Naked Bankers

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Translated from Hebrew.

Europe is full with zombie banks. Even in the United States, JP Morgan endangers the entire world economy. Only the bankers, as usual, hide their condition. The new book by Prof. Anat Admati is shaking the whole world of finance. Interview with her make thing seem really scary

A person gets up in the morning, goes to his bank branch and finds it closed. Day in and day out, the bank remains closed. All branches. Only the ATM gives a little cash, there is a long queue and the sun beats down. And when the bank finally opens, after an endless week, the man checks his account status, repeatedly examines the numbers, and discovers to his horror that a significant portion of his savings simply evaporated. The money is not in the bank. This drama, more or less, occurred two weeks ago only 300 km from here, in Cyprus, and provided a reminder of an unpleasant truth: It's not over.

Ask Professor Anat Admati. “Do not believe those who say the situation is better than it was before the financial crisis of 2007-2009, that we have a safer system that is getting better as reforms are put into place,” she writes. “The banking system today, even with the proposed reforms, is as dangerous and fragile as the system that brought us the recent crisis.” Admati does not only points to the problem, but also offers the solutions. “This situation could change,” she states, but is quick to clarify that “Only public pressure can bring the political will that is necessary. Without public pressure and political will, there is no reason to expect that the situation will change.”

Admati makes this call to arms in her new book, published six weeks ago, that is making waves as if a heavy rock was dropped straight to the heart of the financial swamp. The name of the book makes clear what Admati, senior economist at Stanford, thinks the bankers and their friends, and especially what she thinks of their arguments why you cannot, nor desirable, to change the status quo: “The Bankers’ New Clothes.”

“I do not expect much from the system,” says Admati to Kalkalist. “They will continue to say those things, because a lot of money and interests are involved. The book is intended primarily for decision makers. This is not a system that would correct itself, it needs effective regulation. And today, the regulators act as if they are there to serve the banks. But in some areas there is a conflict between the banks and the public, especially when it comes to risk. The question of who wins, and now, relatively, the banks win. There are obvious things that can be done for the public, and yet they are not done.”

Why?

“Because banks do not want that. Because they confused the decision makers, or the decision makers prefer not to ask too many questions. I'm not sure why. This is a difficult combination of a lack of understanding and interest. The bank robber said when asked why rob a bank: ‘that’s where the money is.’ But this is a matter of public safety, just as nuclear reactors or aviation - when you cut corners people harmed.”

This is not the whole problem. Admati stresses that a fundamental difference between banking and other industries complicates attempts to repair the system. “Unlike airplanes falling from the sky - where you have a black box and you know who to blame, and people do not accept the lack of safety - risk in banking is abstract. Therefore it is easier for bankers and decision makers to cut corners and tell stories. For example, they can claim that the financial crisis in 2008 was like an earthquake, it just happened. The Federal reserve has the narrative that ‘it was mainly a liquidity problem, we saved the system, everything is better now.’ I'm not saying they should not have done what they did during the crisis. But what they are doing now to prevent the next crisis? In order to repair the system? As it is, the status quo prevails, because that way we have become accustomed to, and it is difficult to change. Luckily, I have tenure at Stanford, so I can talk”, she says and hints about reluctance by many to go against the system.

The most important lesson from the crisis

Admati, a professor of finance and economics at the leading school of business administration by *Financial Times*, spent the past eighteen months in “the bunker” writing. In her previous interview for Calcalist magazine, during a trip to Israel in hot August 2011, she was contemplating the next step in her struggle to change the banking system, and said she is considering “writing a book to help people better understand what the role of the financial system in the economy and the ways where it can be beneficial and harmful.” The idea became intensive work with coauthor Martin Helwig, an economist who is a director of the Max Planck Institute in Bonn. “We want people to ask more questions,” she said in that interview, “so if people want to repair the system, they will have tools to do it, they will understand what to do.”

