income will be a onetime charge of $7 to $10 billion and an ongoing cost of $4 billion dollars a year, which is more than they earned last quarter. How a free enterprise system is supposed to work is that if a bank or anyone else charges too much, competition can come in and lower the price to steal business. Banking is not a monopoly and that is how free markets work. When government tries to artificially restrict pricing it will only create higher charges in other areas, like higher loan fees or rates, which slows down economic growth which hurts the entire country. The article that my friend sent tried to mislead the reader by pointing out that overdraft income was over three times what the banking industry earned from all other sources last year. That is misleading because the low earnings for banks that was quoted, is a result of huge amount of loan losses eliminating most of their normal income for the last several years, not a function of overdraft fees being excessive relative to total bank earnings. Finally on this point, why aren't people any longer responsible for their own actions? No one forces a person to overdraw their account or to use a credit card. I spend a great deal of my article space telling people not to use credit unwisely or overdraw their account, but I don't blame the bank when they do. Is a grocery store to blame if a person buys alcohol, misuses it and has a car wreck? Is the grocery to blame if a person buys too much food, eats too much and become obese?

Public Perception # 4: Banks are to blame for not loaning more money to small business to get us out of the recession. Banks want to loan all the money they can because that is their basic source of income. Unfortunately, there are several factors affecting the slowdown in loan growth. First, business and individuals are so scared right now that they are paying off debt at unprecedented rates. Consumer and business debt was paid down by $2 trillion last year. Secondly, with all the uncertainty regarding additional bank regulation and possible higher capital ratios banks are uncertain what they can do and what is prohibited. The new Financial Regulation bill will multiply the number of regulators and compliance probably tenfold which has a cost that will mean restrictions on credit and more costs to consumers. Finally, with the huge losses banks have incurred and the large unemployment and extreme drop in housing values, there are not as many good loans available as previously. It is much more difficult to make a loan to a person with a job than without and easier to loan a person with equity on his home than a person without equity. The bottom line here is that banks want to make all the good loans they can. That is their main source of making money. But they are going to be careful making risky loans when times and repayment is more uncertain.

Public Perception # 5: The new Financial Regulation bill will prevent a future crash. Unfortunately, from what I have read, I am not optimistic that this new bill does much to prevent a future crash. There is certainly additional regulation but we had plenty of regulators before, who apparently were not any better able to anticipate a drop in real estate value, or unsafe practices. The huge taxpayer losses caused by FNMA and Freddie Mac, which will most likely never be paid back, was not addressed in this legislation. It appears like we created an additional several thousand pages of regulation and cost that will more likely serve to restrict economic growth. In practice, the financial industry's loses in real estate has made all financial institutions unwilling to make low down payment or low documentation loans. Once burned twice shy as the saying goes. No one now believes home values can only go one direction and no one that I am aware of is making home loans without good underwriting standards and adequate down payment. This is a result of the crash, not a result of financial regulation.

Public Perception # 6: Banks caused all this. Let's destroy the banking industry and that will solve our problems. Policy makers have repeatedly made banks the villain without taking any responsibility for their poor policy decisions and have heaped on costly new regulation, penalty fees and restriction to their income sources. This has also happened to varying degrees to other industries such as healthcare, insurance and oil. That may be fine if none of those are industries in which you are involved. The overriding concern is that the whole approach to destroying an industry serves to undermine other business and industry. Why wouldn't other industries think, maybe I'll be next. This atmosphere leads to uncertainty which restricts business and individuals from wanting to create jobs, and spend money, both of which would help the economy recover.

All of this is why I believe that for the best interest of our country, bank bashing needs to stop. Banks are the underpinning of the economy in that they provide needed financing. If they are weakened the economy and job creation will be much slower and everyone suffers. I hope this column has clarified some of what I believe is misinformation regarding banking, its role in the recent recession, and why continuing to punish banks will hurt the economy.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.