The Bankers' New Clothes: What's Wrong with Banking and What to Do about It

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What is Wrong with Banking?

The financial 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?

- Very high indebtedness
  - Causes distress and insolvency
- Reliance on fragile debt (deposits, short-term)
  - Causes liquidity problems and runs.
- Interconnectedness Creates contagion
  - Contractual chains,
  - Information
  - distressed sales.
- Opacity, ineffective regulation
  - Poor disclosures, hidden risks
  - “Shadow banking”

Distortions and Inefficiencies

- Too-big (systemic/important/many)-to fail.
- Inefficient lending and investment.
- Governance problems
  - Bankers chase returns, take risks, mis-sell
  - Shareholders exposed to risks without proper compensation, pay for misconduct.
  - Creditors and taxpayers bear downside risk
  - Society suffers collateral damage

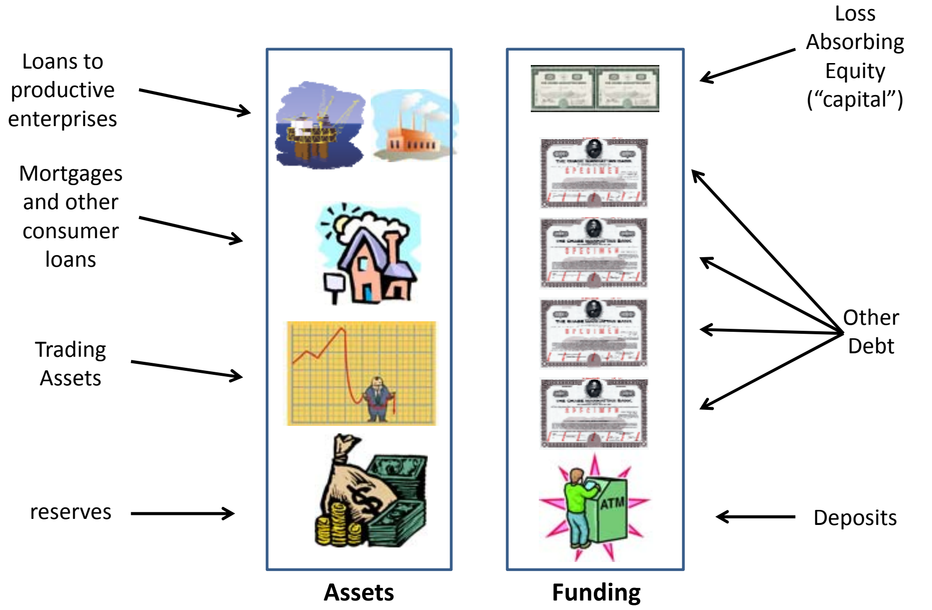
What to do?

- Better resolution ("let them fail"). Essential, but,
  - cross border issues
  - trigger problematic
  - disruptive and costly
  - *distress is already harmful*
- Ring fencing, Glass-Steagall, Volcker. Maybe, but
  - "Systemic" comes in many forms (LTCM, Lehman, AIG)
  - no-bailout commitments not credible.
  - interconnectedness remains
  - "too many to fail"

An Ounce of Prevention is Worth a Pound of Cure

- Are financial crises like natural disasters?
  - NO!
- Is the high fragility of banks essential to banking and must be accepted?
  - NO!
- Would we have to sacrifice anything if we try to reduce the fragility significantly?
  - NO!
- Fragility can be significantly reduced, bringing about large benefits to society at essentially no cost!

