Why Banks Still “Own the Place”

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Stanford University

Stigler Center, Chicago Booth
December 2, 2015

https://www.gsb.stanford.edu/faculty-research/excessive-leverage
http://bankersnewclothes.com/
What’s Wrong with Banking?

• **System is too fragile and inefficient** due to
  – Opacity, complexity, and interconnectedness
  – Excessive reliance on (short term) debt
  – Severe governance problems and distortions *that are not solved in markets*.

• **Flawed laws and regulations.**

• **Politics and lack of accountability.**
Size of 28 Global Banks

2006: $37.8 trillion total
2013: $49.2 trillion total

Average $1.35 trillion
Average $1.76 trillion

Sources: SNL Financial, FDIC, bank annual reports, Bank of England calculations.
The Largest Corporations in the World by Asset Size (Forbes, 5/2014)

- Fannie Mae
- ICBC
- ICBC Holdings
- HSBC Holdings
- BNP Paribas
- Mitsubishi UFJ Financial
- China Construction Bank
- JPMorgan Chase
- Agricultural Bank of China
- Deutsche Bank
- Bank of China
- Barclays
- Credit Agricole
- Bank of America
- Freddie Mac
- Citigroup
- Mizuho Financial
- Royal Bank of Scotland
- Société Générale
- Wells Fargo
- Banco Santander
- Sumitomo Mitsui Financial
- ING Group
- Lloyds Banking Group
- UniCredit Group
- UBS
- AXA Group
- Credit Suisse Group
- Allianz
- Bank of Communications
- London Stock Exchange
- Goldman Sachs Group
- MetLife
Derivatives for 21 Banks

2006: $409 trillion (notional)
2013: $661 trillion (notional)

Average $19 trillion
Average $31 trillion

Sources: SNL Financial, FDIC, bank annual reports, Bank of England calculations.
Global Banking Network
(Cross-Border Banking Claims)

IMF Global Stability Report, April 2014
“Shadow Banking,” Pozsar, Adrian, Ashcraft and Boesky, 2010
-2.5%

$20,000
$10,000
-10%

$20,000

-$20,000
Total Liabilities and Equity of Barclays 1992-07 (Source: Bankscope)

From: 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**

Loans = $700B <  
Deposits = $1.1T

Other debt (GAAP): $1T  
Other debt (IFRS): $1.8T

Equity (book): $184B  
Equity (market): $126B

Significant off-balance-sheet commitments

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<table>
<thead>
<tr>
<th>Cash</th>
<th>Loans</th>
<th>Deposits</th>
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<table>
<thead>
<tr>
<th>Trading and Other Assets</th>
<th>Other Debt (mostly short-term)</th>
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<tbody>
<tr>
<td></td>
<td>Long-Term Debt</td>
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<tr>
<td></td>
<td>Equity</td>
</tr>
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</table>

**GAAP Total $2.26 Trillion**

**IFRS Total $4.06 Trillion**
Credit Card Debt Surges in US

- $60B in new credit-card debt in 2014 Total is 55% higher than 2013.
- 18% say they expect never to pay off their debt
By Contrast: JPM Small (up to $1m) Business Loans
(Data from bank reports per CRA)

Source: Prof. Rebel Cole, DePaul University
### Complex Institutions with Many Non-Financial Subsidiaries

