

The Virus of Financial Deregulations

Anat Admati

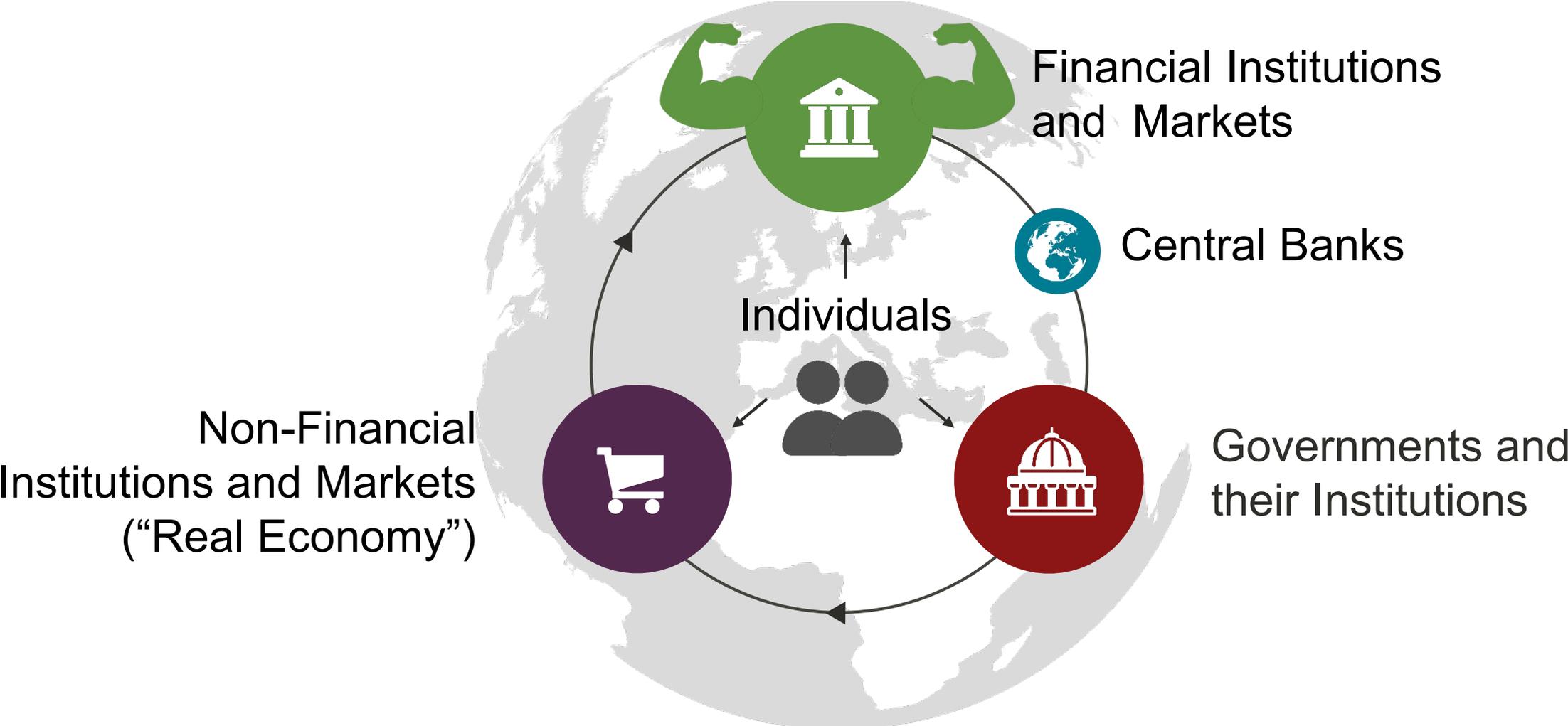
Graduate School of Business

Stanford University

The Greens/EFA Webinar

June 10, 2020

People, Corporations, Governments and Markets



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TUESDAY, SEPTEMBER 16, 2008 - VOL. CCLII NO. 65

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DJIA 10917.51 ▼ 504.48 -4.4% NASDAQ 2579.91 ▼ 3.6% NYSE Closed (12214.76) DJ S&P 500 2744.81 ▼ 4.0% 10-YR TREAS 4.2 3/32, yield 3.482% OIL \$95.71 ▼ \$5.47 GOLD \$793.00 ▲ \$22.00 EURO \$1.4310 YEN 104.01

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

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 In-

*By Suzanne Craig,
Jeffrey McCracken,
Jon Hilsenrath and
Deborah Solomon*

ternational 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 reverberating 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,
Leam Flevyn
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.

