Are financial crises unpreventable?

Is the system working well as long as there is no crises?
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)

Natural Disaster? Sudden “Shock?” “100-year flood?”
“The storms are perhaps man-caused and you can debate that, but the catastrophes because of the storms? Uh, those are man-made.”

Henk Ovink, Dutch Water Ambassador, “60 Minute,” September 23, 2018
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.

Banks use inefficiently little equity funding

“Equity is Expensive” is based on flawed claims in a policy context.
Historical Equity/Asset Ratios in US and UK

Mid 19th century: 50% equity, unlimited liability

After 1940s, limited liability everywhere in US

“Safety nets” expand

Equity ratios decline


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.
JPMorgan Chase Balance Sheet
Dec. 31, 2011 (in Billions of dollars)

The Mantra in Banking: “Equity is Expensive”

Expensive to whom?
Why?

Are banks so special and different that none of what we know about the economics of corporate funding applies?
Bank Debt is Special by Providing “Liquidity”

Does it follow that it is efficient for banks to have little equity? NO!!!

» Bank equity is subject to the same economic forces as other corporations
» Default destroys liquidity benefits
» Safer banks have fewer runs.

Do Banks “Create” Money by Lending?

The liquidity benefits of deposit and other debt affect the terms of “liquid debt”

Trust in bank safety (or in safety nets) also matters

Permitting banks to “create” deposits by lending, or using the term “money” for liquid debt does not change the fact that liquid debt is a liability

Economists’ misleading half truths have their roots in the mystique of “money”

James Tobin, “Commercial Banks as Creators of ‘Money’” 1967
Free Markets Do Not Produce Efficient Outcome

Bank

- Fragmented lenders.
- Costly (or impossible) coordination
- Free rider problems
- Contracts work poorly to create commitments
- Banks are inherently inefficient
- Safety nets exacerbated conflicts of interest
- Regulation can help address
- Reducing collateral harm is extra benefit

“The Maturity Rat Race:” Incentives to Shorten Maturities
The Leverage Ratchet Effect
Admati, DeMarzo, Hellwig and Pfleiderer, Journal of Finance, 2018

Debt contracts lead to self-reinforcing distortions on both sides of the balance sheet. Leverage adjustments are history-dependent, asymmetric. Biased towards asset sales in leverage reduction.

Shareholders’ Preferences For Leverage Reduction

Initial Balance Sheet
Debt/Assets = 0.9
Equity: 10
Assets 100
Liabilities 90

Balance Sheets with Reduced Leverage (lower debt to assets)
Debt/Assets = 0.8
Equity: 20
Assets 100
Liabilities 80
Assets 12.5
Liabilities 90

A: Asset Liquidation
B: Pure Recapitalization
C: Asset Expansion
### Banks vs Non Bank Corporations Leverage

<table>
<thead>
<tr>
<th>Non Banks (without regulation)</th>
<th>Banks or BHC (with “Capital Regulation”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have risky, long term, illiquid assets</td>
<td>Ditto</td>
</tr>
<tr>
<td>Can use retained earnings (or new shares) to invest and grow</td>
<td>Ditto</td>
</tr>
<tr>
<td>Rarely maintain less than 30% equity/assets, often much more</td>
<td>Rarely have more than 6% equity/assets, sometimes less</td>
</tr>
<tr>
<td>Sometimes don’t make payouts to shareholders for extended periods (Google, Berkshire Hathaway).</td>
<td>Make payouts to shareholders if pass “stress tests” (unless indebted to government)</td>
</tr>
</tbody>
</table>

### Borrowing and Downside Risk

<table>
<thead>
<tr>
<th>Heavily Indebted Non Banks (no safety net)</th>
<th>Heavily Indebted Banks (many supports)</th>
</tr>
</thead>
<tbody>
<tr>
<td>May become distressed/insolvent</td>
<td>Ditto</td>
</tr>
<tr>
<td>Inefficient decisions</td>
<td>Ditto</td>
</tr>
</tbody>
</table>
| May default or file for bankruptcy  
✓ Shareholders are wiped out  
✓ Lenders are paid by seniority  
✓ Assets are depleted | May remain insolvent  
✓ Depositors maintain balances  
✓ Secured lenders are protected  
✓ Access to Fed, Bailouts in crisis |
| Lenders try to protect themselves when lending, hard to borrow. | Can keep finding lenders despite opacity, risk, and extreme debt. |
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 policymakers for supports
Key Implications for Banking

- Intense distortions…
  - Fragmented, passive creditors
  - Excessive guarantees
  - Broad “safe harbor” exemptions
  - Tax subsidy of corporate debt

- … make regulations useful
  - Replace missing commitments
  - Protect the public
  - To avoid fire sales and loan restrictions, must manage adjustments. **Key tools: profit retention, equity issuance**

Private Considerations (Mostly Bank Managers)

- More Debt
  - Others bear downside risk
  - Tax subsidies
  - ROE-based bonuses
Too Little Equity in Banking is Socially Expensive!
Excessive fragility and distortions benefit few

- More Debt
  - Others bear downside risk
  - Tax subsidies
  - ROE-based bonuses

- More Equity
  - Reduces risk of runs and liquidity problems
  - Reduces risk and cost of insolvencies
  - Reduces distortions in investments
  - Reduces distortive subsidies

Modigliani and Miller (M&M) and Banking
A Six-Decade-Long Debate

The main message of M&M (1958) is NOT that the funding mix of any firm, is irrelevant.

