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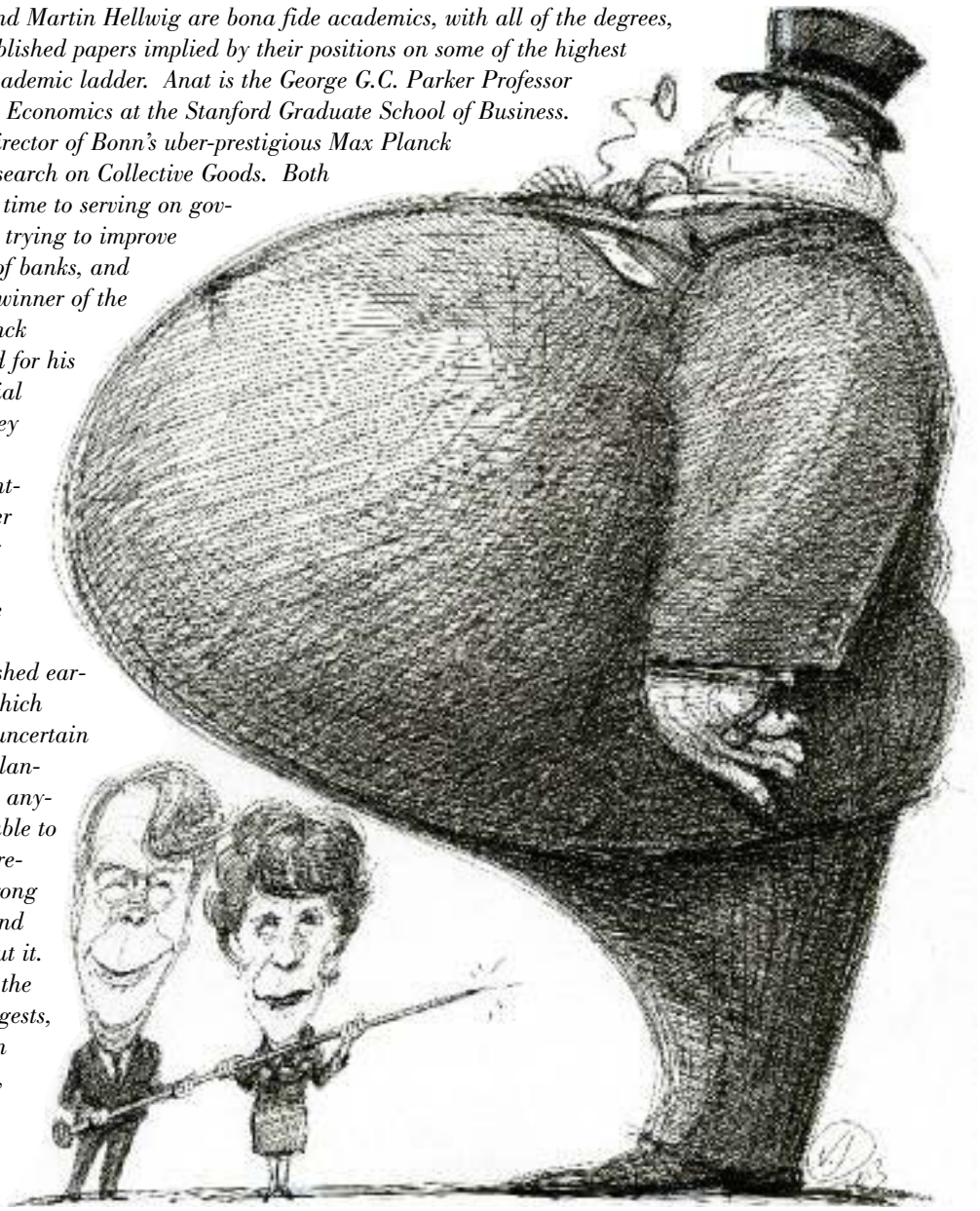
listeningin

Puncturing Banks' Lies

Raise Equity–Lots–To Slash Taxpayer Risk, Say Admati & Hellwig

Anat Admati and Martin Hellwig are bona fide academics, with all of the degrees, honors, and published papers implied by their positions on some of the highest rungs on the academic ladder. Anat is the George G.C. Parker Professor of Finance and Economics at the Stanford Graduate School of Business. Martin is the director of Bonn's uber-prestigious Max Planck Institute for Research on Collective Goods. Both actively donate time to serving on government boards trying to improve the regulation of banks, and Martin was co-winner of the 2012 Max Planck Research Award for his work on financial regulation. They are in no way intellectual lightweights, in other words. The pair are also the authors of "The Bankers' New Clothes," published earlier this year, which explains in no uncertain terms – and in language virtually anyone should be able to understand – precisely what's wrong with banking and what to do about it. In so doing, as the illustration suggests, they've taken on formidable foes, but they are pulling no punches – and



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Victor Juhasz
Page One Illustration

continuing to battle to call attention to their very specific ideas about how banking has been derailed by its addiction to debt and to their very practical suggestions about what to do about it.
The simplicity of their book's presentation belies the tremendous nuance and depth of the research behind it, something hinted at by the footnotes that fill almost half of the volume's pages. For a full display, go to their website, bankersnewclothes.com. But first, get a flavor of their passion about the need to bring sanity back into bank risk-taking, by listening in our recent intercontinental conversation.
KMW

I'm in awe that you two managed to not only write such a clear and utterly accessible book on banking issues for ordinary readers – and taxpayers – but to do it from two continents. A mind-boggling achievement.
Anat: To us, too!

And your reward is now jointly being considered public enemy No. 1 by the banking industry. How does that feel?
Anat: It is not fun. What's frustrating about this is that although we went to great lengths to go through and explain the issues in the simplest of terms –

And also backed up those explanations with all the footnotes even the most punctilious academic could want –
Anat: Right. But it often seems that people haven't seriously bothered to read and engage with our arguments. They seem to prefer to just reject them out of hand.

Perhaps because they really have no good answers –
Anat: We've just added a document to our website, called, for now, "The Parade of Banker's New Clothes Continues" [See accompanying Guest Perspective] in which we debunk 23 flawed claims by bankers that have been made repeatedly since our book was published. But it's a work-in-progress, because ridiculous new claims (or variations on their old themes) are advanced practically every day. We can't address all of the nonsense, but we're trying to refute the most confusing of the claims, the highest-profile ones, to try to keep people focused on how much safer the banks – and taxpayers – would be if banks were required to operate with considerably more equity on their balance sheets. In other words, how much safer we would all be, if banks were required to be more similar to other corporations, which carry considerably more equity on their balance sheets. The claims we're being called upon to refute are all over the place, and sometimes have to be broken down according to little nuances. "The Modigliani-Miller Theorem is about a perfect world." "M&M doesn't apply to banks." "Banks are special because of this, because of that, etcetera." "Bonds are as good as equity, cheaper than equity," that kind of thing.

"So yes, the question now is what will it take to make these fundamental changes to the banking system? If the financial crisis didn't move us to act, what will it take?"

In other words, your critics have been dredging up all sorts of arcane academic-speak and confusing side issues instead of addressing your central premise?
Anat: Right. Nobody can explain what would be wrong with banks retaining their earnings. How would the world be worse? They just throw around these threats – like banks would be forced to stop lending – and they just keep repeating them. They sometimes make up reasoning, as well. So our effort seems endless after writing the earlier papers and our book, do you know what I mean? It never ends, no matter what you do. We have to write yet *another* debunking paper.
Martin: Well, let's not see this *too* negatively.
Anat: I agree, at least people are talking.
Martin: When we first started to work on all of this, back in the summer of 2010.

