In banking, it’s all other people’s money

By Anat R. Admati
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Each week, In Theory takes on a big idea in the news and explores it from a range of perspectives. This week, we’re talking about financialization. Need a primer? Catch up here.

Anat R. Admati, a professor of finance and economics at Stanford Graduate School of Business, co-authored “The Bankers’ New Clothes: What’s Wrong With Banking and What to Do About It” with Martin Hellwig.

The intense conflict of interest between bankers and the rest of society is captured well in a passage from “Traders, Guns and Money,” a book written by former banker Satyajit Das:

“Traders risk the bank’s capital [money from investors, including shareholders] ... If they win they get a share of the winning. If they lose, the bank picks up the losses ... the money at risk is not their own, it’s all other people’s money. ... Traders can always play the systemic risk trump card. It is the ultimate in capitalism — the privatization of gains, the socialization of losses. ... Traders are given every incentive to take risk and generate short-term profits.”

This book, like many other accounts, also describes a culture where lying to clients, investors and regulators is pervasive. The worst consequences of corporate fraud, when it is caught, are usually fines paid by the corporation without any individual named or held accountable, which do not help change people’s behaviors. Worse, current regulations still fail to do enough to protect the public from the distorted incentives for excessive risk-taking in banking.

Our persistently unstable financial system fuels repeated cycles of boom, bust and crises — the most intense and harmful of which involve excessive borrowing. In credit booms, too many loans are made, including some that are wasteful and misdirected. Those who borrow too much in the boom often suffer harsh consequences in the bust. Widespread distress prolongs recessions.

Heavy borrowing is addictive. Distressed homeowners may be tempted to take a second mortgage. Similarly, heavily indebted corporations often continue borrowing even if doing so depletes their assets, because it benefits their shareholders and managers, who control the decisions and benefit from the full upside of risk. But this is at the expense of creditors or taxpayers, who are harmed by the increased likelihood of larger losses.
To protect their interest, prudent lenders monitor and set harsh terms when lending to distressed borrowers, which makes heavy borrowing unattractive for corporations. Without any regulations and despite tax codes that encourage corporations to use debt instead of equity funding, healthy corporations outside banking rarely fund more than 70 percent of their assets by debt and many successful firms borrow little (actual ratios depend how assets are valued). Profits are a popular source of unborrowed funds, and corporations can also sell new shares to invest and grow.

In contrast, debt addiction is especially intense in banking, and this addiction is not properly countered by market forces in part because banks tend to have passive creditors. Insured depositors, or lenders entitled to seize some of the banks’ assets ahead of depositors if the bank fails to pay them, don’t monitor banks’ risk or impose harsh terms. Deposit insurance guarantees, access to central bank supports and the possibility of government bailouts, combined with the tax subsidization of debt, perversely feed and enable debt addiction. Only effective regulations can correct the resulting harm and inefficiencies of this situation.

Excessive borrowing by lenders such as banks is a key source of financial instability. Those who feed credit booms by lending too much, however, both the institutions and the key decision-makers within them, tend to suffer least in the bust. Deposit insurance, central banks and governments often protect banks and their creditors, especially in a crisis. When lenders become distressed or insolvent “zombies,” they can become reckless and dysfunctional. Yet, policymakers routinely tolerate weak banks, which can harm economic recovery.

Key regulations that are meant to make banks safer and healthier remain inadequate, and the flawed design of existing regulations adds further distortions. Bankers and policymakers provide false reassurances about the health of institutions and of the system. Many flawed and misleading claims are made about the costs and benefits of making the system safer, muddling the policy debate and confusing the public. Institutions considered too big to fail are especially dangerous, as their implicit guarantees enable and encourage them to become inefficiently large, complex and reckless. The risks they take are often obscured from investors and regulators. Implicit subsidies to the entire financial sector may cause it to become too large, distorting markets and competition.

The conflict of interest between bankers and society is made worse by counterproductive parts of the tax and bankruptcy laws that perversely enable and reward dangerous conduct such as excessive borrowing. Those laws should be changed.

The main obstacle to improving the banking system is political. Too many of those involved in controlling this system either have other priorities or seem unwilling to challenge a powerful industry. Policymakers charged with protecting the public put our money, and our economy, at excessive risk.

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