Myths about the Stability and Efficiency of Global Finance

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Fields / OECD-NAEC / Rebuilding Macroeconomics Symposium on Systemic Recovery, April 27, 2021
Is the financial system “sufficiently” resilient? NO, it is too fragile every day!!

Is the system efficient? NO, it is bloated and distorted every day!!

Is there a tradeoff between resiliency and efficiency in finance? NO, finance can be improved at no social cost!!
The Economy is a Web of Legal Promises (IOUs), People and Entities
What happens if a “shock” disrupts someone’s ability to fulfill promise?

- Household debt
- Small and medium size enterprise debt
- Corporate debt
- Contingent liabilities (derivatives, insurance)
- Other contracts
How Finance Can Benefit Society

Payment System
Cash or private debt claims

Money Across Time
beneficial exchange

Risk Sharing
Insurance and diversification

Guiding Investments
Scrutiny, pricing, monitoring

Should be trustworthy and efficient.
Making Finance Work

Too Little…

● “Unbanked”
● Cumbersome payments and trade
● Difficult to save and fund investments
● Exposure to downside risks

Too Much…

● Huge, complex, and opaque system.
● Highly interconnected
● Enormous “systemic” institutions
● Appears inefficient and reckless

How to enable “enough” finance but avoid “too much?”
Key for “Proper” Financial Development

- Education (financial literacy)
- Effective laws, regulations, and enforcement
- Technology (mostly for payment system)

Literacy and effective rules and enforcement are key
Myths about Global Finance: All are False!

- The financial system is much safer than it was before 2007
- Reformed regulations are “science-based” and address “TBTF”
- Global financial markets allocate resources efficiently
AIG, Lehman Shock Hits World Markets

Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit

The convulsions in the U.S. financial system sent markets across the globe tumbling, as two of Wall Street's biggest firms looked set to exit the scene and insurance giant American International Group Inc. turned to the Federal Reserve and the state of New York for assistance.

The U.S. stock market suffered its worst daily point plunge since the first day of trading after the Sept. 11, 2001, terrorist attacks. Financial markets were rattled by the rushed sale Sunday of Merrill Lynch & Co. and the bankruptcy-court filing of Lehman Brothers Holdings Inc., which scrambled Monday to sell its assets-prized businesses before too many employees and customers walked out the door. (Please see related article on Page C1.)

All day Monday, top Lehman officials were huddled in Manhattan at their Seventh Avenue offices. (See related article on Page C1.)

AIG Faces Cash Crisis
As Stock Dives 61%

American International Group Inc. was facing a severe cash crunch last night as ratings agencies gave it fire-sale ratings, forcing the giant insurer to raise $16.5 billion to cover its obligations.

With AIG now tottering, a crisis that began with falling home prices and went on to engulf Wall Street has reached one of the world's largest insurance companies, threatening to intensify the financial storm and greatly complicate the government's efforts.
U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up

Emergency Loan Effectively Gives Government Control of Insurer; Historic Move Would Cap 10 Days That Reshaped U.S. Finance

BY MATTHEW KAHRNTSCHING, DEBORAH SOLOMON AND LIAM PLEVEN

The U.S. government seized control of American International Group Inc.—one of the world’s biggest insurers—in an $85 billion deal that signaled the intensity of its concerns about a danger a collapse could pose to the financial system.

The step marks a dramatic turnaround for the federal government that would prevent the insurer from falling into bankruptcy. Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided AIG had to stay in full insurance businesses, giving the Fed some protection even if markets continue to sink. And if AIG rebounds, taxpayers could reap a big profit through the government’s equity stake.

“This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy,” the Fed said in a statement.

It puts the government in control of a private insurer—a historic development, particularly considering that AIG isn’t directly regulated by the federal government. The Fed took the highly unusual step using legal authority granted in the Federal Reserve Act, which allows it to lend to nonbanks under “unusual and exigent” circumstances, something it invoked when Bear Stearns Cos. was rescued in March.