Work that lead to your academic paper on all of this, which – considering the genre – couldn't have been clearer.
Anat: Right, that's how we spent the summer of

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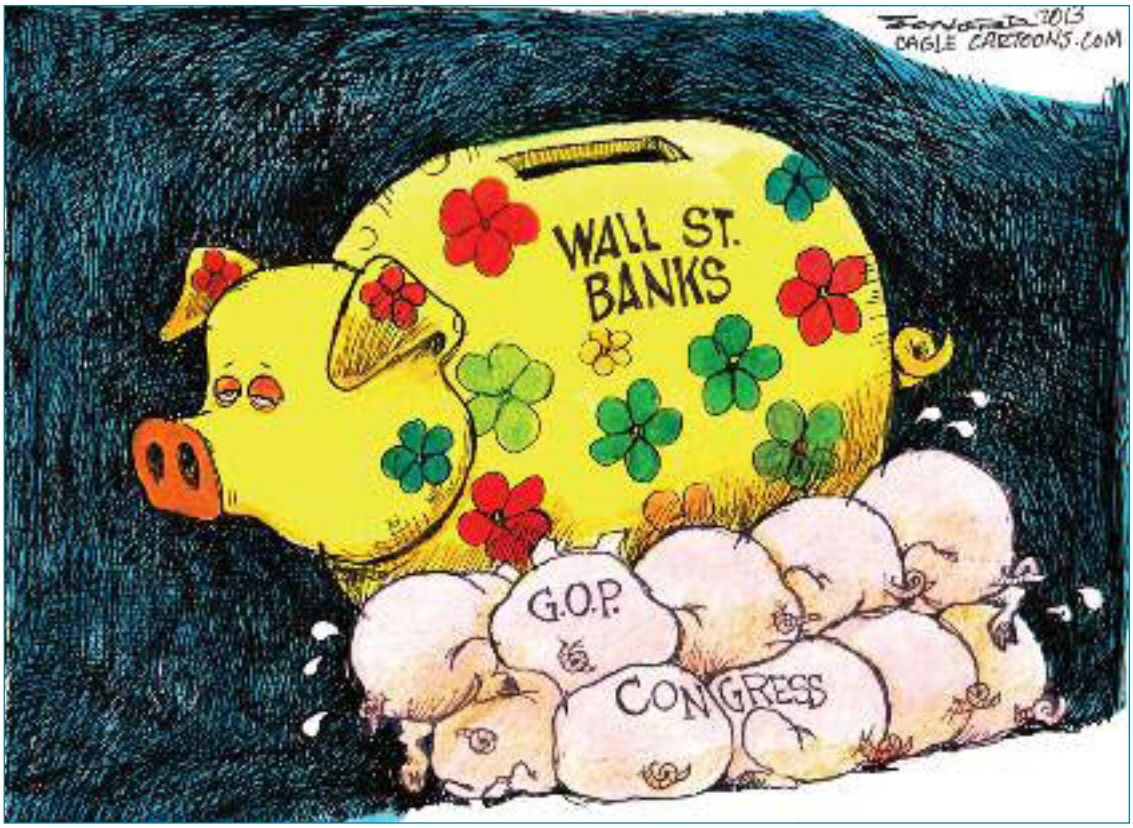
2010, and it became clear after some months of trying to engage in the debate that something like our book had to be written for the policy makers, just from some of their reactions to our paper.

Martin: At that time, I told Anat, "Don't expect this paper to have too much of an effect," because I have more than ten years experience in doing policy work – and the few occasions on which I did have an effect were very peculiar, sort of random, events. Normally, entrenched interests are just very strong.

Anat: It's true, he's very cynical about it. Martin said to me, "There's too much money involved. Forget it."

Martin: So by comparison to my prior experiences, I think our paper in 2010 and now our book have been remarkably successful.

Anat: I agree. They have generated a lot of debate and I'll even begrudgingly hear from policy people on occasion that "Bankers' New Clothes" is having an impact. But they still don't dare to say it out loud. They are still kind of inching their way – they're not going to turn around overnight and see the light.



Isn't that extraordinary, considering that the banks – and the entire global economy – had a near-death experience in 2007-2008 – in large measure because of the banks' heedless risk-taking, and yet virtually nothing has been done to reform or restrain them in any real sense?

Anat: That's what's been shocking to us, too. How is it possible? Clearly, some of the myths we address in our book are just entrenched in the minds of bankers and policy makers. When you add some beguiling narratives, which even are advanced by some academics, that fit people's convenience, and then you add politics into the equation, somehow you get this situation. I mean, even in academia, banking has been in a little bit of a bubble, an island, getting a pass.

Is that because, if I can be so crass, that's where so much donation money is?

Martin: Let me give a parallel. Ten years ago, I was involved in policy discussions about encouraging more competition in energy markets. One of the issues there was that the large energy providers used their power over the transmission grids to foreclose competition. So the question arose: Shouldn't we do something about how they manage the transmission grids, reduce regulation and so on? Now, the main argument on the side of the energy providers was always: "If we tamper with the system, we endanger the safety of electricity supply. Germany last year had an average of only 15 minutes per consumer of outages. That's a European record and if we move away from that system, that's going to be bad for everyone, bad for the economy." Well, when a politician hears any of that sort of argument, they are shell-shocked. They don't want to be seen as risking the safety of the electricity supply.

Subsequently, of course, when politicians were nudged by the European Commission and new regulations came, none of the threats about the safety of the grid were realized. Except that now, I have to admit, they are beginning to be realized – but that is only because the politicians, emboldened by that earlier success, on their own have decided, "We must change from nuclear to renewable energy

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sources." The trouble there is that using renewables puts enormous new demands on the grid network, and the grid actually doesn't have the capacity to deal with that. But now the politicians are not afraid because they're engaged in the holy war about nuclear versus alternatives.

Anat: It's about different politics. Another example was the options expensing debate, a really stupid debate that got completely surreal and political over nothing, over calculating a number.

Because that calculation could hugely influence the size of CEO's paychecks.

Anat: It took accounting scandals to straighten out the expensing debate. All the warnings of disastrous consequences were nonsense in that debate. There were fallacies, irrelevant fact, and myths featured in that debate, just like we're trying to debunk in the banking debate. I went back and looked at the policy comments used to befuddle the politicians on a simple accounting change. Unfortunately, it's not necessary to make valid arguments to affect policy. That's what happened in the mid-1990s when special interest groups warned of dire consequences if the FASB changed the treatment of executive stock options in corporate income statements. They claimed the proposed rule would make it more difficult for U.S. firms to raise funds; make them less competitive globally, and stifle innovation. The lobbying was intense. the Senate passed a resolution opposing the measure, and FASB backed down. It wasn't until ten years later, after Enron and other accounting scandals, that a version of the proposal was implemented – and none of the earlier warnings came true. The sky didn't fall when the accounting rules changed. So yes, as you asked, the question now is what will it take to make these fundamental changes to the banking system? If the financial crisis didn't move us to act, what will it take?

On the bright side, "your side" did win a recent *Economist* magazine online debate on whether "too big to fail" banks are also "too big to be allowed to exist."

