THE BANKERS' NEW CLOTHES

The Bankers' New Clothes is a book for our times, chronicling the false arguments and manoeuvers of bankers as they tried to mislead governments and customers alike about the need to save them. Owen Sweeney looks at the issues brought up in this recent publication

By, Anat Admati and Martin Hellwig
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The autumn of 2008 is where we begin our literary journey and discover why there is an illustration of three men in the nude on the front cover of a banking book. For the reader, the starting line is, of course, the financial crash of the late 2000s.

Banking institutions across the world did not plead for a rescue but insisted that the fate of the global economy depended on it. Before the dust had begun to settle in the aftermath of the crash, bankers were already insisting that further regulation designed to prevent future collapse might hinder the performance of banks.

The events leading to the subsequent taxpayer bailouts and government interventions that followed the crash inspired both Admati and Hellwig to write this book and begin their mission to educate the masses and be wary of *The Bankers' New Clothes*.

Anat Admati is the George GC Parker Professor of Finance and Economics at Stanford's Graduate School of Business. She serves on the FDIC Systemic Resolution Advisory Committee, set up by Congress to provide and monitor deposit insurance, while her co-author Martin Hellwig is a director at the Max Planck Institute for Research on Collective Goods.

As academics and distinguished members of international committees, Admati and Hellwig were baffled to see the world rollover in the face of invalid arguments and misuse of facts from the bankers to support their existence that largely went unquestioned.

In the view of the authors, the bankers were essentially announcing to the world 'It's all a bit complicated, we have to be allowed to run things the way we want to, or else'. From here, *The Bankers' New Clothes* works to teach readers how simple banking systems really are, once the

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smoke and mysticism is wiped from them.

In a gradually increasing build-up, the book explains how banks work and how they operate with their customers. The example of a woman taking out a mortgage is used to illustrate day-to-day finance issues facing everyday people such as income and outgoings, mortgage repayments and factoring in interest rates. We move quickly into risks of insolvency and the addictive nature brought on by access to cheap credit.

'Borrowing Banking and Risk', 'The Case for More Bank Equity and Moving Forward' are the pillars of knowledge holding up *The Bankers' New Clothes*. The sub-focuses on the 'Dark Side of Borrowing' and 'the Politics of Banking' offers valuable insight into the modern financial world.

The central thesis of *The Bankers' New Clothes* is that banks made up absolutely ridiculous justifications of the way they ran their business in order to placate governments, who were the ultimate fall-guy when banking as an industry began to unravel in 2008.

In the years leading up to the crisis of 2008, which is still reverberating today, banks were generating gargantuan profits – their basic business model was described by The New Statesman as 'a mountain of lending underwritten by a molehill of equity'.

The book argues that a safer and healthier banking system is possible without sacrificing any of the benefits of the system, and at essentially no cost to society. Banks are as fragile as they are – not because they must be, but because they want to be – and they get away with it. It's because they keep arguing that they are safe and risk-averse institutions and that this crisis was a freak event. Their argument is that this was a blip along the way on a path of unrelenting progress, but *The Bankers' New Clothes* argues that this entire argument is a fallacy. Where this situation benefits bankers, it distorts the economy and exposes the public to unnecessary risks.

What Admati and Helwig do particularly well is to cut through all the distractions and get to the meat of the argument. They are relatively unconcerned with the arguments that have dominated the popular discourse thus far. It's not about regulation or the lack thereof, or about Glass-Steagall and separating commercial banking from investment banking. They argue that the simple fact of the matter is that banks borrowed too much without the equity in their balance sheets to protect themselves if anything went wrong, which was always a likely scenario given they were participating in massively risky lending – whether that was fuelling property bubbles all over the world or speculating in derivatives markets that few, if any people, really understood.

One may already be familiar with 'Paid to Gamble', a concept now referenced by financial experts around the world. This chapter devoted to the banks' reluctance to hold high quantities of capital reserves is backed up by the bankers' flawed argument that in doing so they would not have enough funds to offer a return on equity. Any reader keeping up with the pace of the book will instantly shout 'How much equity can you return to shareholders when a bank collapses?'

