HOW CONGRESS CAUSES BANK FAILURES

Why did some banks and financial institutions fail and others succeed?

There are many reasons, but one common ingredient of those that have not failed is that they are organized as partnerships and/or are controlled by a family, or are closely held by a few senior officers. That is, they have "skin in the game."

The oldest and largest partnership bank in the United States is Brown Bros. Harriman & Co., which was formed in 1818 and is a premier financial institution.

Brown Bros. has weathered the financial crisis just fine because it is not overleveraged and did not take foolish risks because the partners were not playing with shareholders' money - they risk their own money every day. Banks that are partnerships are called private banks because their stock is not held by the public.

Perhaps the best-known "private banks" are those in Switzerland. Many of them have existed for well over a century, and some are between 200 and 300 years old.

A financial institution does not get to be that old by taking foolish risks with either customers' money or the capital provided by the partners. Some of the Swiss banks have been controlled by the same family for more than 200 years - quite an accomplishment.

In the United States, there are examples of family-controlled banks that have done quite well, both by their customers and owners. The Burke & Herbert Bank & Trust Co. in Alexandria has been around since 1852, and the president of the bank, Hunt Burke, is the great-great grandson of the founder.

This bank has prospered by sticking to basic banking in the Northern Virginia area. Burke & Herbert also declined to participate in the U.S. Treasury's Troubled Asset Relief Program (TARP) because the bank did not need the help.

American International Group Inc. is perhaps the best example of both good management and bad, so it is instructive to look at its history. AIG was formed in China as an insurance company in 1919 by an American, Cornelius Vander Starr. For the first few decades of its existence, it operated almost entirely outside of the United States.

One of the major reasons for its success was that it developed a compensation system that rewarded executives for the long-run success of the company. Profit-participating partnerships were formed, which granted executives units that were not exercisable until the executive retired. Thus, the senior managers of the company had a very strong incentive to see that the company was both highly profitable and successful over the long run. They had no incentive to "bet the

company."

These partnerships were formed "offshore," and hence taxable income was deferred, which was appropriate for a company whose major business was outside the United States. A couple of decades ago, AIG both greatly expanded its U.S. business and decided to branch into other areas of finance, some outside its core competency in insurance.

As AIG moved into other financial products, it began to compensate many of its executives in the more traditional Wall Street system of the big bonus for quick profits - particularly after then-New York Attorney General Eliot Spitzer forced out Maurice "Hank" Greenberg as chief executive officer on bogus charges, and put government-approved management in place.

Such a compensation system encourages executives to take undue risks because if they succeed, they receive huge personal payments, and if they fail, the stockholders take the loss - which is exactly what happened to AIG.

Knowing the above, you may be asking yourself, why are not more banks and other financial companies organized as partnerships?

The transference of ownership can be more cumbersome than with a traditional corporation. However, a major problem in the United States is the fact that the tax code requires partners individually to pay full tax on their pro-rata share of the profits as they are earned.

This makes it difficult for the enterprise to build up the necessary capital and reserves to expand the business in a prudent manner.

A properly structured tax code would encourage companies to reward their executives on the long-run profitability of the enterprise, rather than on short-run profits, which is now the case.

Members of Congress rant against the short-term mentality of many in Wall Street and elsewhere, but it is precisely the tax and regulatory systems put in place by Congress that have caused much of the problem.

The Congress and the Securities and Exchange Commission have discouraged use of long-term stock options in a number of ways, including the recent dopey requirement that forces companies to "expense" stock options even though they have no way of knowing the so-called expense.

If compensation provided by corporations, limited-liability companies and partnerships was not taxed until it was *actually received* by the employee, companies would have a strong incentive to build compensation plans that rewarded employees for taking prudent - but not reckless - risks and helped to ensure the long-run profitability and viability of the enterprise.

Some in Congress will shout that not immediately taxing deferred compensation will result in a loss of tax revenue to the government, ignoring the obvious fact that the financial meltdown (in part caused by foolish legislation and regulation) is resulting in a far greater loss of revenue.

If members of Congress had their pay raises based only on the increase in real, per capita, after-tax incomes that their fellow citizens either do or do not receive each year - rather than the nonperformance-based raises they now give themselves - they would have a long-run incentive to put in sound economic policies.

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