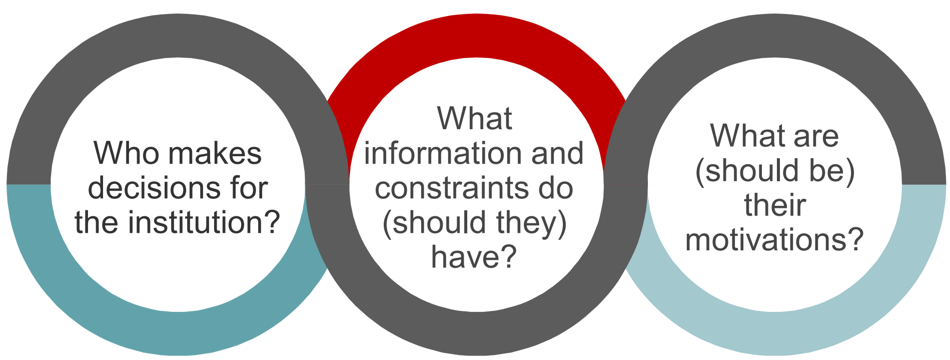
Governance in Finance: Politics, Confusion, and Missed Opportunities

Anat Admati
Graduate School of Business
Stanford University

5th IWH-FIN-FIRE Conference on "Challenges to Financial Stability"
Halle, Germany, August 19, 2019

Governance Questions (For All Institutions)



Is the outcome "socially efficient?"

Corporations: Key Features

Abstract legal entities

Separate from stakeholders

Derive existence and rights from governments and legal systems

- ✓ Property rights
- ✓ "Locked in" capital
- ✓ Limited liability
- ✓ Political speech (?)
- ✓ Religious (?)

> "The social responsibility of managers is to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom."

Milton Friedman (1970)

Standard View of Corporate Governance

Corporations "owned" by shareholders

Main challenge:

Align managers with shareholders

+ Financialized compensation
  - **Stocks and options**
  - **Accounting profits**
  - **Return on Equity**

Who are Shareholders and What Do They Want?

Individuals or institutions?

Diversified or concentrated?

Also employees or customers?

Ultimately citizens and taxpayers?

Actions taken in the name of "shareholder value"
may actually be harmful to most shareholders.

The Standard Approach to Corporate Governance…

Assumes…

All markets are competitive

Contracts and "rules of society" (laws, ethics) protect all impacted others

- Employees
- Customers
- Creditors
- The public

Ignores…

Some or most shareholder may not prefer highest stock price at all costs

The opacity of corporations

Diffuse corporate responsibility

Corporations' involvement in shaping rules and enforcement (politics!)

Incentives within government institutions

Regulatory capture, conflicted experts ("thin political markets")

"Yes, the planet got destroyed. But for a beautiful moment in time we created a lot of value for shareholders."

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THE WALL STREET JOURNAL.

TUESDAY, SEPTEMBER 16, 2008 · VOL. CCLII NO. 65 ★★★★ $2.00

AIG, Lehman Shock Hits World Markets

Focus Moves to Fate of Giant Insurer After U.S. Allows Investment Bank to Fail; Barclays in Talks to Buy Core Lehman Unit

By Susanne Craig, Jeffrey McCracken, Jon Hilsenrath and Deborah Solomon

The convulsions in the U.S. financial system sent markets across the globe tumbling, as two of Wall Street's biggest firms looked set to exit the scene and insurance titan American International Group Inc. turned to the Federal Reserve and the state of New York for assistance.

The U.S. stock market suffered its worst daily point plunge since the first day of trading after the Sept. 11, 2001, terrorist attacks. Financial markets were rattled by the rushed sale Sunday of Merrill Lynch & Co. and the bankruptcy-court filing of Lehman Brothers Holdings Inc., which scrambled Monday to sell its most-prized businesses before too many employees and customers walk out the door. (Please see related article on Page C1.)

All day Monday, top Lehman officials were huddled in Manhattan at their Seventh Avenue

ing. For much of the day, the major U.S. market indexes were down 2%, which, while a good-sized decline, was smaller than many had thought would be the case. But in the final hour of trading, a wave of selling hit, driven by concerns about the fate of AIG. The Dow Jones Industrial Average ended down 504.48 points on Monday, off 4.4%, at its daily low of 10917.51, down 18% on the year. Of the Dow industrials' 30 components, all but one—Coca-Cola Co.—fell, led by a 60.8% plunge in AIG.

In Europe, London's FTSE 100 index dropped 3.9%. Several Asian markets, including Japan and China, were closed Monday due to holiday. By Tuesday, Tokyo shares were down 5.1% in early trading, and Hong Kong's Hang Seng index was down 6.1%.

Monday's action was the latest fallout in a widening financial crisis that began a year ago with the fall of American housing prices and is now reordering the U.S. financial system. Steps unveiled by the Federal Reserve to expand its emergency lend-

AIG Faces Cash Crisis As Stock Dives 61%

By Matthew Karnitschnig, Liam Pleven and Serena Ng

American International Group Inc. was facing a severe cash crunch last night as ratings agencies cut the firm's credit ratings, forcing the giant insurer to raise $14.5 billion to cover its obligations.

With AIG now tottering, a crisis that began with falling home prices and went on to engulf Wall Street has reached one of the world's largest insurance companies, threatening to intensify the financial storm and greatly complicate the government's efforts

THE WALL STREET JOURNAL.

WEDNESDAY, SEPTEMBER 17, 2008 · VOL. CCLII NO. 66

U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up

Emergency Loan Effectively Gives Government Control of Insurer; Historic Move Would Cap 10 Days That Reshaped U.S. Finance

By Matthew Karnitschnig, Deborah Solomon and Liam Pleven

The U.S. government seized control of American International Group Inc.—one of the world's biggest insurers—in an $85 billion deal that signaled the intensity of its concerns about the danger a collapse could pose to the financial system.

The step marks a dramatic turnabout for the federal government, which had been strongly resisting overtures from AIG for an emergency loan or some intervention that would prevent the insurer from falling into bankruptcy. Just last weekend, the government essentially pulled the plug on Lehman Brothers Holdings Inc., allowing the big investment bank to go under instead of giving it financial support. This time, the government decided

surance businesses, giving the Fed some protection even if markets continue to sink. And if AIG rebounds, taxpayers could reap a big profit through the government's equity stake.

"This loan will facilitate a process under which AIG will sell certain of its businesses in an orderly manner, with the least possible disruption to the overall economy," the Fed said in a statement.

It puts the government in control of a private insurer—a historic development, particularly considering that AIG isn't directly regulated by the federal government. The Fed took the highly unusual step using legal authority granted in the Federal Reserve Act, which allows it to lend to nonbanks under "unusual and exigent" circumstances, something it invoked when Bear Stearns Cos. was rescued in March.

As part of the deal, Treasury

ance industries, while Wall Street has watched two of its last four big independent brokerage firms exit the scene.

The U.S. on Sept. 6 took over mortgage-lending giants Fannie Mae and Freddie Mac as they teetered near collapse. This Sunday, the U.S. refused to bail out Wall Street pillar Lehman Brothers, which filed for bankruptcy-court protection and is now being sold off in pieces. That same day, another struggling Wall Street titan, Merrill Lynch & Co., agreed to sell itself to Bank of America Corp.

The AIG deal followed a day of high drama in Washington. The Treasury's Mr. Paulson and Federal Reserve Chairman Ben Bernanke convened in the early evening an unexpected meeting of top congressional leaders. Late in the trading day Tuesday, anticipation that the government might assist the insurer

Lending Among Banks Freezes

By Carrick Mollenkamp, Mark Whitehouse and Neil Shah

Banks abruptly stopped lending to each other or charged exorbitantly high rates Tuesday, threatening to spread the troubles of American International Group Inc. and Lehman Brothers Holdings Inc. to a broad range of financial institutions and the global economy.

The breakdown came despite efforts by central bankers to keep money flowing. Central banks in the U.S., Europe and

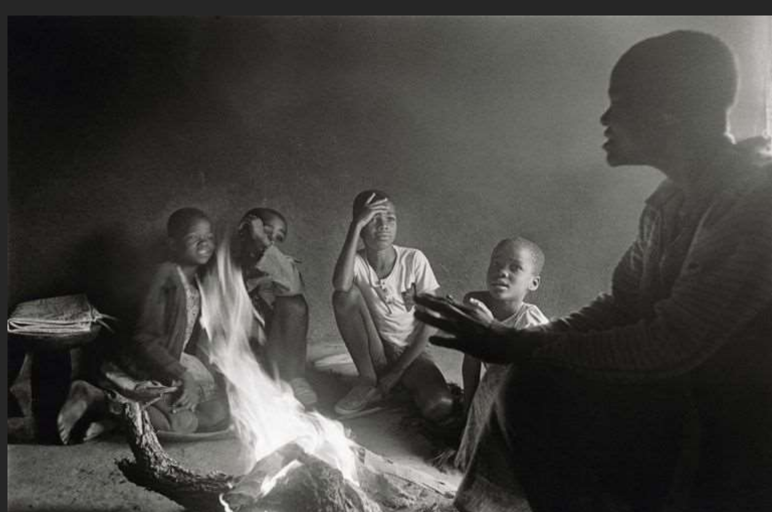
Kenneth Arrow, 1921-2017

"[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.

Kenneth Arrow, "Risky business," *Guardian*, October 15, 2008"

Crisis Narratives: What Happened?



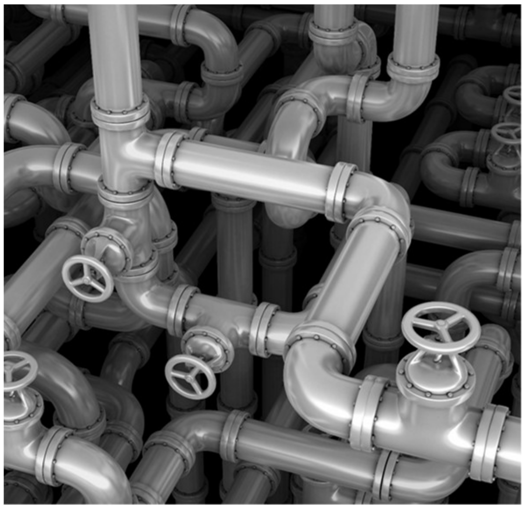
My daughter came home from school one day and said, ‘daddy, what’s a financial crisis?’