The assumptions for “irrelevancy” are false in reality.

The key conclusion:

Rearranging how risk is allocated does not by itself change the cost of funding
Bank capital is costly because, the higher it is, the lower will be the return on equity for a given return on assets.

Equity, Risk, and Return on Equity (ROE)

More equity:
- Higher ROE on upside
  - Lower ROE in downside
- Less risk for equity
  - Lower required ROE.

Chasing returns by taking risk or excessive leverage may harm shareholders!

Basel II: A spectacular failure

Basel III: An inadequate tweak,
“a well-intended illusion”
Thomas Hoenig, April 2013
Between summer 2007 and end of 2008, the largest 19 US institutions paid out nearly $80B to shareholders.

Regulatory Measures are Uninformative

“Tier 1” capital ratios: What crisis?

2006 was a great year in banking

Between summer 2007 and end of 2008, the largest 19 US institutions paid out nearly $80B to shareholders.

Regulatory Measures are Uninformative

“Tier 1” capital ratios: What crisis?

Largest 19 institutions received ≈$160B under TARP (bailouts).

Fed committed $7.7 trillions in below-market loans to 407 banks.

“Tier 2 capital” proved useless to absorb losses (except Lehman).
Regulatory Measures are Uninformative

“Tier 1” capital ratios: What crisis?

Market-based measures

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

Basel “Capital Regulation”
(No proper justification)

<table>
<thead>
<tr>
<th>Basel II (pre-crisis)</th>
<th>Basel III (reformed rules)</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Common equity Tier 1 capital” to risk-weighted assets: 2%</td>
<td>“Common Equity Tier 1 Capital” to risk-weighted assets (RWA): 4.5%</td>
</tr>
<tr>
<td></td>
<td>» Plus 2.5% conservation buffer</td>
</tr>
<tr>
<td></td>
<td>» Plus 1.5% “Tier 1” to RWA</td>
</tr>
<tr>
<td></td>
<td>Leverage Ratio: “Tier 1” to total</td>
</tr>
<tr>
<td></td>
<td>» Basel III: 3%</td>
</tr>
<tr>
<td></td>
<td>» US: BHC: 5%, insured banks: 6%</td>
</tr>
<tr>
<td>“Tier 2” Loss-absorbing debt</td>
<td>“Tier 2”/TLAC (“loss-absorbing debt”).</td>
</tr>
</tbody>
</table>
“Tripling almost nothing does not give one very much.

Martin Wolf, “Basel III: The Mouse that Didn’t Roar,”
Financial Times, Sep 13, 2010

“...If at least 15% of banks’ total assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any. Temporarily restricting bank dividends is an obvious place to start.


Financial Times, November 9, 2010
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

Risk Weights Undermine the Purpose of Regulation

- Complex; illusion of “science,” ignore interest rate risk, and correlation of “tail events.”
- Manipulable, distortive, and political
  
  » E.g., Favor government and traded assets over business lending
- Low equity levels, intensify distorted incentives, used to “economize” on equity
  
  » Add fragility, interconnectedness, systemic risk
“Anything but Equity” Why?

Too Little Equity

Much Safer

Will it Work? Why do we need it?

Government (Taxpayers)

Shareholders

Other lenders
(TLAC, Co-Cos, Bail-in Debt)

Short-term secured lenders

Depositors
(unsecured, insured)
“Too Big To Fail remains with us.”

Tom Hoenig (FDIC)
February 2018

How much capital should banks issue? Enough so that it doesn't matter!


Well-designed leverage regulation:
Not a silver bullet, but best bargain in regulation
Why live dangerously and waste resources when there are alternatives?

Why not get more stability and fewer distortions at bargain cost?

Bank Stress Tests: False Reassurances

- Inappropriate “pass” benchmarks
- Numerous strong assumptions
- Cannot predict contagion dynamics
  - Common and correlated exposures (OFR, 2016)
  - Run dynamics
  - Derivatives and CCPs (OFR, 2015)
- Very costly!!
[The suggestion that the largest bank holding companies are strongly capitalized and would be able to lend to households and businesses during a severe recession] is a comically absurd conclusion… And the fact that that assertion continues to be made has to undercut whatever credibility one would otherwise attach to the very substantial efforts that have been made to strengthen financial regulation.