DOJONES

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

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DAX 11099.02 ▲141.51 1.3% NASDAQ 2200.90 ▲1.1% NIKKEI 11609.73 ▼5.0% DJ STOCK 50 2658.77 ▼3.1% 10-YR TREAS ▼1/32, yield 4.49% OIL \$91.15 ▼\$4.56 GOLD \$776.50 ▼\$6.60 EURO \$1.4143 YEN 105.92

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 KARNITSCHING,
DEBORAH SOLOMON
AND LIAM FLEVEN

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 AIG had gone too far to fail.

Insurance 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 non-banks under "unusual and exigent" circumstances, something it invoked when Bear Stearns Cos. was rescued in March.

As part of the deal, Treasury Secretary Henry Paulson, in-

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

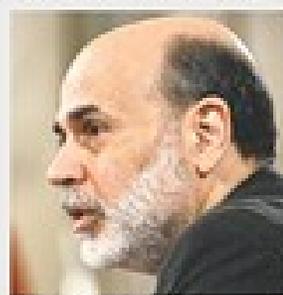
The U.S. on Sept. 8 took over mortgage-lending giant Fannie Mae and Freddie Mac as they teetered near collapse. This Sunday, the U.S. refused to bail out Wall Street pillar Lehman Brothers, which filed for bankruptcy-court protection and is now being sold off in pieces. That same day, another struggling 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 helped propel the Dow Jones In-

Urgent Mission

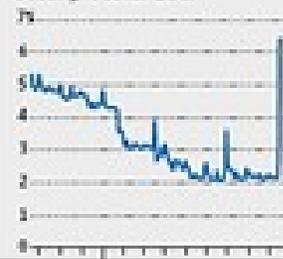
Plunging shares, soaring credit costs push the government to step in.

DAX daily close



Fed chief Ben Bernanke

Overnight dollar Libor



Lending Among Banks Freezes

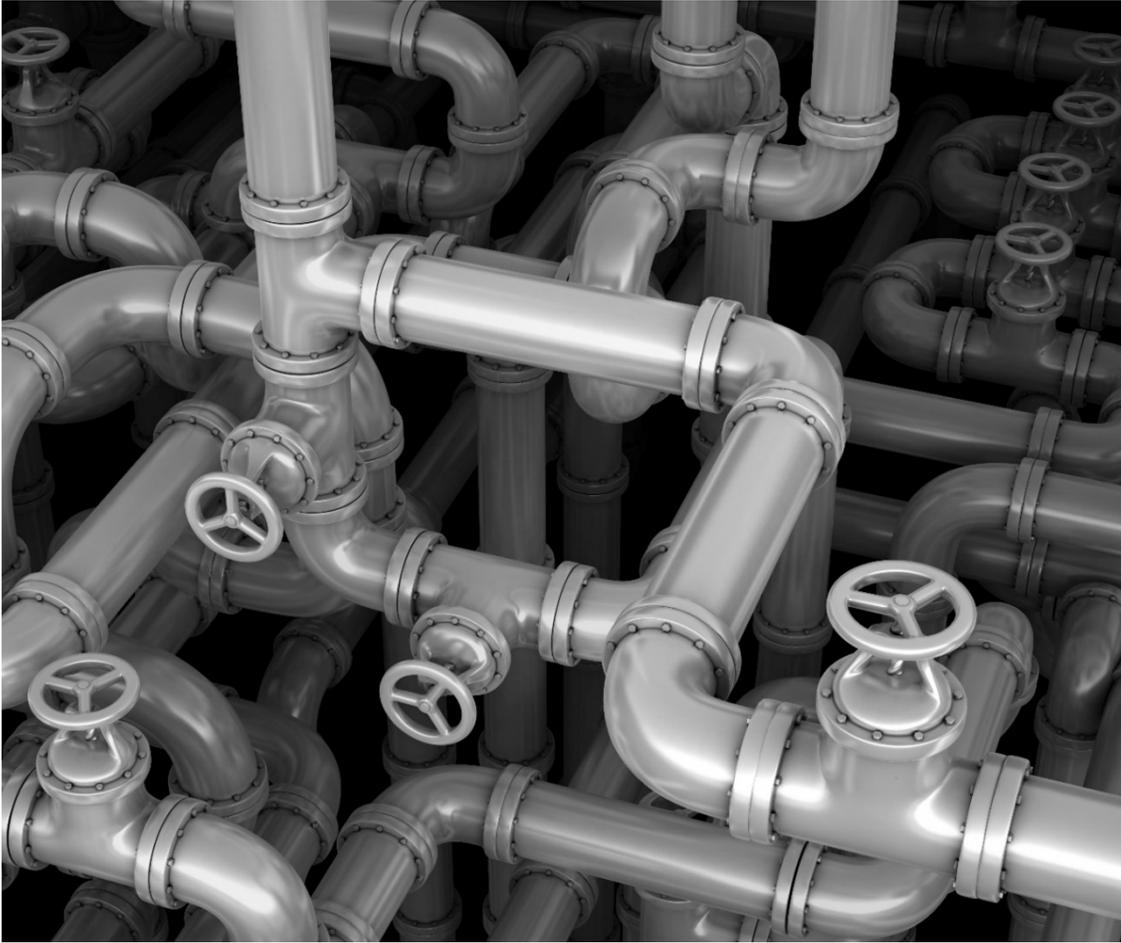
BY CAROL Mollenkamp,
Mark Whitehouse
AND NEIL SHAH