From an educational point of view, the book's simple explanations of everyday banking practices is so well implemented that readers will easily be able to grasp the more complex banking issues and the arguments associated with some of the bigger banking institutions that are presented in later chapters.

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In the book's forward-thinking section 'What Can Be Done?', we are asked to consider banking as 'A Fragile Fortress'. Read on and we are delivered the image of Jamie Dimon shouting out of a balcony from said fortress explaining that JP Morgan Chase has $184 billion of equity on the bank's balance sheet and that his institution is impenetrable.

Snapping out of this Manhattan fairytale, the authors point out that some of the problems that JP Morgan may face cannot be seen by looking at the balance sheet. Problems that may occur from liability exposure to subsidiaries it had set up globally for tax and global market infiltration reasons. Put another way, the fragile fortress may have one hell of a portcullis but that doesn't mean it shouldn't lock the back door.

It's hard not to be seduced by the metaphors and other literary devices utilised by Admati and Hellwig that are designed to assist in the simplification process, but it becomes clear that the secondary purpose of recruiting followers into the future lobbying efforts is also being served.

Having said that, if the authors were bent on militarising the opinions of the reader the sub-heading 'Perverse Incentives' could have included a reference to the 2007 rewarding of reinsurance staff of Munich RE.

The company attracted some controversy after a shareholder blew the whistle on a party that had rewarded staff with the services of prostitutes. The incident was one of the worst examples of how members of the financial world had rewarded themselves.

Instead the sub-section quite rightly deals with the ongoing consequences of rewarding institutions with 'too big to fail' status, even going as far to say that banks are willing to pay more to acquire and merge with other institutions in order to benefit from the subsidies and special treatment that comes with being such an entity.

The Bankers' New Clothes is informative, interesting and in some places quite entertaining. The only thing that is stopping this literary work from entering into a business studies or accounting curriculum is the weighted opinion that suggests bankers are opposed to global economic interests; regardless of whether or not we've all thought this to be true, it can't be presented as fact as there are of course exceptions. *The Bankers' New Clothes* is a must-read for every novice and expert across the wide spectrum of the financial industry.

See overleaf for an exclusive interview with Anat Admati, the co-author of this book

INSIDE THE COVERS

***Lafferty* Insights caught up with Anat Admati, one half of *The Bankers' New Clothes* writing team, to further demystify the clouds covering the pillars of the banking industry and discover what set one of the authors on this teaching journey**

What motivated you and Mr Hellwig to write *The Bankers' New Clothes*?

In 2010, as we followed the developments around financial reform we became concerned about the misdirection of the efforts and the prevalence of many flawed claims and narratives that seemed to dominate the debate. Alarmed, we started writing about the issues and trying to impact policy through policy papers, commentary, participation in conferences and private communication, but despite our efforts, it appeared the flawed claims and lobbying succeeded in preventing highly beneficial reform.

In engaging in this debate, we discovered a disturbing combination of confusions and misunderstandings, entrenched myths, and a strong resistance to engage in discussion of the issues. The line between what many knew and what they wanted to know was blurry. Bankers, regulators, politicians and even academics, seem to believe that banks are so unique and special that the basic principles of finance and economics do not apply to them.

Whereas some people may lack the background necessary to understand the issues or evaluate claims that are made, many bankers and others who are considered banking experts offer flawed narratives that conveniently ignore important parts of reality.

Even those who know better often prefer to avoid challenging the banks. The result of this situation is that the banking system remains dangerous and distorted, benefitting few and harming numerous others who are unaware of the situation or unable to change it.

By summer 2011, we concluded that change is highly unlikely unless more people understand the issues and are able to counter the flawed claims. Writing a book that would demystify banking and explain the issues as clearly as possible to the broadest readership seemed to be an essential step.

The Bankers' New Clothes is the expression we use for the variety of flawed claims that we show to have as much substance as the emperor's nonexistent clothes in the famous Hans Christian Andersen story.