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” to Beliefs or Valuations?

A Liquidity Problem?



"A Classic Bank Run?"

FT
FINANCIAL TIMES

The sequel to the global financial crisis is here

High credit ratings have hidden a structural instability, writes Frank Partnoy

The dangers of complex investments, as highlighted by the film The Big Short, still loom large

Frank Partnoy JULY 31, 2017

Harvard Business Review

How a Cyber Attack Could Cause the Next Financial Crisis

by Paul Mee and Til Schuermann

SEPTEMBER 14, 2018

The Atlantic

How Climate Change Could Trigger the Next Global Financial Crisis

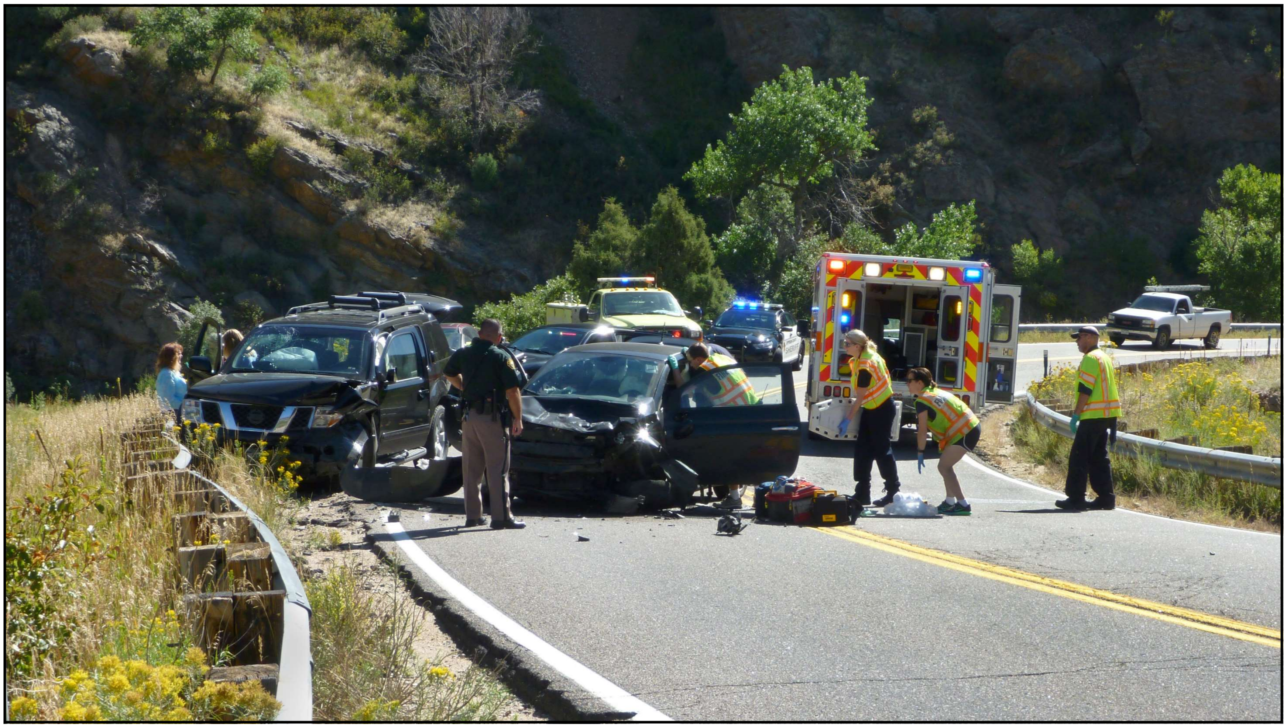
The Federal Reserve should act aggressively to reduce that risk, a leading economic historian argues.

ROBINSON MEYER AUG 1, 2019

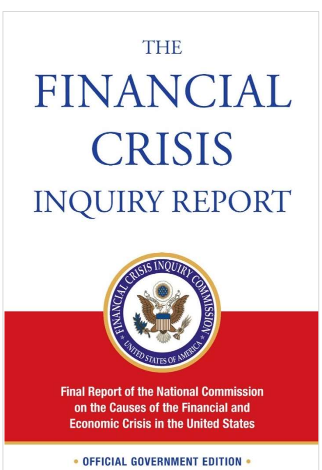
NGFS
Central Banks and Supervisors
Network for Greening the Financial System

Are financial crises preventable and if so, how?

Is the system working well as long as there are no "crises?"




SPEED
LIMIT
55



Delivered January 27, 2011

The financial crisis was avoidable

Widespread failures in financial regulation

Breakdown in corporate governance

Explosive and excessive borrowing.

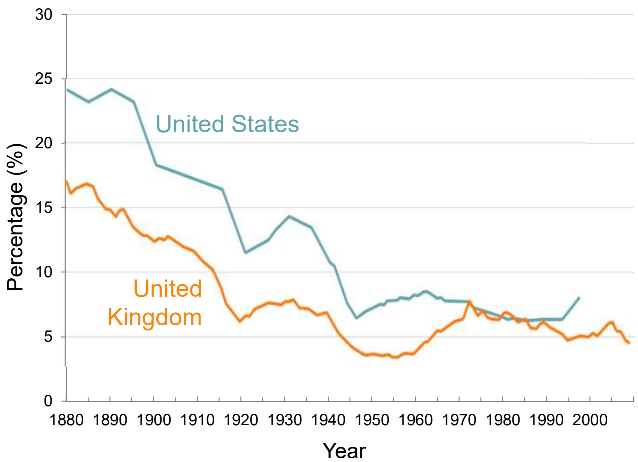
Lack of transparency

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.

Historical Equity/Asset Ratios in US and UK



Mid 19th century: 50% equity, unlimited liability

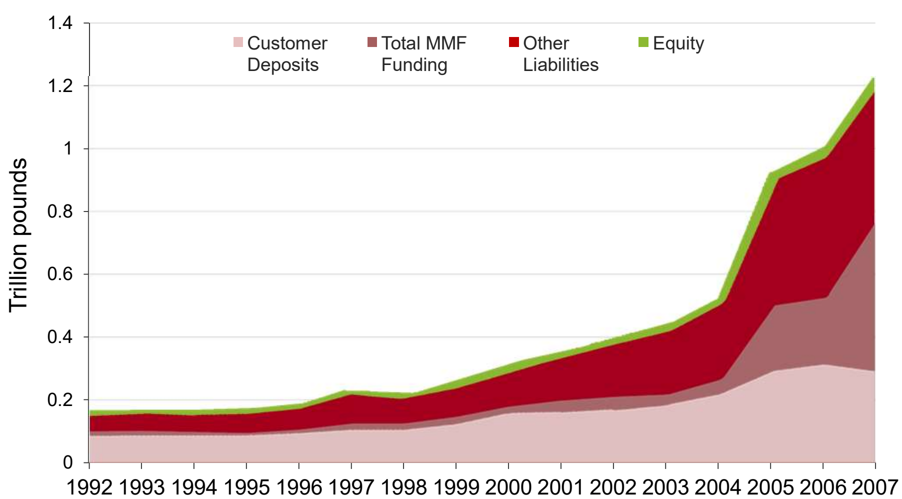
After 1940s, limited liability everywhere in US

"Safety nets" expand

Equity ratios decline

Alesandri and Haldane, 2009; US: Berger, A, Herring, R and Szegö, G (1995). UK: Sheppard, D.K (1971), BBA, published accounts and Bank of England calculations.

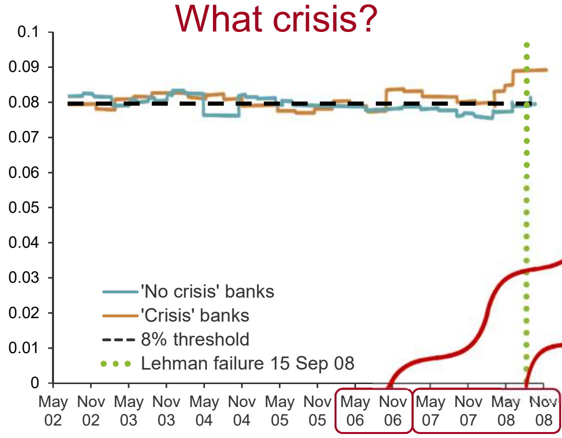
Total Liabilities and Equity of Barclays 1992-07



Hyun Song Shin, "Global Banking Glut and Loan Risk Premium," IMF Annual Research Conference, November 10-11, 2011; Figure 22.

Regulatory Measures are Uninformative

“Tier 1” capital ratios:
What crisis?



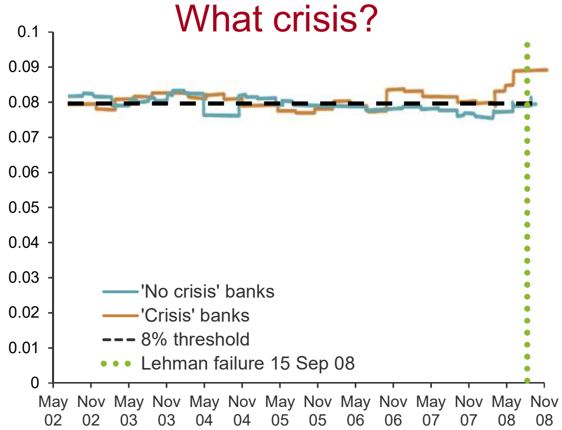
2006 was a great year in banking

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

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).