As part of the deal, Treasury Secretary Henry Paulson, insurance industries, while Wall Street has watched two of its last four big independent brokerage firms exit the scene. The U.S. on Sept. 6 took over mortgage-lending giants Fannie Mae and Freddie Mac as they teetered near collapse. This Sunday, the U.S. refused to bail out Wall Street pillar Lehman Brothers, which filed for bankruptcy-court protection and is now being sold off in pieces. That same day, another struggling Wall Street titan, Merrill Lynch & Co., agreed to sell itself to Bank of America Corp.

The AIG deal followed a day of high drama in Washington. The Treasury’s Mr. Paulson and Federal Reserve Chairman Ben Bernanke convened in the early evening an unexpected meeting of top congressional leaders. Late in the trading day Tuesday, anticipation that the government might assist the insurer helped prop up the Dow Jones Industrial Average.
These events present a challenge to standard economic theory…. policies to prevent future financial crises will depend on a deeper understanding of the processes at work.

Asymmetric information is key, precisely in the complex securities that [the standard theory] called for.

Kenneth Arrow 1921-2017
My daughter came home from school one day and said, ‘daddy, what’s a financial crisis?’

And without trying to be funny, I said, ‘it’s the type of thing that happens every five, seven, ten years.’

Jamie Dimon, January 2010
(to Financial Crisis Inquiry Commission)
A Liquidity Problem?

“A Classic Bank Run?”
Narratives Inform Policy
Was the 2007-2009 Financial Crisis a Natural Disaster? A Sudden “Shock?” A “100-year flood?”
The financial crisis was avoidable
Widespread failures in financial regulation
Breakdown in corporate governance
Explosive and excessive borrowing.
Lack of transparency
Government was ill-prepared and responded inconsistently
Widespread breaches in accountability at all levels.

The crisis reflected distorted incentives and failure of rules and governance
Total Liabilities and Equity of Barclays 1992-07

Hyun Song Shin, “Global Banking Glut and Loan Risk Premium,” IMF Annual Research Conference, November 10-11, 2011; Figure 22.
Shadow Banking

Pozsar, Adrian, Ashcraft, and Boesky, Federal Reserve Bank of New York, July 2010: revised February 2012
The US System

IMF Financial Stability Report 10/2014, Figure 2.1.1

[Diagram showing the flow of financial transactions involving banks, lenders, borrowers, and various financial instruments such as RMBSs, CDOs, SIVs & ABCP, monoline insurance, and credit & liquidity puts.]
The Safety Net of Banking Corporations is Special

Deposit insurance

Central bank support
- “liquidity” and “lender of last resort” facilities
- Subsidized borrowing
- Low interest rates

Government bailouts
- Direct investment, e.g., TARP, to prevent default.
- Guarantees, e.g., JPMorgan Chase acquisition of Bear Stearns.
- Nationalization, e.g., Royal Bank of Scotland, Lloyds, Dexia.
Zombie (Insolvent) Borrowers: Opaque and Dysfunctional

Unable to raise equity

“Gamble for resurrection”

Anxious to take cash out

Avoid equity

Sell assets, even at fire-sale prices

Underinvest in worthy “boring” assets

Try to hide insolvency in disclosures

Lobby others for supports
A Brief Revisit of 2007-2013 Bailouts in US

Bear Stearns; TARP funding of banks, AIG, GM, Chrysler; guaranteed money market funds; trillions in “liquidity support” and massive purchases of government and mortgage securities by the Federal Reserve (QE)

Propped up financial firms and markets; minimal if any help for homeowners; about 3.8 million foreclosures 2007-2010
Numerous banks became insolvent, massive bailouts by central banks, governments; indirect bailouts (e.g., of Greek government); some nationalization (e.g., RBS, Dexia)

“Doom Loop” governments/banks
(2 minute applause)
Dodd Frank Act Title II: FDIC Systemic Resolution. “Let them Fail!”
Loss-Absorbing Debt (a.k.a “Total Loss Absorbing Capacity,” Contingent capital, etc.): Clever “Bail-In” or Fool’s Gold?
Governments in Europe Find Workarounds to Bail Out Ailing Banks

State injections into banks in Germany and Italy continue to protect investors over taxpayers.
“Heroic Savior” Button
JPMorgan Chase: “Fortress?”

