International Banking and macroprudential spillovers

Comments for Policy Panel

Anat Admati
Stanford University

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The Bad News

- Regulatory reform is an unfocused, complex mess.
- The financial system is reckless and distorted every day.

"Without reform... another crisis is certain."
Mervyn King, *End of Alchemy*, March 2016


FLIGHT RECORDER
DO NOT OPEN
LINE IN
AC
AMPERS
AUXILIARY
FLIGHT RECORDER

“Macroprudential”

- Fuzzy concept, multiple goals; e.g.,
  - Protect the financial system from macroeconomic shocks
  - Monitor “systemic risk” arising from the financial sector that can harm the broader economy
  - Prevent “asset price bubbles” and excessive credit
- Macroprudential vs microprudential is false dichotomy.
  - ***Well-designed microprudential regulations can achieve many macroprudential policy goals.***
  - ***Effective microprudential tools are “regulatory bargains.”***

Heavy Indebtedness Causes Great Inefficiencies and Collateral Harm

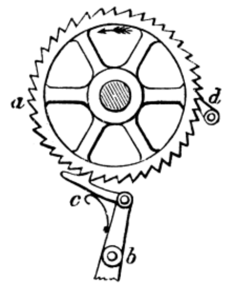
- True for households, hence LTV, DTI regulations can be useful.
- Subsidizing mortgage debt and corporate debt relative to equity is bad, distortive policy that should change.
  - Tax and other debt subsidies for housing and for corporations are distortive and inefficient, particularly perverse for banks.
- Heavily indebted corporations, including banks, make inefficient investment and funding decisions.
  - Excessive risk taking and use of debt (“addiction”).
  - Underinvestment in worthy projects and leverage reduction.

THE LEVERAGE RATCHET EFFECT

(Forthcoming *Journal of Finance*)

Anat Admati
Stanford

Peter DeMarzo
Stanford



Martin Hellwig
Max Planck

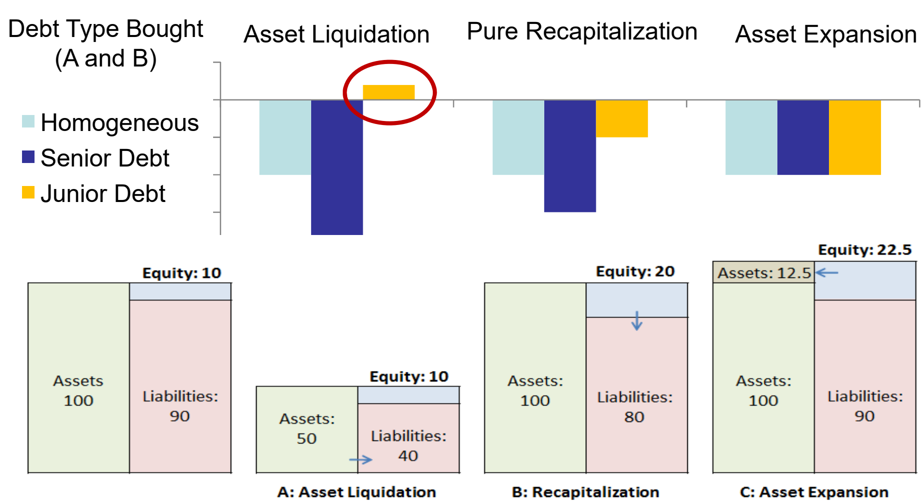
Paul Pfleiderer
Stanford

Shareholders' Preferences For Leverage Reduction

Homogeneous assets, NPV = 0 for asset transactions

Main conflict is between shareholders and senior creditors.

Key result (many more): Adjustment to "ratio" may be inefficient!