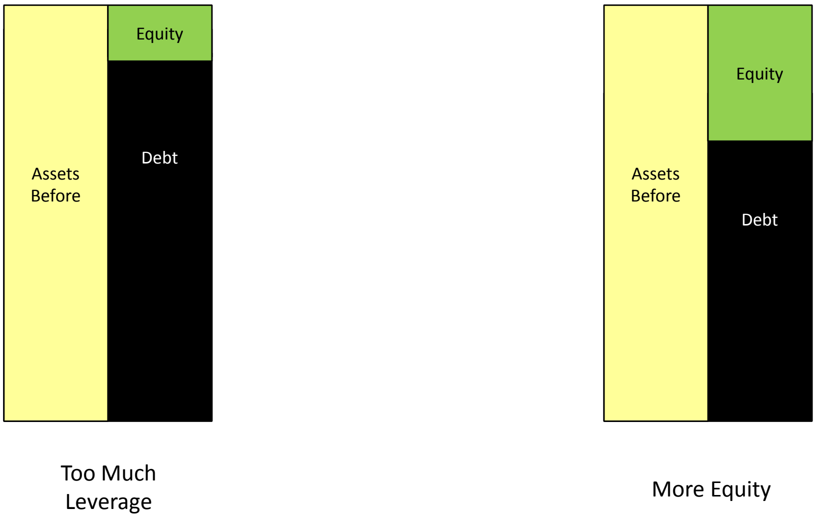
Bank Capital is a Source of Funding



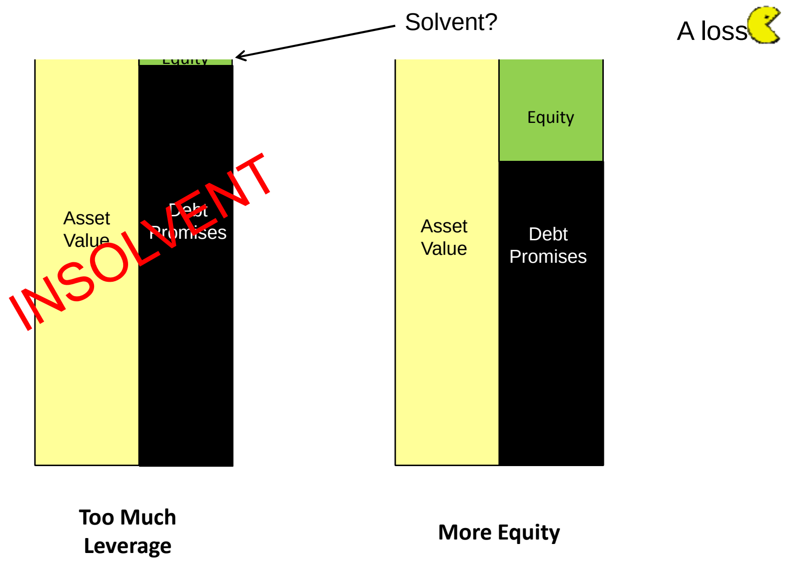
Banks Don’t “Set Aside” their own Equity

- Confusing jargon!
- “Hold” or “set aside” is misleading.
- Equity (“capital”) is not the same as reserves.
- Capital requirements concern funding only.
  - No constraints on loans and investments.
  - A firm does not “hold” securities it issues.
- Confusion implies false tradeoffs with lending.
- “Hold capital” = borrow less, use more equity.

Simple Truth: Equity Absorbs Losses and Lowers Chance of Distress



Equity Absorbs Losses



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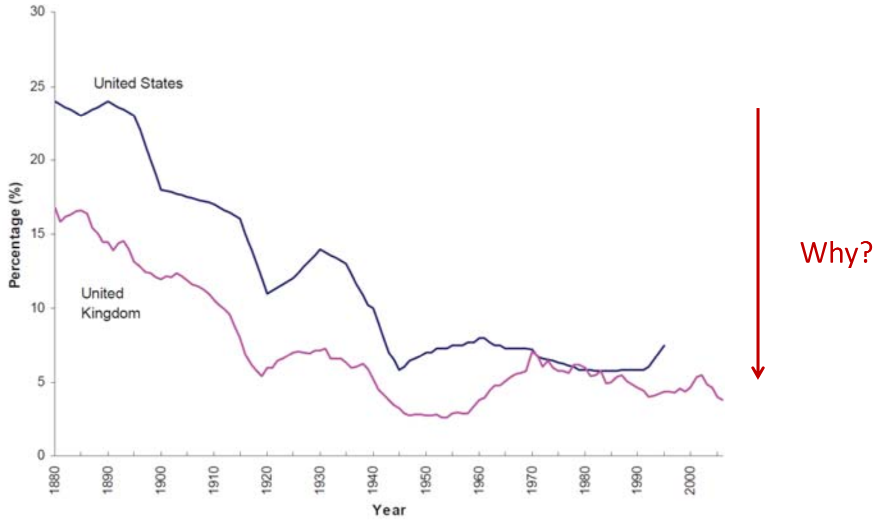
History of Banking Leverage in US and UK

