The Persistence of a Reckless Banking System

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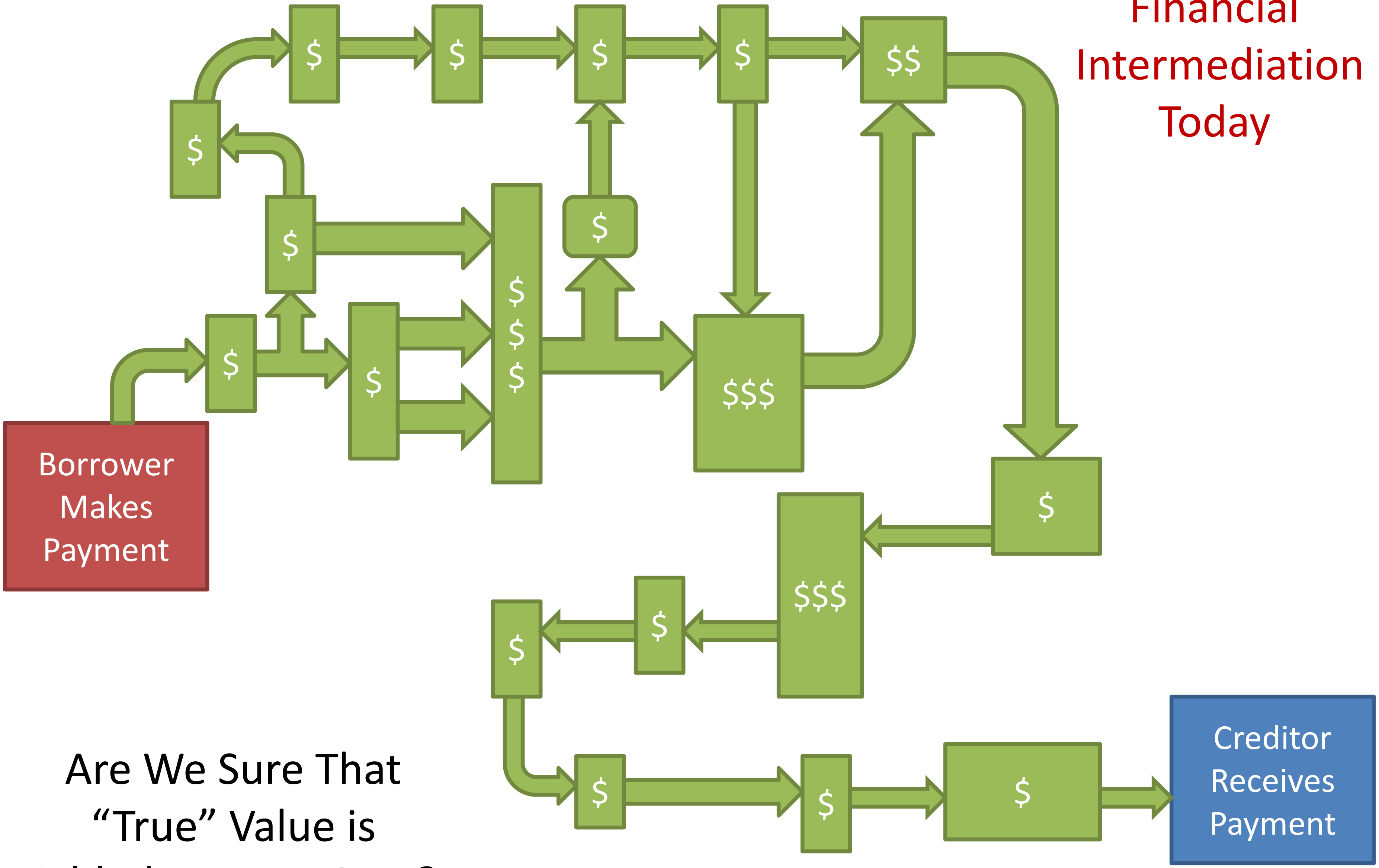
Our Banking System

- is too fragile and dangerous
- exposes the public to unnecessary risks
- distorts the economy
- suffers from severe governance problems
- is not regulated effectively in most countries
- does not support the economy as well as it can

What Makes the System Fragile?

- High indebtedness (leverage)
  – Distress and insolvency
- Reliance on deposits and short-term debt
  – Liquidity problems and runs.
- Interconnectedness
  – Contagion effects
- Flawed and ineffective regulation
  – Off balance sheet commitments
  – Shadow banking
  – Over-the-counter derivatives
  – Risk weights.