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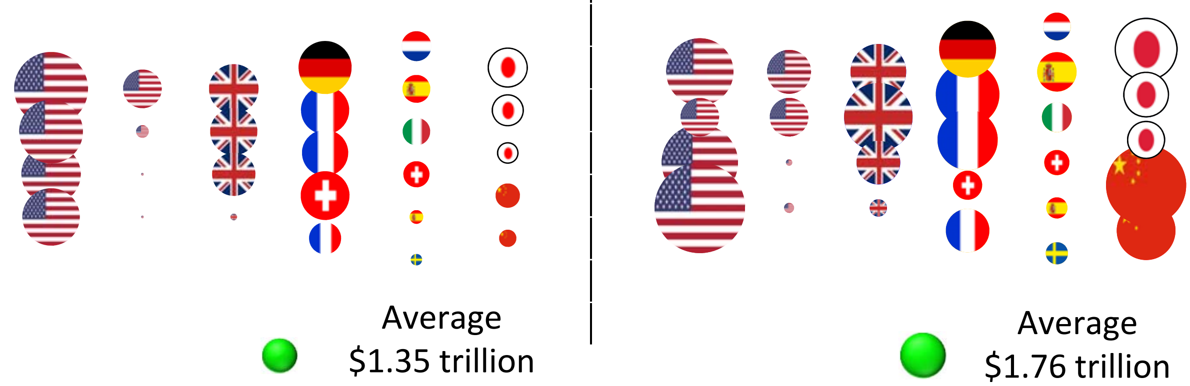
Size of 28 Global Banks

2006: $37.8 trillion total

2013: $49.2 trillion total

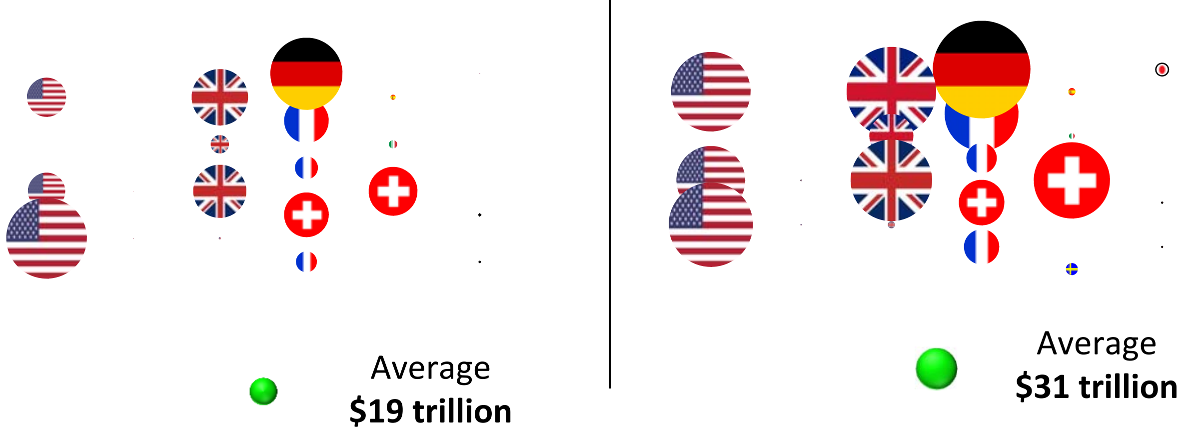


Sources: SNL Financial, FDIC, bank annual reports, Bank of England calculations.

Derivatives for 21 Banks

2006: $409 trillion (notional)

2013: $661 trillion (notional)



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

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."