Lawrence Summers, September 8, 2018

Large Banks are Opaque

“Banking remains too much of a black box... for many investors scarcely an investible proposition.”
Andrew Haldane, BoE, Nov 2011

“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’ public accounts make it impossible to know which are actually risky or sound. Derivatives positions, in particular, are difficult for outside investors to parse.”
Paul Singer, Jan. 2014
A Market-Based Stress test: Raise New Equity!!

Inability to raise equity, or significant dilution, are flags

Weak business model
Dependence on subsidies
Too opaque
“Uninvestible”

Why Not?
Confusion, flawed narratives and claims
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.


“Because we have substantial self-funding with consumer deposits, we don’t have a lot of debt…”

John Stumpf, Wells Fargo Bank CEO, 2013
Because we have substantial self-funding with consumer deposits, we don’t have a lot of debt...

John Stumpf, Wells Fargo Bank CEO, 2013

US banks forced to hold $68 billion in extra capital

Financial Times April 8, 2014
US banks forced to hold $68 billion in extra cash.

Telegraph. April 8, 2014
Every dollar of capital is one less dollar working in the economy.

Steve Bartlett, Financial Services Roundtable, Sept 2010
"This rule will keep billions out of the Economy"

Tim Pawlenty, Financial Services Roundtable, July 2015

"NONSENSE"

Tim Pawlenty, Financial Services Roundtable, July 2015
“With such friends [as academics], who needs lobbyists?
Risk manager in a major systemic institution, 2016

“It Takes a Village to Maintain a Dangerous Financial System,”

“Science is what we have learned about how to keep from fooling ourselves.

Richard Feynman

“Chameleons: The Misuse of Theoretical Models in Finance and Economics,”
Paul Pfleiderer, 2014 (forthcoming, Economica, 2018)
High Leverage, Fire Sales, and “Deleveraging”

A 1% Asset Decline with 3% equity

⇒ 33% Balance Sheet Contraction

- Asset Fire Sales
- Illiquidity / Market Failure
- Bailouts

A Liquidity Problem?  

“A Classic Bank Run?”
Liquidity Regulations: Costly and Challenging

**Market liquidity**
» Related to information dissemination in markets

**Funding liquidity**
» Related to financial strength

**The challenge**
» Markets can freeze (too much info asymmetry)
» Insolvency concerns cause withdrawals and runs

BHCs have access to LOLR (Fed); Mutual funds must not over-promise liquidity

Fear of “Shadow Banking” is an Excuse

Crisis exposed ineffective enforcement.
+ Rules are meaningless unless enforced properly.

Enforcement challenge is invalid argument against regulation:
+ Allow robbery if robbers go to dark alleys?

Regulators have sufficient authority to trace risk
Money Market Fund Investments by Assets (billions)

SEC form N-MFP filings. *Other instruments of money market funds include U.S. Treasuries, U.S. Agencies, and tax-exempt securities.

Ultimate Borrowers
- Money
- Hedge Funds
- REPOs/PRIME BROKERAGE
- Collateral
- Money/Collateral
- CCPs

Nonbank and Bank Nexus
- Intermediaries
- Money Market Funds
- Custodians
- Long-term household and corp. savings

Ultimate Savers
- Money
- Short-term household and corp. savings

Source: Collateral and Financial Plumbing, Manmohan Singh, 2014; "Leverage: A Broader View," Manmohan Singh and Zohair Alam
Special Vehicles In “Normal Times”

- Regulated Bank
  - Assets
  - Insured Deposits

- Shadow Bank Vehicle Sponsored by Bank Holding Company
  - Assets
  - Uninsured Deposit-like Claims

... and in “Troubled Times”

- Regulated Bank
  - Assets
  - Insured Deposits
  - Assets taken Back on Balance sheet
  - New Insured Deposits

- Shadow Bank Vehicle Sponsored by Bank Holding Company
  - Assets
  - Uninsured Deposit-like Claims

Bank Holding Company
“Banks and private Markets: Making Fresh Connections”
Paul J. Davies, Wall Street Journal, August 8, 2018

Non-banks took market share from the big banks, but almost all of the extra loan-arranging non-banks did was funded by borrowing from those big banks.”

“We don’t know how much will wash back onto their balance sheets next time the music stops.”

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
“Beware of Unintended Consequences”

“Undesirable” effects may reflect
+ Intended outcomes (fewer distortions in markets for loans or “liquidity”
+ Poorly designed regulations
  too little equity
  risk weights
  liquidity regulations

The “unintended consequence” of policy failures are distortions and crises!!

What about profits from misconduct?
“operational risk?”
Danske’s €200bn ‘dirty money’ scandal
Financial Times, October 2, 2018

Summary

The financial system is too fragile, distorted and dangerous

We can have a better system, but we need proper diagnoses and political will