Financial Intermediation Today



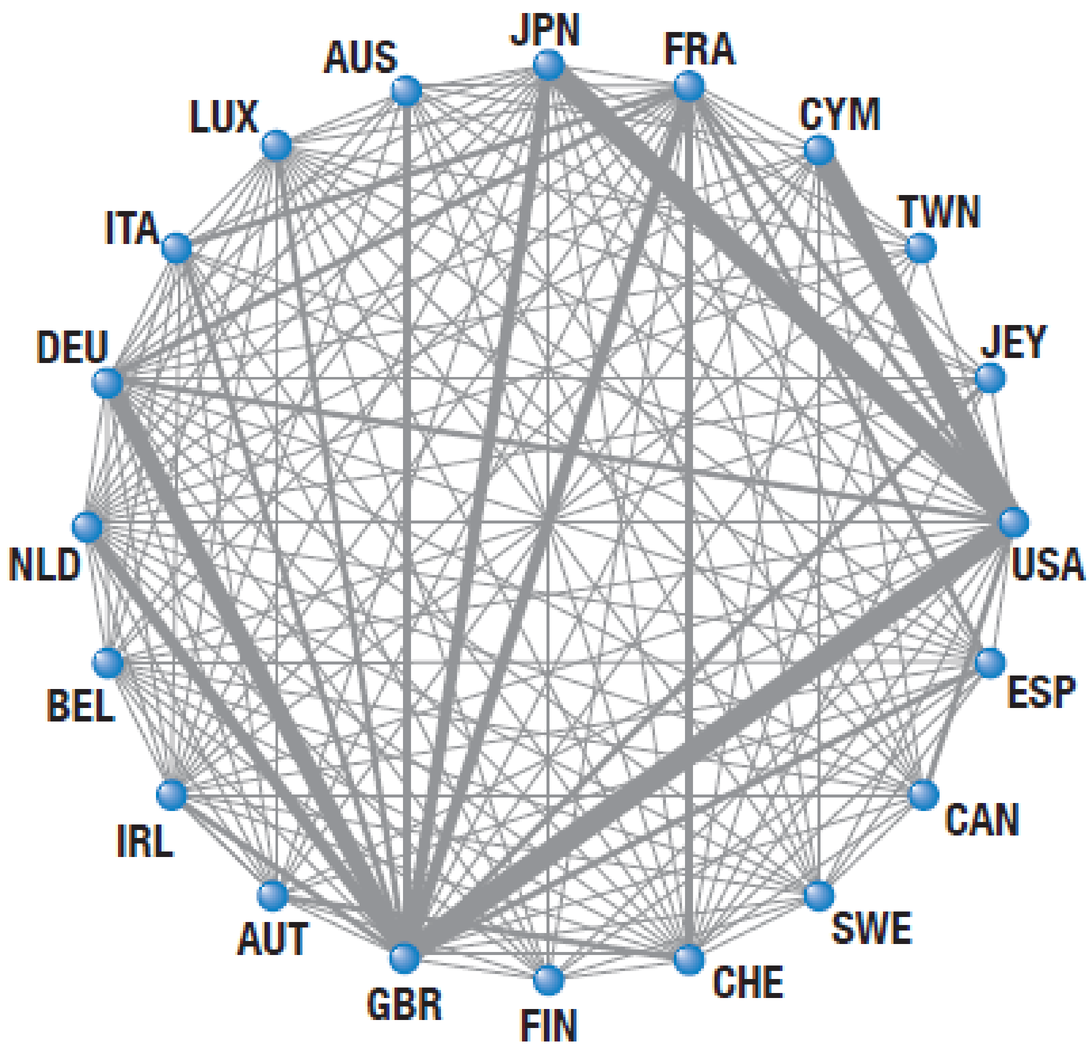
Are We Sure That "True" Value is Added at Every Step?

$ = point at which a fee is earned (and possibly conflicts of interest created)

Interconnected System Prone to Contagion

Global Banking Network: 20 Core Countries

(Cross-Border Banking Claims; width proportional to size)



IMF Global Stability Report, April 2014

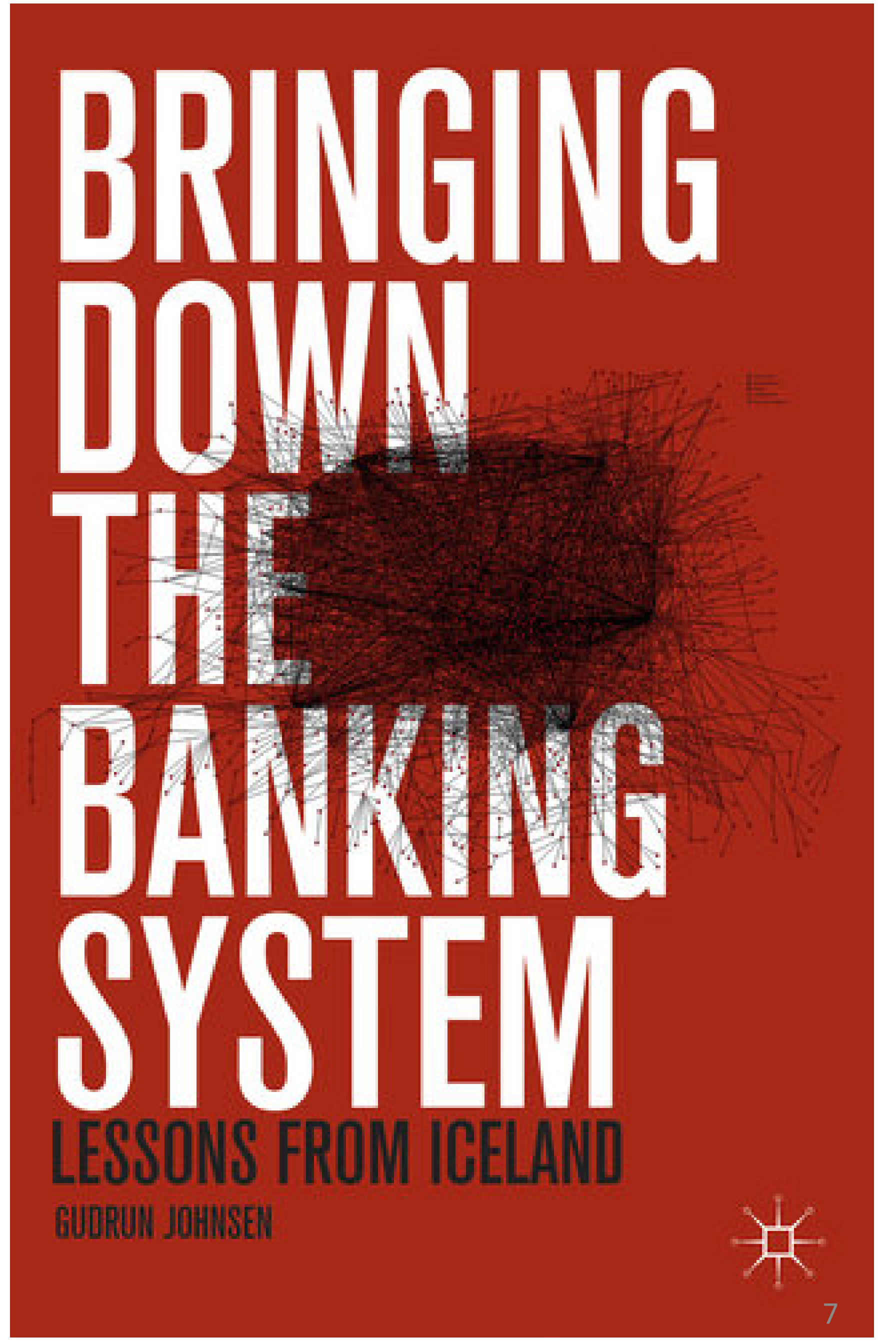
97% of the Icelandic banking sector collapsed in October 2008 as a result of rapid growth of credit, size to GDP and inadequate financial supervision

How?

Why?