(Mid 19th century: partnerships with unlimited liability, 50% equity)



Source: US: Berger, A, Herring, R and Szegö, G (1995). UK: Sheppard, D.K (1971), BBA, published accounts and Bank of England calculations. From Alesandri and Haldane (2009

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Some Facts

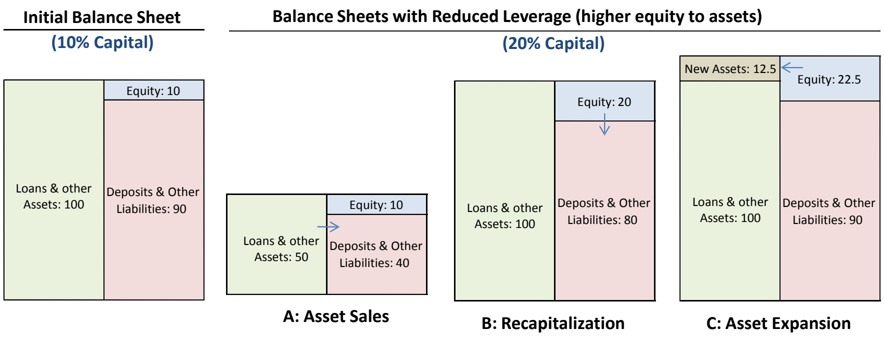
- Healthy non-banks rarely have less than 30% equity (without regulation).
- Corporations can grow without borrowing.
- Retained profits are an obvious source of equity funding.
- Banks typically have less than 10% equity, often much less.
- Basel III rules require only 3% equity/total.

A Simple Preventative Measure: Reduce Indebtedness in Banking!

- Reduce likelihood of distress or failure.
- Reduce contagion effects and spillovers.
- Reduce too-big-to-fail subsidies.
- Shift downside risk from taxpayers to investors.
- Reduce likelihood of liquidity problems and runs.
- Reduce likelihood of credit crunch.
- no interference with any banking activity.
- Best bargain: essentially no cost to society!

More Equity Does Not Restrict Any Banking Activity

- Three ways to reduce leverage.
- Same loans in Balance Sheet B.
- Same loans and debt in Balance Sheet C: Add equity!



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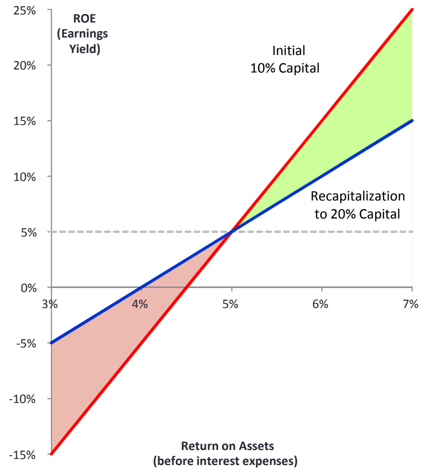
More Equity Makes ROE Less Risky

- More equity means
  - Lower ROE in good times
  - Higher ROE in bad times
  - ⇒ Risk to equity reduced

- With lower risk, *required* return on equity is lower



ROE Focus is Flawed and Dangerous

- ROE, unadjusted for risk and leverage, does not measure shareholder value.
- Leverage increases risk and thus required ROE.
- Any firm or manager can increase average ROE by increasing leverage or risk.
- Reaching "target ROE" by increasing risk and leverage endangers the bank and the economy.