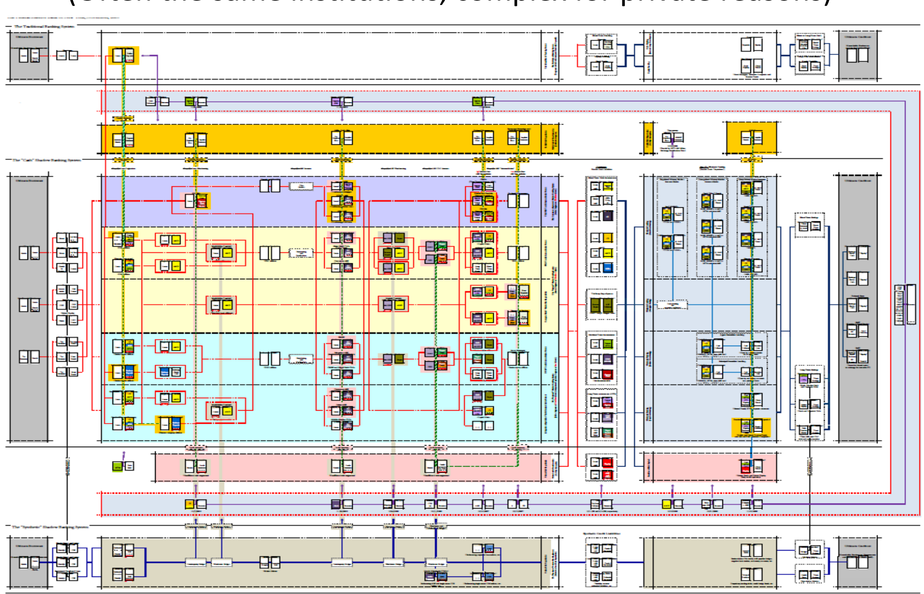
Kevin Warsh, Jan. 2013

"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

"Shadow Banking," Pozsar, Adrian, Ashcraft and Boesky, 2010

(Often the same institutions, complex for private reasons)



"Too Big to Fail" and Complex System are Symptoms

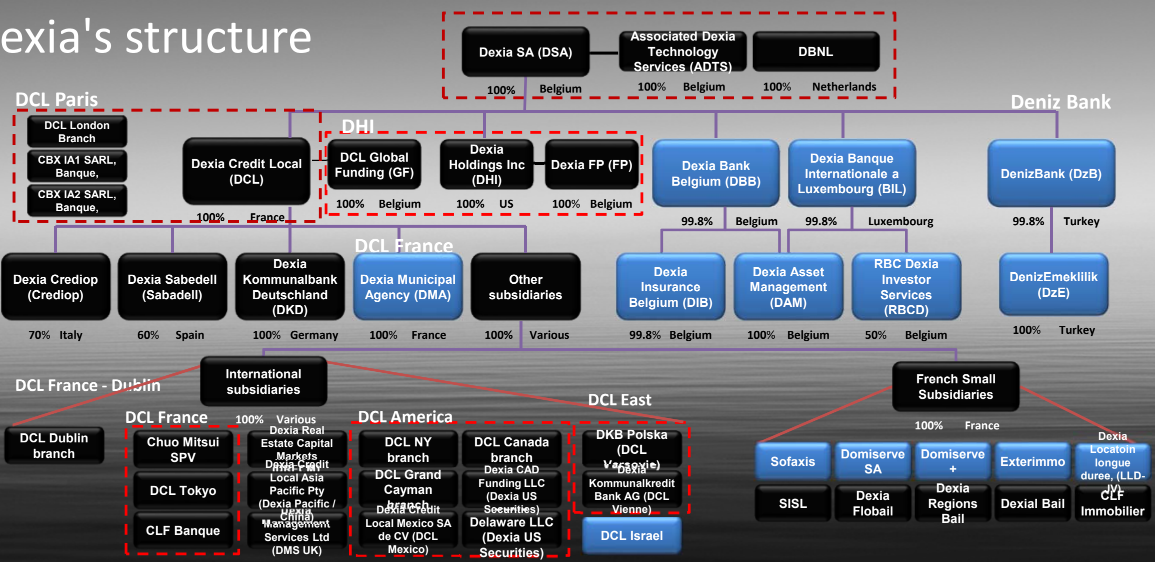
- It's not just about crises or bailouts
  - System is inefficient and distorted every day.
  - "Fail" can cause collateral harm whoever pays direct cost.
- **It's about basic accountability, governance and public safety**
  - Do we allow reckless speed if "industry" pays for ambulances?
  - Private gains and social losses = crony capitalism
  - Pure subsidy extraction should not be a viable business model
- **Bad system, boom, bust and crises are "unintended consequence" of distorted incentives and ineffective regulations**

"Let Them Fail?"

- FSB 2014 "Key Attribute of Cross-Border Resolution" includes huge wish-list of legal and regulatory steps.
- IMF 2014: failure of cross-border SIFI "not a viable option"
- Conversion of TLAC to equity only in resolution, requires determination of insolvency. By whom?

Too complex to Resolve?