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 Japan pumped out more than \$100 billion of new money Tuesday.

Natural Disaster? Sudden “Shock?”





A Liquidity Problem?



“A Classic Bank Run?”



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, JP Morgan Chase CEO, January 2010
(to Financial Crisis Inquiry Commission)

Are financial crises preventable?

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

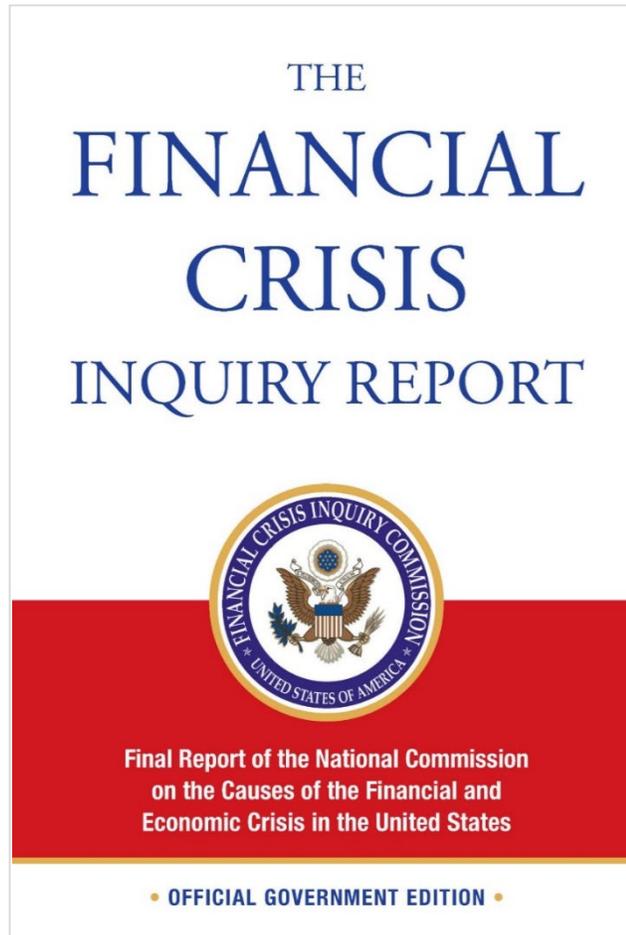
Why financial regulation keeps failing





**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

Widespread breaches in accountability at all levels.

The crisis reflected distorted incentives and failure of rules and governance

What is the Financial System Meant to Do for Society?



