“Too Big to Fail”

OR

What’s Still Terribly Wrong with Banking

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Our Banking System

• is too fragile, inefficient and dangerous

• exposes the public to unnecessary risks

• distorts the economy

• suffers from severe governance problems

• is not regulated effectively in most countries
**Who Wins and Who Loses**

- **Borrower-creditor conflict becomes bankers-taxpayers conflict.**
  - Markets fail to control risk and assign liability/responsibility.
  - Inefficient investments, leverage, size.
  - Concentration of market and political power.

- **Governance problems**
  - Bankers take risk, benefit from upside.
  - Shareholders get piece of upside, possibly not enough given risk, pay for misconduct.
  - Creditors/taxpayers bear downside.
  - Society suffers collateral damage.
Do We Have a Problem?

• Ben Bernanke says we do.
• Eric Holder: “too big to prosecute.”
• Trends in size/concentration/complexity
• Highly opaque.
• “Fear of fail” after Lehman.
• Credit rating agencies “bumps.”
• Borrowing terms disconnected from risk.
• Repeated scandals and investigations show control problems, recklessness.

.....YES!!!

Implicit Guarantees
Impose Large Costs on Society

• encourage excessive, dangerous leverage
  – feed leverage ratchets (“addiction” to borrowing).
  – enable maturity rat race, more fragility.
• lead to inefficient investments
  – debt overhang causes underinvestment in valuable loans.
  – excessive risk taking (boom), then credit crunch (bust)
• create other perverse incentives
  – reward excessive growth, interconnectedness, complexity.
  – no accountability can encourage recklessness, fraud, front running, manipulation.
• outsized subsidies distort competition and economy.
Distortive Subsidies

- Substantial evidence using different methodologies.
- Value higher in distress, increases with risk, leverage, size.
- No scale economies above $100B adjusting for subsidies.

Davies, Richard, and Belinda Tracey, “Too Big to Be Efficient? The Impact of Implicit Funding Subsidies on Scale Economies in Banking,” 2012.

“Fail” is Costly and Harmful

- Bankruptcy code does not work.
  - Cross-border issues, complex structures.
  - Interconnectedness creates contagion
  - Disruptions in payment/credit spill over to economy.
  - Do “living wills” establish otherwise? Seems NO.

- OLA: untested, many issues.
  - Triggers are problematic, not defined as insolvency.
  - Significant cross-border issues remain.
  - Largest institutions are bigger, more complex than Lehman.
  - Contagion still a problem, also for assessments.

- Collateral damage starts before “fail,” in distress.
Are We Stuck? NO!!

• Analogy 1:
  – Banks: addicted to “polluting” behavior (borrowing).
  – Recovery/resolution: cleanup of polluted river.
  – Bailouts/guarantees: encourage & subsidize pollution.
  – Instead: Is there a cleaner alternative?

• Analogy 2:
  – Banks: speeding trucks with explosive cargo.
  – Recovery/resolution: emergency plan for explosions.
  – Bailouts: encourage & subsidize reckless driving.
  – Instead: Can we put & enforce safer speed limits?

An Ounce of Prevention:
Reduce Excessive Indebtedness!!

• Reduce likelihood and cost of distress, failure, contagion, liquidity problems, runs, distressed sale, credit crunches.
• Reduce distortive subsidies delivered via easy borrowing.
• Shift downside risk from taxpayers to investors.
• Enable banks to lend in downturns, reduce inefficiencies in lending/investment.
• Correct leverage ratchet, given credit market failure.
• Best bargain: Large benefits, virtually no social cost!
Equity Absorbs Losses
(“Bank capital” NOT “held” or “set aside,” NOT cash reserve)

Too Much Leverage

More Equity

Equity Lowers Chance of Distress, Crisis Bailouts and Damage to Economy

Too Much Leverage

More Equity
JPM Balance Sheet 12/31/2011

Loans = $700B <
Deposits = $1.1T

Other debt (GAAP): $1T
Other debt (IFRS): $1.8T

(GAAP allows more netting.)

Equity (book): $184B
Equity (market): $126B

Significant commitments off balance sheet

History of Banking Leverage in US and UK
(Mid 19th century: partnerships with unlimited liability, 50% equity)

Facts

- Non-banks make risky, long term, illiquid investments.
- US average: 70% equity/assets (market value).
- Non-banks rarely maintain less than 30% equity (without regulation).
- Profits are popular source of unborrowed funds.
- Berkshire Hathaway never pays dividends.
- Banks with less than 10% equity make payouts, expect to be trusted to invest borrowed money.
Bankers Prefer to Borrow, Resist Leverage Reduction.