Anat: [Laughing] They asked me to participate on the question, "Should we break up the banks? I said, "Which side of it do you think I am on?" They said, "Oh, we think you are for breaking up the banks." I said, "Well, my view is actually more nuanced than that. I have something to say, but it's not quite yes/no, if that's what you want to ask, just that." So I wrote my little side comment, but breaking up the banks won that debate.

More nuanced, how?

Anat: Well, the largest 80 corporations in the world are all financial institutions, each controlling hundreds of billions, even multiple trillions worth of assets. We argue that these megabanks are a particularly dangerous part of a fragile and inefficient financial system that exposes millions to unnecessary risk and distorts the economy. Making this system safer is possible and urgent, but others' current reform proposals fail to do so. Among the many benefits of a safer and healthier system would be reducing the excessive subsidies that the megabanks currently benefit from. And with fewer subsidies, the business models of the megabanks may no longer be viable, so they may break up naturally. But just constraining banks' size would *not* address the key distortions of the system. Even if individual banks are smaller, the system could remain too fragile and dangerous if banks pursue similar strategies and fail at the same time, or if the failure of some banks weakens others, imposing costs on taxpayers and harming the economy.

That is why we say that attempts to break up banks by law or by regulation must consider the interconnectedness in the system, and must be accompanied by other steps to reduce the fragility of the system. And that is also why, as you know, we have been suggesting that a highly beneficial reform would be requiring banks to use much more equity funding than current and proposed regulations allow.

It's amazing, your book puts the issues, which are usually couched in impenetrable jargon, into terms even a high school student should understand, and yet so many bankers and even policy makers still seem not to get it.

Anat: Well, we don't *know* what they get and what they don't get. We only know what they want to admit they get. What they believe, we don't know. I only know what they say.

And the arguments that you're hearing, against taking your book's advice –

They are mostly the same as the ones we debunked in our book. Some of them slightly elaborate on what we described in the book. For example, some people are concerned about subsidies to banking not being given, withdrawn. But what we are saying is that you can separate the issue of subsidies, if there's truly a need for some, from the incredibly crazy way in which they are currently delivered – just giving the banks a blanket of cheap funding to do whatever they want – and then hoping that they'll lend. Of course, they threaten that they won't lend if their subsidies are withdrawn – but

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they aren't lending much anyway.

Isn't that the business of the banks? Lending? I mean, if they don't lend, what use are they?

Anat: Not from their perspective. They're in the business of making money. It's not the same as lending. In other words, the subsidies went to, for instance, the London Whale instead of into lending. Consider that JPMorgan lends some $700 billion on a balance sheet of, depending on the accounting, $2.2 trillion of assets. That's one-third by GAAP and it's a lot less by international accounting standards. Consider that: $700 billion of lending, while Jamie Dimon has $1.1 trillion of deposits. "Excess deposits," he has called them. Now they're threatening that if they have to have more equity, they couldn't or wouldn't lend. Why wouldn't they, if they can lend in their current financial position?

Don't those threats make bankers sound like churlish children, saying they'll take their ball and go home if they don't get their way?

Anat: Yet, somehow they get away with it. That's the problem. While the politics are different in different countries, our book could not have been written without a chapter on politics. I actually came at this whole issue not appreciating the impact of politics – but I sure do now.

As bad as the political climate in this country has become, it's nothing compared with how the banks influence governments in other developed economies. Pick up virtually any issue of the FT and you'll find articles demonstrating how badly European banks lag in terms of meeting even today's minimalist capital standards, for instance. Even the Germans.

Martin: Mm-hmm, yes. I'm afraid the German case is a particularly egregious example of political economy problems.

How so?

Martin: One problem is that Germany's two major parties are in perfect agreement on not pushing the banks to raise equity because they both know that, every now and then – and while they may not be in government now, they're sure to be in government later – the power to move a few million without asking anybody, just by making a phone call to the banker, is worth every euro of taxpayer money that may be needed to defend that privilege.

You're saying the politicians think that if they require increases in bank equity, they won't be able to do that?

Martin: Well, here is an example. About three weeks ago, I was at a hearing in Hamburg concerning the provision of additional guarantees for the Landesbanken they have, HSH Nordbank.

What sort of guarantees?

Martin: The hearing was about increasing a second loss guarantee on a portfolio of assets, which is actually gigantic. Why a second loss guarantee? Well, because there's a first loss tranche of 3 billion euros taken over by the bank and then a second loss, which so far is 7 billion euros and is supposed to be increased to10 billion euros, which is being taken over by the government. Why? Well, guarantees don't cost anything.

Until, that is –

Martin: The rationale for having this guarantee is that it will reduce the Landesbanken's risk-weighted assets because it takes away risk from the bank and so it will therefore make sure that – despite bad developments expected for this year and next year (and they actually should be expecting them for the following three years, as well), those bad developments will not push HSH Nordbank's Basel III ratio to fall under 9%. So they play games with risk-weighted assets via this guarantee.

Oh boy, do they. That's not exactly news.

Martin: Well, the Hamburg legislature has been told this is without any risk. But if you then observe that the only reason why a guarantee has an effect on risk-weighted assets is because a model's calculations indicate that there *are* risks, the answer is, "Oh yes, but those risks are not so substantial that we have to worry about anything." Another part of the answer is – and this is again what they tell the legislature – "Guarantees don't lead to money flows and therefore guarantees are not relevant for our budget." This is part of a game of fooling themselves, fooling the voters, fooling the legislators. You can do that much more easily with guarantees. If you had to put in equity, well, that would be a money flow and a money flow would be seen in the budget, would have to be budgeted. If you don't want to budget these things, you don't like equity.

Anat: Yep, like AIG, right?

Martin: By the way, you will be amused by this story, and it can add to your perspective on all of this. At this hearing I said, "Well, yes, lowering risk-weighted assets is going to increase the bank's Basel III capital ratio. But from the numbers that

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I've seen, I have no idea how long the effects may be assumed to last, and moreover, I don't think that the bank is really healthy. The projections that have been given rely on unrealistic assumptions or projections about the shipping crisis. I wouldn't believe them."

The next day, the governing party in Hamburg issued a press release saying the three experts who were there at the meeting all confirmed that increasing the guarantee was suitable for increasing the bank's capital and thereby increasing the bank's stability.

Anat: Oh, *that* you didn't tell me!

Talk about chutzpah –

Martin: So a few days ago, I actually issued a statement saying that was a falsification of what I had said. There is a journalist writing an article about this now. I expect that the politicians thought, since I'm far away from Hamburg, I wouldn't notice their statement. But one of the other experts who had been at the hearing, and who is based in Hamburg – and who had also been very critical – got really annoyed at the political party's statement and told me he found this journalist who was going to write about it.

Anat: And that is just about a Landesbanken. The news reports Kate was referring to were about Deutsche and Commerzbank banks.

Which are to the Landesbanken as giants are gnats.

Martin: Well, the Landesbanken are not that small. They have been much reduced because the European Commission imposed restrictions on them when they were saved in the crisis, but still, the Hamburg Landesbanken that I just mentioned, which is one of the smaller ones, still has assets on the order of $140 billion. It is supported by the city state and the neighboring state, with a total population of something like five million.

It is bigger than I thought.

Anat: And Nordbank has all of these exposures to shipping.

Martin: They have been the world's biggest financier of ships.

Pretty much forever –

Anat: That's not a great business right now.

No and it's exceedingly cyclical, which is also not new. But they really went overboard in the last cycle. Gee, I wonder why.