**Table 2.2: Breakdown by industry of subsidiaries of G-SIBs, 2013 (2007 in parenthesis)**

<table>
<thead>
<tr>
<th>Bank of America</th>
<th>72 (32)</th>
<th>17 (24)</th>
<th>584 (396)</th>
<th>322 (282)</th>
<th>915 (673)</th>
<th>1,910 (1,407)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays</td>
<td>54 (49)</td>
<td>16 (21)</td>
<td>465 (309)</td>
<td>380 (239)</td>
<td>824 (385)</td>
<td>1,739 (1,003)</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>103 (88)</td>
<td>68 (74)</td>
<td>323 (102)</td>
<td>760 (433)</td>
<td>1,338 (473)</td>
<td>2,592 (1,170)</td>
</tr>
<tr>
<td>Citigroup</td>
<td>111 (101)</td>
<td>41 (35)</td>
<td>456 (706)</td>
<td>650 (584)</td>
<td>1,039 (1,009)</td>
<td>2,297 (2,435)</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>30 (31)</td>
<td>4 (4)</td>
<td>89 (91)</td>
<td>52 (63)</td>
<td>67 (101)</td>
<td>242 (290)</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>68 (54)</td>
<td>8 (9)</td>
<td>541 (458)</td>
<td>618 (526)</td>
<td>889 (907)</td>
<td>2,124 (1,954)</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>15 (7)</td>
<td>10 (4)</td>
<td>74 (48)</td>
<td>121 (151)</td>
<td>200 (161)</td>
<td>420 (371)</td>
</tr>
</tbody>
</table>

“Corporate Structures, Transparency and Resolvability of Global Systemically Important Banks”
Jacopo Carmassi and Richard J. Herring, Aug. 2014
<table>
<thead>
<tr>
<th></th>
<th>Banks</th>
<th>Insurance companies</th>
<th>Mutual &amp; pension funds/nominees/trusts/trustees</th>
<th>Other financial subsidiaries(^1)</th>
<th>Non-financial subsidiaries(^2)</th>
<th>Total subsidiaries</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>HSBC</strong></td>
<td>89</td>
<td>37</td>
<td>309 (246)</td>
<td>298 (381)</td>
<td>832 (485)</td>
<td>1,565 (1,234)</td>
</tr>
<tr>
<td><strong>JPMorgan Chase</strong></td>
<td>54</td>
<td>13</td>
<td>305 (229)</td>
<td>205 (145)</td>
<td>518 (375)</td>
<td>1,095 (804)</td>
</tr>
<tr>
<td><strong>Morgan Stanley</strong></td>
<td>19</td>
<td>12</td>
<td>245 (225)</td>
<td>236 (170)</td>
<td>799 (610)</td>
<td>1,311 (1,052)</td>
</tr>
<tr>
<td><strong>Royal Bank of Scotland</strong></td>
<td>33</td>
<td>5</td>
<td>162 (168)</td>
<td>206 (450)</td>
<td>393 (483)</td>
<td>799 (1,161)</td>
</tr>
<tr>
<td><strong>Société Générale</strong></td>
<td>95</td>
<td>20</td>
<td>97 (93)</td>
<td>405 (270)</td>
<td>296 (387)</td>
<td>913 (844)</td>
</tr>
<tr>
<td><strong>UBS</strong></td>
<td>28</td>
<td>4</td>
<td>108 (121)</td>
<td>152 (66)</td>
<td>166 (199)</td>
<td>458 (417)</td>
</tr>
<tr>
<td><strong>Total by industry</strong></td>
<td>771</td>
<td>255</td>
<td>3,758 (3,490)</td>
<td>4,405 (4,263)</td>
<td>8,276 (6,729)</td>
<td>17,465 (15,512)</td>
</tr>
<tr>
<td><strong>% by industry</strong></td>
<td>4%</td>
<td>1%</td>
<td>22%</td>
<td>25%</td>
<td>47%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Note:** May 2013 and December 2007.

**Source:** Bankscope. Majority-owned subsidiaries.

\(^1\) ‘Other financial subsidiaries’ include hedge funds, private equity and venture capital subsidiaries.

\(^2\) ‘Non-financial subsidiaries’ include all companies that are neither banks nor insurance companies nor financial companies. They can be involved in manufacturing activities but also in trading activities (wholesalers, retailers, brokers, etc.). We have allocated foundations and research institutes to this category as well.
Opaque Institutions, Poor Disclosures

- Large banks are “uninvestable;” “complete black boxes.”
- “Much bank reporting has become so complex it has spiraled out of all control and meaning.” Deutsche Bank Research, May 2015
Top 20 banks paid $235B since 2008.

- Whose money?
- “Cost of doing business?”
- Have incentives changed?
- Who’s accountable?
- Too big to manage?
- Is this an efficient system that serves society?
Auditors Give False Reassurances

• None of the bailed out, failed, or forcibly acquired financial firms in US or UK (e.g., AIG, Citi, RBS) received "going concern" qualification from auditors before needing significant financial support or nationalization.