1. Tax subsidies
2. Safety net benefits
3. ROE fixation
4. Leverage Ratchet

For Society, Excessive Bank Leverage is “Expensive!”

1. Reduces systemic risk
2. Reduces deadweight cost of distress, default, crisis
3. Reduces excessive risk taking
4. Improves ability to lend after losses
Financial Markets And Greater Economy

**Debt**
(high levels of leverage create systemic risk and distort risk taking incentives)

**Equity**
(provides cushion that absorbs risk and limits incentives for taking socially inefficient risk)

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Government Subsidies to Debt:

1. Tax shield (interest paid is a deductible expense but not dividends)
2. Subsidized safety net lowers borrowing costs; bailouts in crisis.

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Happy Banker,
Gains are private
Losses are social.

Lower Loan Costs?
How Much Equity?

• Basel II and Basel III Capital Requirements

  – Tier 1 capital Ratio: Relative to risk-weighted assets:
    • Basel II: 2%,
    • Basel III: 4.5% - 7%.
    • Definitions changed on what can be included.

  – Leverage Ratio: Relative to total assets:
    • Basel II: NA
    • Basel III: 3%.
    • US: 5% for large BHC, 6% for insured subs.

• Requirements based on flawed analyses of tradeoffs.

Basel III: The Mouse that Didn’t Roar

“Tripling the previous requirements sounds tough, but only if one fails to realize that tripling almost nothing does not give one very much.”

Martin Wolf, Financial Times, September 13, 2010
More Flaws in Basel Approach

• Risk weighting system highly problematic.
  – Ratios are “too complex to verify, too error-prone to be robust, too leaden-footed to enable PCA.” (Haldane)
  – Illusion of “science;” but ignores key risks (interest rate).
  – Distortive, e.g., favors government over business lending.

• Alternatives to equity unreliable and unnecessary.
  – Questionable loss absorption, especially in crisis.
  – Non-equity securities maintain overhangs and inefficiencies.
  – No justification from society’s perspective.

Much More Effective

• Maintain equity between 20-30% of total assets.
  – Include all relevant exposures.
  – Use market signals for prompt corrective action.

• Huge social benefits; what’s a relevant cost?

• Ban payouts to build up equity.

• Mandate equity issuance: viable banks can raise equity at appropriate prices.
  – Ultimate “stress test.”
  – Unwind zombies!
Book Values can be Uninformative
(Andrew Haldane, “Capital Discipline,” January 2011)

Market Values More Informative
(Andrew Haldane, “Capital Discipline,” January 2011)
The Purported Tradeoff
(Recall: Credit and Growth Suffered greatly)

“More equity might increase the stability of banks. At the same time, however, it would restrict their ability to provide loans to the rest of the economy. This reduces growth and has negative effects for all.”

Josef Ackermann, CEO of Deutsche Bank
(November 20, 2009, interview)

<table>
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<tr>
<th>According to Mr. Ackermann</th>
<th>In Fact</th>
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<tr>
<td>More equity might increase the stability of banks.</td>
<td>Well-designed capital regulation that requires much more equity, will increase the stability of banks.</td>
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<tr>
<td>At the same time, however, it would restrict their ability to provide loans to the rest of the economy.</td>
<td>At the same time, it would enhance their ability to provide good loans to the rest of the economy and remove significant distortions.</td>
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<tr>
<td>This reduces growth and has negative effects for all.</td>
<td>This may reduce the growth of subsidized banks. However, it will have a positive effects for all (except possibly bankers).</td>
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Invalid “Level Playing Field” Argument

• Banks can endanger an entire economy (Ireland, Iceland, Cyprus).

• Banks compete with other industries for inputs (including talent); subsidies distort markets.

• Not a national priority that “our” banks are successful if they impose risk and cost on us.

• Argument creates “race to the bottom.”

“Shadow Banking” Bugbear

• Crisis exposed ineffective enforcement.
  – Regulated banks sponsor entities in the shadow banking system.

• Enforcement challenge invalid argument against regulation:
  – Allow robbery?
  – Give up tax collection?
Sad State of Financial Reform

- Much talk, little effective action, repeated mistakes.
- Regulators have authority, lack mostly the will to act.
- Debate muddled by nonsense and politics.
  - False, misleading claims and narratives.
  - Wrong presumption that markets work.
  - Capture, revolving door, resistance to change.
  - No accountability (abstract risk, diffuse responsibility).
  - “Banks are special” myth. (In fact, Banks are special only in getting away with so much inefficient gambling.)
- Unhealthy system is dangerous, drag on economy.

Book intended to

- Educate, elevate debate.
- Provide specific policy guidance.
- Enlarge the circle of participants
- Create political pressure for action

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