Martin: Well, the word "cyclical" is a euphemism in this case because the cycle was extremely pronounced. The collapse occurred in 2008, but until the collapse, they had been ordering new ships like mad. This year, they *still* have new ships coming on the market. Capacity expansion is predicted to be 10%. Trade growth is predicted to be 5%. They've had this discrepancy since 2008. So by now, I would expect that there is something like 40% or 50% overcapacity in shipping. It won't just be enough to have that excess capacity go down. *You need to eliminate it* and that will take a very long time.

It will indeed. Old, cheap ships can stay in service far longer than people imagine.

Martin: Yet all the discussion in Hamburg was based on predictions that by late 2014, the crisis would be over.

Did they even bother to talk to any shippers? That's ridiculous, from what I hear.

Martin: The shippers would be even more optimistic. They have to be. They are in this business and want the banks to continue lending. So that was also what the projections of the banks were. There was one accountant there who said that was a consensus projection in the industry. I had, on a previous occasion in 2009, already had done some work on the shipping industry and, at that time, did some thinking about market structure and excess capacity and all of that. At that time, I'd been told that I was too pessimistic – except that it turned out I was too optimistic. I expected things to be getting better by now at that time but they haven't been.

The market is crazy because so much ship manufacturing now is done in places where the capital markets do not necessarily control asset allocation. Where the decision to build a ship is all about the need to employ Korean laborers, regardless of the real demand for new ships.

Martin: If you don't want to hear about problems, just say the crisis will be over in a year – or two, if we're unlucky. And poo-poo anyone who argues that yours might not be realistic assumptions. The market for ships is very slow moving. It takes a long time to build a ship, orders were growing up until mid-2008, and the Korean builders have been filling those orders. In 2009, we were told that the 2008 orders would be completed in 2012. Meanwhile, the market for shipping services is weighed down by oversupply. Lots of ships are lying idle in bays around the Baltic Sea, in the Mediterranean, etc., so charter prices are very low and prices for freight seem to some measure of average variable cost.

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Has no one learned the lessons of the Japanese zombie banks?

Anat: That too. Look, the ECB is now warning about bank failures in Europe. There was a headline in the NY Times that read, "European Central Bank warned on Wednesday that euro zone's slumping economy and surge in problem loans were raising the risk of a renewed banking crisis." That's from a "sobering assessment" by your friend, ECB vice president Vítor Constâncio, it says.

Martin: That's amazing. When I heard him speak recently, he said there were no problems.

What has happened in between, I wonder?

Anat: "Over the course of an hour, he expressed concerns about the murkiness of banks' internal models for measuring risk." There you go. We're being heard! I'll send you the link. This was at an OECD meeting in Paris, I guess. At any rate they got these people to say these things there. The story continues quoting him, "national oversight structures are resistant and they will renounce as little power as they can." There you go!

Martin: Well, I can easily see Constancio say that, yes.

Anat: "The euro area's systemic stress is at its lowest point in two years, the ECB said. One suggested reason for lower stress: the official interest rates at record low."

Sure, we're feeding the system. That's why the big U.S. banks today are much bigger than six years ago and have record profits. But when you look at magnification of risk with leverage – But it's like, you make a little bit over zero interest rates and you look great.

Martin: I was going to say, if you can borrow at zero percent and are unable to make a profit, you should *not* be in banking.

Anat: Anybody can do that. I always say, "Let's be bankers in Cypress." I love the line where Michael Lewis asks this Icelandic guy, "How many years would it take you to learn how to fish?" and he says, "Oh, it takes about seven years. You have to be an apprentice, this and that." Then Michael Lewis, this is at the end of the chapter on Iceland in "Boomerang" says to him, "What makes you think you can be a banker right away?" The guy just stops in his tracks and the way Michael Lewis related it, this was the first time he was completely speechless. He says, "Really, I don't know what the answer is to that." Michael Lewis said, "Okay, let's be bankers in Cypress, right? Promise 4% and make 15% from Greece. That's a wonderful spread with borrowed money." Wonderful until…Nobody asks, Why does Greece pay 15% or 20%?" Everybody understands that. So when I go around talking to lay people, I say, "Let's get this spread. We can be bankers, always with borrowed money." It's wonderful, the spread. It's a money machine. The bankers live in a world with no downside. So when they talk about their ROE, it's always the upside ROE. It's always this spread.

And they've become immensely creative in coming up with risk analytics to "prove" that they're not taking inordinate risks – even while betting the globe.

Anat: What is truly remarkable is that when you try to engage sometimes, they'll start using all these fancy words of theirs. So I say something like, "I'm very simple. I just know about balance sheets conceptually. Can we go through a balance sheet, please?" I say, "Okay, so now you tell me that raising your equity to 15% or 20% of capital is going to kill you and ruin your business model and you can't live. So let's see, you do some stuff on one side of the balance sheet, the asset side, you invest. Then you fund it on the other side of the balance sheet, right? So you have your liabilities. Keep everything. Suppose you've made some money on the spread. Now tell me how I ruin your business model if you retain your earnings." There's no answer to that. [Laughs] They just, you know, they can't answer the simple question: "What's your business model?"

At the very least, they don't *want* to answer that question in public.

Anat: Right, the answer is that their business model appears to be to take risks, period, to lever, period. That's exactly what we know from corporate finance. But that is not a *business* unless somebody else covers the downside.

Which is where taxpayers, whether they are American taxpayers or German taxpayers or even Cypriot taxpayers come in –

Anat: Yet bankers think they're entitled to a business in which they just have a risk appetite; that that's a business, to have a risk appetite, to eat risk!

Okay, but there's a lot of misunderstanding when you suggest equity levels, like 30%, for the banks that strike many people as outrageously high. The Brown-Vitter bill only calls for 15% equity, and only for the very largest banks.

Anat: Only six! People are afraid of change. But basically, there's nothing to recommend single-digit equity ratios, except that somehow, the banks got used to them and so they think they are entitled to them. And changing from there scares everybody.

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Why 30%?

Anat: There's no answer to why not. Martin and I have known each other for a long time, but the moment I knew we could collaborate on this was when I read in a paper he wrote in 2009 or early 2010, a section called, "Here's a crazy idea, why not 30% equity?" That's when I thought, now I've found somebody who's as crazy as me, who asks this question. And no one has given us an answer to that question in the four years – and more – that we've been asking it.

Martin: That was actually a paper, most of which I wrote in the summer of 2008. It's a paper on the financial crisis, which doesn't have much about Lehman Brothers, because most of it was written *before* Lehman failed. So the paper described what had been going on since the summer of 2007. It looks strangely anachronistic, in that way, but my feeling at the time was that it was necessary to talk about substantial regulatory change. The really shocking experience, I thought, was to see how little readiness there was – even in the regulatory community – to think about regulatory change. To the extent that they did think about it, they thought more about pet projects that they had all along. I've been telling people this is just like Mr. Cheney and Mr. Rumsfeld coming out on September 12th, 2001, saying, "We've always known that Iraq was a problem, that Iraq was a hotbed of terrorism." I mean, the European Commission had always known that a lack of integration in Europe was a source of systemic risk and the German government had always known that hedge funds were really evil, but there was no analysis – nor any willingness to actually do something seriously.

Wasn't that basically because there was complete regulatory capture? Because the regulatory apparatus was essentially in thrall to the banks.

Martin: Yes. Well, the problem is people have invested so much work and so much pride in this regulatory framework that they're unwilling to discuss changing it.