Dec. 31, 2011 (in Billions of dollars)
Investors can’t understand the nature and quality of the assets and liabilities... The disclosure obfuscates more than it informs.

Kevin Warsh, Jan. 2013

The unfathomable nature of banks’ accounts make it impossible to know which are sound. Derivatives positions, in particular, are difficult for outside investors to parse.

Paul Singer, Elliot Management, Jan. 2014

Wells Fargo: Quaint?
“What’s Inside America’s Banks?” Eisinger and Partnoy, Atlantic, Jan 2013
DON'T WORRY, THIS IS BEING DONE IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES...
Asymmetric leverage adjustments create path dependence and inefficiencies in corporate investment and funding.
Basel II: A spectacular failure

Basel III: An inadequate tweak, “a well-intended illusion”

Thomas Hoenig, April 2013
“The omission of off-balance sheet items in the standard measures implies a substantial underestimation of bank leverage.

Off-balance sheet funding is higher now than in 2007.”

“Leverage, a Broader View,” Singh and Alam, IMF, March 2018
Complex; give the illusion of “science” yet ignore interest rate risk and correlation of “tail events”

Manipulable, distortive, and political
Favor loans to governments and traded assets over business lending; Allow banks to use own models

Used by banks to “economize” on equity
Add fragility, interconnectedness, and systemic risk
French banks owned 40% of Greek government debt in 2010. Regulations (still) assume such loans are riskless (0 risk weight).
Who Owned Greek Government Debt, July 2015
Leading creditors (in euros)

- Germany: 68.2bn
- France: 43.8bn
- Italy: 38.4bn
- Spain: 25bn
- IMF: 21.4bn
- ECB: 18.1bn
- Netherlands: 13.4bn
- US: 11.4bn
- UK: 10.8bn
- Belgium: 7.5bn
- Austria: 5.9bn
- Finland: 3.7bn

Source: Open Europe, BIS, IMF, ECB
Into the rabbit hole…
…and the toxic mix of confusion and politics
“Just about whatever anyone proposes… the banks will claim that it will restrict credit and harm the economy…. It’s all bullshit.”

Paul Volcker (1927-2019), January 2010
(From Payoff: Why Wall Street Always Wins, Jeff Connaughton, 2012)
Is More “Credit” Always Good?

- Too much or too little; boom, bust, and crises
- Credit crunch in bust exacerbates recession
- Credit booms are main predictors of bust/crises
- Risk weights create biases
- Wasteful investments in boom

Credit markets distorted by lenders’ leverage and bad regulation
Invalid “Level Playing Field” Argument

Banks can endanger the entire economy (see Iceland, Ireland)
Banks’ “success” may come at society’s expense
Banks compete with other industries for inputs (including talent)
Race to the bottom in regulation
Fear of “Shadow Banking” is a Lame Excuse

“Innovation” or “regulatory arbitrage?”
Allow robbery if robbers go to dark alleys?
Regulators have sufficient authority to trace risk

“These new rules will fundamentally change the way we get around them”
Fallacies, Irrelevant Facts, Myths… (Flawed Claims)

More “capital” will reduce lending and growth
Return on Equity will decline
There are tradeoffs
It’s complicated
There will be “unintended consequences”
etc., etc....
A must-read for concerned citizens, *The Bankers’ New Clothes* should be studied and memorized by lawmakers and regulators so they won’t be duped by false claims in the future.

Eugene Fama, 2013
Many Enablers (Agents within Institutions)

Financial sector employees (sell side)
Institutional investors (buy side)
Executives and directors
Auditors and rating agencies
Supervisors and regulators
Central bankers
Politicians
The media
Economists, including academics

https://admati.people.stanford.edu/publications/it-takes-village-maintain-dangerous-financial-system
Politics of Banking
Corruptive dependencies banks-governments

“Banks are where the money is;” everyone needs banks

Guarantees appear free, social cost is invisible

Banks seem sources of funding, not risk

“National champions”

Central banks support governments and private banks

Confusion and willful blindness

Banks get away with inefficient recklessness
“Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.”

