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The bankers' new clothes ... yet to be made

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Bankers have, in recent years, become the butt of many jokes and the scapegoats for all that went wrong in the financial crisis. Public anger over austerity measures is aimed at them, while most of them continue to pocket high salaries. Much has been written about the banking industry, about its flaws, its impact on the world economies and possible future solutions.

However, the book 'The Bankers' New Clothes' by Anat Admati from Stanford University and Martin Hellwig from the Max Planck Institute still stands out from the crowd.

For one, it does not beat around the bush – it is clear and straight to the point in an industry usually heaving with jargon. By using language the man on the street can understand, this bold book leads quite literally by example as it reveals insights into the banking industry and why it is in such a mess.

The book is split into three main chapters. They explain what went wrong in the banking sector and suggest how to address this, and how to go forward from here. The authors do not yet see bankers wearing the new clothes – in fact, the clothes are so out of reach at this stage that the cotton needed to produce them has yet to be planted. Instead, the authors speak of a banking system that is distortive and inefficient and operates very differently to that of corporations.

They warn of a very fragile system – one that can and will implode again if it remains in its current, highly interconnected shape. Some of the risks taken in the current banking sector, such as excessive leverage, are entirely unproductive and unnecessary, and only the very select few will benefit from them, while many will suffer. Stakeholders in the banks, such as taxpayers, not only experience the downside of such excesses without benefiting from any of the upside but also suffer collateral damage beyond their control.
Diversified investors such as pension funds also lose out in this system, as they bear more risk than they are compensated for.

The banking sector, however, gets away with all of this by hiding behind a smokescreen of "nonsense" language and poor balance sheet disclosure, as the public struggles to understand what goes on. Banks, for example, often hide behind liquidity problems, although the authors point out that nobody goes into default because of liquidity problems alone.

The situation does, indeed, look bleak. But the book does not say the banking sector cannot be changed – it alludes that there are powerful forces at work that do not want the system to be changed.

The authors' suggestion for creating a better banking system mainly lies in a single word – equity. Instead of the small amounts of equity banks currently hold of around 5%, they suggest they ought to hold an equity ratio of 20-30%. Banks' argument that holding equity is too expensive is dismissed.

In addition, the authors call for effective regulation of the banking sector. So far, the lobbying power of banks has been too great and influential, which has led to flawed regulations. The authors contend that even Basel III will be unable to move the sector forward. It is the shareholders – such as pension funds – that can help change the existing culture by calling on banks to become safer by increasing their equity.

They should also call upon the regulators, the authors say, to contain the system and not succumb to lobbying.

'The Bankers' New Clothes – What's Wrong with Banking and What to Do About It', by Anat Admati & Martin Hellwig, Princeton, RRP £19.95

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