Is Equity "Expensive?"

- If equity is "expensive" because it has higher required return than debt, and if ROE measures shareholder value, then
- Why would Apple use 100% equity? Why not borrow and create leverage?
  - Apple could borrow very cheaply!
  - Leverage would increase its ROE!
- Bank stocks trade in same markets as others, are held by same or similar end investors.

How Much Equity?

- Basel II and Basel III Capital Requirements
  - Tier 1 capital Ratio: Equity to *risk-weighted assets*:
    - Basel II: 2%,
    - Basel III: 4.5% - 7%.
    - Definitions changed on what can be included.
  - Leverage Ratio: Equity to *total* assets:
    - Basel II: NA
    - Basel III: 3%.
- Basel III is based on flawed analyses of tradeoffs; risk-weight system is complex and counterproductive.

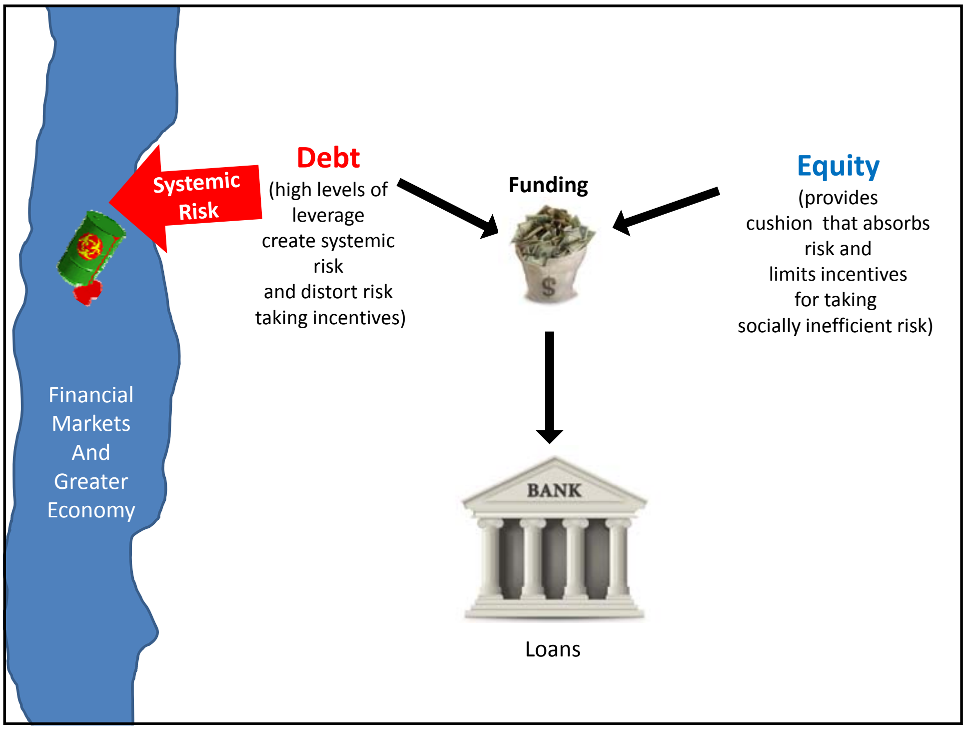