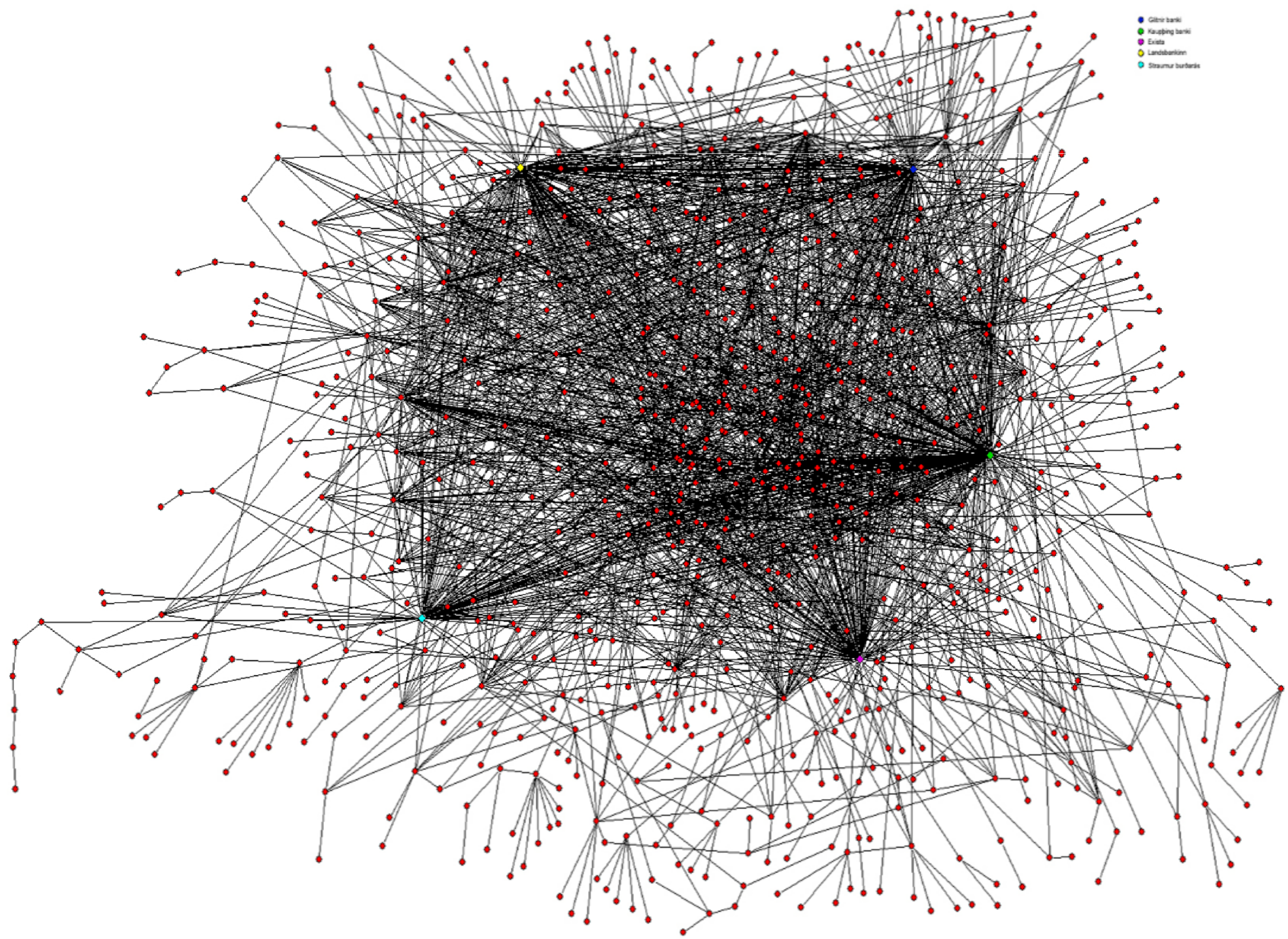
Why didn't anybody stop it?

What can we learn?



Cross Ownership in Iceland (pop. about 300,000)

(Special Investigation Commission Report, Vol. 9., Appendix 2, pp. 23



Distortions and Inefficiencies

- Too- big/systemic/opaque-to fail/control/regulate.
  - large subsidies distort competition
  - perverse incentives and ability to grow inefficiently.
- Inefficient lending and investment.
  - bias against business loans, in favor of trading, gov't loans. Distressed/insolvent banks don't make new loans.
  - too much or too little lending, booms and busts.
- Severe governance and control problems
  - bankers take risks, benefit from upside, little if any downside
  - shareholders may not be properly compensated for risk
  - creditors and taxpayers share downside
  - society suffers from instability and inefficiency

