

The Persistence of a Reckless Banking System

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The fall of 2008 was scary. For most people, the aftermath of Lehman Brothers' bankruptcy resembled a major earthquake with strong aftershocks. Official narratives have promoted the image of the crisis as a rare, unpreventable and unforeseen natural disaster, the “100-year flood.” Policymakers emphasize the extraordinary measures they have taken to prevent the system from collapsing and to support recovery since. Alas, they say, it was truly a disastrous event, but we are working on recovery, please be patient.

Citizens count on the government to take action when disasters hit. We want to believe that politicians, central bankers and regulators are doing all they can for us. Bankers, politicians and regulators may believe what they say. But in fact they advance false and misleading narratives. The result is to mask and divert attention from an unhealthy industry and from the continued failure by policymakers to protect the public from excessive risk in banking. The tolerance, and even implicit support and encouragement of reckless practices harms millions of innocent citizens.

The observation that financial crises are not like natural disaster has been made by many. At the conclusion of their book *This Time is Different: 800 years of Financial Folly*, Reinhart and Rogoff state: “We have come full circle to the concept of financial fragility in economies with massive indebtedness. . . . Highly leveraged economies . . . seldom survive forever, particularly if leverage continues to grow unchecked. . . . Encouragingly, history does point to warning signs that policy makers can look at to assess risk—if only they do not become too drunk with their credit bubble–fueled success.” In an article from 2000, the then-U.S. Treasury secretary Lawrence Summers, referred to “the increasing salience of long-standing financial-sector weaknesses, arising from some combination of insufficient capitalization and supervision of banks and excessive leverage and guarantee—the combination that, along with directed lending, has been captured in the term ‘crony capitalism,’ ” as a root cause of most crises. “Panics and runs,” continued Summers, “are not driven by sunspots: their likelihood is driven and determined by the extent of fundamental weaknesses.” He concludes that “preventing crises... will depend heavily on strengthening core institutions and other fundamentals.”

The rhetoric from leaders, similarly, often sounds promising. Yet, when it comes to taking action that involves countering the distorted incentives in the banking system, the political will is still very weak. In the book *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It* that I wrote with Martin Hellwig (Princeton University Press, March 2013) we explain

some of the key issues in a way non-experts can understand and we advocate beneficial steps that can be taken immediately.

The original preface of the book and a new preface written for the paperback edition a year later are attached to this document. The quote from Upton Sinclair which we use as the epigraph of Chapter 8 (entitled “Paid to Gamble”) hints at the reason that confusion and conflicted interests continue to pervade the debate: “It is difficult to get a man to understand something, when his salary depends upon his not understanding it!.” And understanding is not enough. It is hard to get politicians or regulators to understand and especially to act on something when the funding of their campaigns or favorite project, or their own future job prospects depend on them not understanding or not acting on it. As I wrote in a commentary in September, 2013, “despite the enormous harm from the financial crisis... too many politicians and regulators put their own interests and those of “their” banks ahead of their duty to protect taxpayers and citizens.” (“Five Years of Non-Reform,” Project Syndicate, September 13, 2013). Chapter 12 of the book gives a flavor of the politics of banking.

The reform efforts undertaken in many countries are unfocused and insufficient. Among the clearest evidence for this is the fact that they do not tackle properly the continued weakness of some banks and the persistence of institutions considered “too big to fail.” These enormous institutions, which operate in dozens of countries and whose distress or failure would cause havoc, are still able to borrow excessively at subsidized rates, take large risks, and hide these risks from investors and regulators.

The largest banks have paid \$100 billion in fines in the U.S. alone since 2008. Numerous scandals indicate that they suffer from pervasive problems of governance and control. The key problem both within the banks and among policymakers is one of accountability. Ordinary people and businesses who take too much risk (or who fail in their duties) typically suffer the consequences when risks don't turn out well or when their failures become obvious. For bankers or policymakers, by contrast, the consequences of taking excessive risk with other people's money were minimal. The recovery efforts have worked quite well for them. Many large banks had record profits in 2013. The same was true in 2006, just ahead of the calamities that followed.