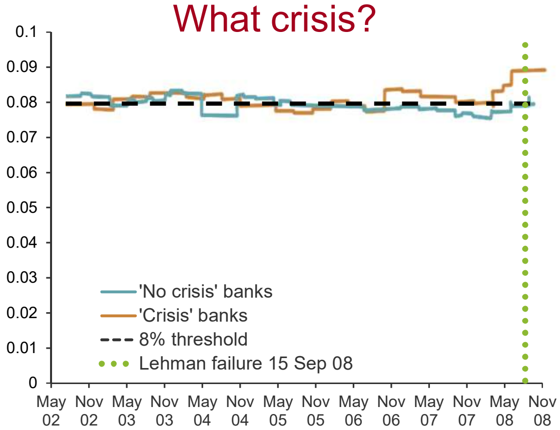
Fed committed $7.7 trillions in below-market loans to 407 banks.

“Tier 2 capital” proved useless to absorb losses (except Lehman).

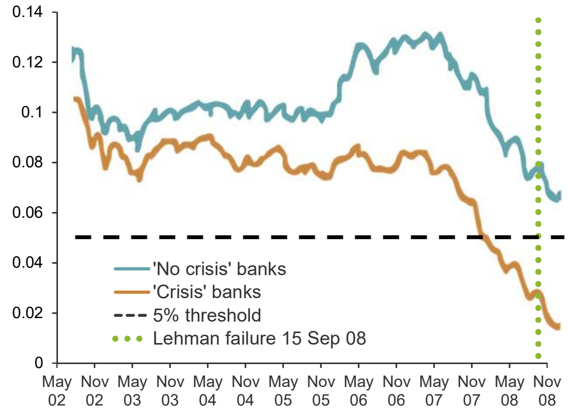
From: Andrew Haldane, “Capital Discipline,” January 2011

Regulatory Measures are Uninformative

“Tier 1” capital ratios:
What crisis?



Market-based measures



From: Andrew Haldane, “Capital Discipline,” January 2011

JPMorgan Chase Balance Sheet

Dec. 31, 2011 (in Billions of dollars)

The Mantra in Banking: “Equity is Expensive”

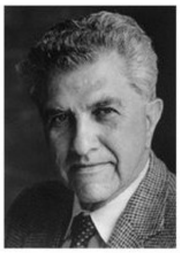
Expensive to whom?

Why?

Are banks so special and different that none of what we know about the economics of corporate funding applies?

Modigliani and Miller (M&M) and Banking

A Six-Decade-Long Debate



The main message of M&M (1958) is <u>NOT</u> 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

"

From Banking Textbook

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

Frederic S. Mishkin, 2013, The Economics of Money, Banking and Financial Markets, 3rd Edition, p. 227

"

“

From B… Textbook

Bank c… …use,
the … …er will
be t… …y for a
given … …ssets.

FALSE

Frederic S. Mishkin, 2013, The Economics of Money, Banking and Financial Markets, 3rd Edition, p. 227

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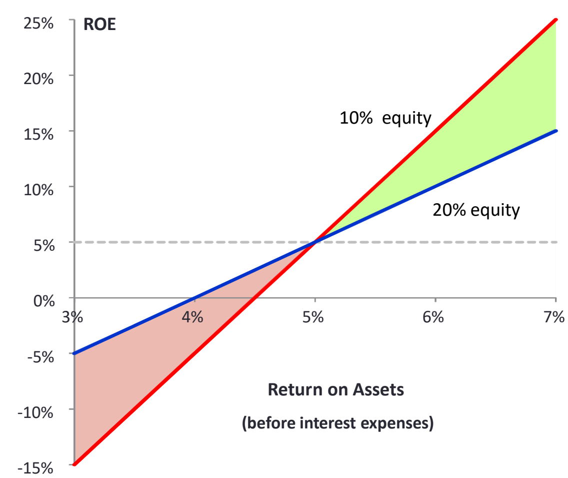
Equity, Risk, and Return on Equity (ROE)

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!



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.

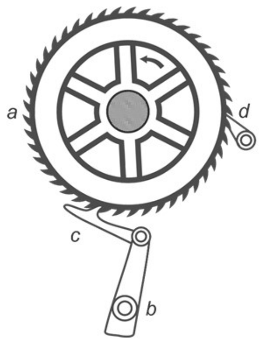
What is Money?

Except for cash, money is *somebody's* debt

Non-cash "money claims" generally have risk of default, unless central banks or governments provide guarantees.

The Leverage Ratchet Effect

Admati, DeMarzo, Hellwig and Pfleiderer, *Journal of Finance, 2018*



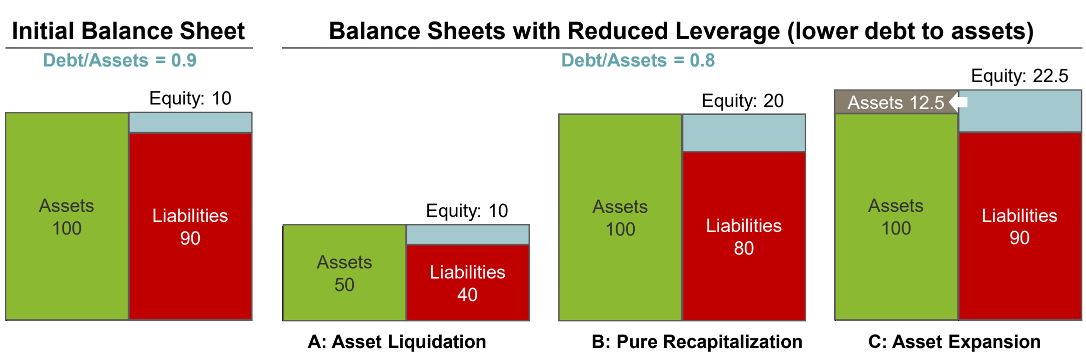
Debt contracts with imperfect commitment create biases and inefficiencies when on both sides of the balance sheet are taken to maximize "shareholder value"

Leverage adjustments are history-dependent and asymmetric, borrowing is addictive, begets more borrowing and creates strong resistance to any reduction

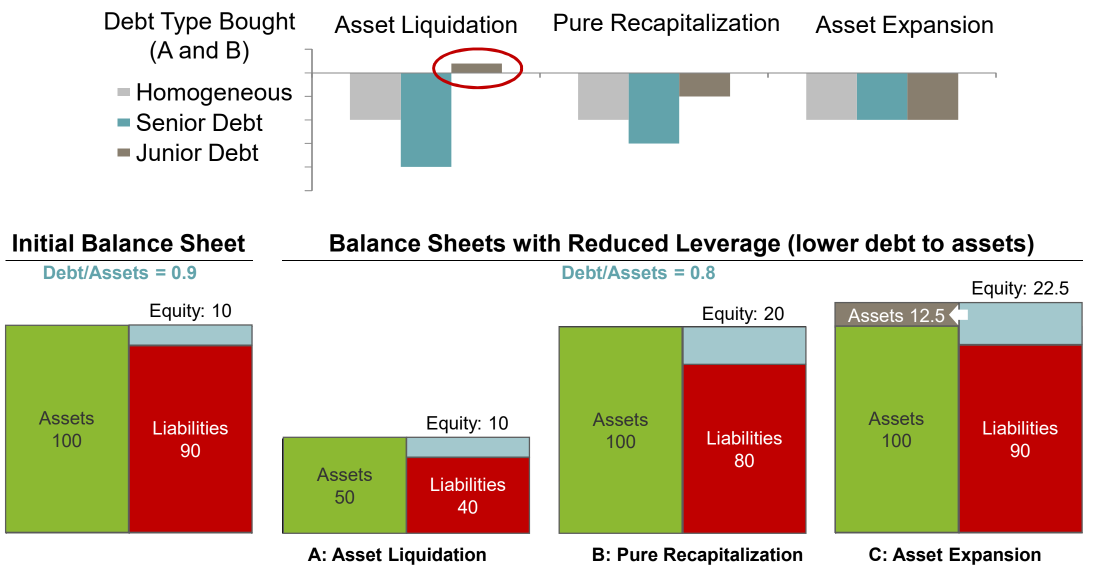
Asset sales even at distressed price are favored for leverage reduction (or survival)

Leverage Reduction with Asset Transactions

Three ways to reduce leverage ratio. Which way will shareholders choose (if forced)?



Shareholders' Preferences For Leverage Reduction



Banks vs Non Bank Corporations Leverage

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

Borrowing and Downside Risk

Heavily Indebted Non Banks (no safety net)	Heavily Indebted Banks (many supports)
May become distressed/insolvent	Ditto
Inefficient decisions	Ditto
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.

“Free” Markets Do Not Produce Efficient Outcomes in Banking

Bank

Depositors and other counterparties

Fragmented lenders.