The book identifies a lot of failures with banking systems and regulations that are supposed to govern them throughout the world. What positive things have you observed in the financial world? What has impressed you?

Paul Volcker [former chairman of the Federal Reserve] once quipped that the most important, and possibly the only beneficial, innovation in banking in recent years has been the ATM.

We would add that the ability to conduct banking business such as monitor account activity and make transfers online has been clearly beneficial.

The case is much less clear about other financial innovations such as derivatives and securitisation, which can help spread or transfer risks more efficiently, but can also enable distortions and excessive risk taking and interfere with effective regulation.

Although we are dealing with a very vicious cycle in a very real financial world, sometimes it is difficult not to laugh when looking back at some of the quotes that prominent bankers have let slip out of their mouths. Your book is engaging but was it designed to be so entertaining?

On one hand, the topic is indeed very serious and we aim to educate and advocate because we are concerned.

But if the book was written as a boring textbook, those who might care about what we have to say might not be willing to suffer through it, and of course those who do not want to read the book would be happy to continue avoiding the argument and ignore us and what we say.

So we tried to write the book in a way that would engage readers of all or most levels, and even be entertaining, in a cynical kind of way.

You are right that some of the statements that are made are so silly and outrageous that they are funny.

A previous title of the book was 'Gambling on Nonsense', referring to how bankers get away both with taking too [many] risks and with talking nonsense. In the very final stage of the writing, we managed to come up with a full set of epigraphs for the chapters. The one from Upton Sinclair ('It is difficult to get a man to understand something, when his salary depends upon his not understanding it') was there all along.

The lesson is that even if many people who present themselves as confident experts say something, it does not make it necessarily true. The combination of confusions and self-interest (or political considerations) is powerful.

We give an example of a debate in the US some twenty years ago about a simple change to close loopholes in accounting reporting rules, something relatively minor. Many silly statements and threats were made in that debate, and they affected policy and kept a status quo that did not make much sense.

Your book talks about 'Kate', the young woman facing the world of mortgages, savings and the addictive nature of credit. Is she the manifestation of your target audience? Does she represent someone in your life, perhaps a student or a family member, in a generation that you fear for if things don't change?

We struggled with how to draw all readers into the discussion and how to get most quickly to the issues around banking and regulation. Eventually, we decided that readers must first understand the basic principles of funding, particularly for corporations, and debt and equity, and then all the issues that arise with borrowing, liquidity and solvency concerns, distress and bankruptcy.

This helped get the reader oriented when we start discussing banking problems and the possible solutions. It also became clear that the best 'entry' to understanding how borrowing works would be through a mortgage example that all readers can relate to.

Kate is a generic borrower and she does not correspond to anyone in our lives. Once we decided to use the example, giving our borrower a name, we tried to make as many of the conceptual points about borrowing and the incentives of the borrower using this example.

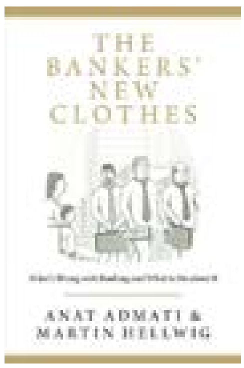
Importantly, to capture banking and the situation of corporations whose owners and shareholders have limited liability, Kate's mortgage had to be of the 'no-recourse' type, so that, like corporations, she can walk away and leave the house to her lender if the value of the house is low enough that she decides to abandon it.

Such loans are available in some states in the US, but many home borrowers elsewhere, including for example Ireland or Spain, have not had this option, and remain indebted even as the value of the house is much below their mortgage debt.

In fact, Kate is ageless in the book. You may visualise her as young because in the discussion of guarantees and subsidies, Kate has a generous aunt named Claire who guarantees her mortgage and possibly other debts.

To your question: We are concerned for all of us, young and older, if things don't change. We are made to live with a dangerous and distorted system and we seem to have difficulty convincing regulators and politicians to engage and take up the challenge of make it better.

There are some common sense things to do, but the political will to do them, as we conclude, is still missing. We hope change comes before more harm is done and before we suffer through more costly financial crises.



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