Despite it's obvious failings, which explains a lot of your cynicism. Basel, no matter what numeral is attached to it, is an unmitigated mess. It actually encourages all kinds of bad behaviors.

Anat: Yes, that what you can see in the London Whale report from Sen. Carl Levin's committee. They were trying to manipulate the models. That's what you can see in the ways that, to cite just two examples, Deutsche Bank and Commerzbank are trying to avoid raising more equity by fiddling around with risk weights – and in the way all of the banks talk about "risk weight optimization."

Martin: Actually, Deutsche just did raise equity. Commerzbank is the one that can't even raise it.

Anat: Well, they *can* raise equity, if they are solvent at all, presumably, at some price. And part of that price actually includes the "too big to fail" subsidy. So their price is kind of a call option, with upside. What's the chance of being wiped out with equity?

Martin: Commerzbankbank can't go to the market anymore. There *is* an issue about solvency.

Anat: Right and about transparency, the opaqueness, of their business.

Martin: Well, yes, one thing one doesn't know is what are going to be the eventual costs of winding down their covered bond subsidiary?. The other thing one doesn't know is what's the value of their shipping portfolio? Commerzbank Bank is the second largest German institution in shipping.

Which, as we said earlier, is not a good business to be in, at the moment. Not a good place to have a lot of assets parked.

Anat: And it's also not terribly diversified –

Martin: Well, that is difficult to say because with Commerzbank, shipping is $20 billion on a balance sheet of $700 billion. You might say, for an institution that large, it's not *too* bad, but the problem is they have very low equity.

So I've been raising the question recently, when talking to people, "If I look at Lloyds Bank, they have sold shipping loans at a 50% discount. If I apply that 50% discount to the shipping loans of HSH Nordbank or Commerzbank Bank, what does that mean?"

Nothing good?

In the case of Commerzbank Bank, which has already taken some writedowns, it means, say, a $7 billion additional writedown. That would, well, put the squeeze on them concerning capital requirements. In the case of HSH Nordbank6, the additional writedown would be something like $13 billion. That would exhaust both the asset guarantees that they have, and their equity. All this, again, depends on valuations, but valuations are political – I mean, the ones that they use. And there is little confidence that one gets any view as to what the true situation is.

Isn't that the rub not just with Commerzbank, but the whole banking sector? Analysts can try to get a handle on their financials, but it's like playing with a sand castle. Everything is so dependent

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on judgments about valuations; what has or hasn't been written off, what's on their balance sheets, versus what's off their balance sheets – even calculating their debt/equity ratios is problematic, is it not?

Anat: Sure. It's the numbers, assets versus liabilities, so who comes up with the numbers? But we try in our book to stay more abstract than that, because it's too technical. We kept thinking, "Oh, well lose the reader," when our goal was to expand the set of participants in the debate. But what's behind the numbers *is* a big problem.

Martin: The real question is, to what extent is there toleration of *political determination* of these numbers? That's very much a question of regulatory culture and a question of how much political forbearance there is of weakness in banks. To what extent are the authorities *complicit* in the strategy of Let's not rock the boat?

Anat: See, in our "enlightened" regulatory environment, regulators are supposed to look at multiple signals. They are supposed to look at market values. They are supposed to really try to get at where the banks are, and watch where the risk is going, when they tell them it's gone. All of that. But it appears too often that the banks are just in a game of appearances.

Isn't the basic fear that if the regulators followed your advice to reject the bankers' big lies, the financial system would pretty much collapse?

Anat: *If it shrinks, it may be a good thing*. Why can't banking be more of a *normal business*? I often marvel at just how much person-time is spent on this industry. I'm in Silicon Valley and I look around and ask, Why is *this* industry so high maintenance? Why is it demanding so much attention? Why can't the banking industry be a little bit more normal? Fine, so they run into liquidity problems from time to time. Fine, so you have to regulate them. But the amount of ink being spilled on that, if you think of things like living wills – oh, we're going to have to show them how complex they are. Well, any company can get complex. Investors and the markets should figure it out for themselves! Why is it everybody's else's business all the time to help the banks function and be productive?

That's another reason your book is exceptional. You dare to talk about the *social costs* of allowing the financial industry to absorb so much of the economy.

Anat: Everyone loves cheap credit and everybody just wants to forget exactly how the banks fund this credit and how much risk is taken; all of that. We just never look at the funding side of the banks and realize how crazy it is.

Martin: Even if you *do* look there, the moment the banker tells you, "I'd love to fund this for you, but there's a strange regulation that prevents me from making this particular funding decision…"

Anat: Yes, then you rush right out to remove that pesky regulation.

Martin: Well, that when you find that you don't like the regulation.

Anat: And if you even ask, what's wrong with the regulation, what you hear is, "Oh, it's going to be so expensive for me to raise this money otherwise." There's an ideology, of course, that says let the markets work. But this is a major example of a place where there is a huge conflict of interest between what people choose privately and what's good for society. It requires a real, forceful regulation to counter this leverage addiction, this borrowing addiction, that's actually fed by the subsidies and the guarantees in banking. Even just guarantees feed this addiction to borrowing, which is the problem in banking from the beginning.

Certainly there were problems in banking long before there was deposit insurance.

Anat: Right. But our take on that is that just because banking has always been fragile, doesn't mean that it was ever actually efficient; that bankers always wanted to be taking more risk with depositors' money than depositors could stop them from taking.

Which why the history of banking is a history of crises, and crashes.

Anat: There was always government lending and other big risks that they preferred over making workaday loans, and they have always had all these exposures that are correlated – not as independent – as one would wish. The risks are more like earthquake insurance than car insurance.

Meaning they take risks with fat tails that they'd prefer everyone just ignore.

Anat: Yes, fat tails and correlations and they don't put their own capital at risk in the bank, the way normal companies do in their own businesses. Their deposits start banks off indebted, and they don't want to add equity to that. In fact, they'd prefer to add debt if they could get away with it. In the 19th century, they couldn't. Depositors wouldn't agree to leave money in a bank unless it was backed by their own money. Then the creditors come in. And there are all these collateral issues. That's scary too.

What do you find scary about the banks'

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collateral issues?

Anat: Well, it's just that the banks borrow with all these repos and in all of these other indirect ways, via derivatives, using collateral that is probably encumbering the balance sheet enormously. They re-hypothecate so the multiplier goes to using the same collateral.

Many, many times over.

Anat: Right, so in distress, who owns it? It defaults. Every creditor thinks they can walk off with it. I'm scared of that. In a crisis, would the FDIC have enough money to pay the depositors if the collateral walks off?

That's a good question.

Anat: We've already seen small countries get to the point where they didn't have enough resources to pay depositors.

Martin: Right, Cyprus had virtually nothing.

Anat: In our case, there's just so much debt that I don't know if we really understand that it's there. We saw Repo 105 in Lehman – hiding their leverage. And there are all of these knotted up balance sheets with counterparties. It's scary.

That kind of business has become even more concentrated in the very largest banks in the time since the crisis.

Anat: They're the only ones people want to deal with because they *think* they're too big to fail.

I'd suggest they're too big to survive

Anat: Yes, I think those balance sheets, if you ever had to undo all their legal commitments, would be a mess. I don't want to know – I'm looking at the FDIC's systemic resolution plan (an heroic effort) but it's going to be *no fun* if it ever comes to it. My fear, I don't think they would ever dare, use it on a Citi or a JPMorgan. Certainly Tim Geithner wouldn't have. I don't know that Jacob Lew would. That is what I keep asking, who's going to trigger this thing? That is the systemic resolution that the bankers tell us will save us. And what about cross-border exposures?