The challenge: Finance is fraught with conflicts of interest and differences of information and control

DEBT





+2.5%

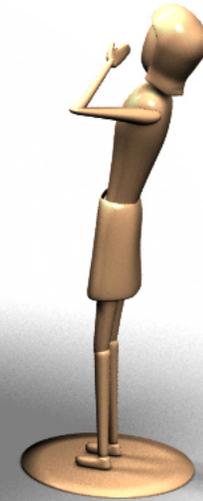
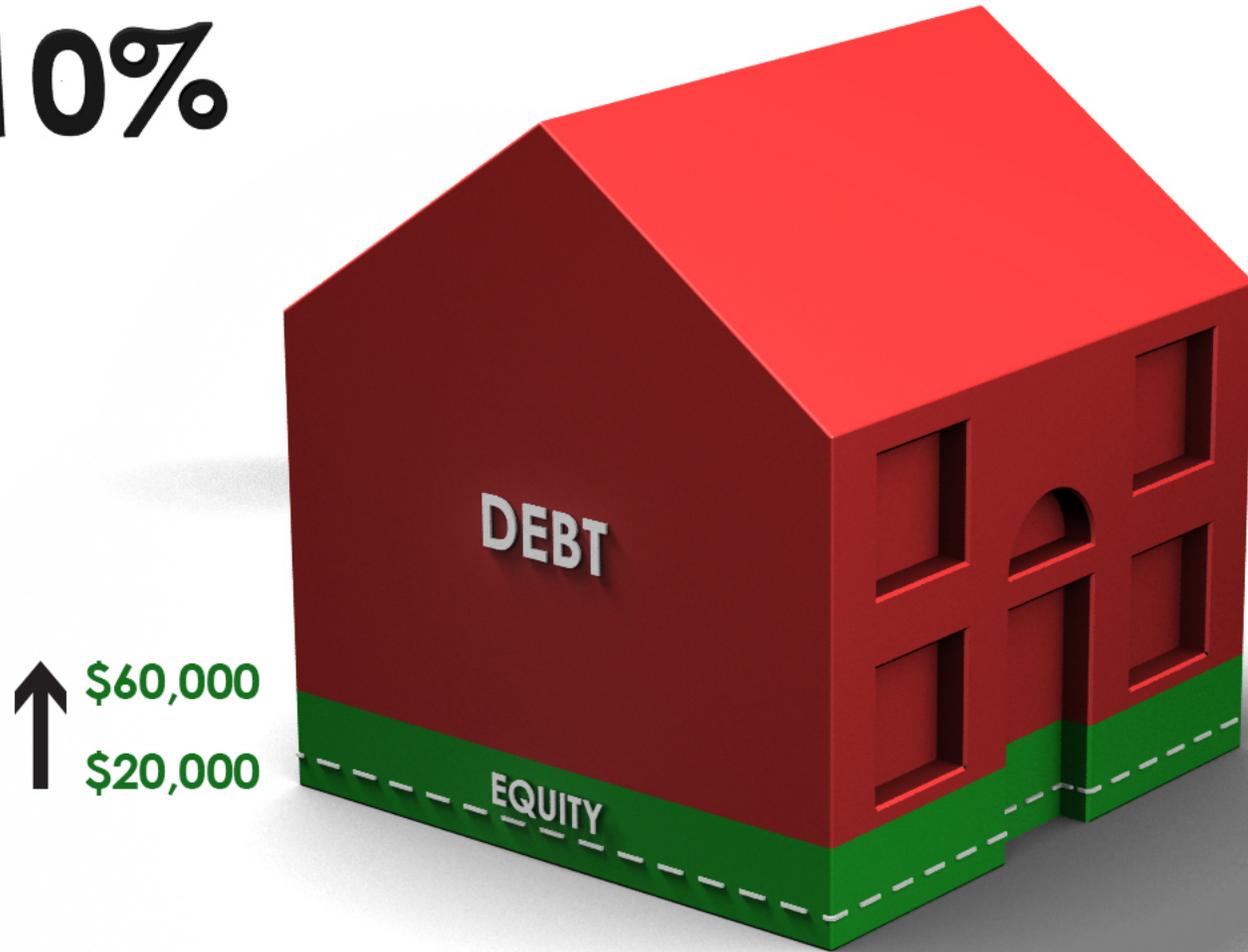