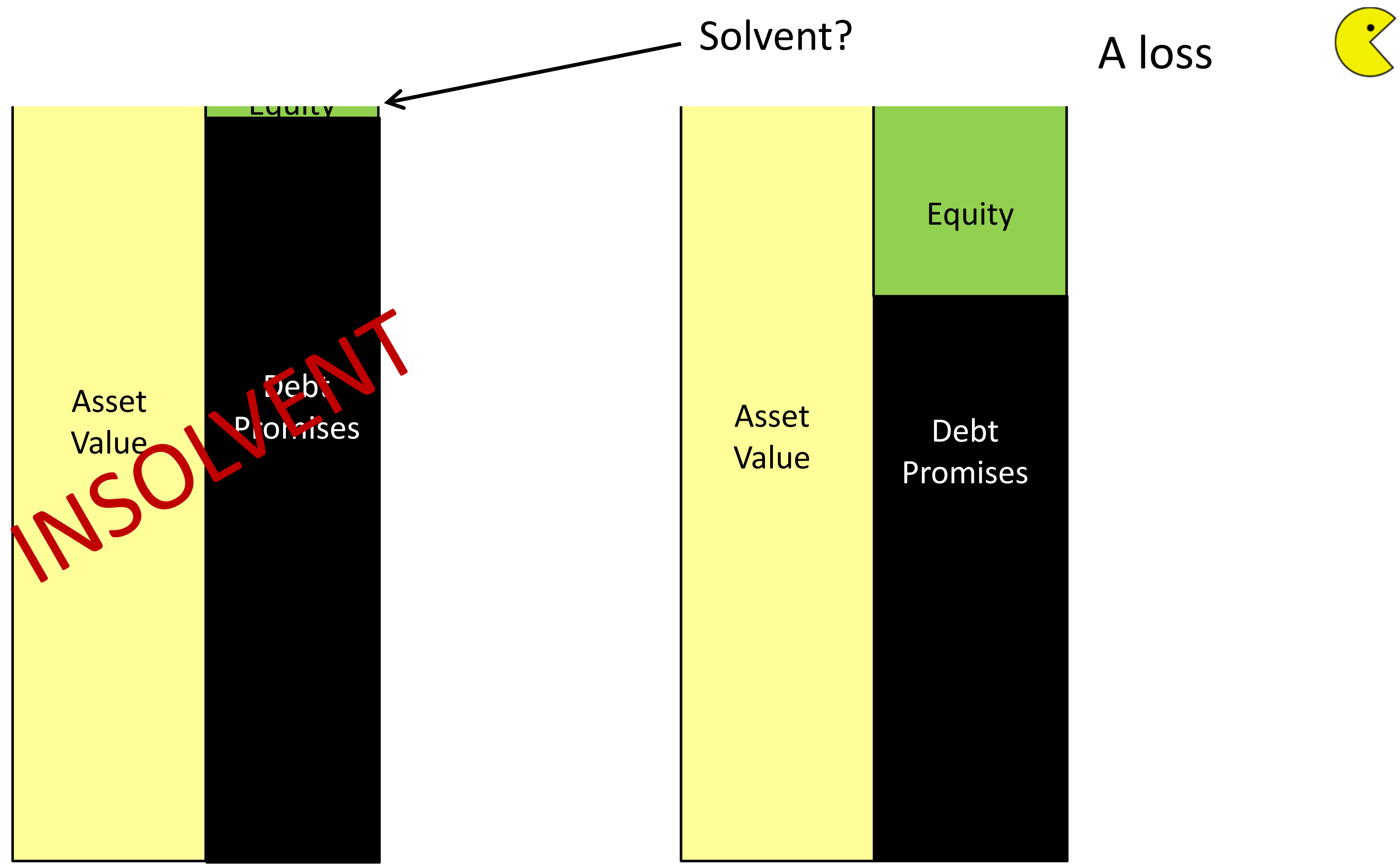
What to do?

- Better resolution. Essential, but,
  - cross border issues
  - trigger unclear, political
  - disruptive and costly even in the best case
  - distress is already destabilizing and harmful
- Ring fencing, Glass-Steagall, Volcker. Possibly, but
  - concern for depositors not only reason for systemic concerns (LTCM, Bear Stearns, Lehman, AIG)
  - no-bailout commitments are not credible.
  - interconnectedness remains.
  - “too many to fail”

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?