• PwC gave JPM a clean opinion on its internal controls over reporting for 2011; restatement after “London Whale.”
“Let Them Fail?”

- “Fail” is too late: instability would precede insolvency
- Bankruptcy or resolution are disruptive and harmful in the best case, whoever is paying the direct costs.
- Won’t work if entire industry is weak.
- Enormous legal challenges cross border.
  - FSB 2014 “Key Attribute of Cross-Border Resolution:” huge wish-list of legal and regulatory steps.
  - IMF 2014: *failure of cross-border SIFI “not a viable option”*
Equity: Self Insurance at Market Prices; Huge Benefits

- Reduces likelihood of distress, default, crisis, bailouts.
- Reduces likelihood of liquidity problems and runs.
- Shifts downside risk to shareholders who get upside.
- Reduces “deleveraging multiples,” distress sale intensity.
- Reduces TBTF subsidies, counters perverse incentives.
- Improves investment decisions: reduces excessive risk taking, likelihood of credit crunch from debt overhang.
- Helps “transmit” monetary policy to real economy.
The Mantra

“Equity is Expensive”

To whom? Why?
Only in banking?
History of Banking
Leverage in US and UK

- 19th century: banks were partnerships with unlimited liability; equity often over 50% of assets.
- Bank equity did not have limited liability everywhere in the US until 1940s.
- Equity ratios declined consistently to single digits.
- Growing “safety nets” played a role.
- Similar patterns elsewhere.

Some Facts

• Non-banks make risky, long term, illiquid investments.
• Without regulations
  – US average: 70% equity/assets (market value).
  – Nonbanks, including REITs and hedge funds, rarely have less than 30% equity (if healthy)
• Profits are popular source of unborrowed funding.
  – Berkshire Hathaway, Google, Microsoft.
• Banks with (sometimes much) less than 10% equity make routine payouts to shareholders.
Private Considerations

**DEBT**
1. Leverage Ratchet
2. Tax subsidies
3. Safety net benefits
4. ROE fixation

**EQUITY**
For Society, Excessive Leverage is “Expensive!”

DEBT
1. Leverage Ratchet
2. Tax subsidies
3. Safety net benefits
4. ROE fixation

EQUITY
1. Reduces systemic risk
2. Reduces cost of distress, default, crisis
3. Reduces excessive risk taking incentives
4. Better able to lend after losses
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)

Systemic Risk

Financial Markets And Greater Economy

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.

Debt Funding Equity

Systemic Risk Debt

Financial Markets And Greater Economy

Higher Stock Price
Happy Banker, Gains are private Losses are social. Lower Loan Costs?
Perverse Debt Subsidies

• Blanket subsidies to “lenders” enable and reward inefficient growth and ever more recklessness; credit markets are distorted.
  – More equity would address these distortions.

Banks are Special in...

• ...having passive creditors (e.g., depositors), and many supporters in central banks, governments, regulatory bodies, media, academia;
• ... harming in subtle and abstract way;
• ... getting away with so much inefficient recklessness.
How Much Equity?

• Basel II and Basel III Capital Requirements
  – Tier 1 capital Ratio: Relative to risk-weighted assets:
    • Basel II: 2%,
    • Basel III: 4.5% - 7%.
    • Definitions changed on what can be included.
  – Leverage Ratio: Relative to total assets:
    • Basel II: NA
    • Basel III: 3%.
    • US: 5% for large BHC, 6% for insured subs.
• Requirements based on flawed analyses of tradeoffs.
Is Basel III “Tough?”

