TW Notes on
Anat Admati and Martin Hellwig
The Bankers' New Clothes
Princeton 2013

The pro bank views after the crisis were based largely on "flawed narratives and invalid arguments"... many of them had no interest in engaging on the issues - not because of what they knew or did not know but because of what they wanted to know" p x
"Banking is not difficult to understand" p xi but many people believe it is and don't understand that "Most of the issues are quite straight-forward" xi
"Today's banking system, even with proposed reforms, is as dangerous and fragile as the system that brought us to the recent crisis" xi, xii
"A major reason for the success of bank lobbying is that banking has a certain mystique... [Many of the claims made by leading bankers and banking experts actually have as much substance as the emperor's new clothes in Andersen's story" p2

[The bankers] "may admit mistakes were made, but they portray the crisis primarily as a fluke" p3

"Tighter regulation, we are warned, would interfere with what banks do to support the economy, and this would have serious 'unintended consequences'" p3

"politicians seem to be taken in by the lobbying" p3

They note some academic research does support the view that banking fragility may be necessary for banks to perform their functions for the economy but question the relevance of the assumptions made in such analysis

Serious reform requires much less borrowing (leverage) and better incentive structures

Banking lobbyists have argued that higher capital requirements would substantially reduce the amount banks could lend but A & H argue that this is a fallacy based on a misleading meaning of capital in the banking context.

It isn't a pile of cash that

can't be spent, its the equity of the banks and determines how much they can borrow not how much they can lend

Most non bank corporations in the US have borrowing less than 50% of their assets while for banks its often >90% For some European banks its >97%

For banks debt is cheaper than equity because the ~~state~~ cost of the debt is partially borne by taxpayers through lower borrowing costs because of too big to fail

The too big to fail problem is greater today than before the crisis. There have been more mergers and the reforms aren't adequate to offset this

"~~Living~~ Living Wills" Even the ~~best resolution mechanism is~~ ~~the~~ best resolution mechanism is likely to be disruptive and costly" p13

They give an excellent discussion of how modern banking works

The IMF estimates the total losses to financial institutions from the mortage bust was ≈ $500 bn

The stock market crash after the tech bubble generated losses of >$5 trillion but banks weren't highly exposed to them and a chain reaction wasn't started
"The simplest form of contagion occurs through the effects of a borrower's default on his creditors" p 61
Most banking crises before 2007 didn't have major international effects (The Asian crisis was an exception)
They discuss the increased interconnectedness of the banking system and the overconfidence generated by the quantitative risk models
They discuss the limited credibility of threats to let large banks fail and that there's no internationally agreed system to deal with resolution
There's a major problem still of off balance sheet items. US accounting ~~rules~~ rules don't include derivatives while the international ones do
For J P Morgan Chase this leads to
$3.22 trillion under GAAP and
$4.06 " " IFRS
Its "fortress balance sheet" of 8% equity would drop to 4.5%

The GAAP nets all derivatives
but they ignore credit risk
Lending is a minority part of
Chase's assets, 1/3 under GAAP
and < 1/5 under IFRS
On 12-30-11 the market price
of Chase's stock was $126 bn
while the book value was $184 bn
The market value of Citi and B of A
in recent have frequently been below
50% of book.
This is one reason bankers ~~too~~
wrongly look at equity as expensive
"there is little to suggest that banks
that grow beyond about $100 billion
in assets ~~[illegible]~~ create gains in efficiency"
p89 and large banks may become
inefficient with "serious governance
and control problems" p89
The main advantage is the implicit
subsidy from TBTF
They think proposals like the Volcker
rule, the Independent Commission on Banking
in the UK and the Liikanen report for
the EU assume the main concerns
are for depositors and the payments
system ignore the problems of
non bank financial institutions

like Bear Stearns, Lehman, LTCM and AIG and that commercial banking activities can also be a major source of risks such as the Irish and Spain banks funding of their housing booms

"The key objective of banking regulation should be to reduce the fragility of individual banks and of the system so that it can support the economy reliably" p 91