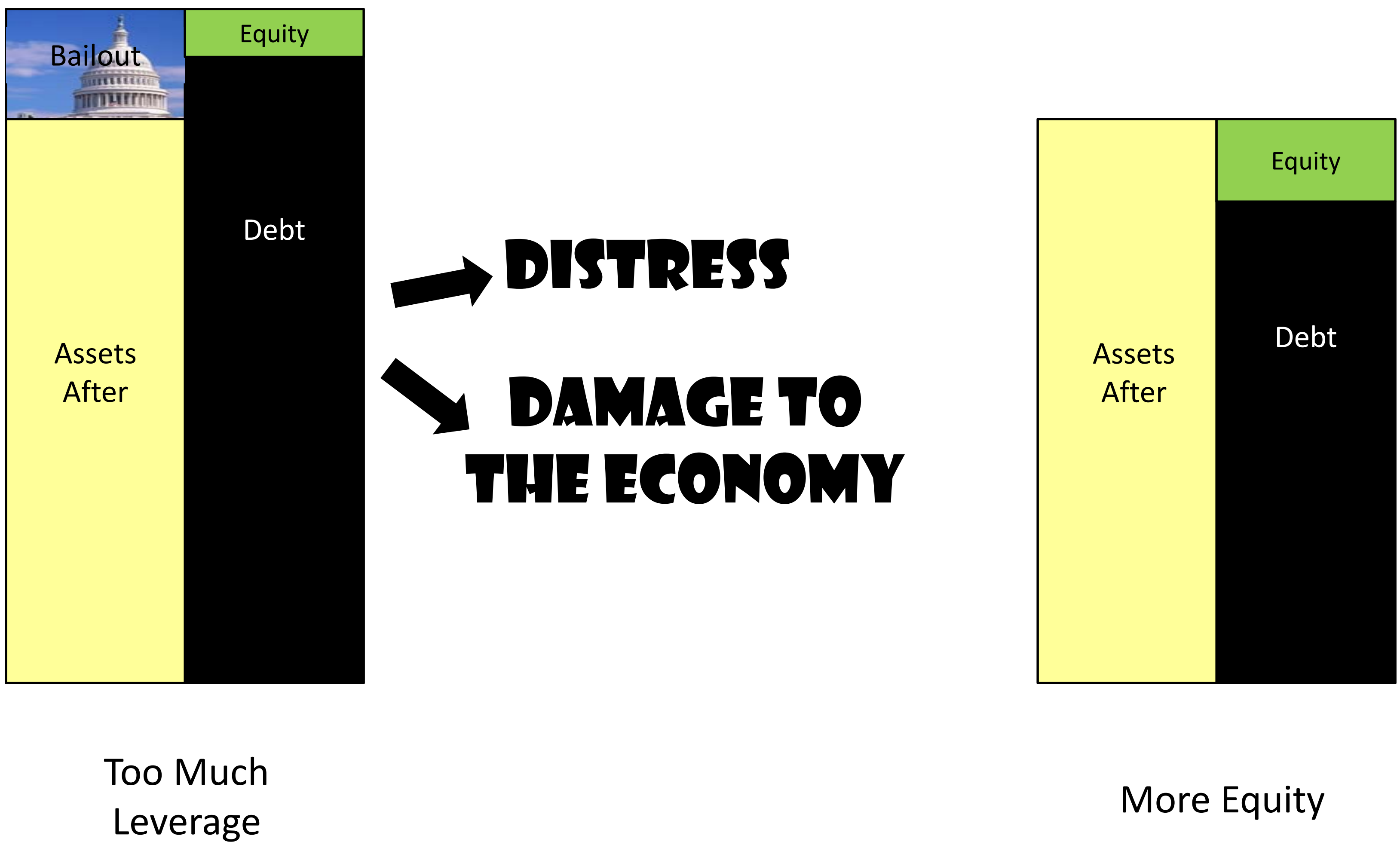
Equity Absorbs Losses



Too Much Leverage

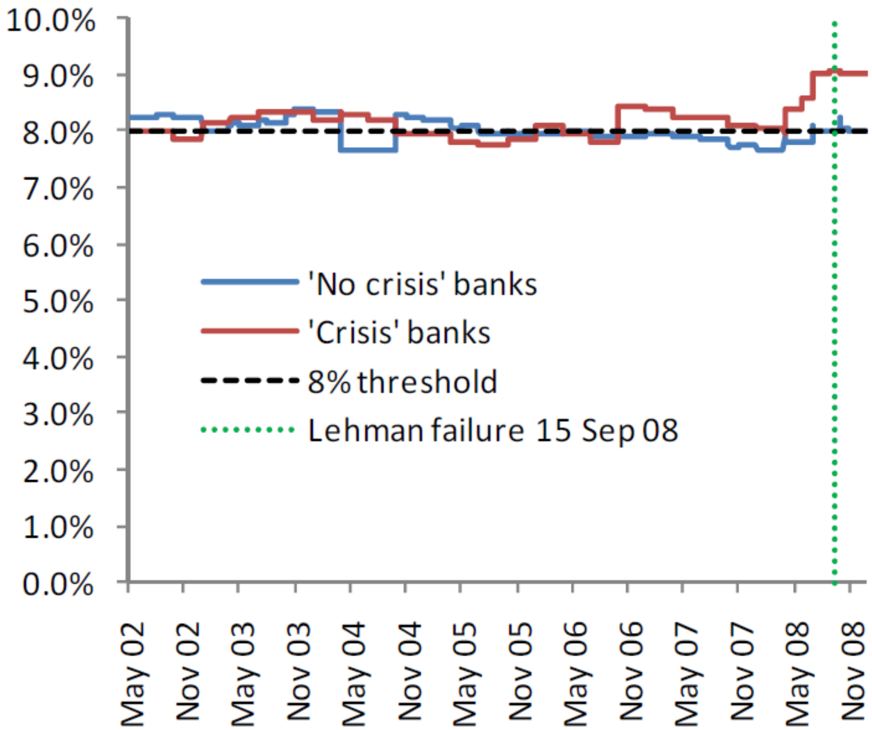
More Equity

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

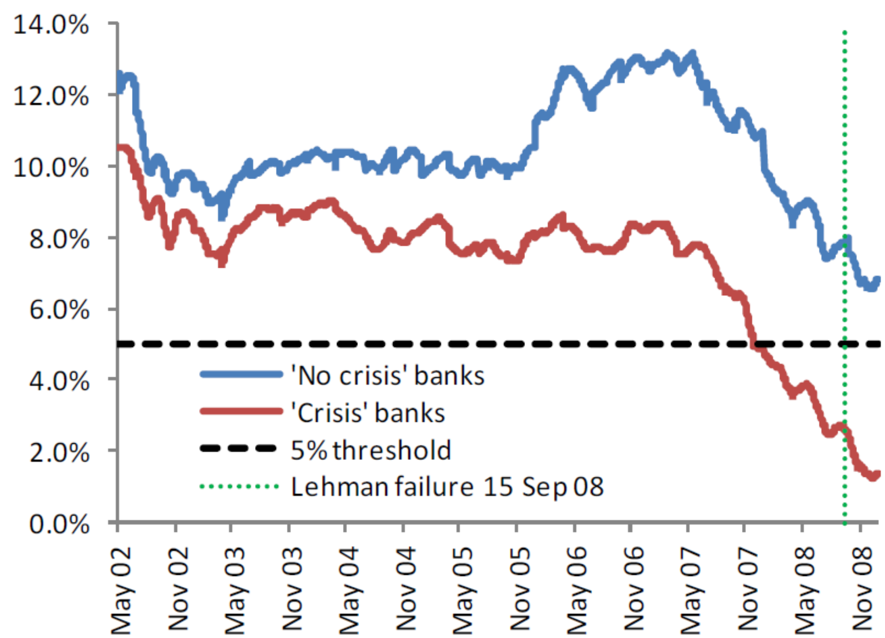


The "Fortress Balance Sheet" Myth

Accounting measures don't show crisis



High market values can mislead



From: Andrew Haldane, "Capital Discipline," January 2011)

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.

Pervasive and Insidious Confusion!

- **Nonsense**: "Every dollar of capital is one less dollar working in the economy" (Steve Bartlett, Financial Services Roundtable, Sep. 17, 2010.)
- Equity ("capital") is *not* cash reserves or "rainy day fund." Banks don't "Hold" or "set Aside" capital.
- Capital requirements do *not* constrain loans or investments.
- Confusion implies false tradeoffs.
- "Hold more capital" = use more unborrowed funds (equity) for loans and investments.

Is Basel III "Tough?"

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

"Basel III, the Mouse that Did Not Roar," Martin Wolf, *Financial Times*,

September 13, 2010

"How much capital should banks issue? Enough so that it doesn't matter! Enough so that we never, ever hear again the cry that "banks need to be recapitalized" (at taxpayer expense)!"