Senator Richard Durbin (D-III), 2009
The Lobbyists’ Perspective

“When the President signed the financial reform law, that was half time.”

Scott Talbott, Chief Lobbyist
Financial Services Roundtable
“Banks are not special, except for what they are allowed to get away with…. The model is intellectually bankrupt. The reason that this is not more widely accepted is that bankers are so influential and the economics are so widely misunderstood.”

“Without reform... another crisis is certain”

Mervyn King,
(former Bank of England Governor)
*End of Alchemy*, 2016
“Too-Big-to Fail remains with us”

Thomas Hoenig,
(former FCID vice chair)
February, 2018
“Global finance is a system that works for the few and against the many. We need finance – but when finance grows too big it becomes a curse. The City of London sucks talent out of every sphere, siphons wealth and hoovers up government time. Yet to be ‘competitive,’ we’re told we must turn a blind eye to money-laundering and appease big business with tax cuts. We are told global finance is about wealth creation; the reality is wealth extraction.”
Danske’s €200bn ‘dirty money’ scandal
Financial Times, October 2, 2018
COVID-19
Novel Coronavirus
The seeds of the next debt crisis

With debt levels already at a record high, coronavirus raises the risk of a credit crunch in a world of low interest rates
“unconventional central bank policies may simply set the stage for the next boom and bust cycle, fueled by ever declining credit standards and ever expanding debt accumulation.”

William White, former head of Monetary and Economics Department at Bank of International Settlement (BIS), in “The Seeds of the Next Debt Crisis,” FT, March 3, 2020,

https://www.ft.com/content/198d1cf4-e73f-11d9-a721-00000e2511c8

“BIS warns on domestic and international debt”
U.S. Airlines Spent 96% of Free Cash Flow on Buybacks

By Brandon Kochkodin

March 16, 2020, 9:53 AM PDT

US airlines pushing for massive bailout gave $45bn to shareholders in five years

- Delta, American, United, Southwest and Alaska want help
- Top airlines handed out billions to investors and executives
Economics, Law and Finance Professors from Major Universities Write to Congress: “Bail Out People Before Large Corporations”

Posted on March 24, 2020 by ProMarket writers

“Bailouts allow investors to keep all the profits in good times without bearing the losses in bad times. Instead, bailouts impose losses on taxpayers, including those most in danger of losing their paychecks,” over 230 leading economists argue in a letter to Congress regarding the $2 trillion package that’s meant to mitigate the economic impact of the coronavirus outbreak.
How the Coronavirus Bailout Repeats 2008’s Mistakes: Huge Corporate Payoffs With Little Accountability

As the government rushes to aid the economy, how that’s done, who benefits and who is left behind matter. So far, the signs are ominous.

by Jesse Eisinger  April 7, 2020, 11:30 a.m. EDT

The design of the rescue package has left those who watched and studied 2008 deeply frustrated. “I do not have a good explanation of how we continue to fumble this,” said a Hill staffer familiar with the CARES Act. “This will paper over bank balance-sheet problems, help tech valuations and boost leveraged loans. In three months, the stock market will look good. But the vast majority of workers will be worse off. The law will amplify inequality and the power of large corporations over labor and the workforce, and they won’t be able to recover for a generation.”
America’s Zombie Companies Are Multiplying and Fueling New Risks

By Lisa Lee and Michelle F Davis
May 19, 2020 3:00 AM PDT

- The Fed’s credit-market support is staving off bankruptcies
- Yet it may also be setting the economy up for long-term pain

Too Big to Fail: The Entire Private Sector

By Matt Phillips
May 19, 2020

Fed Vow Boosts Debt Binge as Borrowers Cut Thousands of Jobs

By Bob Ivry, Lisa Lee, and Craig Torres

June 5, 2020, 1:00 AM PDT  Updated on June 5, 2020, 6:50 AM PDT

Trillion-Dollar Spigot
Corporate bond sales surged after the Fed announced purchasing plans on March 23