Contracts work poorly to create commitments

Banks are inherently *inefficient*

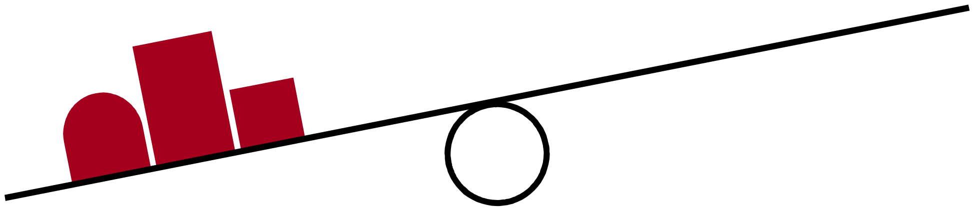
Safety nets exacerbated conflicts of interest

Regulation can help address

Reducing collateral harm is extra benefit

“Bank Leverage, Welfare and Regulation,” Admati and Hellwig, 2019

Private Considerations (Mostly Bank Managers)



More Debt

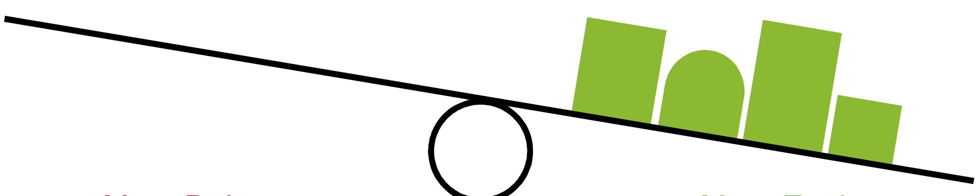
Others bear downside risk

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

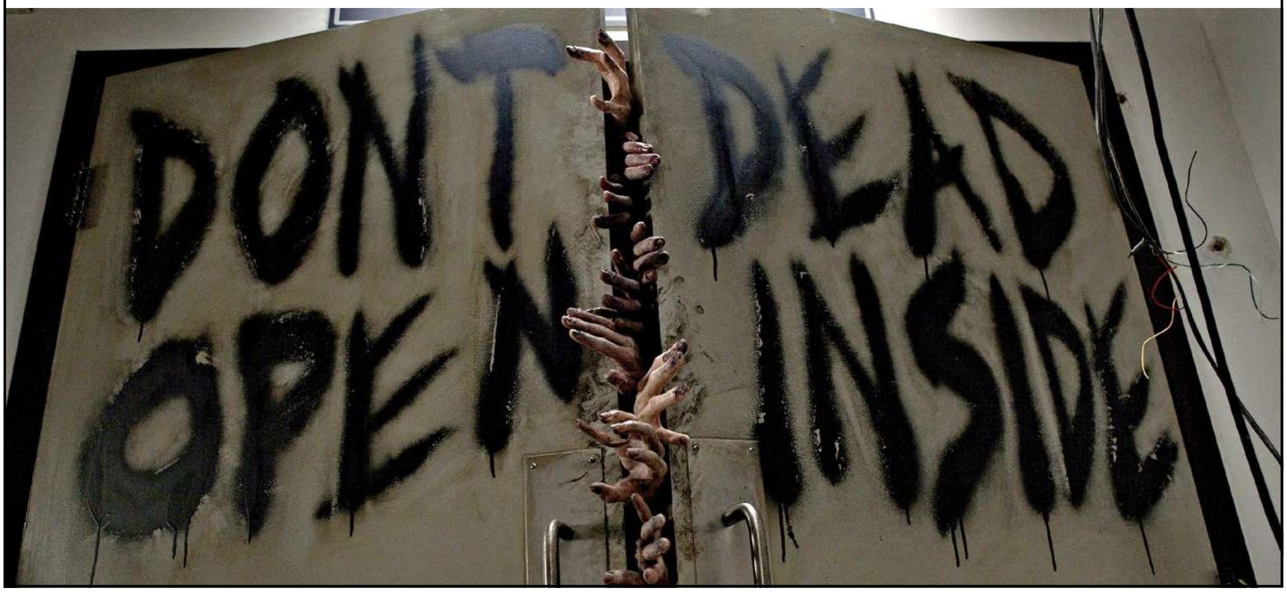
Reduces risk of runs and liquidity problems

Reduces risk and cost of insolvencies

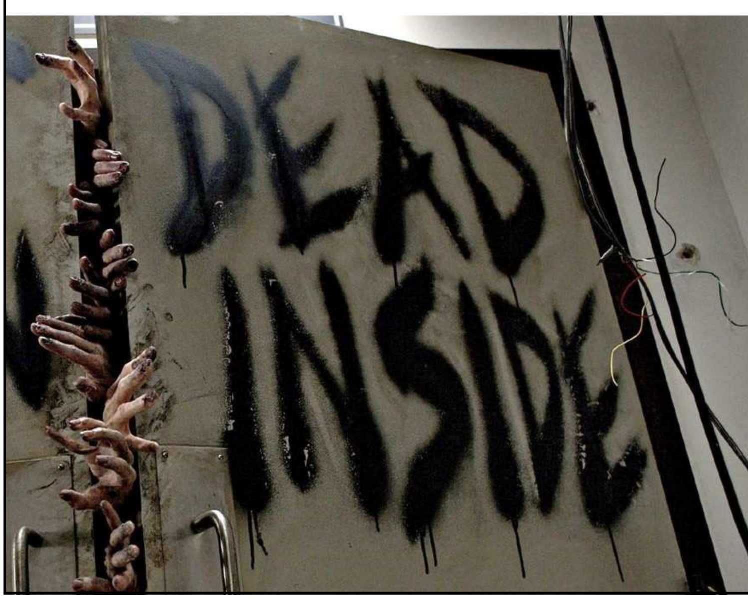
Reduces distortions in investments

Reduces distortive subsidies

Zombie (Insolvent) Borrowers: Opaque and Dysfunctional



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

FINANCIAL TIMES

Deutsche Bank: Show of strength or a fiction?

Three former employees tell US regulators that trades were valued in a way that hid billions in losses

© Bloomberg News

Tom Braithwaite, Michael Mackenzie and Kara Scannell DECEMBER 5, 2012 3

Josef Ackermann was bullish. Even as the global financial industry was reeling, the Deutsche Bank chief executive began 2009 by boldly declaring that his bank had plenty of capital and would return to profit that year.

Eric Ben Artzi First Reported DB Fraud to SEC March, 2011

August 18, 2016

Deutsche Bank whistleblower rejects award because SEC 'went easy' on execs

https://www.theguardian.com/business/2016/aug/18/desutsche-bank-whistleblower-turns-down-award

We must protect shareholders from executive wrongdoing

I turned down a whistleblower award, writes former Deutsche Bank employee Eric Ben-Artzi

ERIC BEN-ARTZI + Add to myFT

Opinion **Corporate culture**

Lessons from the Deutsche Bank whistleblower Eric Ben-Artzi

A corporate culture must allow employees to dissent, before they take it outside the company

MICHAEL SKAPINKER + Add to myFT

Eric Ben-Artzi © FT

Michael Skapinker AUGUST 24, 2016 18

Deutsche Bank AG + Add to myFT

How Deutsche Bank's high-stakes gamble went wrong

Over two decades, the institution went from sleepy German lender to the world's largest bank — only to plummet into a downward spiral that some claim has left it 'beyond repair'

Patrick Jenkins and **Laura Noonan** NOVEMBER 8, 2017 125

At its peak in the middle of 2007, Deutsche Bank claimed the title of the world's biggest bank, amassing total assets of close to €2tn.

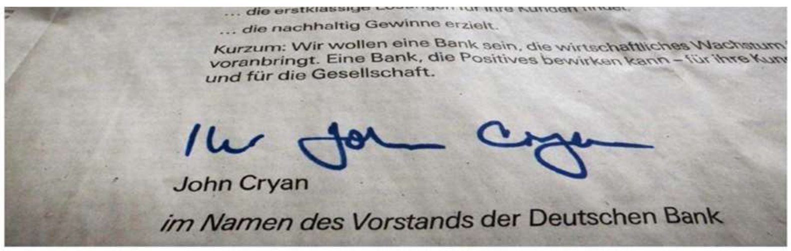
Over the 1995-2016 period, shareholders earned in net €7bn; Bonuses to traders were €71bn over same period.

February 6, 2017

Handelsblatt
TODAY

Deutsche Bank CEO Apologizes

In an unusual step, Deutsche Bank's CEO John Cryan has apologized to the German public in full-page newspaper ads for "serious errors" that cost the Frankfurt-based company its reputation and trust as well as billions of euros.

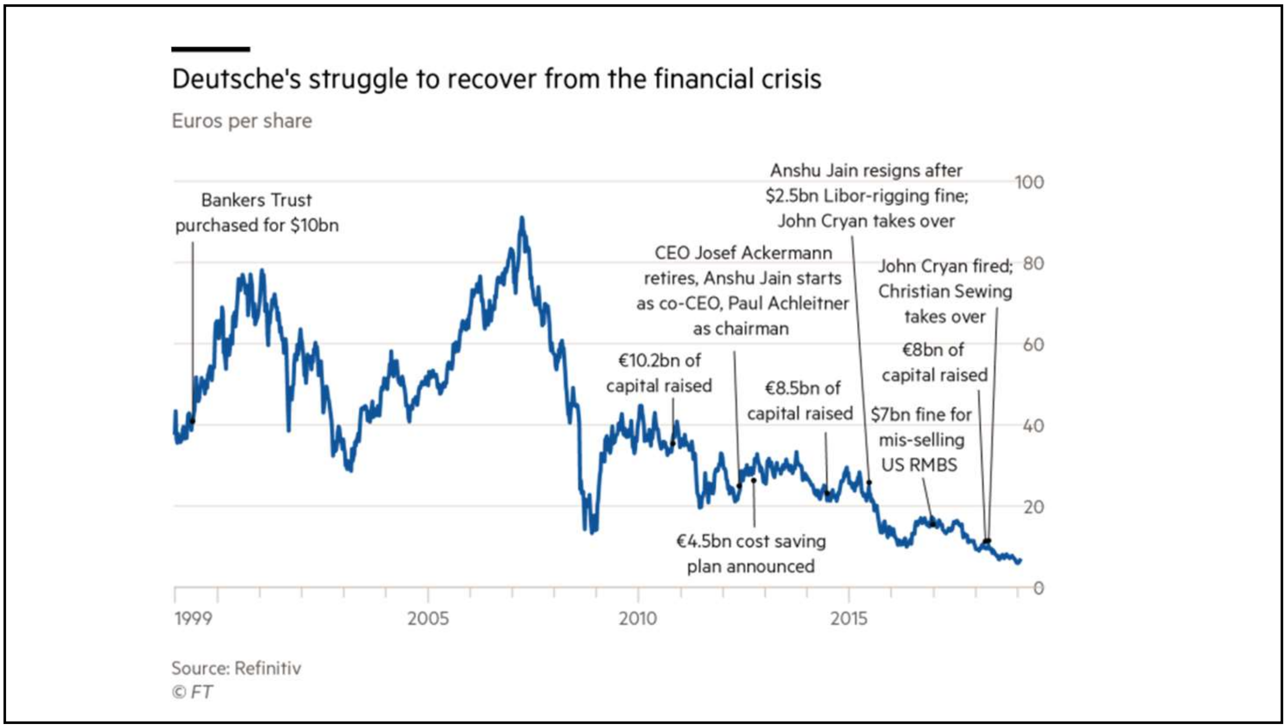


The Big Read Deutsche Bank AG + Add to myFT

Deutsche Bank gambles on a last throw of the dice

Mired in controversy for years, the lender is set to reveal yet another radical overhaul. But is Christian Sewing's plan 'too little too late'?