PREFACE

IN THE FALL OF 2008, it seemed obvious that radical reform would be needed. For more than a year, banks and financial markets had been in a state of crisis. Then, in September, the entire financial system was about to collapse. One institution after another was failing or about to fail. Governments and central banks stopped the panic by massive interventions, but even so, the economy went into a decline of a magnitude unseen since the Great Depression.

We hoped for a serious investigation and discussion of what had gone wrong and what would have to be done to avoid a recurrence of such a crisis. We hoped that the lessons of the crisis would be learned. But we were disappointed. There was no serious analysis of how the financial system might be made safer.

Many claimed that they “knew” what had caused the crisis and what needed—or did not need—to be done, and they did not look any further. Bankers and their supporters argued that not much was wrong with the banking system. Serious reform, they routinely said, would interfere with what banks do and harm the economy. If we wanted banks to lend and to support growth, they wanted us to believe, we had to accept this system pretty much the way it was.

This made no sense to us. Much of the discussion seemed to ignore what had happened. Many arguments seemed downright false. As academics who have spent our lives studying the financial system—Anat as a finance and

economics professor at Stanford and Martin as an economics professor and director of a research institute in Bonn—we were shocked to see press reports and policy recommendations with misleading uses of words, flawed understanding of basic principles, fallacious and misleading arguments, and inadequate uses of mathematical models. Banking experts, including many academics, seemed to believe that banks are so different from all other businesses that the basic principles of economics and finance do not apply to them.

We were not surprised that bankers lobbied in their own interest and said whatever might serve their needs; often their paychecks and bonuses were at stake, and the status quo worked for them. But we were dismayed—and increasingly alarmed—to see that flawed narratives and invalid arguments were not challenged but instead seemed to be winning the debate on both sides of the Atlantic. Reform efforts seemed to be stalling. Proposals were headed in the wrong direction. Simple opportunities to improve the system were being overlooked.

We wrote about the issues, arguing for reform and exposing the invalid arguments that were being given against reform. However, important parts of the policy discussion go on behind closed doors. Even when regulators ask for public comment on a proposed regulation, most contributions come from the industry and its supporters, and additional lobbying goes on behind the scenes.

In trying to have discussions with those involved in the debate, we discovered that 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. Politicians, regulators, and others often prefer to avoid challenging the banking industry. People like convenient narratives, particularly if those narratives disguise their own responsibility for failed policies. Academics get caught up in theories based on the belief that what we see must be efficient. In such a situation, invalid arguments can win the policy debate.

We also discovered that many people, including many who are involved in the policy discussion, do not have a sufficiently full understanding of the underlying concepts to form their own opinions about the issues or to evaluate what others are saying. The jargon of bankers and banking experts is

deliberately impenetrable. This impenetrability helps them confuse policymakers and the public, and it muddles the debate.

We are concerned about this situation because the financial system is dangerous and distorted. We have written this book to explain the issues to the broader public. We want more people to be better informed so they can form their own opinions. We want to expand the set of participants and elevate the level of the debate.

When policymakers ignore risks, all of us may suffer in the end. A stark example was provided in Japan, where corrupted regulators and politicians colluded for years with the Tokyo Electric Power Company and ignored known safety concerns. When an earthquake and a tsunami occurred in 2011, this neglect led to a nuclear disaster that was entirely preventable.

Weak regulations and ineffective enforcement were similarly instrumental in the buildup of risks in the financial system that turned the U.S. housing decline into a financial tsunami. Yet, despite the wreckage, serious attempts to reform banking regulation have foundered, scuttled by lobbying and misdirection.

Banking is not difficult to understand. Most of the issues are quite straightforward. Simply learning the precise meanings of some of the terms that are used, such as the word *capital*, can help uncover some of the nonsense. You do not need any background in economics, finance, or quantitative fields to read and understand this book.

