Ten Years after the Financial Crisis: What Have We Learned?

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LESSON 0
The financial system can cause enormous harm

Policy implications depend on causes and tradeoffs
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)

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“The Sequel to the Financial Crisis is Here”
Financial Times, July 31, 2017

“High credit ratings have hidden a structural instability...”  - Frank Partnoy

Italy political crisis hits financial markets
BBC News, May 29, 2018

"62% increase in breaches in 2013"  "1 in 5 organizations have experienced an APT attack"  "US $3 trillion total global impact of cybercrime"

"8 months is the average time an advanced threat goes unnoticed on victim’s network"  "2.5 billion exposed records as a result of a data breach in the past 5 years"
Natural Disaster? Sudden “Shock?” “100-year flood?”

A Liquidity Problem?

“A Classic Bank Run?”
[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.


“What we need is good regulation. It’s really not a question of more or less…it’s to make sure it’s good and effective.”

Jamie Dimon, SIEPR, 2010

The Lobbyists’ Perspective

“When the President signed the financial reform law, that was half time.”
Who makes decisions for the institution?

What information and constraints do (should they) have?

What are (should be) their motivations?

Is the outcome “socially efficient?”

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.
LESSON 1
Banks use inefficiently and unnecessarily little equity funding

“Equity is Expensive” is based on flawed claims in a policy context.

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.
JP Morgan Chase: “Fortress?”
Dec. 31, 2011 (in Billions of dollars)
Tough Reforms?

3% 5% 6%
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
LESSON 2

Rules in banking are overly complex, poorly designed, and inadequate

They allow risk to be obscured and add distortions
### 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: <strong>2%</strong></td>
<td>“Common Equity Tier 1 Capital” to risk-weighted assets (RWA): <strong>4.5%</strong></td>
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<tr>
<td></td>
<td>» Plus 2.5% conservation buffer</td>
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<tr>
<td></td>
<td>» Plus 1.5% “Tier 1” to RWA</td>
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<tr>
<td>“Tier 2” Loss-absorbing debt</td>
<td>Leverage Ratio: “Tier 1” to total</td>
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<td></td>
<td>» Basel III: <strong>3%</strong></td>
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<tr>
<td></td>
<td>» US: BHC: 5%, insured banks: 6%</td>
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<td></td>
<td>“Tier 2”/TLAC (“loss-absorbing debt”).</td>
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“Tripling almost nothing does not give one very much.”

Regulatory Measures are Uninformative

"Tier 1" capital ratios: What crisis?

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

"No crisis" banks
"Crisis" banks
8% threshold
Lehman failure 15 Sep 08

2006 was a great year in banking

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

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).

From: Andrew Haldane, "Capital Discipline," January 2011
Regulatory Measures are Uninformative

“Tier 1” capital ratios: What crisis?

Market-based measures

Bad Regulations Matter

The Awful Case of Greece

French banks owned 40% of Greek government debt in 2010. Regulations (still) assume such loans are riskless (0 risk weight).

BIS (2014), Company Data, EBA (For 2010-11 Greece Exposure Data), German Bankers Association, Morgan Stanley Research
Leading creditors (in euros)

<table>
<thead>
<tr>
<th>Country</th>
<th>EU bailout loans</th>
<th>Private banks</th>
<th>Other</th>
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<tbody>
<tr>
<td>Germany</td>
<td>68.2bn</td>
<td></td>
<td></td>
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<tr>
<td>France</td>
<td>43.8bn</td>
<td></td>
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<tr>
<td>Italy</td>
<td>38.4bn</td>
<td></td>
<td></td>
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<tr>
<td>Spain</td>
<td>25bn</td>
<td></td>
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<tr>
<td>IMF</td>
<td>21.4bn</td>
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<tr>
<td>ECB</td>
<td>18.1bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>13.4bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>11.4bn</td>
<td></td>
<td></td>
</tr>
<tr>
<td>UK</td>
<td>10.8bn</td>
<td></td>
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<tr>
<td>Belgium</td>
<td>7.5bn</td>
<td></td>
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<tr>
<td>Austria</td>
<td>5.9bn</td>
<td></td>
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<tr>
<td>Finland</td>
<td>3.7bn</td>
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</table>

Source: Open Europe, BIS, IMF, ECB

The Economic Crisis In Greece
Real Output, (Index, pre-crisis peak = 100 1/)

U.S. Great Depression | Greece

Eurostat; Haver Analytics; and IMF staff calculations. 1/ Pre-crisis peaks are 2007 for Greece, 1997 for Asian crisis, 2008 for Eurozone crisis, and 1929 for Great Depression. 2/ Including Indonesia, Republic of Korea, and Thailand.
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

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
“Shadow Banking” (Partial Picture)
Pozsar, Adrian, Ashcraft and Boesky, 2010

The US System
"Without reform... another crisis is certain"

Mervyn King, (former Bank of England Governor)
End of Alchemy, 2016

LESSON 3

Too-Big-to-Fail institutions remain a perverse symptom of failed markets and rules

“Let fail” defies credibility
Size of 28 Global Banks

2006
$37.8 trillion total
Average
$1.35 trillion

2013
$49.2 trillion total
Average
$1.76 trillion

Sources: SNL Financial, FDIC, bank annual reports, Bank of England calculations.
Derivatives for 21 Banks

2006
$409 trillion (notional)

Average
$19 trillion

2013
$661 trillion (notional)

Average
$31 trillion

Sources: SNL Financial, FDIC, bank annual reports, Bank of England calculations.