Patrick Jenkins and **Stephen Morris** in London and **Olaf Storbeck** in Frankfurt 111
JULY 5, 2019



Basel II: A spectacular failure

Basel III: An inadequate tweak

“a well-intended illusion”

Thomas Hoenig, April 2013

Basel "Capital Regulation"

(No proper justification)

Basel II (pre-crisis)	Basel III (reformed rules)
"Common equity Tier 1 capital" to risk-weighted assets: **2%**	"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" Loss-absorbing debt	"Tier 2"/TLAC ("loss-absorbing debt").

> "Tripling almost nothing does not give one very much."

Martin Wolf, "Basel III: The Mouse that Didn't Roar,"
Financial Times, Sep 13, 2010

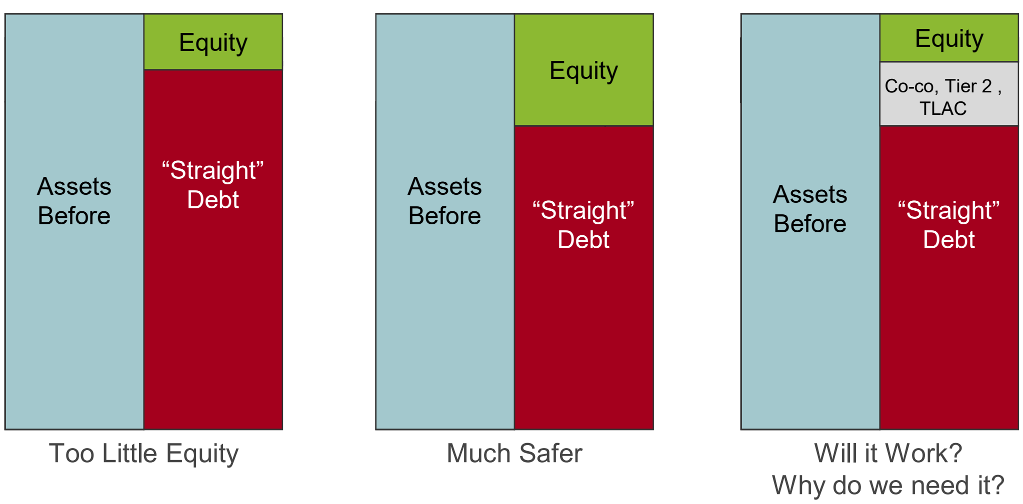
“If **at least 15%** of banks’ total assets were funded by equity, the social benefits would be substantial. And the social costs would be minimal, if any.

Temporarily restricting bank dividends is an obvious place to start.”

Anat R. Admati, Franklin Allen, Richard Brealey, Michael Brennan, Markus K. Brunnermeier, Arnoud Boot, John H. Cochrane, Peter M. DeMarzo, Eugene F. Fama, Michael Fishman, Charles Goodhart , Martin F. Hellwig, Hayne Leland, Stewart C. Myers, Paul Pfleiderer, Jean Charles Rochet, Stephen A. Ross, William F. Sharpe, Chester S. Spatt, Anjan Thakor

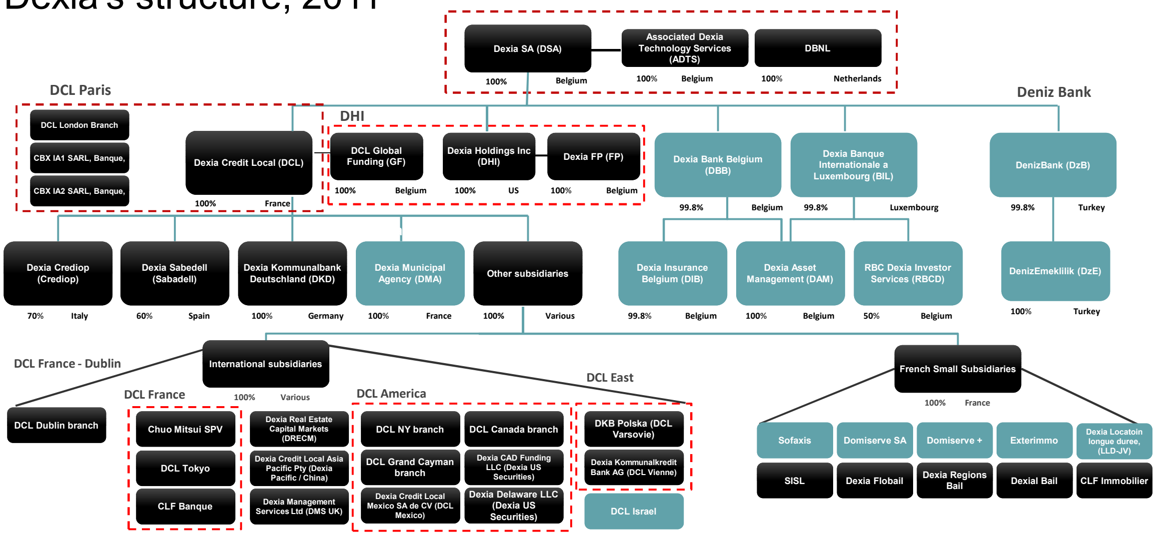
Financial Times, November 9, 2010

“Anything but Equity” Why?

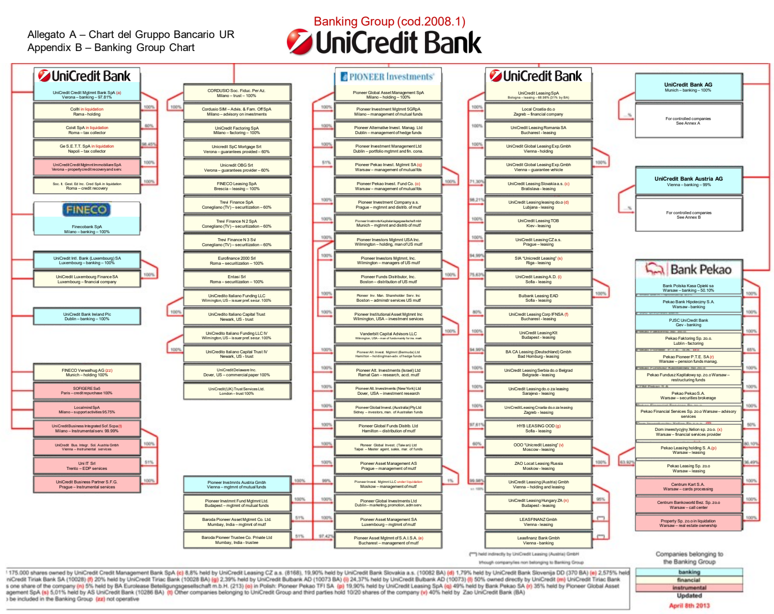


Too complex to Resolve?

Dexia's structure, 2011



UniCredit Simplified structure (2014)



https://studylib.net/doc/8411950/allegato-a---appendix-a.xlsx

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!

“Running on Empty,” John Cochrane, *Wall Street Journal*, March 1, 2013

”

Well-designed leverage regulation:
Not a silver bullet, but best bargain in regulation

Bank Stress Tests: False Reassurances

Inappropriate “pass” benchmarks

Numerous strong assumptions

Cannot predict contagion dynamics

- » Common and correlated exposures
- » Run dynamics
- » Derivatives and CCPs

Very costly!!

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”

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

“

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, correlation of “tail events.”

Manipulable, distortive, and political

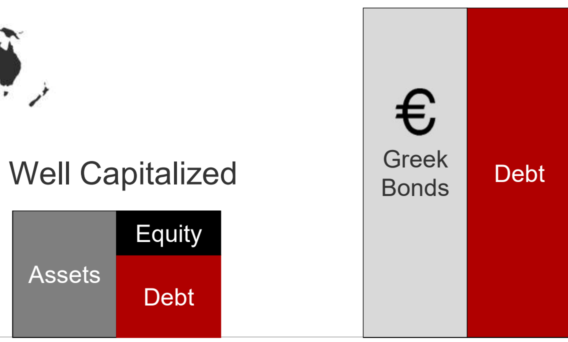
- » E.g., Favor government and traded assets over business lending

Already low equity levels mean RW are used to “economize” on equity

- » Add fragility, interconnectedness, systemic risk

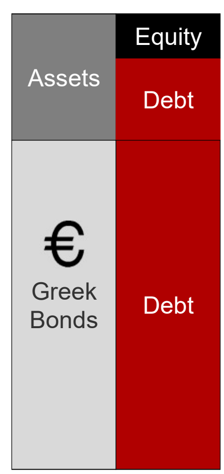
The Impact of (Zero) Risk Weights

Well Capitalized

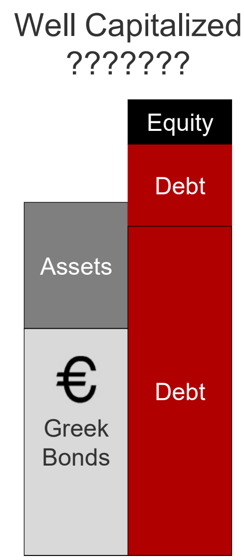


The Impact of (Zero) Risk Weights

Well Capitalized
???????