+5%



↑ \$40,000
\$20,000

+10%



-2.5%



-5%



\$20,000
\$0

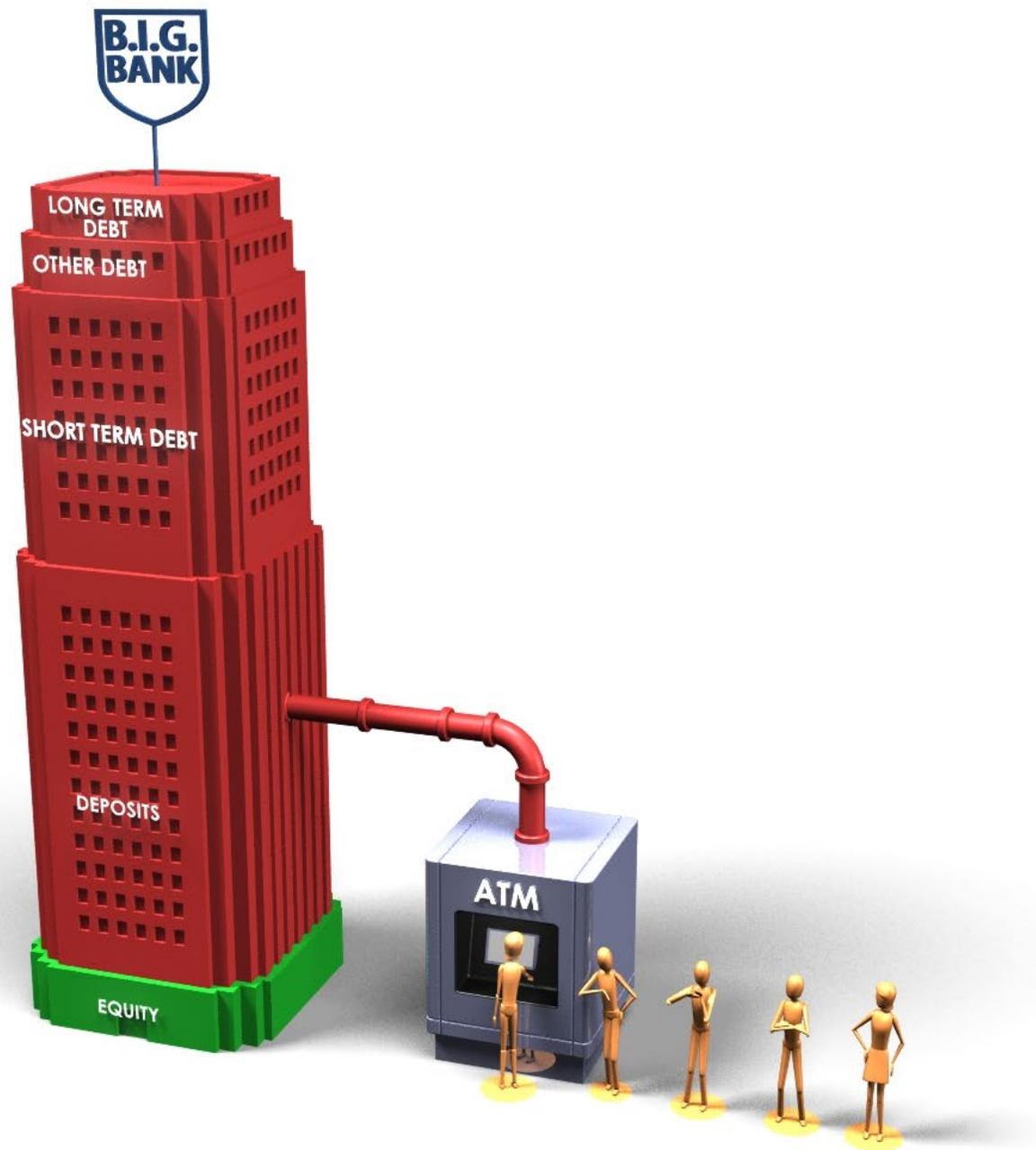
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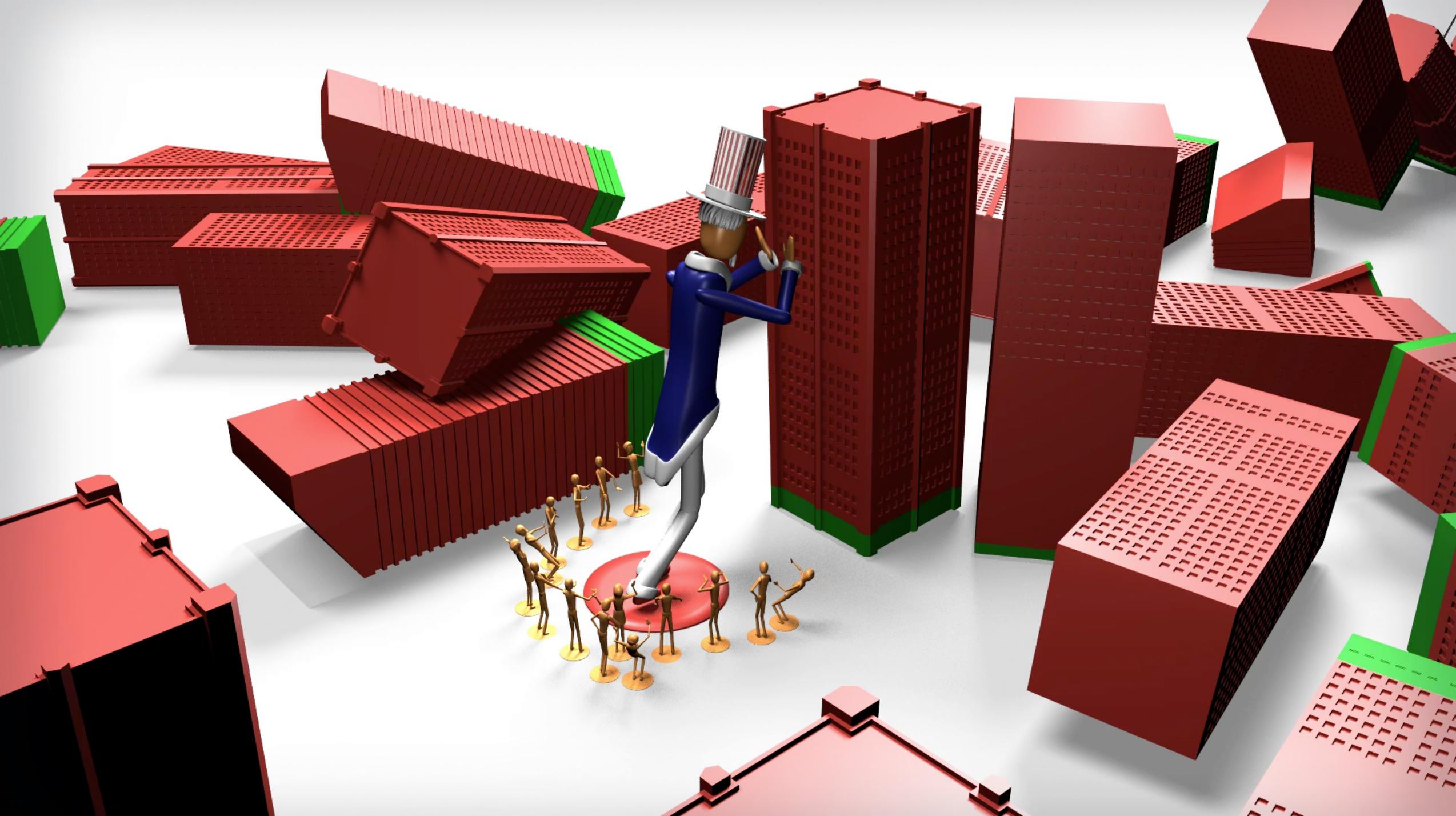