Basel III:
The Mouse that Didn't Roar

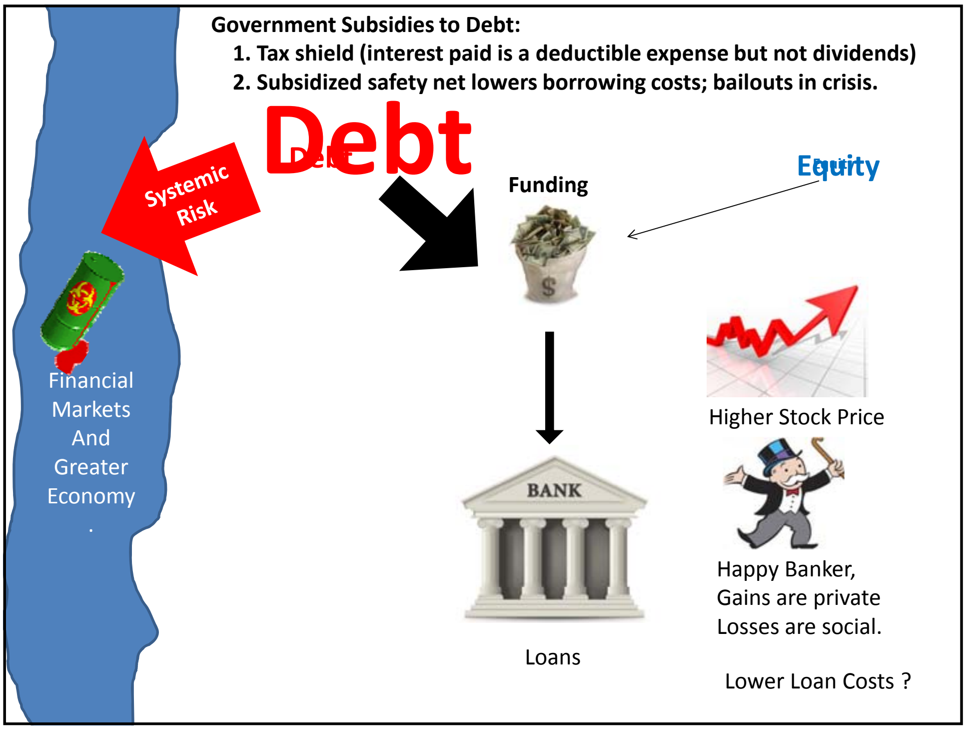
"Tripling the previous requirements sounds tough, but only if one fails to realize that tripling almost nothing does not give one very much."

Martin Wolf, *Financial Times*, September 13, 2010

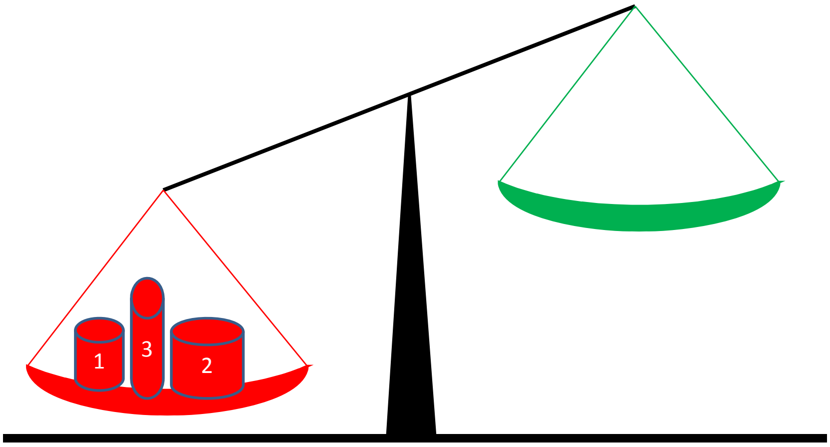
Effective Capital Regulation

- Maintain equity between 20-30% of *total assets*.
  - Avoid netting, include all exposures.
  - Significant social benefits; what's a relevant cost?
- Ban payouts to build up equity.
- Viable banks can raise equity at appropriate prices.
  - Ultimate "stress test."


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)
Financial Markets And Greater Economy
BANK
Loans


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

Banks/Bankers Prefer to Borrow and Resist More Equity.