The main message of the book in clear: There is no justification for the current nature of the banking system, which relies on excessive leverage, such that good times yield higher profits for the shareholders and bankers - and difficult period endanger the rest of the economy. Bankers’ arguments defending the system against any change - the credit crunch warnings to attempt to postpone the inevitable - Admati and Helwig debunk fatally one by one.

The result is applauded. Martin Wolf, the influential commentator of the *Financial Times*, stated that this is “the most important book to emerge from the crisis.” *The Economist* called it “powerful,” while *New Yorker* said it is “essential.” In the list of those endorsing the book you can find all the who's who in the fight financial reform: Bank of England Governor Mervyn King, the legendary Federal Reserve chairman in the eighties Paul Volcker, and Simon Johnson, former chief economist of IMF and currently one of the harshest critics of banks. “You must read this book,” Johnson says, and recommends it at every opportunity. Even before this book, Admati was recognized as a leading voice, but her struggle is now a global resonance, as she skips between central bank conference in Copenhagen to lectures in London, to a conference in

Hong Kong organized by the Institute of New Economic Thinking funded by George Soros, from one TV studio to another.

You focus passionately on one corner of the economy. In the big picture, how important is reform in the banking system?

“Very important. The banking system is responsible for the payment system, should be sure to work the economy is like a road system of the economy. Additionally, it has a role in financing small businesses, it is very important to the economy. Distortions created so that when the banking system, the economy can tolerate., and worst of all, when banks become large as they were in Iceland, Ireland or Cyprus - they fall all the economy fall. this is the biggest problem that banking: banks too big to fail. This is very dangerous. system that is very healthy, it ranges from euphoria crises, hence my passion. fact that it is so dangerous. "

To emphasize the depth of the danger, Admati reminds born crises in the financial system and the economy did not go the rest of them look like they are part of a cycle recessions tides of the economy. As the pair of economists Professor Carmen Reinhart and Professor Kenneth Rogoff have shown their acclaimed study from 2009, which examined financial crises throughout history, crises in the financial system are translated into economic crisis especially acute and protracted. They dragged them all the economy into a deep pit. "Look what was slowing economy after the fall of Lehman Brothers," says Admati. "This is the danger, it will happen again. For me, this system all the time is not healthy, because it has a distortion."

Cyprus parable: When the government is the responsible adult for the banks

Admati explains the distortion in the banking system through the largest funding exercise most of us do in our private lives: the mortgage. She offers as an example the story of Kate, who invests $30, 000, adds a mortgage and buy a house worth $300,000. Kate invests a tenth of the house and the rest is funded by borrowing. Borrowing has dramatic consequences, good and bad. Suppose that the price of the house increased by 5%, and Kate sells it at $315,000. Leaving aside the interest rate, it means that after paying the mortgage, Kate will retain $45,000. It's a nice profit, an increase of only 5% or so house becomes a return of 50% on her investment thanks to the magic of leverage. On the other hand, if the home value will drop by 15%, which is not far-fetched scenario, Kate will be left with a house worth $255,000 and a mortgage of $270,000. She owes more than the house is worth, and cannot pay the mortgage from selling the house. That high leverage magnifies the profit, but also the risk that Kate’s equity will be wiped out.

At this point Admati adds a twist. What if Kate has a rich aunt, who announces in advance that if the home value will drop she would to make up the missing amount to repay the mortgage? Kate can now get a mortgage with low interest rate, since there is no danger that she will not pay back. And she can also take a larger mortgage and reduce her own equity investment. After all, if she will only spend $10,000 dollars and house price will increase to $315,000 her return would be 150%. And really, why should she invest any of her own money at all? With no investment, she can take all the profit from the increase in price. If there are losses, her aunt will pay.

In the real world, Kate is the banks. They try to finance their activities as much as possible with money they borrowed - mostly from depositors and other creditors - and fund as little as possible through equity, i.e., money from their owners or shareholders. In the position of the rich aunt is the government: the implicit and explicit guarantees it provides to banks, its promise to save them in time of trouble, allow banks to borrow at relatively low interest rates, and motivates them to reduce their equity and increase leverage as possible. In this way, bankers can generate high returns to their shareholders much of the time, and keep their bonuses rolling. As the banks become highly indebted, their ability to absorb losses without becoming distress decreases. When bad times come, it becomes everyone’s problem and often the governments come to the rescue.