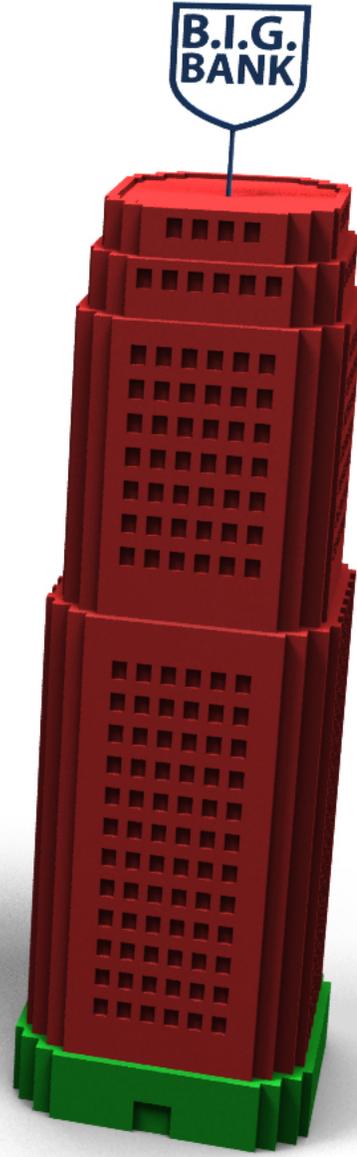
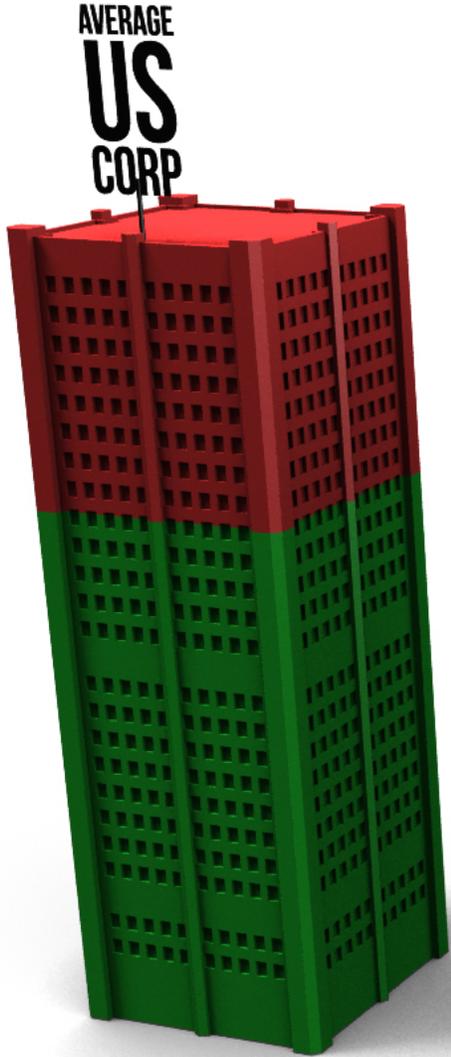
↓ \$20,000
-\$20,000