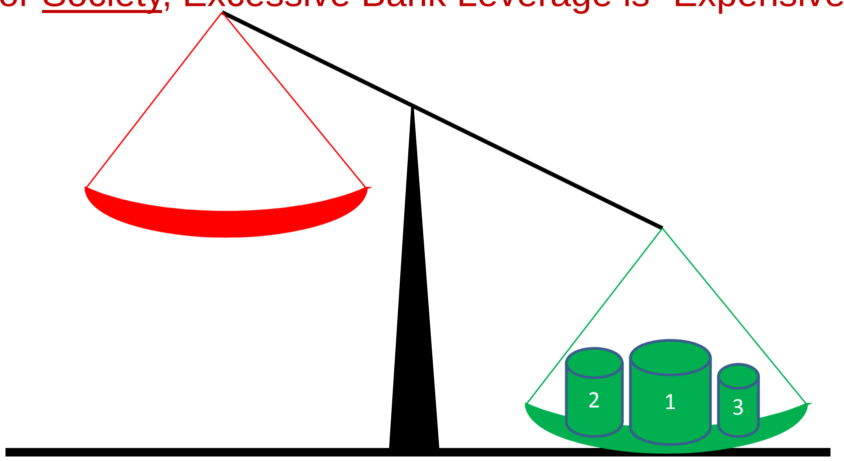


DEBT

1. Tax subsidies
2. Safety net benefits
3. ROE fixation
4. Debt overhang effect

EQUITY

For Society, Excessive Bank Leverage is “Expensive!”



DEBT

~~1. Tax subsidies~~
~~2. Safety net benefits~~
~~3. ROE fixation~~
~~4. Debt overhang~~

EQUITY

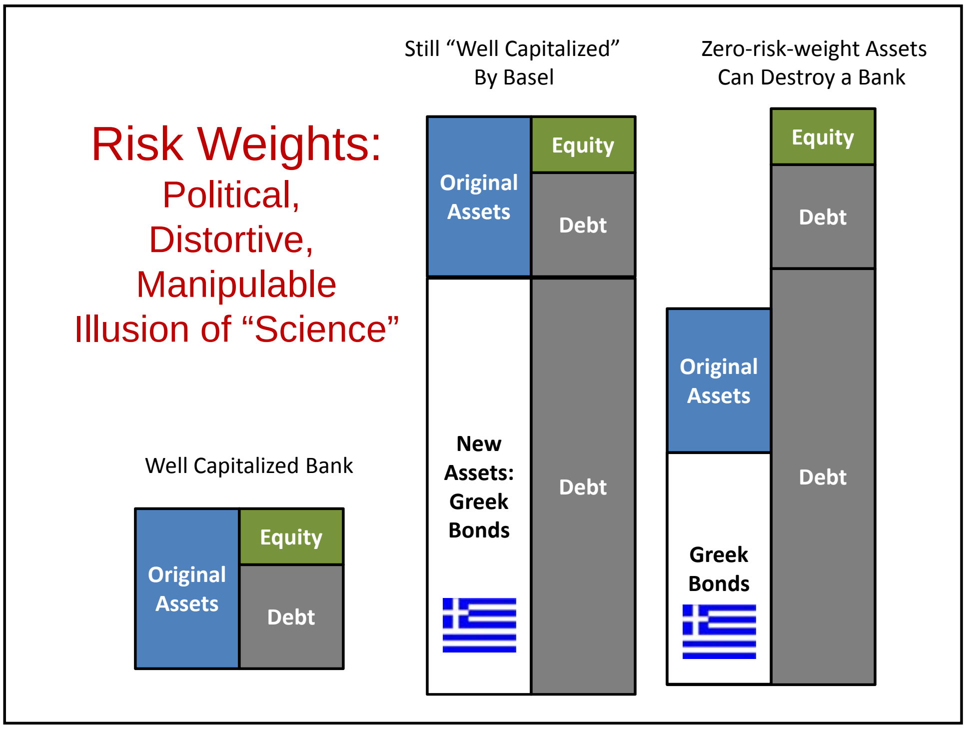
1. Reduces systemic risk
2. Reduces deadweight cost of distress, default, crisis
3. Reduces excessive risk taking
4. Improves ability to lend after losses

Misguided Approaches

- Delay, avoid recognizing losses.
  - Weak banks do not serve the economy well.
  - Hidden insolvencies are dangerous, delays are costly.
  - "Time has trick of getting rotten before it gets ripe."
- View every problem as "just a liquidity problem."
  - Pure liquidity problems are not hard to solve.
  - Use of more equity by banks not costly to society.

