Banking and the Economics and Politics of Debt

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“Breaking the Bottlenecks: Steps towards Sustainable Growth”
Conference organized by Stanford and LBS Alumni in Greece
Athens, Greece, June 8, 2016
<table>
<thead>
<tr>
<th><strong>Households, Businesses, Banks, Governments</strong></th>
<th><strong>Borrow</strong></th>
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<tbody>
<tr>
<td><strong>Assets/Investments</strong></td>
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<td>Households</td>
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<td>• Houses, jewelry, etc.</td>
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<td>• Savings</td>
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<td>(Non-bank) Corporations</td>
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<td>• Cash/financial assets</td>
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<td>• Real assets</td>
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<td>Banks</td>
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<td>• Loans and other financial assets</td>
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<td>• (Non-financial assets)</td>
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<td><strong>Funding Sources</strong></td>
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<tr>
<td>Households</td>
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<td>• Mortgages/credit cards/loans</td>
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<td>• Wages/pensions/savings</td>
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<tr>
<td>(Non-bank) Corporations</td>
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<tr>
<td>• Bank debt, debt from bond investors</td>
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<tr>
<td>• Owners/shareholders equity</td>
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<tr>
<td>Banks</td>
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<tr>
<td>• <strong>Deposits</strong>, other debt</td>
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Heavy Borrowing Creates Inefficient “Overhang”

- Debt is a hard, legal commitment, IOU.
  - Debt magnifies risk
  - Debt must be paid, “restructured,” or borrower defaults.
  - Debt overhang interferes with borrower’s ability and willingness to fund new investments
  - Debt distorts decisions, becomes addictive
    - Intense borrower-creditor conflict biases investments
    - Borrower keeps borrowing if possible
    - Addiction is fed and enabled by guarantees and subsidies
+2.5%

$30,000
$20,000

DEBT
(MORTGAGE)

EQUITY
+5%

$40,000
$20,000
-5% 

$20,000 → $0
Total Liabilities and Equity of Barclays 1992-07

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

Too Little Equity

More Equity

溶剂？

A loss

资产价值

债务承诺

股权

股权吸收损失
Zombie (Insolvent) Banks

Symptoms

- Unable or unwilling to raise equity.
- “Gamble for resurrection” (bad, risky investments)
- Anxious to take cash out
- May sell assets, even at fire-sale prices
- Underinvest in worthy “boring” assets
- Try to hide insolvency, would not restructure loans
- Lobby policymakers for supports
Equity Can Prevent Crises, Bailouts and Harm

Too Little Equity → DISTRESS → DAMAGE TO THE ECONOMY

More Equity
The Mantra

“Equity is Expensive”

To whom? Why?
Only in banking?
Depositors
Short-term secured lenders
Long-term lenders
Shareholders
Government, Central Bank (Taxpayers)
Depositors
Private Considerations (Mostly Bank Managers)

**DEBT**
1. Leverage Ratchet
2. Tax subsidies
3. Safety net benefits
4. ROE-based bonuses

**EQUITY**
For **Society**, Excessive Leverage in Banking 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
Financial Markets And Greater Economy

Systemic Risk

Debt

Funding

Equity

Loans
Government Debt Subsidies:
1. Tax shield
2. Subsidized safety net, explicit and implicit

Financial Markets And Greater Economy

Systemic Risk

Debt

Funding

Higher Stock Price

Gains are private
Losses are social.

Lower Loan Costs?
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

Basel Capital Regulation
(No Science, highly complex)

**Basel II**

- “Common equity Tier 1 capital” to risk-weighted assets: 2%

- “Tier 2” Loss-absorbing debt

**Basel III**

- “Common Equity Tier 1 Capital” to risk-weighted assets (RWA): 4.5%
  - Plus 2.5% conservation buffer
  - Plus 1.5% “Tier 1” to RWA

- **Leverage Ratio: “Tier 1” to total**
  - Basel III: 3%
  - US: BHC: 5%, insured banks: 6%

- “Tier 2”/TLAC loss-absorbing debt.
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”

“Basel III, the Mouse that Did Not Roar,” Martin Wolf, *Financial Times*, Sep 13, 2010

“If a much larger fraction, at least 15%, of banks’ total, non-risk-weighted, assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.”

Regulatory Capital Measures Uninformative

Tier 1 capital ratios don’t show crisis

Market value/book assets ratios

From: Andrew Haldane, “Capital Discipline,” January 2011)
(See also “The Law of the Opposite: Illusionary Profits in the Financial Sector,” Godron Kerr)
How (Zero) Risk Weights Work

“Well Capitalized”

????????
“Well-Capitalized” Banks Fail on “Riskless” Assets
Making Equity Requirements Work

• Safe target, e.g., 30% allowed down to 20%.
  – *Measurement issues are critical*

• Prompt corrective action
  – Stopping payouts if risk builds up
  – Focus on amounts, not ratios

• Signs that regulation is working
  – Fewer “zombie” symptoms
  – Better governance
The Bad News

Regulatory reform is an unfocused, complex mess.

“Without reform... another crisis is certain.”

Bad Regulations Matter: The Case of Greece

- Swiss abrupt retreat.
- Fraction of Greek government debt in French Banks: 40% in 2010, 0.6% in 2015,
- “Greek” 2010-2011 bailouts rewarded French and German banks for reckless lending to Greece.
- Similar to AAA-rated securities or AIG.

The pattern:
• Banks made bad loans, tolerated and encouraged by bad regulations (zero risk weight assumes safe!)
• The public is left with losses and huge collateral harm.
• Regulatory failures are obscured and persist.
Greek Government Creditors in July 2015

- Eurozone: 60%
- European Financial Stability Fund: €141.8bn
- Greek Loan Facility: €52.9bn
- IMF: 10%
- European Central Bank: 6%
- Greek banks: 3%
- Other bonds: 15%
- Foreign banks: 1%
- Bank of Greece: 1%
- Other loans: 3%

Source: Open Europe
“Extend and Pretend” is Bad Policy

• All zombie borrowers are dysfunctional and; must be dealt with!
  — Zombie banks don’t make new loans, avoid restructuring NPL.

• “Extend and pretends”
  — Delays essential reforms
  — prolongs recession and harm
  — increases eventual cost.

• Everyone’s horizon is too short.
Politics and Confusion: A Toxic Mix

bankersnewclothes.com
Banks and Governments: Complex Relationships

- Governments own or give “charters” to banks
- Central banks support private banks and governments.
- Banks lend to governments.
- Governments provide public support to bank creditors through deposit insurance, loans, guarantees, etc.
- Governments must regulate banks to counter incentives to abuse privileged access to subsidized debt funding.
- Symbiotic relations interfere to create fragility and distortions.
Insidious Language Confusion

“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
Remarkably Safe: Is Banking more Complicated?

June 7, 2016
Spin and Narratives Maintain Dangerous, Distorted System

- “A lot has been done”
- “It’s very complicated”
- “The cost is too high”
- “There will be unintended consequences”
- “We must maintain level playing field”
- “We need more models”
  etc. etc............

Additional writings and materials are available at

https://www.gsb.stanford.edu/faculty-research/excessive-leverage

http://bankersnewclothes.com/