- Investment grade
- High yield

Wall Street Reaps a Bonanza on Fed’s Support for Corporate Debt

By Paula Seligson and Lisa Lee
July 13, 2020 3:00 AM PDT

More Deals, More Fees
U.S. investment-grade bond fees doubled in the first half of 2020
- Underwriting fees

BANKS STAND TO MAKE $18 BILLION IN PPP PROCESSING FEES FROM CARES ACT
That's money taken directly out of the $640 billion pot of funding Congress allocated to the PPP program.

Source: Bloomberg league table data

https://theintercept.com/2020/07/14/banks-cares-act-ppp/
The Fed is addicted to propping up the markets, even without a need

By Steven Pearlstein

June 17, 2020 at 3:00 a.m. PDT

The leveraging of America: how companies became addicted to debt

With the corporate sector already owing $10tn, many businesses are doubling down on new loans to survive the pandemic

JULY 9 2020

Mark Vandevelde in New York

Amid the prospect of a new generation of “zombie” companies unable to pay their interest bills, the pandemic is reviving the debate about whether it makes economic sense for the corporate sector to have taken on such a large volume of debt — and whether there is a way to unwind it without causing a broader crisis. The financial crisis prompted a similar discussion about excessive financial engineering, but the response in the decade since that crisis has been to increase leverage, not to wind it down.
Greensill: Hidden Risk and Fragility in “Supply Chain Finance”

Financial Times, Tuesday March 2, 2021

“Why is supply chain finance controversial? The short answer: its accounting treatment”
US put off derivatives rules for a decade before Archegos blew up

Regulation of swaps used by Bill Hwang was pushed back once again by Covid

Margin requirements for smaller financial firms using swaps, such as Bill Hwang’s Archegos Capital, had been due to go into force last year © Financial Times

Joe Rennison, Eric Platt, Colby Smith and Phillip Stafford APRIL 11 2021

https://www.ft.com/content/7819e714-bf9d-4f83-a6e4-497df534f77c
Why Didn’t Wall Street See Archegos and China Huarong Coming?

We all want the financial system to operate smoothly but even experts can overlook the footnotes and step into a quagmire of bad investments.

By Shuli Ren and Howard Chua-Eoan

April 14, 2021, 4:00 PM PDT

If it wasn’t for ViacomCBS Inc.’s sudden sale of new shares that resulted in an enormous margin call, the Hwang time-bomb could still have been ticking.

And right now, all eyes are on a contagious dollar bond rout spurred by China Huarong Asset Management Co., once impeccably investment grade and secure in the public eye because it is majority-owned by the Ministry of Finance.

…with $22 billion in dollar bonds outstanding, the country’s largest distressed asset manager has become distressed itself. Media reports of restructuring have contributed to market anxiety not just in Asia but everywhere money flows.
C.E.O. Pay Remains Stratospheric, Even at Companies Battered by Pandemic

While millions of people struggled to make ends meet, many of the companies hit hardest in 2020 showered their executives with riches.

By David Gelles

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<thead>
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<th>Company</th>
<th>C.E.O.</th>
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<td>JPMorgan Chase</td>
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A Persistently Opaque, Fragile, and Inefficient Financial System

Recklessness is enabled by…

Expansive safety nets
- Explicit and implicit guarantees and central bank supports

Badly designed rules (laws and regulations)
- Bad tax and bankruptcy codes that enable and encourage excessive (short term) borrowing and hiding of risk
- Poorly designed complex (capital and other) regulations that add and exacerbate distortions
- Conflicted auditors and rating agencies
- Confusion and politics
Entrenched opaque system, symbiotic relations with governments, excessively reliant on central banks, misunderstood by public, exacerbates inequality
“Time Gets Rotten Before it Gets Ripe”

“No, Tuesday is out. How about never --- is never good for you?”
Next Financial Crisis?