In this book we discuss many statements and views. At times we use generic terms, attributing statements to “bankers,” “regulators,” or “politicians.” Having talked and collaborated with many people connected to banking and public policy, we know that not every banker, regulator, or politician subscribes to the same views. Many in these groups and elsewhere advocate and work to bring about beneficial reform. In each of the groups, however, the views we discuss are so prevalent, and have had such an impact on policy discussions, that we feel justified in generalizing to make our points.

Do not believe those who tell you that things are better now than they had been prior to the financial crisis of 2007–2009 and that we have a safer system that is getting even better as reforms are put in place. Today’s banking

system, even with proposed reforms, is as dangerous and fragile as the system that brought us the recent crisis.

But this situation can change. With the right focus and a proper diagnosis of the problems, highly beneficial steps can be taken immediately.

Having a better financial system requires effective regulation and enforcement. Most essentially, it requires the political will to put the appropriate measures in place and implement them. Our hope in writing this book is that if more people understand the issues, politicians and regulators will be more accountable to the public. Flawed and dangerous narratives—“the bankers’ new clothes”—must not win.

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PREFACE TO THE PAPERBACK EDITION

The fifth anniversary of the Lehman Brothers bankruptcy led many to ask whether the financial system is safe today. The answer to this question is no. The key factors that caused the subprime mortgage crisis to upset the global economy are still in place. Politicians and regulators have allowed effective reform to be stalled.

Bankers and their supporters often threaten that proposed regulation will “harm credit and economic growth.” Such threats scare policymakers. Yet the explanations given for the claims, if any, are nonsensical or misleading. Actually, the sharpest downturn in lending and growth since the Great Depression occurred in the fall of 2008. This downturn was not due to regulation, but to the reckless practices and excessive fragility of banks and the financial system. The suggestion that making banks safer would be harmful for us all is simply false.

Much is wrong with banking and much can be done to make it better. Bankers may benefit from the dangerous system we have, but most others are harmed. The system is fraught with inefficiencies that harm the economy every day. Even now, the continued weakness and flawed incentives of banks dampen new lending that would help economic recovery. Financial crises, and the damage they bring to the economy, are just the most visible harm created by this unhealthy system. Yet, confusion and politics have prevented beneficial reform.

Refuting the claims made by bankers and others is not difficult. However, many people either don't understand or believe that they don't understand

the issues. Many feel that they are not in a position to evaluate or challenge the banking “experts.” Others don’t want to engage or have reasons to avoid speaking up.

We wrote this book to inform and empower more people to participate in the debate. By explaining the issues in plain language, we wanted to create a larger constituency for effective financial reform. Enlarging this constituency is essential for bringing about change.

We have been gratified by the reception of our book. Many have told us that they found the book useful. More voices have joined ours in challenging flawed claims and urging effective reform. Some policymakers have become more aware of the issues, and some of the issues we raise are being discussed in regulatory or legislative bodies.

However, we remain alarmed by the state of the financial system. Banks continue to be unsafe and ill prepared for the risks they are taking. Many of them have not yet fully acknowledged, let alone overcome, their losses on previous investments. Institutions considered “too big to fail” are particularly reckless and dangerous.

We also remain dismayed by the fact that the policy debate continues to be muddled. The same claims we have debunked, and some new nonsensical statements, continue to be made and to impact policy. People make false assertions while ignoring, mischaracterizing, or trying to dismiss our arguments. In a document entitled “The Parade of Bankers’ New Clothes Continues” (posted on the book’s website bankersnewclothes.com) we outlined and briefly criticized some of the flawed arguments we came across in the first few months after the book’s publication.