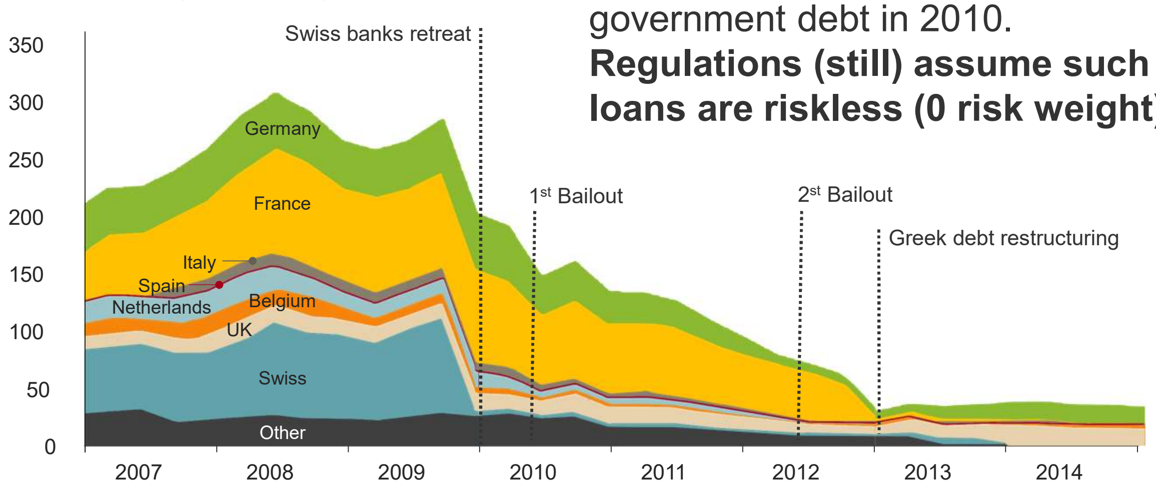


Riskless Debt?



Bad Regulations Matter

The Awful Case of Greece

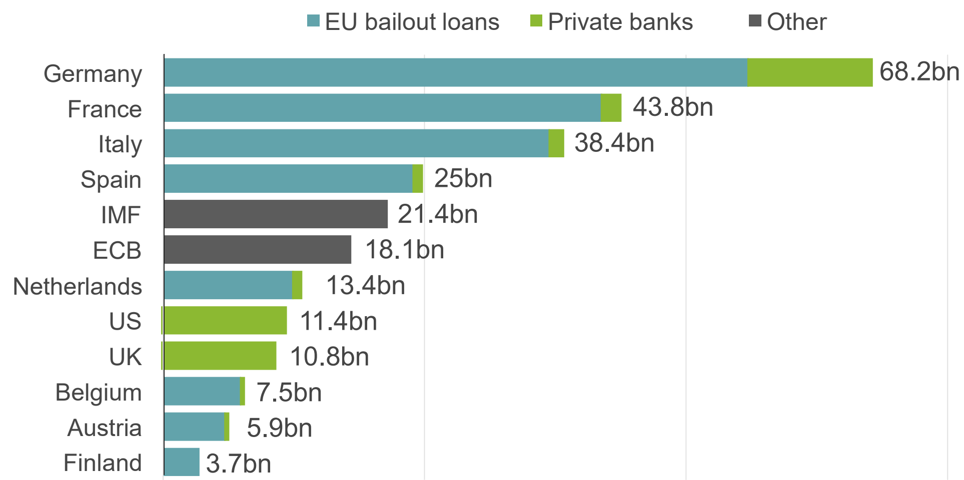


French banks owned 40% of Greek government debt in 2010. **Regulations (still) assume such loans are riskless (0 risk weight)**.

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

Who Owned Greek Government Debt, July 2015

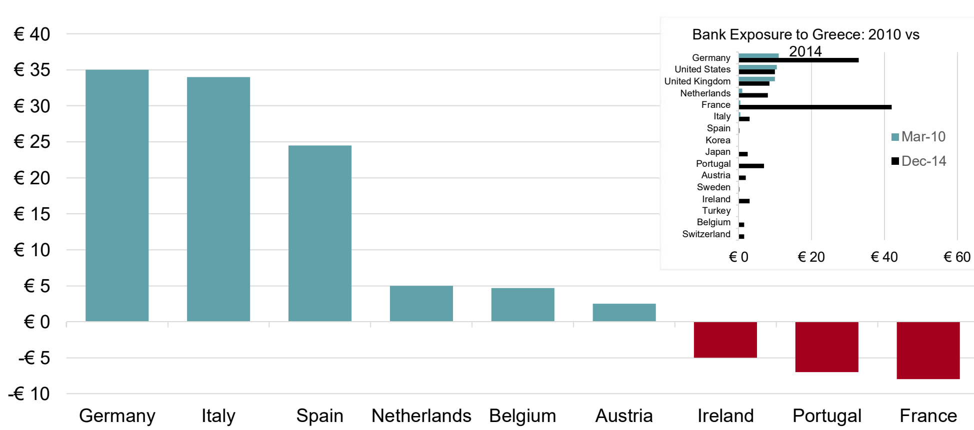
Leading creditors (in euros)



Source: Open Europe, BIS, IMF, ECB

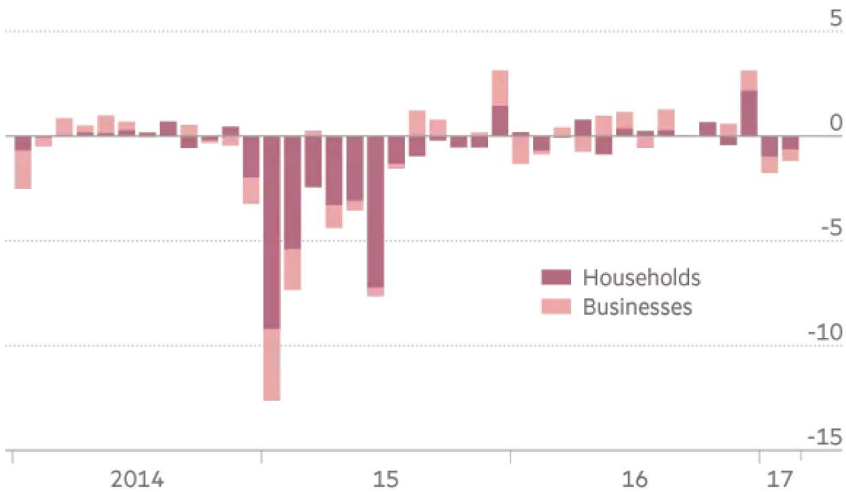
"Greek Bailout: Italy and Spain Funded a Massive Backdoor Bailout of French Banks," Ben Steil and Dinah Walker, July 2, 2015

Change in Combined Sovereign and Bank Exposure to Greece Since 2010



https://www.cfr.org/blog/greece-fallout-italy-and-spain-have-funded-massive-backdoor-bailout-french-banks
Data sources: BIS, EFSF, ECB, IESEG; Been Steil and Dinal Walker; blogs.cfr.org/geographics

Monthly deposit flow from Greek Banks



Source: European Central Bank, *Financial Times*

Greek Crisis 2010-2018

“We can only achieve a political union if we have a crisis.”
Wolfgang Schäuble, November, 2011.

“Embarrassment for Christine Lagarde and IMF”

The Independent, July 28, 2016

GREEK Greece REPORTER

German Ex-Finance Minister Schäuble Admits ”I Asked a Lot From The Greeks”

By Nick Kampouris - Mar 5, 2019

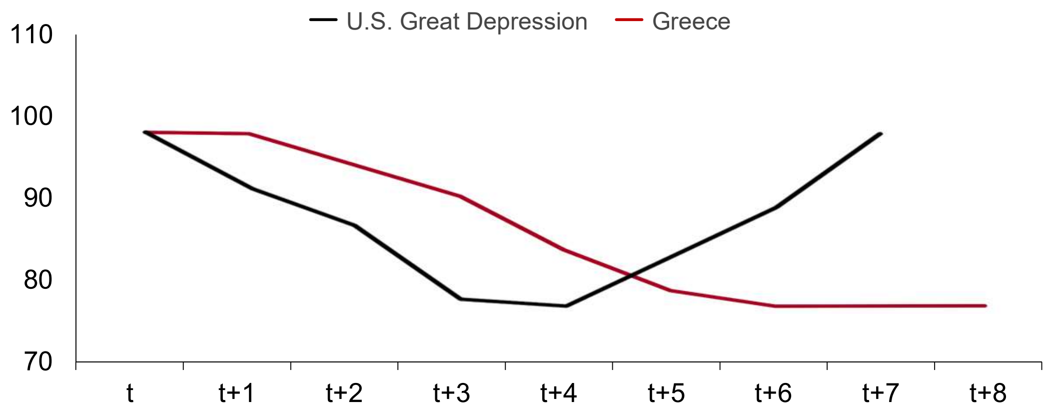
Wolfgang Schaeuble with former Greek Finance Minister, Yianis Varoufakis. File photo from 2015

Wolfgang Schäuble, the former Finance minister of Germany and the current President of the German Parliament, gave an interview to *Berliner Morgenpost* newspaper on Monday in which he admitted that he ”asked a lot from the Greeks” during the peak of the financial crisis.

Schäuble, who was one of the main political figures whose decisions shaped the course of the Greek and Eurozone financial crisis between 2010 and 2017, said that he had ”good reasons” to ask a lot from the Greek nation.

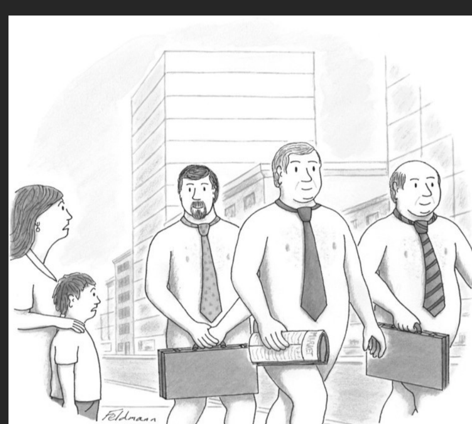
The Economic Crisis In Greece

Real Output, (Index, pre-crisis peak = 100 1/)



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.

Confusion and Politics: A Toxic Mix



http://bankersnewclothes.com/

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

“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.”