"Running on Empty," John Cochran, *Wall Street Journal*,

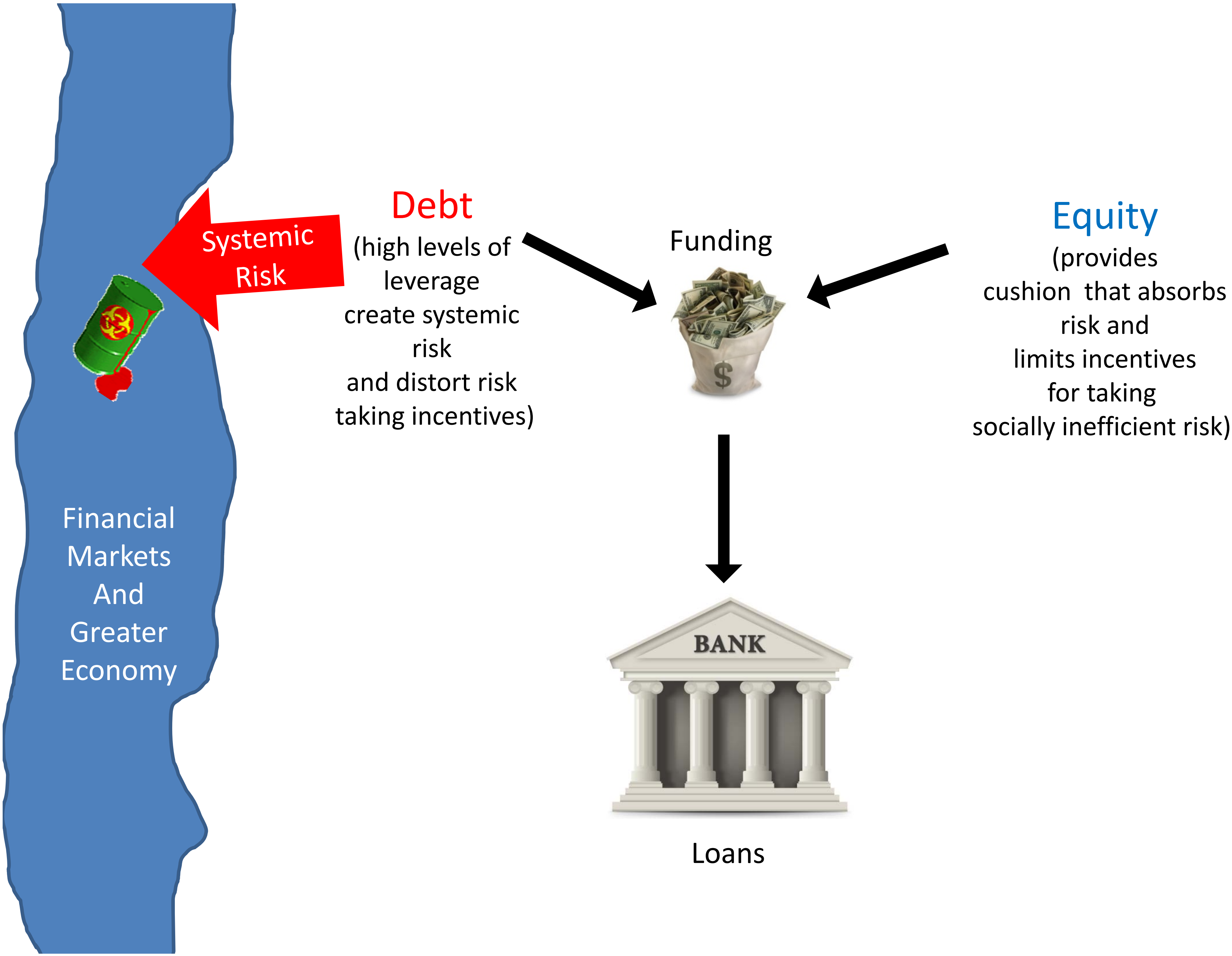
March 1, 2013

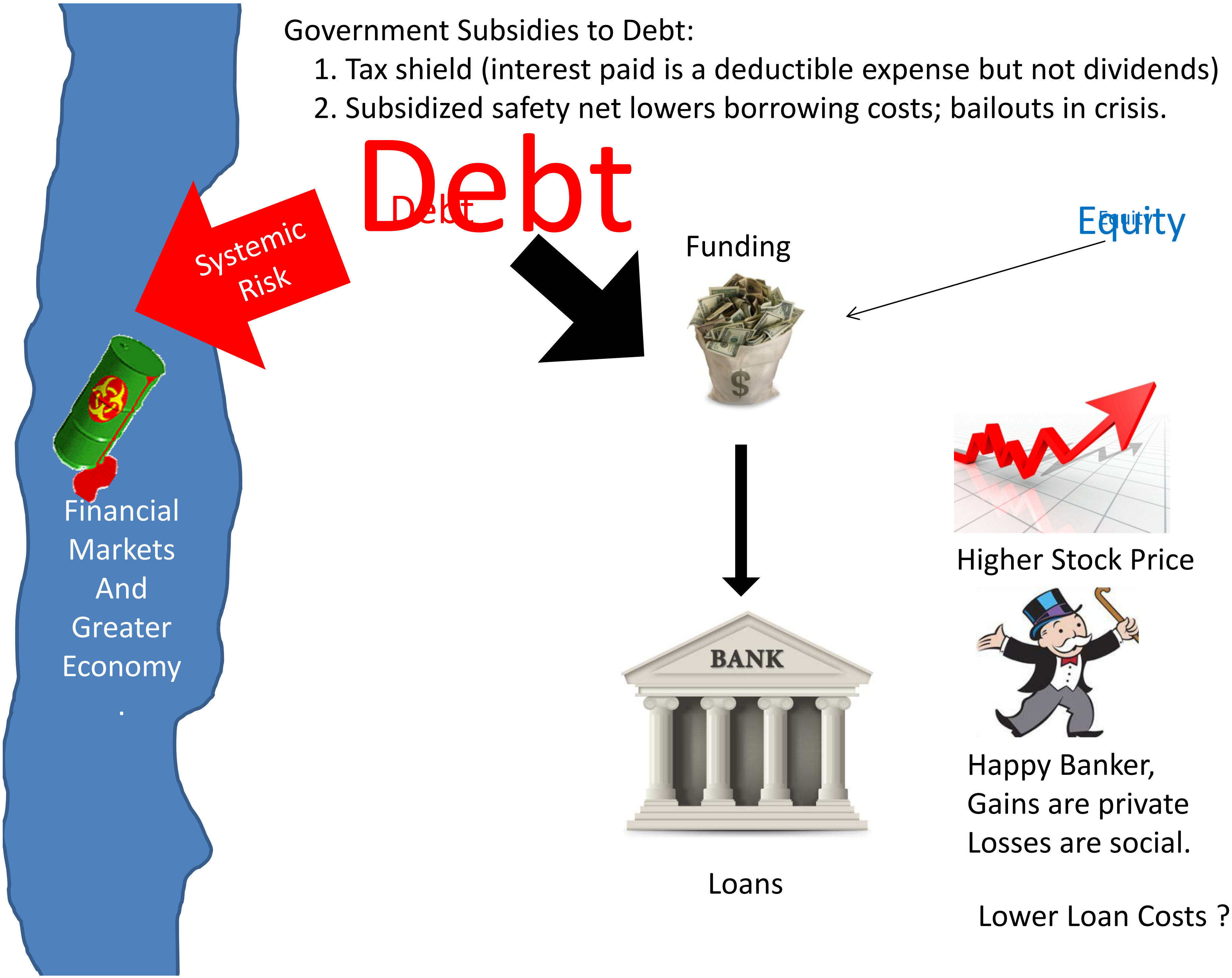
Facts

- 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.