Someone suggested to us that there are “blind spots” within the banking community. But the blindness often appears willful—“see no evil, hear no evil.” In her insightful book *Willful Blindness: Why We Ignore the Obvious at Our Peril*, Margaret Heffernan observed: “We turn a blind eye in order to feel safe, to avoid conflict, to reduce anxiety, and to protect prestige.” Willful blindness helps bankers and policymakers to overlook and ignore risks they take and to deflect criticism.

Our book has clearly touched a raw nerve. Someone familiar with banking told us that our explanations are so clear that “most bankers could com-

prehend” them, “but, unfortunately, would find [the conclusions] difficult to accept.” Someone working for a bank said: “If I give your book to my boss, I will get fired.” An executive in a major bank refused an invitation to a private dinner that one of us would be attending, saying “I can’t do that.”

The Bankers’ New Clothes focuses mainly on bankers and lobbyists making false or misleading claims and on the politicians and regulators who listen to them and collaborate with them. Yet, flawed claims and willful blindness can also be found among academics and in the media; they too participate in the continuing parade of bankers’ new clothes. For example, the 2013 edition of a best-selling textbook, written by a prominent academic and former central banker, repeats fallacious statements that have been publicly debunked in our book and in earlier writings; these statements contradict basic lessons taught in required business school courses in finance.

In our book we also took on some of the claims and narratives made in academic banking research and excluded others that seemed too esoteric. For example, some academic research claims that banks need to be fragile and borrow a lot because their depositors and other creditors monitor the banks’ managers and “discipline” them if they misbehave. Readers of preliminary drafts told us that this idea was too academic, too far from the real world to be worth discussing in the book. The material became an “omitted chapter” posted on the book website.

Rather than being fallacious, some academic research consists of *myths*, theoretical constructions that claim to explain what banks do as something essential or efficient while ignoring those parts of reality that suggest entirely different explanations. An analogue would be a theory that “explained” the fact that people smoke cigarettes by claiming that it was good for their health, while ignoring the fact that smoking cigarettes is addictive and can cause significant harm. Similarly, borrowing and taking risk can be addictive and harmful, but this fact is ignored in much of the academic research about banking. The research often consists of abstract theoretical analyses with no attempt to match the theory to reality.

Many of these analyses are based on the presumption that the amount of risk in banking must be efficient because it is a result of free market activity. This presumption is convenient for lobbyists who fight regulation and for

policymakers who don't want to intervene. Those who like the conclusions of theoretical or empirical studies don't care whether the conclusions are valid or whether the assumptions made in the studies have anything to do with reality.

Biases and willful blindness are also evident in the media. Reporters frequently quote bankers, policymakers, and experts without challenging the claims or asking for a balancing opinion. In attempting to explain policies or debates, media reports sometimes provide false and misleading information. For example, the debate about banks' indebtedness is often erroneously framed as if it concerned money that banks set aside as cash reserves; or the simple fact might be forgotten that deposits are part of the banks' debts.

In this paperback edition, we have clarified the writing in a few places, but we do not discuss developments after the book was completed in October 2012. Those developments, including the crisis in Cyprus, repeated scandals and investigations of large banks, the issuance of some debt by Apple, or some banks making high profits again, do not change our arguments and conclusions in any way. For example, most financial institutions, including Bear Stearns and Lehman Brothers, had record profits in 2006, only to fail or to receive massive supports in 2008 and since. If banks are profitable, such "success" often comes from their taking excessive risks that benefit few while harming others.

Our main message is that by taking simple steps to reduce excessive risks and excessive risk taking, our banking system can become safer, healthier, and better able to support the economy. For example, healthy banks can become more resilient by reinvesting their profits or by selling new shares to investors, as is routinely done by other companies.

Some banks may no longer be viable. A cleanup of such banks and of the financial system is important even if it means eliminating or shrinking some banks. Hiding from reality and providing public support to banks that cannot otherwise survive or which are too big and too complex to control, as governments all over the world are doing, is dangerous and expensive.

Once the fog of confusion is lifted, the path to effective reform can be seen clearly.

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