The problem of debt overhang is still affecting banking systems everywhere. Secondly, extreme interconnectedness is still with us. The two main drivers of systemic risk, before Lehman, were interconnectedness through asset markets (if one bank engages in a fire sale, asset prices are driven down, so all banks must have write-downs and are squeezed for capital), and interconnectedness through derivatives. All of that interconnectedness is still fully there. So all the things that turned a small problem, mainly subprime, into a global crisis are still there.

Exactly. There is no cross-border resolution. Which means that with the top 5 or 6 banks in the U.S., at a minimum, there can be no resolution because of their international exposures.

Anat: That's right. We barely even, maybe, have some understanding with the U.K. but it's not even clear that we have any plan there for sharing losses.

And obviously we can't depend on the EC to get its act together to do anything if their major banks run into problems.

Martin: On the subject of cross-border resolutions, one perspective is that single-entry resolution schemes keep the business going or provide room to keep the business going. But there's also another perspective, which I was recently told about when I was at a conference in Istanbul. A number of people there said that when the European Union, in

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the fall of 2011, raised capital requirements, that just meant that the banks there withdrew anything that they had in their subsidiaries in Albania or Croatia or wherever, and so these countries got in trouble. If you think about single-entry resolution in that context, would the, say, Austrian resolution authority be allowed to just do whatever it wants to do with the assets of subsidiaries in Albania? There are so many distribution issues. I don't think that we're going to get there. Even in the case of U.S./U.K. relations, I think that so far these relations are very much driven by the notion – or these initiatives are very much driven by the notion – that you can resolve the problems and keep the bank going as a going concern. When it's a question of cutting things back, eliminating activities, well, for a big international bank like Barclays, can you *really* imagine the U.K. giving the U.S. supervisor or the FDIC the authority to determine what's going to happen with Barclay's operations in London?

No. And that's the problem. Likewise the U.S. regulators aren't going to allow their British counterparts to come in and supervise Citibank or Bank of America in New York.

Martin: Right.

So, we're doomed to a repeat of 2007-2008? Because we have done so little to address that crisis's causes?

Martin: Yes and no.

Anat: It will be a little different. We are suffering the consequences of the last crisis and will suffer the consequences of the next one, too – unnecessarily much.

Martin: Let me be more specific. First, we haven't gotten out of the financial crisis yet. Maybe the U.S. has gotten a bit farther out of it than Europe. But, in Europe, there are still lots of very weak banks. The problem of debt overhang is still affecting banking systems everywhere. Secondly, extreme interconnectedness is still with us. The two main drivers of systemic risk, *before* Lehman, were interconnectedness through asset markets (if one bank engages in a fire sale, asset prices are driven down, so all banks must have write-downs and are squeezed for capital), and interconnectedness through derivatives. All of that interconnectedness is still fully there. So all the things that turned a small problem, mainly subprime, into a global crisis are still there. U.S. money market funds are as dangerous as they ever were. Think about it, why did Lehman Brothers' failure get systemic? There were two channels. One of them was asset price declines and the other was the run on money market funds and the run by money funds on investment banks and European banks. Well, money market funds in the U.S. are as fragile as they were in September 2008.

Almost nothing has changed. The money market funds had their dollar NAVs backstopped for a while. That was it.

Anat: Nothing was done in terms of preventing them from becoming destabilizing again. They need support from their sponsors all the time.

Isn't that a fundamental weakness? The "maturity transformation" bankers like to boast about essentially means borrowing short to lend long.

Anat: There's just too much of it, too many layers, too much interconnected leverage. And bankers make it worse and worse, by economizing on equity. Equity is the longest duration portion of the capital structure, and in a business failure, it does not leave you with a legal promise. So allowing this economizing on equity is sort of a sickness of the system.

Okay, but money market funds of course contend that they've been enormously helpful to the economy, enhancing liquidity, permitting small investors to access higher returns –

Martin: And when the run comes, they need deposit insurance.

Anat: That is economics. Everything is wonderful, cheap credit is wonderful, liquidity is wonderful, and we want it basically at below-market prices. That's the problem. It's mispriced. You get too much of it, it's subsidized and the risks are building up – but nobody wants to look at that!

Of course not. Bankers are hooked on playing with what people on Wall Street brazenly call OPM, for other people's money.

Anat: Yes. Banks are able to play with OPM much more than other companies, take risks with borrowed money. Now, shareholder money is also other people's money, but the problem with banking is that the other people are mostly creditors. That's a problem. There's too much borrowed money that they play with. They throw a bone to the shareholders sometimes, but their main conflict of interest is with the creditor and the public.

Martin: Another problem is that the banks don't have banks to keep them in line. If you borrow, and if you're *not* a financial company; if you are a small or medium enterprise and you borrow, you

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typically borrow from a bank. In vetting your loan, the bank would typically tell you, "You should have a lot of equity. We're not going to lend to you unless you have 20% or 30% equity."
But there is *nobody* telling that to the bank. In fact, the repo market has been invented in order to make sure that lenders would *not* say such things to bankers. The repo structure basically puts those short-term creditors ahead even of depositors, makes them jump the queue, and gives them the *illusion* that they don't have to worry about the bank.
Anat: So no creditor worries for the banks. It's a completely abnormal situation.

No worries about their creditors. There goes any notion that a debt-heavy capital structure "disciplines" bankers. A notion you pretty well obliterated in the "lost" chapter you cut out of your book, for the sake of simplicity, but have published on your website. [See Deep Dive.] Banking vulnerabilities rooted in repos first manifested way back in the 1970s, but they've only grown larger since.
Anat: A few legal scholars, like Mark Roe, David Skeel, have been pointing to some of the safe harbor and other provisions of the rewritten bankruptcy code as making things a lot worse, although their work hasn't generated much attention. But the code really must be looked at again – especially all of the ways that the banks now somehow get away with diluting previous creditors.

Funny, the bank lobby had a huge hand in rewriting the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which tilted the scales of justice ridiculously in the banks' favor, in everything from safe harbors to student loans and mortgages. The banks have the best political system they can buy.
Anat: Either that, or the political system owns the bank. It's a symbiosis in the case of the Landesbanken, right?
Martin:. Yes. They need the money.
Anat: And banks are where the money is. So it's different politics in different countries but it somehow always seems to end up with an unhealthy symbiosis and no accountability really. I heard Sen. Olympia Snow talking about accountability for attacks on embassies and it crossed my mind that we don't have accountability for whoever allows risks to build up in the financial system. It's purely for the politicians or the regulators.

Don't forget for the bankers themselves.
Anat: Yes, the bankers themselves are responding to the incentives. Who puts the incentives in front of them? Who puts these risk weights in front of them and allows them to employ this leverage and listens to their nonsense.

It's an endless circle, isn't it? Because the bankers hold so much sway over the politicians and regulators.
Anat: Sure, it works for that whole system. That's what we were facing. It's like there are just too many people with their own self-interests tied to maintaining the system as it is.
I'm reading a book called, "Willful Blindness," about how people just don't want to know certain things, don't want to look certain places. It talks about some psychological experiments where people refuse to look or refuse to acknowledge what's right before their eyes. It's by a woman named Margaret Heffernan. I met her recently in the U.K. and am finally getting around to reading her book, which has a lot of different stories that relate to governance issues and to public health issues. She tells one about a woman who discovered asbestos contamination in a town in Montana, where there was enormous resistance to the idea that the town was contaminated – not just at the mine, but all over town. People were dying from cancer and yet somehow the people in town were almost resistant to knowing about it, as was, of course, the corporation that was doing it.