“Why Bankers are Intellectually Naked,” Martin Wolf, *Financial Times*, March 17, 2013

Politics of Banking

Symbiosis and “bargains” banks-governments

- “Banks are where the money is;” everyone needs banks
- “National champions”
- Guarantees appear free, social cost is invisible
- Central banks support governments and private banks
- Banks seem sources of funding, not risk
- Willful ignorance or confusion

Banks get away with inefficient recklessness.

“

Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.

Senator Richard Durbin (D-Ill), 2009

”

The Lobbyists’ Perspective

“When the President signed the financial reform law, that was half time.”

Bloomberg

Bank of Italy Knew for Years Paschi Masked Losses, Report Shows

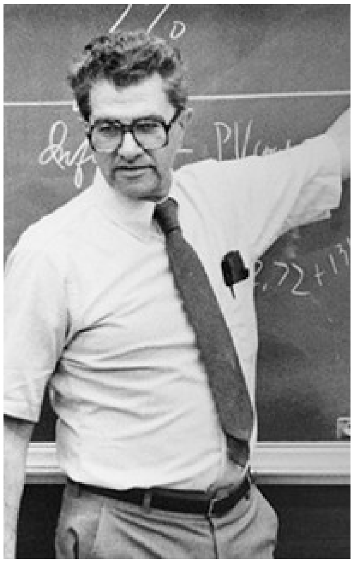
By Vernon Silver, Sonia Sirletti, and Sergio Di Pasquale
November 1, 2017, 9:01 PM PDT

- ► Central bank didn't alert prosecutors, Milan court told
- ► Deutsche Bank and ex-executives on trial for complex trades

Italy's central bank knew Banca Monte dei Paschi di Siena SpA papered over a loss of almost half a billion dollars two years before prosecutors were alerted to the complex transactions, documents revealed in a Milan court show.

A 2010 report from the Bank of Italy, headed at the time by Mario Draghi, now president of the European Central Bank, shows inspectors were aware that a 2008 trade struck with Deutsche Bank AG was the mirror image of an earlier deal Monte Paschi had with the German lender. The Italian bank was losing about 370 million euros ($431 million) on the earlier transaction, dubbed Santorini, as of December 2008.

Into the rabbit hole…



“The banker sitting next to me was lamenting the profitable lending opportunities being passed up by capital constrained banks, when I broke in to ask: “Then, why don’t they raise more capital?” . . . “They can’t,” he said. “It’s too expensive. Their stock is selling for only 50 percent of book value.” “Book values have nothing to do with the cost of equity capital,” I replied. “That’s just the market’s way of saying: We gave those guys a dollar and they managed to turn it into 50 cents.”

Merton Miller, “Do the M&M Propositions Apply to Banks?”
Journal of Banking and Finance,1995”

“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 regulator
to understand something
when his future job
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."

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

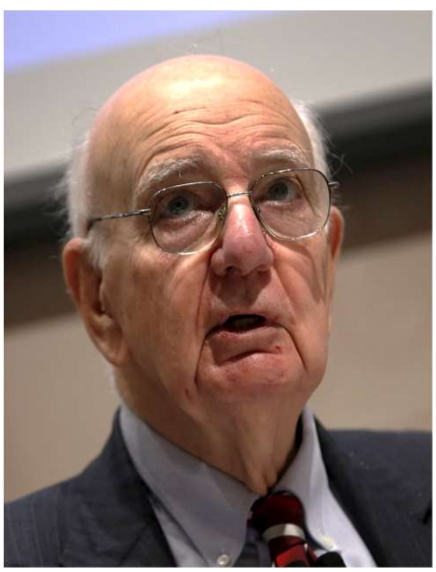
John Stumpf, Wells Fargo Bank CEO, 2013

"

Because we have
sub ... elf-
co ... sits,
we d ... a lot
of debt...

John Stumpf, Wells Fargo Bank CEO, 2013

"



"

Just about whatever anyone proposes… the banks will claim that it will restrict credit and harm the economy….
It's all bullshit

Paul Volcker, January 2010

(From *Payoff: Why Wall Street Always Wins*, Jeff Connaughton, 2012)

"

“More equity might increase the stability of banks. At the same time, however, it would restrict their ability to provide loans to the rest of the economy. This reduces growth and has negative effects for all.”

Josef Ackermann, Deutsche Bank CEO, November 20, 2009 interview

Is More “Credit” Always Good?

- Too much or too little; boom, bust, and crises
- Credit booms are main predictors of bust/crises
- Wasteful investments in boom
- Credit crunch (overhang) in bust exacerbates recession
- Risk weights bias lending

Credit is distorted by lenders’ extreme leverage and by bad regulation.

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

US banks old $68
billi sh.

, 2014

Every dollar of capital is one
less dollar working in the economy.

Steve Bartlett, Financial Services Roundtable, Sept 2010

“

Every d [illegible] is one
less doll [illegible] economy.

Steve Bartlett, Financ[illegible] Roundtable, Sept 2010

”

“

This rule will keep
billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015

”

“

This ep
billions conomy

Tim Pawlenty, Financi oundtable, July 2015

”

“

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 for[...]oney and they
ca[...]s.
Dodd Fran[...] from lending.

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

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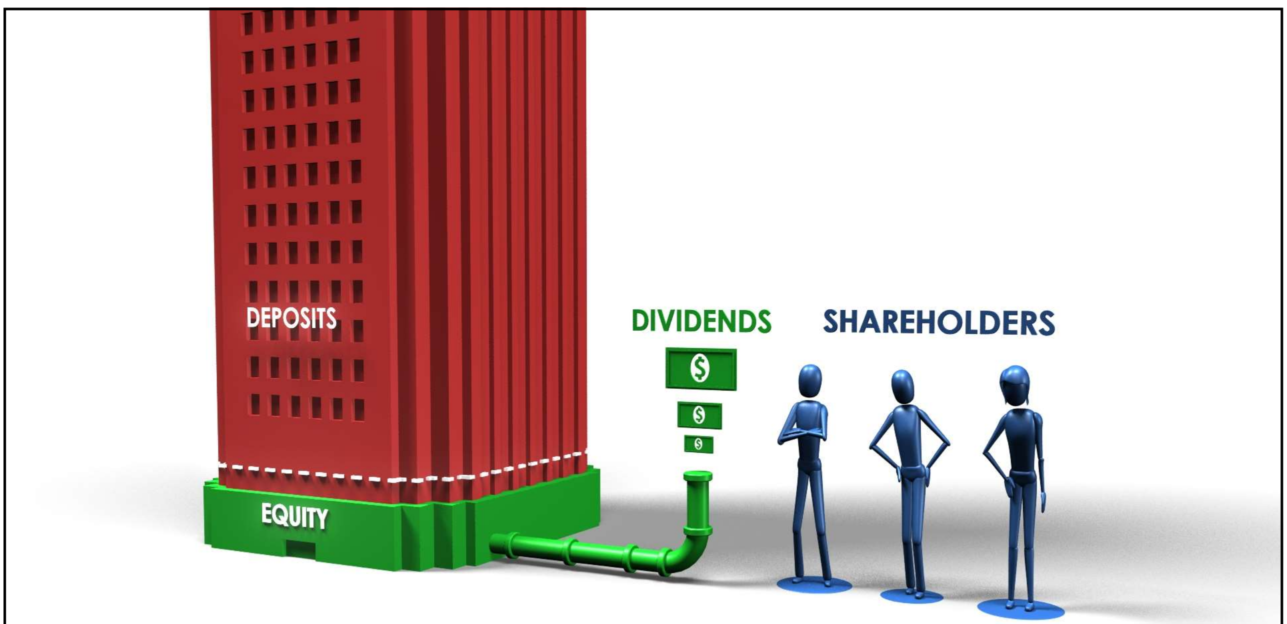


Excuses, Diversions, and Spin

"Much has been done

It's very complicated

There will be "unintended consequences"

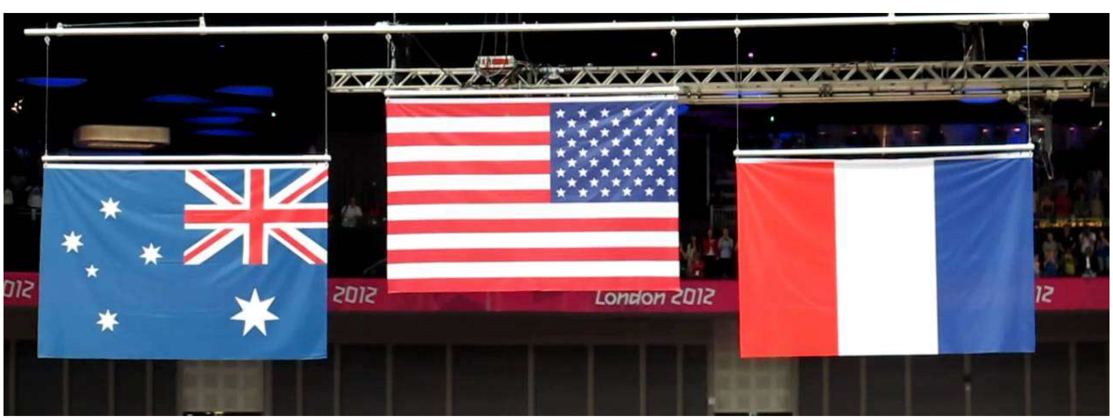
There are tradeoffs

We must maintain level playing field

etc., etc....

"The Parade of Bankers New Clothes Continues: 31 Flawed Claims Debunked," Admati and Hellwig, revised 2015

Classic Lobby Line: "Our Banks" Must Win in "Global Competition"



“I’m very close to thinking the United States shouldn’t be in Basel any more. I would not have agreed to rules that are blatantly anti-American. Our regulators should go there and say: ‘If it’s not in the interests of the United States, we’re not doing it.’”

Jamie Dimon, JPMorgan Chase CEO, September 11, 2011

He objected to both the additional buffer of 2.5 per cent and the way capital is calculated. Mortgage-servicing rights, a US market feature which takes cashflow from homeowners paying mortgages, are strictly limited in counting towards tier one capital.

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

Fear of “Shadow Banking” is an Excuse

Crisis exposed ineffective enforcement.

