Governance in Finance: Politics, Confusion, and Missed Opportunities

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Stanford University

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

Governance Questions (For All Institutions)

- 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?”
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)
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.”
**THE WALL STREET JOURNAL.**

**TUESDAY, SEPTEMBER 16, 2008 - VOL. CCLI, No. 83

AIG, Lehman Shock Hits World Markets

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

For much of the day, the Dow Jones industrial average, a key U.S. market benchmark, was down 7%, which, with a good-sized rally, was similar to many analysts who thought the worst was over. But about the fate of AIG and Lehman, the world's largest insurer and largest Wall Street investment bank, respectively, there was little optimism.

AIG facces Cash Crisis As Stock Dives 61%

**BY MATTHEW KARRINGTON, LAM ELEVEJ, AND PHILIP CHAMBLEY.

American International Group Inc. was taking a serious cash crunch last night as its stock tumbled, adding to pressure on the company to raise more capital to handle its leveraged bets. The company was reportedly meeting with potential suitors, including other insurers, to explore a sale of some of its businesses. The company's late decision to raise capital was hampered by the plunging stock and the arrival of new players in the market, such as Chinese insurers and private equity firms.

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

**By Matthew and Richard Gambino, Brian Solomon, and Mike Strickland.

The U.S. government asked control of American International Group, one of the world's largest insurers, to a government-controlled insurance company that would prevent the company from failing, setting the stage for a potential sale of the company. The government was said to be considering a deal that would be the largest ever for an insurer. The move came after AIG's stock dropped 61%, which would be the worst ever for a company. The government also announced plans to inject $85 billion into the U.S. financial system, which would be the largest ever for an insurer.

Emergency Loan Effectively Gives Government Control of Insurer: "Historic Move Would Cap 30 Days ThatENDERED U.S. FInance"

**By Matthew and Richard Gambino, Brian Solomon, and Mike Strickland.

The U.S. government announced plans to inject $85 billion into the U.S. financial system, which would be the largest ever for an insurer. The move came after AIG's stock dropped 61%, which would be the worst ever for a company. The government also announced plans to inject $85 billion into the U.S. financial system, which would be the largest ever for an insurer. The move came after AIG's stock dropped 61%, which would be the worst ever for a company.
[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.


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?”

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
Are financial crises preventable and if so, how?

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


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

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).
Regulatory Measures are Uninformative

“Tier 1” capital ratios: What crisis?

Market-based measures

JPMorgan Chase Balance Sheet

Dec. 31, 2011 (in Billions of dollars)

From: Andrew Haldane, “Capital Discipline,” January 2011
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 NOT 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.

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


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)

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Leverage Reduction with Asset Transactions

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

<table>
<thead>
<tr>
<th>Initial Balance Sheet</th>
<th>Balance Sheets with Reduced Leverage (lower debt to assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt/Assets = 0.9</td>
<td>Debt/Assets = 0.8</td>
</tr>
<tr>
<td><strong>Assets</strong> 100</td>
<td><strong>Assets</strong> 100</td>
</tr>
<tr>
<td><strong>Liabilities</strong> 90</td>
<td><strong>Liabilities</strong> 80</td>
</tr>
<tr>
<td><strong>Equity</strong> 10</td>
<td><strong>Equity</strong> 20</td>
</tr>
</tbody>
</table>

A: Asset Liquidation

B: Pure Recapitalization

C: Asset Expansion
Shareholders’ Preferences For Leverage Reduction

Debt Type Bought
(A and B)
- Homogeneous
- Senior Debt
- Junior Debt

Asset Liquidation
Pure Recapitalization
Asset Expansion

Initial Balance Sheet
Debt/Assets = 0.9
- Equity: 10
- Assets: 100
- Liabilities: 90

Balance Sheets with Reduced Leverage (lower debt to assets)
Debt/Assets = 0.8
- Equity: 20
- Assets: 100
- Liabilities: 80

A: Asset Liquidation
- Equity: 10
- Assets: 50
- Liabilities: 40

B: Pure Recapitalization
- Equity: 20
- Assets: 100
- Liabilities: 80

C: Asset Expansion
- Equity: 22.5
- Assets: 12.5
- Liabilities: 90

Banks vs Non Bank Corporations Leverage

<table>
<thead>
<tr>
<th>Non Banks (without regulation)</th>
<th>Banks or BHC (with “Capital Regulation”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Have risky, long term, illiquid assets</td>
<td>Ditto</td>
</tr>
<tr>
<td>Can use retained earnings (or new shares) to invest and grow</td>
<td>Ditto</td>
</tr>
<tr>
<td>Rarely maintain less than 30% equity/assets, often much more</td>
<td>Rarely have more than 6% equity/assets, sometimes less</td>
</tr>
<tr>
<td>Sometimes don’t make payouts to shareholders for extended periods (Google, Berkshire Hathaway)</td>
<td>Make payouts to shareholders if pass “stress tests” (unless indebted to government)</td>
</tr>
</tbody>
</table>
### Borrowing and Downside Risk