More Flaws in Basel Approach

- Risk weighting system is highly problematic.
  - Trusts models that cannot be trusted and are manipulable.
  - Distorts banks' decisions, for example, bias in favor of government, highly-rated assets over business lending.
  - Do we fine tune speed limits for loaded trucks?
- Alternatives to equity are unreliable and unnecessary.
  - Imposing losses on creditors is difficult, especially in crisis.
  - Any non-equity can create debt overhang.
  - No justification from society's perspective.



"Shadow Banking" and Enforcement Challenge

- Crisis exposed ineffective enforcement.
  - Must watch the *system*.
  - Regulated banks sponsor entities in the shadow banking system.
- Enforcement issues are not a valid argument against regulation:
  - Allow robbery?
  - Give up tax collection?

"Level Playing Field" Argument is Invalid

- Banks can endanger an entire economy (Ireland, Iceland, Cyprus).
- Banks compete with other industries for inputs (including talent); subsidies distort markets.
- It is not a national priority that "our" banks are successful if they impose risk and cost on us.
- Argument creates "race to the bottom."

The Sad State of Financial Reform

- Much talk, little action or change.
- Debate muddled by flawed claims - bankers' new clothes - and politics.
  - Confusing language and fallacious claims
  - Convenient but flawed narratives.
  - Presumption that markets work, resistance to change.
  - Politics binds bankers, politicians, regulators.
  - Risks in banking are abstract, responsibility diffuse.
- Unhealthy system is dangerous, drag on economy.

The Purported Tradeoff

"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)

In Fact

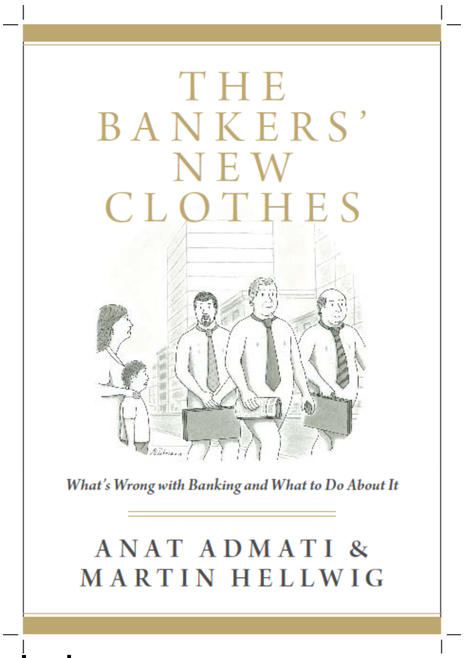
Well-designed capital regulation that requires *much* more equity, ~~might~~ will increase the stability of banks. At the same time, ~~however,~~ it would ~~restrict~~ enhance their ability to provide good loans to the rest of the economy and remove significant distortions. This may reduce~~s~~ the growth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

Useful Analogies

- Analogy 1:
  - – Banks: addicted to harmful behavior.
  - – Recovery/resolution: emergency help or coroner.
  - – Bailouts: feed and encourage addiction.
  - – Can we stop consumption of addictive substance?
- Analogy 2:
  - – Banks: speeding trucks with explosive cargo.
  - – Recovery/resolution: emergency plan for explosions.
  - – Bailouts: encourage and subsidize reckless driving.
  - – Can we put effective speed limits?

Book intended to

- Educate
- Advocate and proviee specific policy guidance.
- Enlarge the circle of participants
- Create political pressure for action



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