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

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

The “Fortress Balance Sheet” Myth

Accounting measures don’t show crisis

High market values can mislead

From: Andrew Haldane, “Capital Discipline,” January 2011)
(See also “The Law of the Opposite: Illusionary Profits in the Financial Sector,” Godron Kerr)
Basel Regulatory Ratios Don’t Predict Failure!
ESRB Academic Scientific Committee report, June 2014

Figure 17: Global banks’ T1/RWA (%) in 2006

Risk weighting is highly problematic

• Flawed and complex “science illusion”.
• Manipulable
  – internal models
  – inflated credit ratings
  – off-balance-sheet commitments;
  – Derivatives; credit insurance
• Distort investments, e.g., government over business lending
• Exacerbates fragility and interconnectedness.
Basel Regulations and the 2010 “Greek Bailout”

Capital regulations view government debt as risk-free.

“Greek” bailout rewarded French, German, other banks for recklessness.

Similar: AAA rated securities, position protected by CDS.

Source: BIS (2Q14), company data, EBA (for 2010-11 Greece exposure data), German Bankers Association, Morgan Stanley Research
More Flaws in Basel Approach

- Hybrid alternatives are complex, unreliable, unnecessary.
  - Unreliable loss absorption; haven’t worked in the past.
  - Maintain overhangs and inefficiencies.
  - Triggers are problematic and destabilizing
  - Must worry about whether holders can absorb losses
    - *Dominated by equity for purpose of regulation.*

- If hybrids create equity “just in time,” prevent costly bankruptcy, should all firms use them instead of equity?
“Anything but Equity”

Too Much Leverage

Assets Before

“Straight” Debt

Equity

Hybrids

Assets Before

“Straight” Debt

Hybrid (coco, TLAC)

Equity

Simply Have More Equity!

Assets Before

“Straight” Debt

Equity
Regulators Failed to Intervene as Crisis Looms

From: “Dividend Policy and Capital Retention: A ‘Systemic First Response’,“
Eric Rosengren, Federal Reserve Bank of Boston, October 2010

- Dividend amounts Mid 2007-2008 top 19 almost half TARP (bailouts)
- TARP was effectively *debt with strings* after dividends had depleted *equity*

![Cumulative Cash Dividends and Capital Purchase Program Funds Received](image-url)
Are Stress Tests Reassuring?

- Projected ratios are poor indicators of health.
- Tests don’t properly address contagion dynamics.
- Models prone to fail, “unknown unknowns.”
- Benchmarks based on false presumption that equity is scarce and “costly.”
- Alternative market stress test of the business models: “raise a specific amount of equity!”
Confusions and Politics: Toxic Mix

bankersnewclothes.com

https://www.gsb.stanford.edu/faculty-research/excessive-leverage
Insidious Confusion re “Capital”

“US banks forced to hold $68 billion in extra cash”

*Telegraph*, April 8, 2014

**FALSE**
The Lobbying Cry

“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
“Bank capital is costly because, the higher it is, the lower will be the return on equity for a given return on assets.”

“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 journalist to understand something when his access to news depends on not understanding it.”

Upton Sinclair, author
“Credit and Growth will Suffer”

Credit and growth has *suffered* dramatically from financial Instability, not “too much” equity.

“just about whatever anyone proposes, no matter what it is, the banks will come out and claim that it will restrict credit and harm the economy.... It’s all bullshit.”

Paul Volcker to Senator Ted Kaufman, Jan. 15, 2010

*The Payoff: Why Wall Street Always Wins*, Jeff Connaughton, 2012
Flawed Excuses

• “We must protect ‘our’ banks in global competition.”
  – Correction: We must protect our citizens.

• “Tough regulations will increase the shadow banking system.”
  – Shadow banking grew from failure to enforce (lighter) regulation.
  – TBTF institutions are shadow hedge funds.
  – Avoid taxes? Allow robbery?
Financial Regulation: an Unfocused Mess

- Regulators have plenty of authority, lack *political will*.
- Complex, costly approaches taken as simple opportunities are missed.
- Checking box instead of protecting the public.
- Narratives and spin cover past and continued failures.
Who is System Working for?

“The few who understand the system will either be so interested in its profits or be so dependent upon its favours that there will be no opposition from that class, while the great body of people, mentally incapable of comprehending the tremendous advantage that capital derives from the system, will bear its burdens without complaint, and perhaps without even suspecting that the system is inimical to their interests.”

The Rothschild brothers of London, 1863