+ Rules are meaningless unless enforced properly.

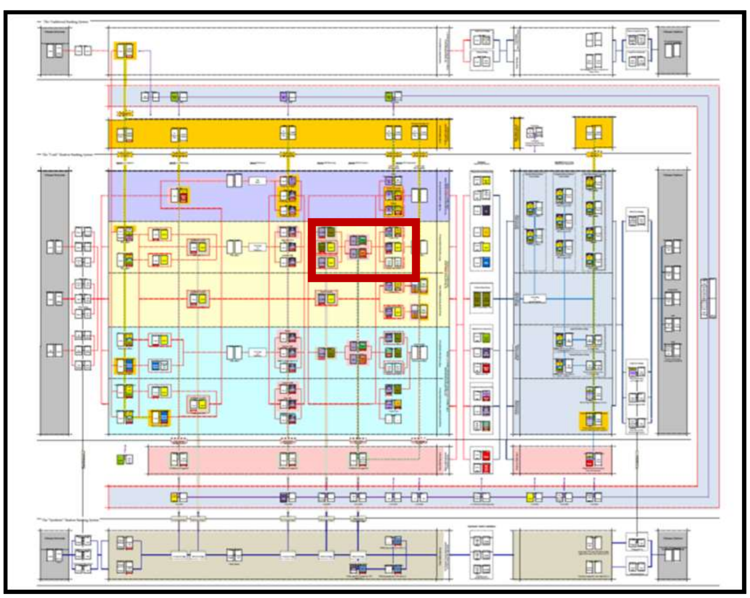
Enforcement challenge is invalid argument against regulation:

+ Allow robbery if robbers go to dark alleys?

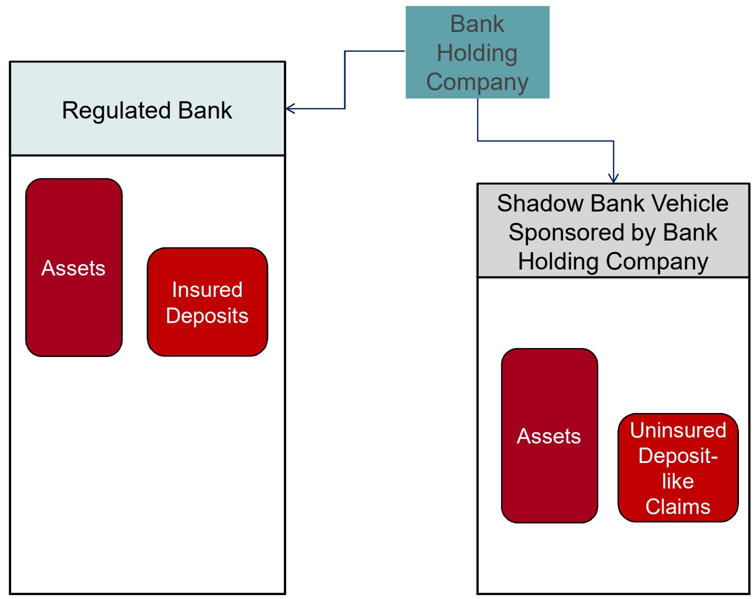
Regulators have sufficient authority to trace risk

Shadow Banking

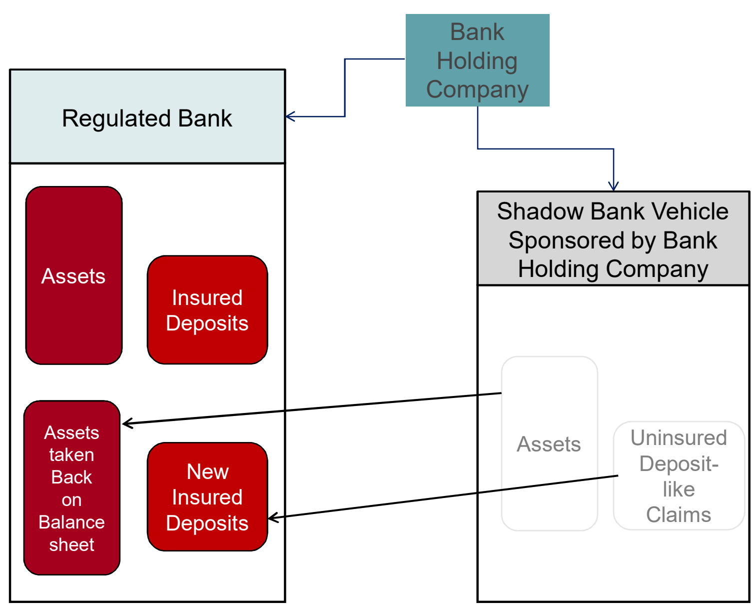
Pozsar, Adrian, Ashcraft, and Boesky, Federal Reserve Bank of New York, July 2010: revised February 2012



Special Vehicles In “Normal Times”



… and in “Troubled Times”



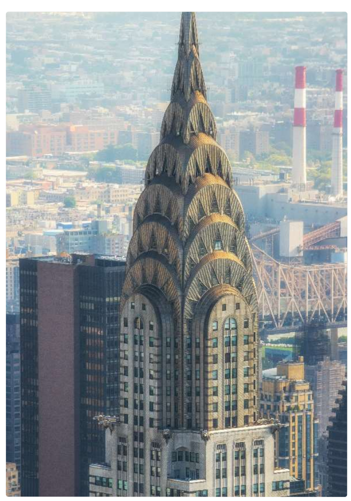
Financial "Innovation" and Regulatory Arbitrage

"These new rules will fundamentally change the way we get around them"

New Yorker, May 16, 2016

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 and Economists, including in academia**

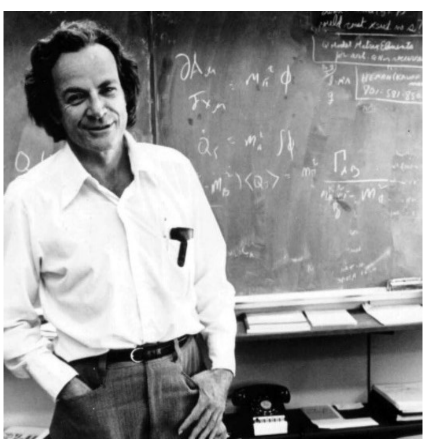
“

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,”
Anat Admati, in *Just Financial Markets: Finance in Just Society*, Lisa Herzog (ed.), 2017



“

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, *Economica*, 2018)

FINANCIAL TIMES

The Bank of England must think again on systemic risk

FEBRUARY 14, 2016 by: John Vickers

BBC

Vickers warns over weaker bank safety buffers

15 February 2016

The man who led an inquiry into the future safety of Britain's banks has said Bank of England plans are not strong enough.

Sir John Vickers, who headed up the Independent Commission on Banking (ICB), said: "The Bank of England proposal is less strong than what the ICB recommended."

In a BBC interview, he added: "I don't think the ICB overdid it."

February 15, 2016 10:54 pm

Bank of England rebuffs Vickers criticism

Martin Arnold

itv NEWS

Sir John Vickers: 'Bank of England stress tests not tough enough'

10 January 2017

Sir John Vickers wrote to the governor of the Bank of England, Mark Carney, on December 5th to express his concerns about the limitations of the stress tests and urged him to consider including a market-based test.

The Bank of England declined to comment on the issue although it stands by the credibility of the stress tests in their current form.

Mark Carney is due to appear before the Treasury Select Committee to answer questions about the recent Financial Stability Report on Wednesday.

Preventable harm by corporations in the name of “shareholder value” and government failures are pervasive

Faster, Higher, Farther: How One of the World's Largest Automakers Committed a Massive and Stunning Fraud
Jack Ewing, 2017

“Purdue Pharma Knew Its Opioids Were Widely Abused”

(and the US government failed to intervene more aggressively)

New York Times, May 29, 2018

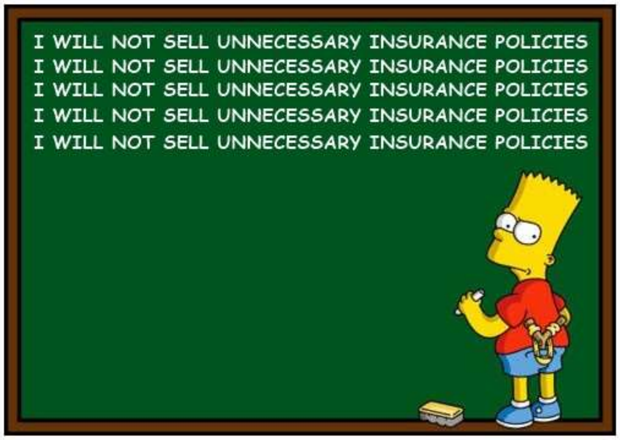
Danske’s €200bn ‘dirty money’ scandal

Financial Times, October 2, 2018

“The Roots of Boeing’s 737 Max Crisis: A Regulator Relaxes Oversight”
New York Times, July 27, 2019

“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



Are democracy and the justice system working in the corporate context?


Ten findings, 10 years after Wall Street brought the economy to the brink.


10. The perpetrators of the pain have not been brought to justice. A comprehensive list of all the top bank chief executives who served time behind bars. PAGE 15


10. The C.E.O.s Of Wall Street Sent to Jail

intentionally left blank.

New York Times Business Section, September 16, 2018

Journal of Economic Perspectives—Volume 31, Number 3—Summer 2017—Pages 131–150

A Skeptical View of Financialized Corporate Governance

Harvard Law School Forum on
Corporate Governance and Financial Regulation

Why Financialized Corporate Governance Works Poorly

Posted by Anat R. Admati, Stanford University, on Wednesday, August 9, 2017

Financial crises, corporate scandals and blind spots: who is responsible?

blogs.lse.ac.uk/businessreview/2018/01/25/financial-crises-corporate-scandals-and-blind-spots-who-is-responsible/

January 25, 2018

Thank You!

For more see:
https://admati.people.stanford.edu