Sure, they perceived a threat to their livelihoods and way of life –
Anat: Right, the truth was not convenient. Anyway, the bottom line is that there's no accountability in the financial system.

And it still rankles "the public" that other than Lehman, no high-profile persons or institutions have paid a big price for their roles in the financial crisis.
Anat: Yes, criminal enforcement in these areas is obviously very complicated to do, but there's also a sense that maybe the efforts to hold people accountable weren't very forceful. Of course, there is a lot of small print and a lot of ways they can blame somebody else. But the bottom line, as I said, is that there is no accountability.

It's entirely too easy to hide behind the complexity that we've allowed to be built into the system.
Anat: Throughout the system, and among the regulators and politicians. It's depressing. But what we're trying to do is alert people that this is not okay. Politically, in the last election, the lack of

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accountability in the financial system didn't even come up, but now you do have some voices speaking out. There is some anger. We had Occupy Wall Street. On a different plane, there's Shelia Blair and Jeff Connaughton [WOWS, 9/29/12] and now we have "The Unwinding" by George Packer. I just ordered that book, which should scare some people. We are trying to alert people, it's not okay.

You go beyond that, advocating specific financial reforms.

Anat: Look, it's possible to do a lot more than we are doing. There is no silver bullet, but there are a few basic things to do. Why not do whatever we can, you know? It's crazy.

Your advocacy of sharply higher equity levels in banks drives bankers crazy, Are you fully convinced the industry could withstand a gradual rise in their equity requirements?

Anat: Well, many probably would have to change or restructure or shrink somewhat, but not necessarily. Some hedge funds could take over some of their businesses. They will do what they can convince investors to give them their money to do. Banks don't have an entitlement to do everything. Financial intermediation should happen at the appropriate cost. It's not even clear that they pass on the subsidies they get from the government. But if they do, they go into either too much or too little credit. That was part of an academic discussion I recently took part in. When you have a subsidized industry like banking, which is too big to fail, who actually pockets those subsidies? There's no evidence that as banks become more highly leveraged, that credit spreads decline. So while are they are always threatening that if they aren't subsidized, they won't lend or that they lend more expensively, there isn't evidence of that. Because it's not clear at all that when the banks benefit from subsidies, they pass them on.

One of the big objections I always hear to tightening almost any regulation of the banks is that it can't be done, without disadvantaging our banks in the global competition for business.

Anat: Martin, you should talk about level playing field arguments and global competition. He's very good on that.

Martin: Well, the predecessor to the level playing field argument, or rather an alternative version of it, is "I need to see eye to eye with so and so in another country." I mentioned before the debates about the monopolies in the electricity sector in Germany. Typically, they would say, "We need to see eye to eye with Électricité de France. They don't have competition in France, so we should not have too much competition in Germany." What that really meant was that if Électricité de France paid a billion euros too much to acquire an English electricity generator, then E.On or RWE, the German electricity providers must also be in a position to overpay by a billion euros or two when they acquire their at English subsidiaries. A variation on that was Deutsche Post using its monopoly profits from its statutory monopoly on letter transportation to acquire DHL on its way to becoming the world's No. 1 logistics company. Imposing costs on your home clientele, whether customers or taxpayers, in order to be successful abroad, that's old rhetoric, which is effective in the political realm – but it has absolutely no foundation in economics.

None?

Martin: I mean, in the German context, if you tell a normal person on the street that the level playing field argument means that German electricity companies must be allowed to use nuclear power – because the French companies are allowed to use nuclear power, you'd be told that you're crazy. If you tell them that this means that a chemical company must be allowed to pollute the Rhine and that we need to abandon environmental protection of the rivers because that's the way they do things somewhere in China, you'd get the same reaction. If you tell them that we need to abandon labor protection because that's the only way German solar panel producers can compete with China, where people make the solar panels without any protection from the poisonous stuff that goes into them...of course you wouldn't get an audience. What I am getting at is that once you realize that this is a *domestic* concern, there's absolutely nothing to the level playing fields argument. If you dig a little bit more deeply and ask, "What about the economics?" then the answer is, very simply, that no particular country has any particular right for its firms to be competitive in any particular area. They should be competitive where they have advantages, where they are good. The way to find this out is to have the market work without any public subsidies and without any distortions from external effects, meaning that those must be dealt with by regulation or taxation. But I think the level playing field argument has really been used to prevent regulation amidst a race to the bottom.

Despite your obvious passion about restoring some sanity to the financial system, you must feel pretty hopelessly outgunned –

Anat: Look, we are talking to you right now and

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it's an issue. What should we be doing with our time? When I, for instance, have agreed to go and testify before Congress on Basel III, I have had to rearrange classes and use my research budget to cover expenses, to spend a day sitting in the Capitol, with no lunch, mostly listening to people who were being paid to give their testimony. This is not a normal part of my academic responsibilities, but I actually couldn't get any academic on the East Coast to go speak there. And it was clear, listening to what was being said, that most of the people in the hearing, especially most of the members of Congress, didn't understand what was being discussed. They didn't even understand what bank capital is. I mean, when Jamie Dimon went before the Senate Banking Committee after the London Whale episode broke, that hearing was just pathetic. He had just failed to control risk in his company, which suffered a loss that only JPMorgan could consider small, and what did the senators ask Dimon? What they should be doing! He walked into the building like an oracle. It was pathetic.

Your book should be required reading for everyone in public office.

Anat: Jeff Connaughton said something like that – there should be educational requirements, not just for elected officials, but for their staffs. But people simply don't read. You write for them at a level that anybody can understand, but even if they do read it, they don't process the information. So it's like they failed the course. But we wrote the textbook at the level of no prerequisites, I'm not sure what else we could have done.

I don't think you could have found a simpler way to explain the attractions of leverage to bankers, and their dislike of its opposite, equity, than with your everyday example of a woman with a mortgage. Everybody would snap up a mortgage deal that gave them all of the upside and none of the downside.

Anat: It's not perfect. At first we worried about the non-recourse nature of U.S. mortgages and that we weren't talking about corporations from the start, but we came to see how we could use that example to make many of our points. As to whether people actually get it or not, as I've said to many reporters, "If somebody tells you something, the only thing you can conclude is that they wanted to say that something to you and wanted you to write it. That's it. It doesn't make it true." That goes, too, for the op ed wars in the media. If you're a big shot, you can write any piece and you can say any nonsense, even on the op ed pages, simply because you're a big shot.

Which explains, in part, how the banking industry gets away with confusing bank equity with bank reserves.

Anat: People keep claiming we want banks to hold larger rainy day funds to this day! There couldn't be a more basic misunderstanding of the role of equity in a bank's capital structure. But it's getting better because there are now more people in the room who can challenge that sort of sloppiness. That's what we need – I call it good leverage. We are trying to leverage our message, so more people can debunk and challenge. So we can look at the glass as half full or half empty. I'm impatient but I was told three years ago that it's a marathon, pace yourself. And the debate has evolved. Still, it has been shocking to encounter the misunderstandings about the issues – even inside the economics profession. There's a lot more education that's needed. There are blind spots. Too many people, even economics professionals, haven't thought enough about these issues.