<table>
<thead>
<tr>
<th>Heavily Indebted Non Banks</th>
<th>Heavily Indebted Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(no safety net)</td>
<td>(many supports)</td>
</tr>
<tr>
<td>May become distressed/insolvent</td>
<td>Ditto</td>
</tr>
<tr>
<td>Inefficient decisions</td>
<td>Ditto</td>
</tr>
<tr>
<td>May default or file for bankruptcy</td>
<td>May remain insolvent</td>
</tr>
<tr>
<td>✓ Shareholders are wiped out</td>
<td>✓ Depositors maintain balances</td>
</tr>
<tr>
<td>✓ Lenders are paid by seniority</td>
<td>✓ Secured lenders are protected</td>
</tr>
<tr>
<td>✓ Assets are depleted</td>
<td>✓ Access to Fed, Bailouts in crisis</td>
</tr>
<tr>
<td>Lenders try to protect themselves when lending, hard to borrow.</td>
<td>Can keep finding lenders despite opacity, risk, and extreme debt.</td>
</tr>
</tbody>
</table>

### “Free” Markets Do Not Produce Efficient Outcomes in Banking

- 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

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“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

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
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

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

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 myPT
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.
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.

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
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)

<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>
</tr>
<tr>
<td></td>
<td>» Plus 2.5% conservation buffer</td>
</tr>
<tr>
<td></td>
<td>» Plus 1.5% “Tier 1” to RWA</td>
</tr>
<tr>
<td>“Tier 2” Loss-absorbing debt</td>
<td>Leverage Ratio: “Tier 1” to total</td>
</tr>
<tr>
<td></td>
<td>» Basel III: <strong>3%</strong></td>
</tr>
<tr>
<td></td>
<td>» US: BHC: 5%, insured banks: 6%</td>
</tr>
</tbody>
</table>

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

“Tripling almost nothing does not give one very much.”

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

“Anything but Equity” Why?

Too Little Equity
Much Safer
Will it Work?
Why do we need it?
Too complex to Resolve?

Dexia’s structure, 2011

UniCredit Simplified structure (2014)
“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!


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

Greek Bonds

Debt

Assets
Equity
Debt

The Impact of (Zero) Risk Weights

Well Capitalized

Greek Bonds

Debt

Assets
Equity
Debt
Riskless Debt?

Well Capitalized

???????

Greek Bonds

Assets

Debt

Equity

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

Finland
Austria
Belgium
UK
US
Netherlands
ECB
IMF
Spain
Italy
France
Germany
EU bailout loans
Private banks
Other

Change in Combined Sovereign and Bank Exposure to Greece Since 2010

“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; Benen 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

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

*Schnell Schäuble with former Greek Finance Minister, Yanis Varoufakis. All photo from 2012*

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 Siret, and Sergio Di Pascuale
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.
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.”


“" 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 substantial self-funded, consumer deposits, we don’t have 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 crunch (overhang) in bust exacerbates recession
- Credit booms are main predictors of bust/crises
- Risk weights bias lending
- Wasteful investments in boom

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 forced to hold $68 billion in extra capital.

Financial Times, April 8, 2014

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

Steve Bartlett, Financial Services Roundtable, Sept 2010
“Every dollar of capital is one less dollar working in the economy.

Steve Bartlett, Financial Services Roundtable, Sept 2010

"NONSENSE"

“

This rule will keep billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015

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

Tim Pawlenty, Financial Services Roundtable, 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 forced to hoard money and they can’t take any risks. Dodd Frank has banned them from lending.”

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


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”

Regulated Bank

Assets

Insured Deposits

Shadow Bank Vehicle

Sponsored by Bank Holding Company

Assets

Uninsured Deposit-like Claims

… and in “Troubled Times”

Regulated Bank

Assets

Insured Deposits

Assets taken Back on Balance sheet

New Insured Deposits

Shadow Bank Vehicle

Sponsored by Bank Holding Company

Assets

Uninsured Deposit-like Claims

Bank Holding Company
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,”

“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
The Bank of England must think again on systemic risk

**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."

**Bank of England rebuffs Vickers criticism**

Martin Arnold

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**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.
“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”
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Thank You!

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