Central Banks: Very Special





FIVE POUNDS

20

JB 623

5

JACKSON

SERIES 2009

Treasury Secretary of the Treasury

ZHONGGUO RENMIN YINHANG

中国人民银行

£20

FOR THE GOVERNOR AND COMPANY OF THE BANK OF ENGLAND



20



10

THE UNITED STATES OF AMERICA

IN GOD

WE TRUST

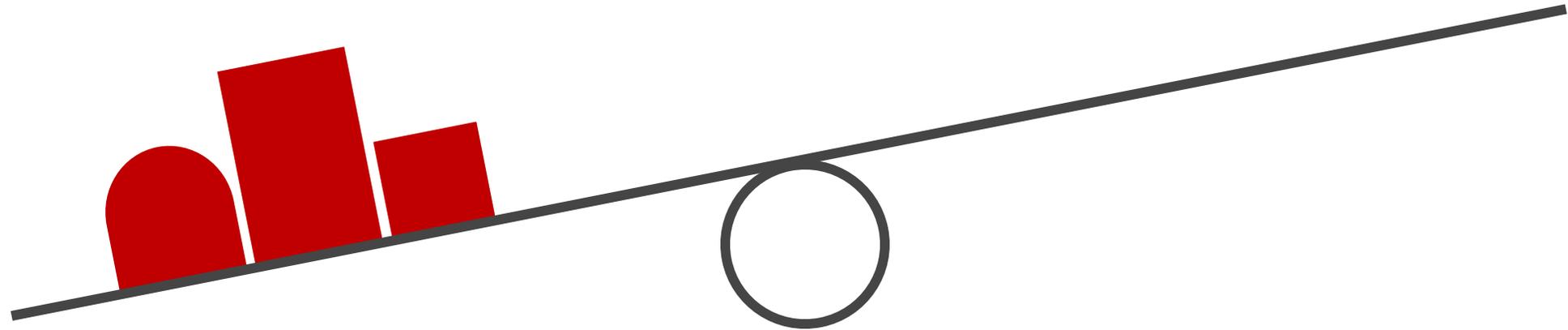
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6251669997528