An extreme example can be seen in the banking system of Cyprus, which completely collapsed last month. “What happened is very simple,” says Admati. “Cyprus wanted to be a financial center, and its banks promised to their depositors a rather high interest rate, 4% and even more. With such rate, and low taxes, they attracted a lot of investors from around the world, over and above all the size of their economy.” More specifically - Cypriot banks’ balance sheets were seven times larger total GDP of the island.

However, in order to pay the high promised interest on deposits, Cypriot banks had to generate returns. “You cannot get 4-5% without taking risk. If Cypriot banks took their depositors’ money and invested it as deposits in Germany, they would have gotten less than 1%. So the banks made loans to the Greek government, which promised to pay interest of 15% or more. Clearly, if you promise your depositors 4% to 5% and you get 15% by investing this money, you are doing great. But why was Greece promising 15%? For same reason we pay high interest on credit cards – because some people don’t pay; interest rate are set to offset this. Greece had to compensate investors for the possibility that it would not pay. This is how interest rates work with risky loans.

The investment of Cypriot banks in Greek government debt proved to be disastrous. The Greek government was forced last year to effectively default on some of its promises. Bondholders lost about 75% of their investment. The Cypriot banks did not have enough equity to absorb this loss, and cover its debt to depositors. For example, the island's largest bank, Bank of Cyprus, reported at the end of the third quarter of 2012, equity in the amount of €2.3 billion to absorb losses on assets totaling €36.2 billion.

After the large loss, Cyprus was unable to cover the deposits, Eurozone institutions refused to help, so depositors with funds above that amount insured by law, €100,000 will lose on their deposits. (The loss is currently projected as 40%, but may reach even 60%.) Even with some international aid, Cyprus economy is expected to shrink by 20% in coming years.

It turns out that there really is a money machine in the world

The story of Cyprus, then, is a story of a small island banks that tried to overshoot, took risk with depositors' money and dragged down an entire country. But Admati sees this fiasco as an illustration of a broader reality. "It showed again that we do not control the banks and the risks they take. We do not make sure that those who enjoy profit also suffer losses when they occur. Banks in Cyprus needed to have a lot more equity given the risk they took. If you promise 4% and get 15% this is wonderful, but there is no money machine where one can get 11% without taking risk. It turns out that there are no money machines in the world."

Admati sees the root of the problem in the fact that no one restrained the banks: "All this happened in front of someone's eyes, but regulators did not want to think about it." According to the regulations of in the Eurozone, banks are not required to use any equity when investing in bonds within the Eurozone countries, whether it is Greek or German bonds. "Creditors generally try to protect themselves. But depositors rely on regulators to keep banks safe or rely on deposit insurance. What happened in Cyprus is the failure of regulators to make sure that banks can absorb more losses. In the end, depositors in Cyprus - and taxpayers in Germany and other countries, had to suffer the losses"

So what is the lesson?

"You have regulation to prevent such incidents. If someone wants to put the money in the bank and be safe, regulators must make sure the bank has enough equity when it makes risky investors to lower the likelihood that the bank cannot pay."

Admati adds another observation: "The bailout agreement recognizes that uninsured depositors are creditors, and they were not promised to be paid back." These depositors were promised high interest and did not ask too many questions. "Nobody thought that 4% without risk is too good to be true. Everyone ignores risk and hope it will work."

Europe, the lost continent. JP Morgan, a paper fortress

Cyprus is possibly less than half a pin on the world map, and its banks take big risks, but their troubles are not unique. European banks invest heavily in European government bonds, including Greece, and some of these governments are in trouble. "There are many unhealthy, inefficient banks in Europe and elsewhere. Central banks and governments try to strengthen them, and yet the whole system is sick." In fact, she says, Europe may have many banks that are actually in a state of insolvency. And since the government is and European banks are connected to each other, this is a very big problem."