By blind spots, are you referring to things like a blind faith in the markets' ability to regulate banking behavior?

Anat: Oh yes. Some economists come at these issues with the bias that it must be efficient; if we see something, there must be a way to explain it as a solution to a problem in the world. So they make it their job to somehow justify and apologize for what we see. To "explain it," so to speak. I put quotation marks on it. If you have another explanation that's not convenient, then somehow, you can't be correct. But if they can write up a model that explains it as an "efficient" solution to a problem, then it must be valid. That's another whole battle we're engaged in. Which is why we have our extra chapter on our website. It's really geared to the academics. We were told it was just too inside baseball to keep in the book, because some of the stuff that academics say about debt "disciplining" bankers doesn't resonate with anybody who isn't an academic. I've had an industry veteran who read a draft say to me, "Why did you spend ten pages on this? Is it an academic thing?" Of course, that's exactly what it is. It can take on a life of its own in policy circles, as if it's a meaningful part of the debate, even though it ignores the big elephant in the room – there's no evidence that debt disciplines bankers in the real world.

Martin: Some would contend that JPMorgan actually has *too much* equity, saying otherwise the London Whale episode would have created a run that would have effectively disciplined the bank!

They certainly kept dancing all the way to

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the edge of the abyss in 2007-2008.

Martin: Yet we have had colleagues criticizing that we don't take the debt discipline argument seriously.

Anat: Yes, yes, yes. We've only been addressing it for three years now. That's why our piece is on the website. They say, "Oh, but I've got this model. I've got this model. Take it seriously." Maybe 200 years from now, some empirical person will sort out the models. I don't need a big puzzle to explain what the banks are doing. My explanation is not the one your friendly regulators or politicians or the bankers like, for sure. The bankers are not saying, "Please discipline me." That proves that it's not true that debt disciplines bankers, right there. If they didn't like the way debt influences them, why would they hate equity so much? Why would they love debt? It makes no sense.

Your explanation, in your book, is that the banks are actually addicted to debt.

Anat: Right. Debt doesn't discipline bankers, it encourages them to keep on borrowing. Ours is just the opposite explanation of the one offered by that academic model. The banks are addicted to debt.

Martin: Right now I'm involved in writing an academic article, including a model, which will debunk one of the pieces that has been presented over the past few months that has been claimed to show why more equity for banks is bad.

Anat: They model the math. They model the assumptions.

Martin: Except that my math is going to be fancier. The title of the article that I am critiquing is, "Why High Leverage is Optimal for Banks."

Anat: That is a title that lobbyists love to use. But they don't ever want to read the paper.

Martin: The problem with the paper is that the authors talk about what's optimal for banks. They never talk about markets. It's not clear what markets this bank is operating in. They never talk about equilibrium and they never talk about whether it might be the case that what's optimal for banks might not be efficient, even within their own model. So at a very basic level, it's make-believe academic analysis which doesn't stand up even to just standard professional scrutiny.

Anat: But beyond that, this really crosses the line like we wrote about in our book, where stuff is written to be abused. You have a paper with the title, "Why High Leverage is Optimal for Banks," which later on says, "In our model," – So there is that qualification, in other words, banks are under some pretty ridiculous assumptions – "In our model, the banks choose to have *riskless debt*." That is it. How unreal world is that? Now what am I supposed to make of that?

Martin: I would actually object to the formulation of their model. It's a make-believe model.

Anat: They actually sent that paper around to the people who signed our letter to the regulators two and a half years ago, saying that raising bank equity to *at least* 15% of non-weighted assets is a no-brainer, and most said, "I reject your model offhand because your model doesn't assume a world anything like what we see." But one response I really liked. He said, "How about this, if the banks really choose riskless debt, *completely riskless*, then that's fine. That's like a narrow bank. But as soon as they take risk, how about we let Anat and Martin design their regulation?"

It was so outrageous. Anyway, that's what we're still dealing with on the academic front. There are many fronts to this. The bankers, the regulators, the politicians, taxpayers, lots of audiences. Some are naive, and some have been captured.

Sure, but riskless debt? Give me a break.

Anat: Yet these things live on a piece of paper and I've had a regulator from this country slap that paper in my face in a conference. I was fuming. "Such and such paper showed…"

I asked, "Did you even read this nonsense? Do you know how bad this paper is, that you are bringing up?"

But that didn't matter. It exists and has a title. That is how academics get used, become a part of the bad thing that's going on. Some of them don't realize even what is happening. When we started talking about this, Martin came up with a good analogy – using flawed models for policy as the same as using a distorted map, like the famous *New Yorker* cover map of the world as seen from the city for travel. You need to reduce the world into something more manageable to understand it. That's the modeling exercise in theory, but you can't use a distorted map to travel, therefore you can't use a model that distorts reality (change one realistic thing and the whole thing turns around) to guide policy. That may seem obvious to you but it seems like a struggle to make that point in academia.

Amazing, considering how much grief has been caused by unwarranted faith in models of things like risk weighting, stress test – just because they are full of fancy equations written by quantum physicists doesn't mean they prove anything.

Anat: But in the case of theory papers, the arguments can be so subtle and the math so beautiful, you can forget that it doesn't describe the world. It describes a world someone wants to sell. That's our

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point about the liquidity narrative, the plumbing narrative of the crisis, favored by the Fed. There were these runs, we don't know why, and we just saved you from worse. That's the Fed's narrative. They just ignore all the facts about how we got to a point where there were runs and then they tell a story about a run which is really a big credit freeze through the system. Even if it was a run, the question is, how did we get to the point of having such a fragile system; how did we allow this to happen? That's the part of the story, they'd like to overlook, somehow. They don't want to seriously engage in that discussion, even if they pay lip service to doing this or that. They've go their models. They've got their stories. They don't seriously want to challenge them. They use them for cover.

Have you found any regulators in Washington receptive?

At the FDIC, you had Sheila Blair and now you have Tom Hoenig. They are the best of the regulators in this country on these issues. They are at a small agency that is actually all about the downside of bankers taking too much risk. So they are trying. But the Fed, the OCC, the SEC, they engage much less, if at all. Internationally, the IMF engages, some central banks want to engage, some regulators, but clearly not all. Everybody wants to blame someone else. And when it comes to sorting out the European banking union – ask Martin!

Okay, does it have more than a snowball's chance in hell?

Martin: Well, one thing that the banking union has got going for it is that it might provide a change in attitude. It would no longer be the national regulators who have the ultimate say. But I have a suspicion it won't work because the legal infrastructure is very weak. And of course, if you think about the participating countries– I mean, Germany has this wonderful view of the banking union. "The banking union is very good in order to make sure that someone looks into the needed writeoffs at those Spanish Cajas."

But don't come near the Landesbanken?

Exactly. Banking union should not mean that the German banks would be subject to European supervision. "We want to supervise you, but don't supervise us."

The Germans aren't alone in that attitude.

But it's not a very convincing as a negotiating strategy. I don't really know what is going to happen and how it's going to work. The problems have always been there with European integration. From the very beginning, anyone who knew how things worked would say, "This cannot work." It is like the story about the bumblebee. If you ask an engineer, he'll tell you a bumblebee cannot fly. Too heavy, the wings are too weak, and some more complaints. But of course, bumblebees do fly. In the case of European integration, it's pretty much the same story, except I have a suspicion that this time the problems may be deeper and it'll be more difficult to find a way out. And the reason is, banks are all about money and about power.

What a great place to call a halt to this interview. Thanks to you both.

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