Dexia's structure



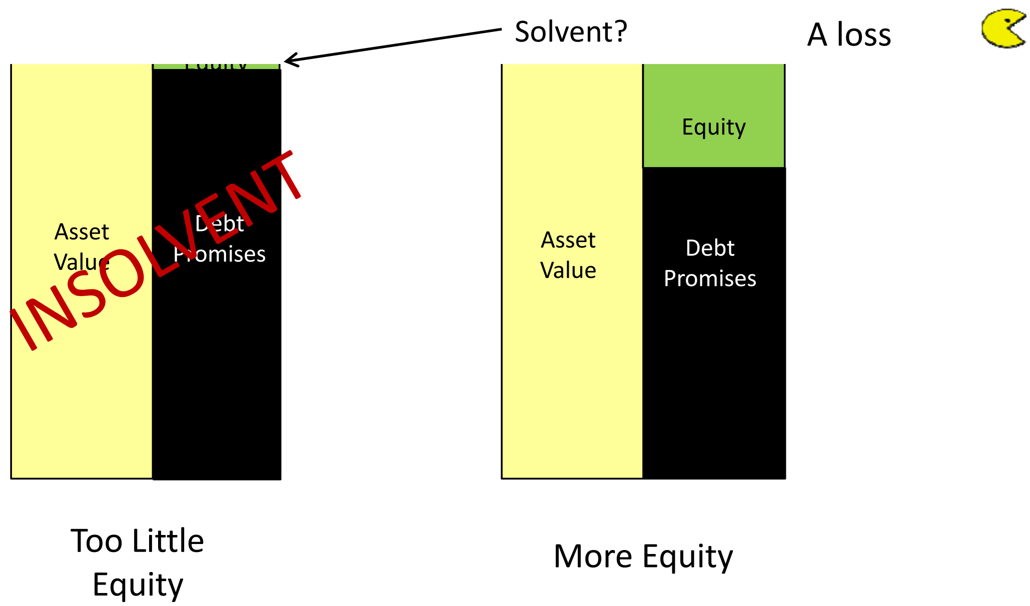
“Fail” is Too Late, Too Costly

Can we do more to prevent it at reasonable cost?

YES!!

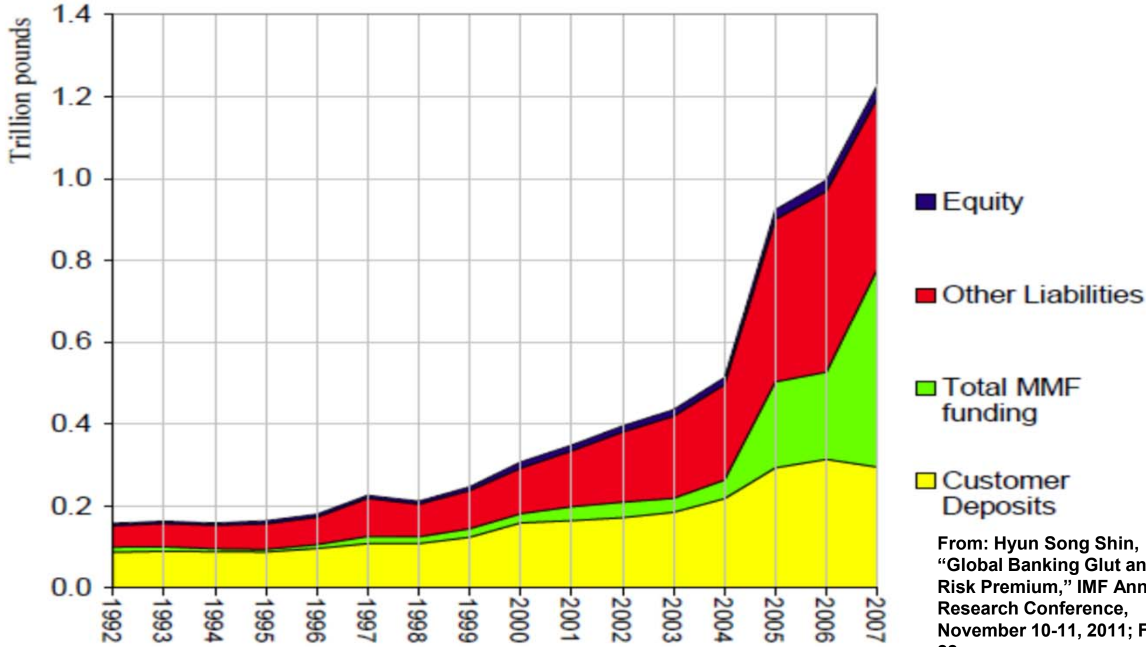
(and get more benefits besides)