What kinds of assets should count for liquidity ratios? In a crisis "Practically all assets other than cash and claims on the central bank may suddenly Turn from very liquid to very illiquid" p 93

The danger of trying to deal with solvency problems through liquidity guarantees

While Basel III eliminates some abuses it doesn't deal with the ability of banks to game the system

"Nonsense in the Debate [over capital requirements "the pervasive confusion of capital with reserves is particularly insidious"

The focus on capital ~~ratios~~ requirements p 97 started in the 1990s

Reserve requirements do have costs and unless they are very high they don't deal with the solvency problem.
They have a good discussion of whether equity financing is especially expensive and criticize the focus on return on equity (ROE) since it ignores the risks being taken.
"Quite often, the market value of a bank's stock is lower than the book ~~value~~ value because bank managers are reluctant to acknowledge losses. This may be due to wishful thinking ... Or managers may want to delay disclosing losses so that they can first reap a ~~bonus~~ bonus for the current year's profits" p 114
.. "risks are difficult to judge and can be easy to hide" p 117
Risks can be high with even with small banks if they are all following similar strategies. ~~Avoiding~~ Avoiding blame because everyone was doing it creates incentives to herd
" Banks do not seem to put significant resources into risk management" 127

Large Banks get huge subsidies from government guarantees, and prospects of bailouts, and cheap borrowing from central banks
* "The Dodd-Frank Act forbids government bailouts" ... hardly anyone considers the no-bailout commitments credible" 139
~~If ...~~ The FDIC is guaranteed by the taxpayer
Tax subsidies in borrowing
Haldane (2011) estimated in 2009 the subsidies associated with guarantees totaled worldwide ≈ $2.3 trillion
For Fannie + Freddie ≈ 1/3 of the implicit subsidy went to shareholders (estimate from CBO)
There have always been bank crises
There hasn't been a big increase in frequency since 1970
The analogy between banking ~~crises~~ crises and natural disasters isn't ~~appropriate~~ appropriate
"... it is abundantly clear that in the run-up to the financial crisis of 2007-2009, short-term debt did not discipline bankers" 164
the "Principle of Unripe Time"
delay can be very expensive

End 2011 Deutsche Bank had €2.2 trillion assets but only €381 risk weighted

The 3% leverage ratio in Basel III is "outrageously low" p 177

For much of the 19th century when banks were partnerships fully liable for debt equity ratios tended to be around 40-50%

The studies supporting Basel III "understate the benefits" of higher equity and make up "fictional 'costs'" p 180

They assume without justification that there is a cost to society of higher bank equity

In many discussions "we have never received a coherent answer to the question of why banks should not have equity levels between 20 and 30 percent of their total assets" p 182

"Abandon the Illusion of Fine Tuning"

"Regulators and others overlooked the fact that the banks' interest in measuring and managing risks are not the same as the public interest in having a safe financial system" 184

The regulation of low risk weights for AAA securities created an artificial demand for them and "contributed to the complete breakdown of market discipline in mortage lending and securitization" 185

The illusion of fine-tuning risk weights "risks themselves are changing all the time, and even the banks lack the information necessary to ~~[illegible]~~ measure them properly" p 186

Demirguc-Kunt et al (2010) and Breasley et al (2011) found that equity to total assets was a better measure of safety than to risk weighted assets

Severe contagion isn't adequately captured in the stress testing

hybrid security holders were bailed out in the crisis

A+W are skeptical about the effectiveness of contingent convertible bonds CoCos

There should be a graduated system for ~~[illegible]~~ dealing with equity shortfalls One step is to require banks to retain all earnings until equity levels are adequate

Regulators need to pay more attention to the risks of rare events

Concerns that they will lose out to international competitors is a powerful argument for the bankers - the 'level playing fields' argument

A ~~deeper~~ "deeper reason" for the bankers' clout is that they have money

"Financial Stability Has No Constituency but is Everyone's Business" p 21[illegible]