Why Bankers Love to Borrow

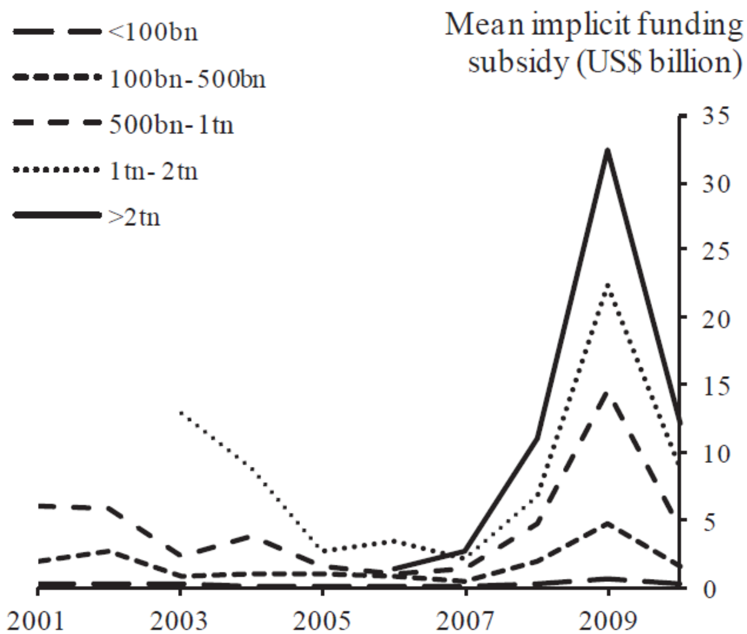
- Intense leverage ratchet at high leverage due to conflict of interest between shareholders and creditors.
  - Maturity rat race shortens maturity.
  - *Guarantees and subsidies feed "leverage addiction."*
- Tax advantage of debt (highly distortive).
- Underpriced guarantees are a subsidy of debt.
  - Bankruptcy costs not borne by bank investors.
  - Borrowing terms do not reflect the risk properly.
- Compensation tied to returns/ROE; encourages leverage and risk ("paid to gamble").

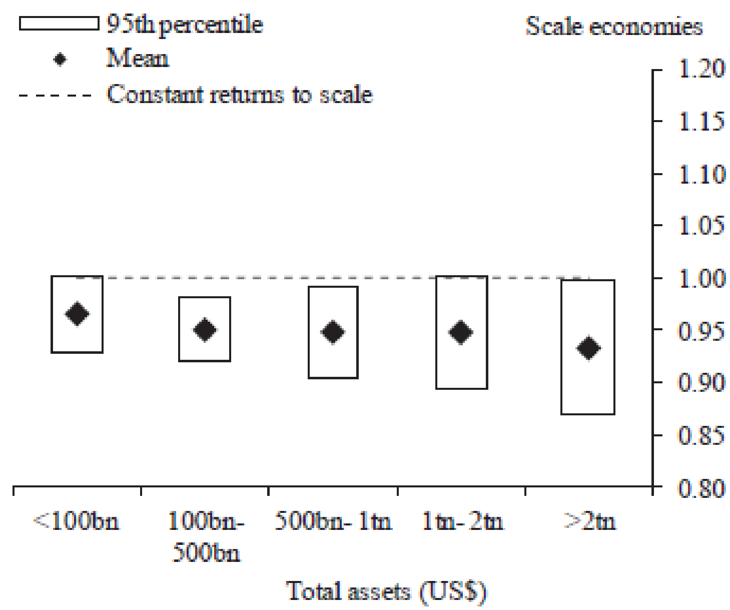

Systemic Risk
Debt
(high levels of leverage create systemic risk and distort risk taking incentives)
Funding
Equity
(provides cushion that absorbs risk and limits incentives for taking socially inefficient risk)
BANK
Loans
Financial Markets And Greater Economy


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.
Debt
Systemic Risk
Funding
Equity
Financial Markets And Greater Economy
.
Higher Stock Price
BANK
Loans
Happy Banker,
Gains are private
Losses are social.
Lower Loan Costs ?

Distortive Subsidies

- Substantial evidence for large subsidies to “systemic” banks.
- 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.

We Perversely Encourage "Financial Pollution" (Excessive Borrowing, Inefficient Size, Recklessness)

Are “Stress Tests” Reassuring?

- Based on problematic assumptions.
- Project accounting numbers, use risk weights.
- Don’t address contagion dynamics.
- Set up inappropriate benchmarks based on false presumption that equity is scarce and “costly.”
  - What is the relevant cost of banning payouts relative to obvious benefits (starting from status quo)?

Implicit Guarantees Impose Large Costs on Society

- encourage excessive, dangerous leverage
  - feed leverage ratchets (“addiction” to borrowing).
  - enable maturity rat race, more fragility.
- Exacerbate distortions in investments
  - debt overhang (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.

Failure of Policy to Correct Failure of Markets

We Can Have a Safer System without Sacrificing Anything

A Bad System Persists

- Effort is unfocused and wasteful.
- The problem is a toxic mix of confusion and politics.
  - Flawed but convenient, narratives.
  - Willful blindness to risk and to key lessons.
  - Presumption that markets work.
  - Myth that "Banks are special." ***Mainly "special" in getting away with so much inefficient gambling.***
  - Capture, revolving door, mixed political objectives.
  - ***No accountability exacerbates recklessness, pervasive control and governance problem***.
- Unhealthy dangerous and inefficient system, drag on economy.

The Payoff: Why Wall Street Always Wins, Jeff Connaughton, 2012

"Unfortunately for America, Obama and Biden (who pledged in his 1972 campaign never to own a stock or a bond) were both financially illiterate."