An ounce of prevention is worth a pound of cure



An ounce of prevention is worth a pound of cure

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.

JPMorgan Chase Balance Sheet
Dec. 31, 2011

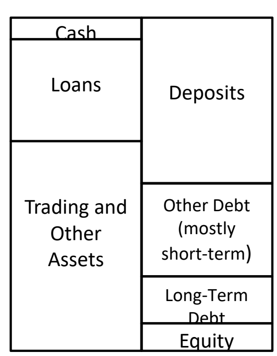
Loans = $700B less than Deposits = $1.1T

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

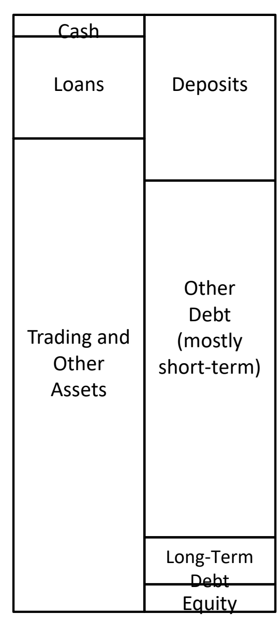
Equity (book): $184B
Equity (market): $126B

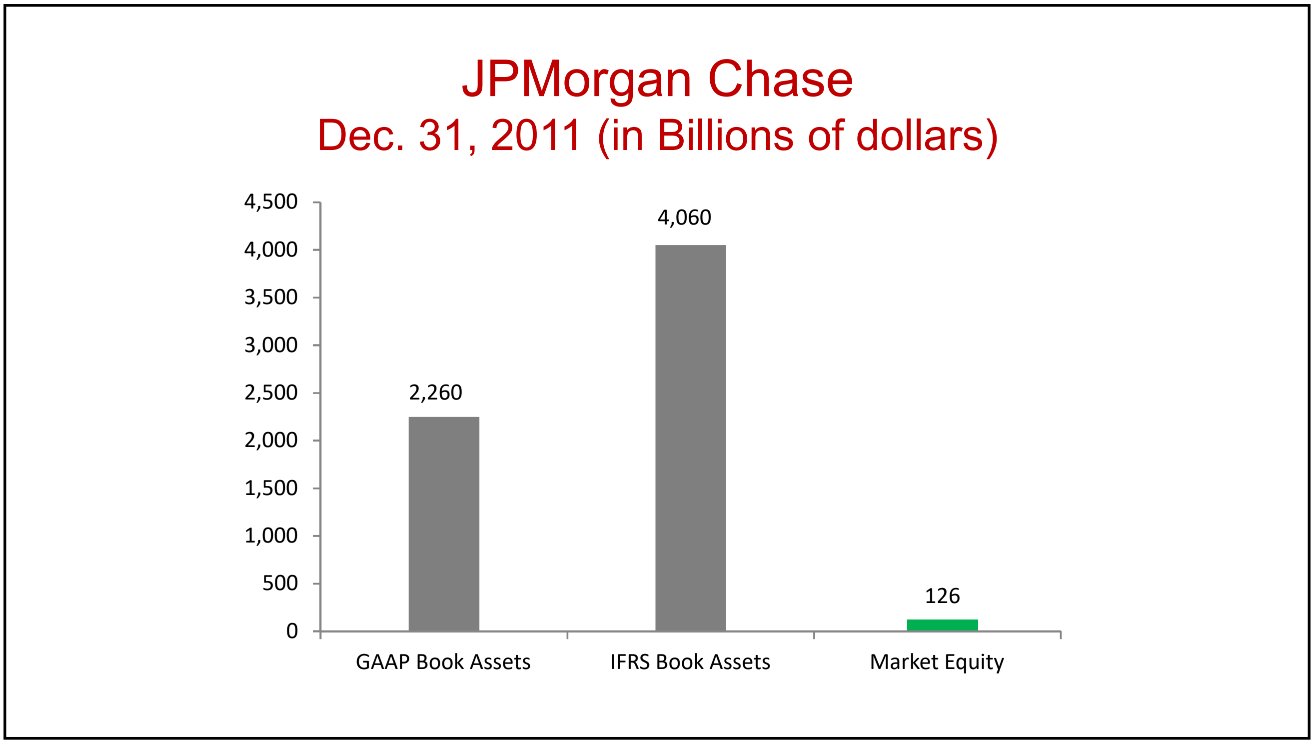
Significant off-balance-sheet commitments