Other economists have made similar observation. Bank of Israel Governor Stanley Fischer, for example, criticized the Europeans stress at the Herzteliya conference last month for not recognizing the sad state of their banking system. "It is better to know the truth when you have a system into debt and problems," said Fischer, and praised the Americans acted quickly compared to Europeans. Admati says "The American banks are in better shape than European banks, but that does not mean they are in good condition." She says that some view giants like Citibank and Bank of America as essentially insolvent.

In fact, Admati does not hesitate to declare that the king is naked even in the context of the most revered and largest bank in the US, JP Morgan Chase. CEO Jamie Dimon, the golden boy of American banking world, put himself at the forefront of the struggle against stricter regulation of banks, and he often states that his bank has a “fortress balance sheet,” with about $200 billion. A loss of $ 6 billion in the wake of his traders bet London was absorbed without blinking, but when Admati and Hellwig’s book examined the balance sheets of JP Morgan, a different picture emerges. “They keep saying, ‘fortress,’ says Admati "And we say, 'fortress? What fortress?’.” A closer look reveals, she writes," that JP Morgan is quite fragile and poses significant risk to the global financial system. "

As Admati and Hellwig show, JP Morgan Chase has almost a trillion dollars of potential liabilities and its commitments to subsidiaries that do not appear in the balance sheet but can easily bring down the bank. Accounting rules related to derivatives (which are often just commercial gambling by another name) are different in the US and in Europe. These rules allow JP Morgan Chase to eliminate about $1.7 trillion of assets and liabilities. If they are included, the equity of the bank shrinks dramatically, from 8% to 4.5%.

And the book reveals another disturbing finding about JP Morgan balance sheet. Banks often speak of their critical role in harnessing the depositors’ money to make loans that are the wheels of the economy. “But JP Morgan has over $1 trillion in deposits and makes only $700 billion in loans. Depositors’ funds might be invested in derivatives. The situation is not as good as we're being told it is. Regulators do not quite know what is going there in these markets.”

First recognize the problems, then increase equity levels

If sunlight shines on the depths of many banks’ balance sheets - it may be clear they are insolvent, or “zombie banks,” the living dead. “This is a very bad situation. Such sick banks are not functioning well. This was the problem in Japan, which led to two lost decades lost, and that is what is happening now in Europe and to some extent even the United States. Weak banks tend to keep bad loans on their balance sheets and avoid recognizing losses. Some second mortgages, for example, may well be total loss to the banks, but they do not want to admit it. They might maintain bad loans and avoid making new loans that the economy needs. This situation is harmful for the economy. Instead of facing reality, the banks, regulators, and other decision-makers go on pretending that the banks are not as sick as they are.”

What is the logic of this charade?

“They are afraid. They think it would be too painful to address now, now is the wrong time. But what we argue that the book is never seems to be the right time, but delay is typically more costly. We should therefore face reality and strengthen the system now.”

Admati and Helwig propose that banks increase their equity significantly. According to proposed rules, banks would be required to have 7% equity (numbers are different from country to country), but the Basel rule use a system that gives different weight to different investments for calculating the ratio. Banks are only required to have 3% equity relative to their entire assets. A loss of 3% of the value of their assets, and the assets are worth less than their liabilities. Admati and Hellwig recommend requiring banks to maintain equity in the range of 20% to 30%. That is, a much larger part of their investments would be funded with shareholders' money. This will most likely ensure that the bank would not need bailouts and can absorb their losses and continue to function.

This is a dramatic change. Some people reminisce fondly about the "good old days of banking," before the financial engineers came to Wall Street and before the growth of derivatives markets. Banks were said to be in the 3-6-3 business: Pay depositors 3%, charge borrowers 6%, and go play golf by 3 pm. But the book shows that even in what is considered "good old days," banks were fragile and prone to failure. For Admati and Hellwig, the seemingly conservative model of banking is already problematic.