"Volcker began, "You know, just about whatever anyone proposes, no matter what it is, the banks will come out and claim that it will restrict credit and harm the economy . . ." He took a long pause while Ted and I leaned in closer to hear what he'd say next. "It's all bullshit." "

The Purported, False Tradeoff

(Recall: Credit and growth Suffer*ed* greatly since 2008)

Josef Ackermann (2009)	In Fact
More equity might increase the stability of banks.	Well-designed capital regulation that requires *much* more equity, will increase the stability of banks.
At the same time, however, it would restrict their ability to provide loans to the rest of the economy.	At the same time, it would enhance their ability to provide good loans to the rest of the economy and remove significant distortions.
This reduces growth and has negative effects for all.	This may reduce the growth of subsidized banks. However, it will have a positive effects for all (except possibly bankers).

Will it Ever Change?

“A root cause of most crises is] the increasing salience of long-standing financial-sector weaknesses, arising from some combination of insufficient capitalization and supervision of banks and excessive leverage and guarantee—the combination that, along with directed lending, has been captured in the term ‘crony capitalism,’ … Panics and runs are not driven by sunspots: their likelihood is driven and determined by the extent of fundamental weaknesses….“preventing crises… will depend heavily on strengthening core institutions and other fundamentals.”

Lawrence Summers, “International Financial Crises: Causes, Prevention, and Cure,” Richard T. Ely Lecture, 2000

This Time is Not Different

"We have come full circle to the concept of financial fragility in economies with massive indebtedness. . . . Highly leveraged economies . . . seldom survive forever, particularly if leverage continues to grow unchecked. . . . Encouragingly, history does point to warning signs that policy makers can look at to assess risk—if only they do not become too drunk with their credit bubble–fueled success."

Carmen Reinhart and Kenneth Rotoff, *This Time is Different: 800 years of Financial Folly, 2010*

The Political Economy of Nonsense

"It is difficult to get a man to understand something, when his salary depends upon his not understanding it!"

Upton Sinclair, *I, Candidate for Governor: And How I Got Licked ,* 1935

- Corruptive dependencies: It is difficult to get a politician to challenge bankers if funding for favorite causes (including government, campaign) and preserving beneficial relationships depend on collaborating.
- More Generally: People often won't to say or do something when it is more beneficial or convenient to avoid it.

"We turn a blind eye in order to feel safe, to avoid conflict, to reduce anxiety, and to protect prestige."

Willful Blindness: Why We Ignore the Obvious at Our Peril, Margaret Heffernan, 2012

Flawed Narratives Divert Attention from Failed Policies

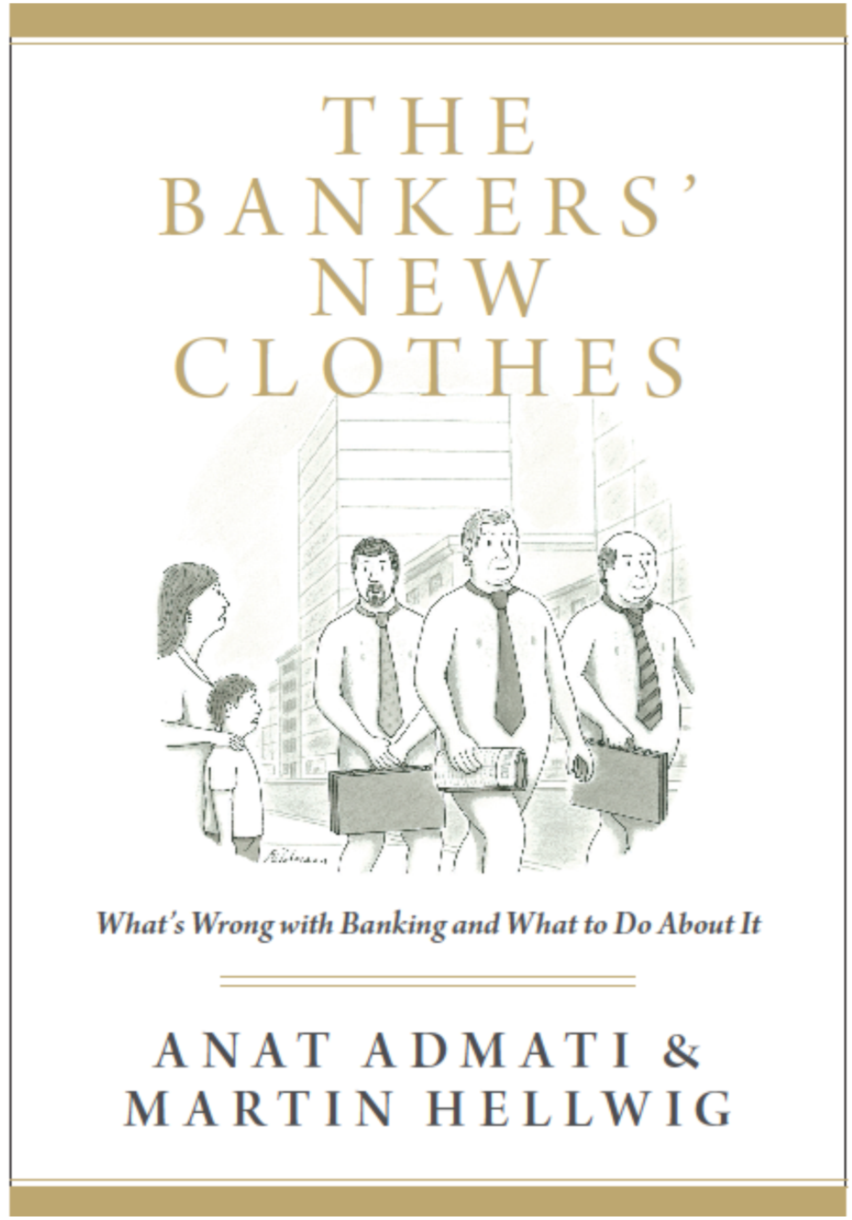
Focus on Liquidity ("Plumbing") Obscures More Serious Solvency Concerns

Safety in Banking vs. in Aviation

- Building codes, car safety, NFL, Tobacco, Guns…
- Harm from financial risk is more abstract.

An Attempt to…

- educate, elevate the debate.
- enlarge the circle of participants, empower people to challenge "banking emperors." (Note: the parade continues!)
- expose lack of accountability.
- outline specific, realistic reform (no silver bullet).
- help increase political pressure for action.



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