GAAP Total $2.26Trillion



IFRS Total $4.06 Trillion



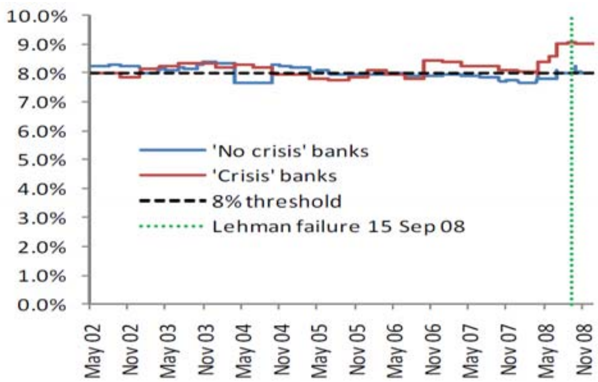


What's in a Regulatory "Capital Ratio?"

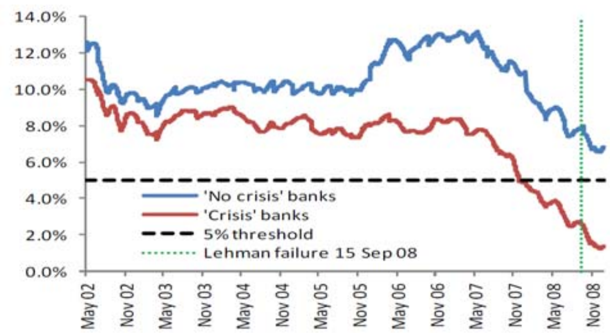
- Numerator
  - Total Shareholder Equity (TSE): accounting shareholder equity
  - Tier 1 Capital (T1), include additional securities
  - Common Equity Tier 1 Capital (CET1) excludes non-equity
  - Tangible common equity (assets exclude goodwill, DTA, ets.)
- Denominator
  - Risk weighted assets (RWA).
  - "Leverage": Total (accounting) assets, or leverage exposures (better; may and should includes some off-balance sheet items)
- Most meaningful to capture indebtedness: "market value" of assets vs "face value" of liabilities (distance to default).

Regulatory Capital Measures are 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)

Zombie (Insolvent) Banks

Symptoms

- Unable or unwilling to raise equity.
- "Gamble for resurrection"
- Anxious to take cash out
- May sell assets, even at fire-sale prices
- Underinvest in "boring" assets
- Try to hide insolvency
- Lobby policymakers

The Mantra

“Equity is Expensive”

To whom? Why?
Only in banking?

“Healthy Banking System is the Goal, not Profitable Banks,” *Financial Times*, November 9, 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.”

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 .