"Look at the history of the banks," Admati says. "It is full of crises. Many involve simple real estate loans, or loans to governments. Reinhart and Rogoff, for example, show that defaults by governments have caused many banking crises. Banks often prefer to make large loans, instead of many small ones. And as they say - a small loan is a problem of the borrower, a big loan is a problem the lender. Today we see some of the same types of failures."

Hence the solution of choice for Admati, designed to provide a thicker cushion so banks sustain losses instead of depositors or taxpayers. Naturally, the banks do not like these proposals, which they say would dilute shareholders and prevent dividends for an extended period. One of the arguments raised by banks (also in Israel) is that raising the capital adequacy requirements will harm the economy, prevent the banks to lend, and create a credit crunch. Admati's response to some of these claims: "Nonsense. More equity does not prevent lending. Loans can be made with shareholders money, not just with borrowed money. Banks can raise equity and lend. They just will not be able to roll the losses to someone else. Someone has to absorb the loss, after all, and I suggest that whoever earns the profits will also absorb the loss."

Admati also takes on the argument that if the banks will have the more equity they will charge higher interest on loans. She compares the current situation to a polluted manufacturing process. "Suppose you pollut the river and you can sell me something cheap. But then I have to clean up the river. Ultimately, it costs me more."

The public also conveniently ignores the "pollution" and prefers cheap credit.

"Of course. I'm not sure, by the way, that subsidies we give banks is reflected in how much interest they charge, but suppose it is so. The situation is as if we subsidized a polluting production process. What is so annoying? That there is a clean process even after taking deposits, which is to finance more loans and other investments with equity. By subsidizing debt, we shoot ourselves in the foot. "

Admati came into the subject from corporate finance, and she mentions that in other parts of the economy firms rely much more on equity than banks do, and some don't borrow much at all. "Show me another healthy business that has less than 20% -30% equity regularly. No such thing. Banks themselves would not lend to someone like that. It's like Merton Miller, a Nobel laureate in economics, said: Banks are protesting against being asked for something they themselves require of their borrowers. They require 20 -30% equity from those they lend to, but refuse to have it themselves."

Is the Senate on an encouraging track?

There is something very logical in the analysis of the Admati ad Hellwig, yet their proposals are considered controversial. The Canadian Globe and Mail said Admati is a heretic in the banking world. Still, her proposal is milder than those who want to fundamentally change the structure of the banking system so that banks will be required to hold 100% of the funds to depositors on reserve (“full reserve banking”). “We do not throw the baby out with the bath water,” she says. “The idea of banking is to transfer the deposits to useful loans, but there is risk involved in this. We do not destroy the whole system by insisting on a lot more equity, but because we want 30% equity, something considered minimal as all other economy, we are considered crazy.”

Why is this position controversial?

“Because the banks have decided that they are entitled to live outside the reality of everyone else, that they are special. You get into certain ways of thinking in the bubble of banking. You forget there is a world outside the bubble. You go into the Rabbit Hole.”

Not only bankers are in this bubble, Admati adds. “Even banking experts are on some island, sometimes forgetting to ask simple questions, suspending judgment, presuming the system must be good. It becomes almost like a religion. Many people know that what we say is true, and many have no interest in hearing what we say because it is inconvenient for them. As Upton Sinclair wrote: "You cannot teach a man something if his salary depends on not understanding it.” That's why we wrote the book. "

And the book, indeed, resonates broadly. In fact, the system might be starting to move in the direction Admati offers. The U.S. Senate approved last month a symbolic resolution that would end the implicit subsidies of banks that are too-big-to-fail. Two weeks ago a draft of a bill by Senators David Vitter and Sherrod Brown, one Republican and on Democratic, requires that banks have 10% equity without the use of risk weights, and the biggest banks will be required to have 15%. This begins to approach the levels Admati proposes.

Admati says the bill shows that lawmakers are willing to go beyond what regulators require. “In a sense, the bill says regulators are not doing a good enough job,” she says. She mentions that it was only in rough draft, and that Brown had tried to proposals of this nature in the past and failed. Still, lawmakers are now talking about banks that required more equity. “Basically it's good,” says Admati. “It's much closer to what we want, and is encouraging.”