“Too Big To Fail remains with us.”
Tom Hoenig (FDIC)
SIEPR, February 2018
LESSON 4

Confusion and politics can be a toxic mix

“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

"NONSENSE"
"Because we have substantial self-funding with consumer deposits, we don’t have a lot of debt"

John Stumpf, Wells Fargo Bank CEO, 2013

"HUH??"

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

John Stumpf, Wells Fargo Bank CEO, 2013
Banks are forced to hoard money and they can’t take any risks. Dodd Frank prohibits them from lending.

Gary Cohn, National Economic Council Director, February 3, 2017

“Banks are forced to hoard money and they can’t take any risks. Dodd Frank prohibits them from lending.

Gary Cohn, National Economic Council Director, February 3, 2017”
“Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.

Senator Richard Durbin (D-Ill), 2009

“%

“%

“It is difficult to get a man to understand something when his salary depends on not understanding it.

Upton Sinclair, author

”%
“It is difficult to get a politician to understand something when his campaign contribution depends on not understanding it.

“"
It is difficult to get a journalist to understand something when his access to news depends on not understanding it.

Excuses, Diversions, and Spin (Flawed Claims)

Much has been done
It’s very complicated
There will be “unintended consequences”
There are tradeoffs
We must maintain level playing field
etc., etc....
Many Enablers

Financial sector employees (sell side)
Institutional investors (buy side)
Executives and boards of financial/other firms
Auditors and rating agencies

Supervisors and regulators
Central bankers
Politicians
The media
Researchers/Economists, including in academia

“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


“I’m always aware of the limitations of analytical methods… I want to be very careful not to make claims I can’t support.”

Kenneth Arrow, 2017
LESSON 5

Market, Governance and Policy failures are not unique to banking

Political bargains can exacerbate rather than address market failures

Governments “vs” Markets?

False Contrast

Market

Government

Proper questions

Which activities are best done by private sector vs public sector?

How do we ensure that governments
+ design and enforce effective rules to enable markets to work properly
+ prevent abuse of power
Much of Arrow’s work, including the health work, is about how the market does not work. And yet so much of our public life is infected by market fundamentalism. Sad.

Sir Angus Deaton
Tribute to Kenneth Arrow
October 9, 2017

The Rub for Better Healthcare Policy in US is the lack of political will.

Victor Fuchs, SIEPR
February 5, 2018
“Purdue Pharma Knew Its Opioids Were Widely Abused”
(and the US government failed to intervene more aggressively)
New York Times, May 29, 2018

Faster, Higher, Farther: How One of the World's Largest Automakers Committed a Massive and Stunning Fraud

Jack Ewing, 2017, WW Norton
“Equifax Officially Has No Excuse”
*Wired*, September 14, 2017

“Facebook’s Ad Scandal Isn’t a ‘Fail,’ It’s a Feature”
*New York Times*, September 23, 2017
“Wells Fargo Leaders Reaped Lavish Pay Even as Account Scandal Unfolded”
*New York Times*, March 16, 2017

“Wells Fargo Hit with $1 Billion Fines Over Home and Auto Loan Abuses”
*NPR*, April 20, 2018

Is the justice system working in the corporate context?
The solution isn’t something we need to do economic research on. We need to figure out a political way to...stop this regulatory capture.

Fiona Scott Morton (Yale), SIEPR event, May 9, 2018

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."
LESSON 6
We can and should do better

Step out of silos, examine assumptions, communicate better, engage broadly and challenge

“I still believe that careful, rational discourse is what we need when dealing with large problems…. That’s the only hope I can think of.

Kenneth Arrow, 2017
“No to NAFTA” fits beautifully on a bumper sticker. The problem is how do we translate the data into narrative and storytelling?

Arturo Sarukhan, former Mexico Ambassador to US
SIEPR event, April 9, 2018
“

… 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, 2012

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**The New York Times**

*We’re All Still Hostages to the Big Banks*

By Anat R. Admati

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**BloombergView**

*Where’s the Courage to Act on Banks?*

Ben Bernanke and the Fed seem to have missed a key lesson of the financial crisis.

By Anat R. Admati

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**National Institute Economic Review**

*The Missed Opportunity and Challenge of Capital Regulation*

By Anat R. Admati
“There’s nobody better to tell me about Dodd-Frank than Jamie”

Donald Trump, February 2017

**Lessons Summarized**

Governance failures in the private and public sectors cause enormous **preventable** harm. The financial system is an extreme example.

We can and should do more to prevent abuse of power, including abuse thru obscuring reality.