Government, (Taxpayers)

Shareholders

Other lenders
(TLAC, Co-Cos, Bail-in Debt)

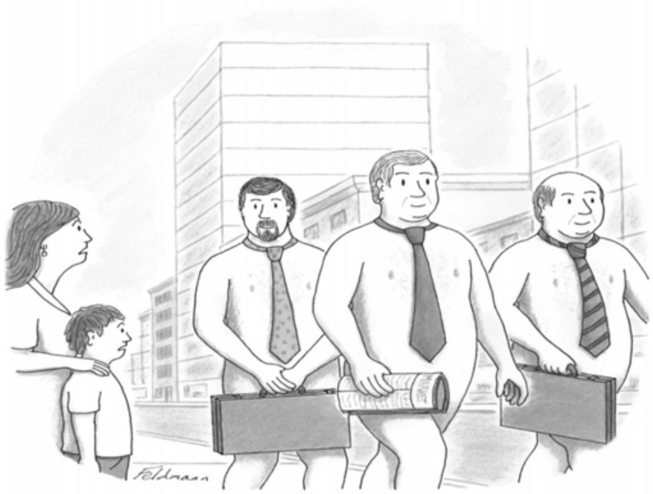
Short-term secured lenders

Depositors
(unsecured, insured)

“Banks are not special, except for what they are allowed to get away with. The problem is bigger than that banks are ‘too big’ or ‘too interconnected’ to fail. It is that they are so complex and so grossly undercapitalised. 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

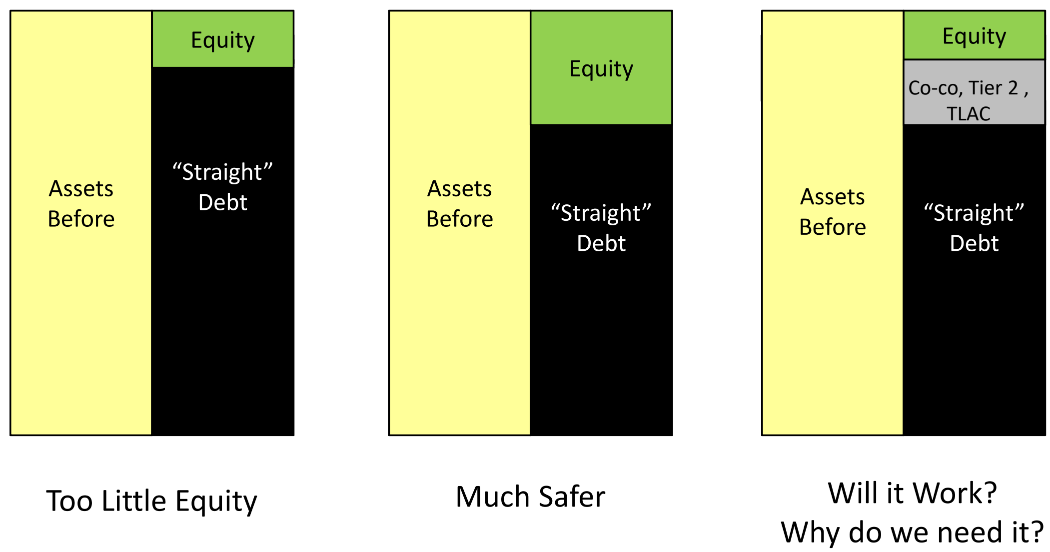
Confusions and Politics: Toxic Mix



Equity Substitutes: "Fool's Gold"
Unreliable, Unnecessary,

- Tier 2 capital failed to absorb losses in the crisis as banks were bailed out and made all payments. **Next time different?**
- **No justification**! Shareholders are most appropriate to absorb losses, and do so automatically (w/o legal process); Italy example.
  - if substitutes are "cheaper" it's only because banks can use them to shift costs and/or risks to public.
  - before conversion debt overhang distorts decisions.

“Anything but Equity” Why?



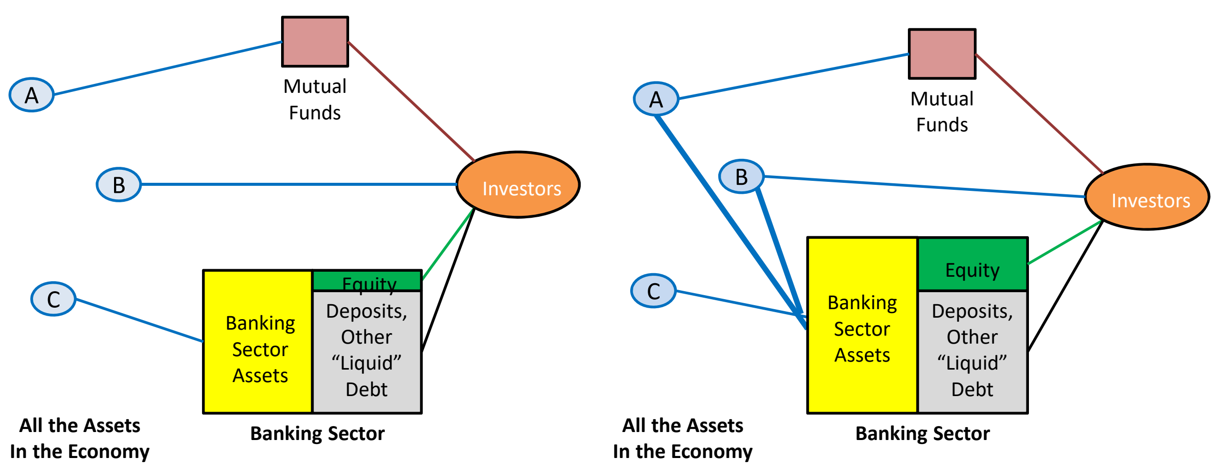
Stress Tests as Conducted: False Reassurances

- Inadequate benchmarks using “regulatory capital” measures
- Cannot predict contagion dynamics in interconnected markets
  - Common and correlated large exposures
  - Opaque derivatives, CCPs
  - Depend on numerous models/assumptions
- Impose large costs
- Based on false premise of scarce and costly equity
  - Why not have safer system and fewer distortions at a bargain?

Market-Based Stress test:
Raise Specific *Amount* of Equity!

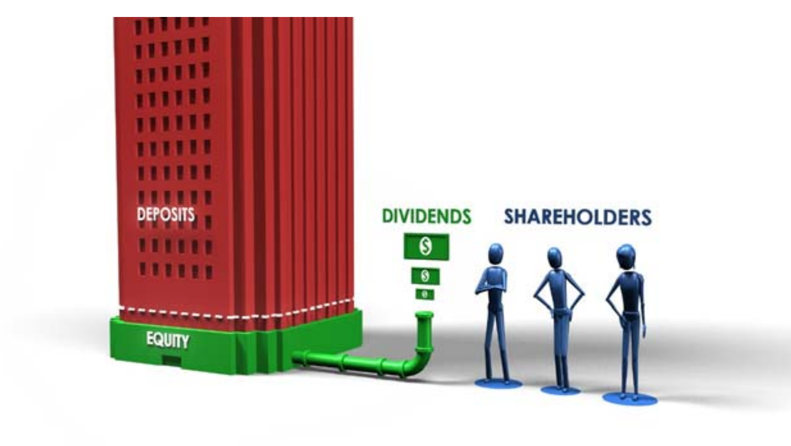
- Profit retention and/or raising new equity does not interfere with any useful activity; reducing subsidies is a stated policy objective!
- Inability to raise equity is a flag!
  - indicates weakness, opacity, unmanageable size, poor business model, excessive dependence on subsidies...
- **Equity is available to viable banks at appropriate price**
  - **from the same investors other businesses must rely on!**
- Plenty of debt capacity elsewhere (other corporations) if investors value non-equity securities.

A Beneficial Shuffle of Claims: Where's the "Cost?"



- Rearranging claims aligns incentives, reduces distortions, corrects mispricing.
- Size of financial firms and industry should be determined in undistorted markets.

Allowing Weak Banks to Make Payouts is BAD POLICY



Key Diagnosis: Political Will is Missing

- The main problem in banking is political.
- Symbiosis between banks and governments
  - "Banks are where the money is"
  - National champions: very dangerous in banking:
  - "Our" banks vs our (or other) citizens: distinction forgotten
  - Distress and inadequate regulation cause harmful spillovers.
- Unlike in aviation, no accountability for enabling a bad system (See "It Takes a Village to Maintain a Dangerous Financial System," *Just Financial Market? Finance in Just Society,* 2017, Lisa Herzog, Editor, OUP.)

Additional writings and materials are available at these websites

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

http://bankersnewclothes.com/