"Money" = Debt

Private Considerations (Mostly Bank Managers)



More Debt

Others bear downside risk

Tax subsidies

“Paid to gamble”

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

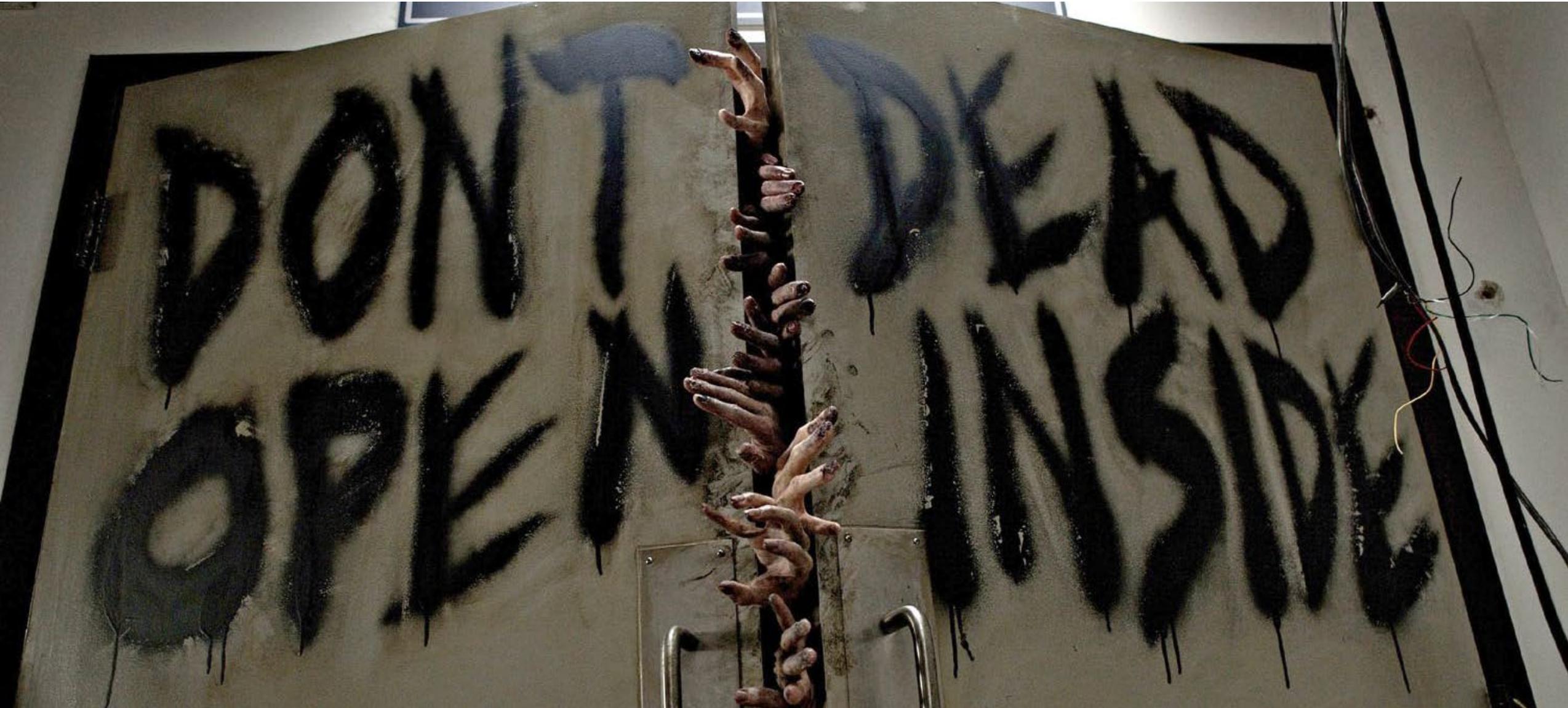
Reduces risk of runs and liquidity problems

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



Breaking the shackles: Zombie firms, weak banks and depressed restructuring in Europe

Dan Andrews, Filippos Petroulakis **February 2019**

Zombie firms have a higher likelihood of being connected to a weak bank.

Evidence on the potential for zombie firms to crowd-out credit to healthier and more productive firms.

Basel II: A spectacular failure

Basel III: An inadequate tweak,
“a well-intended illusion”

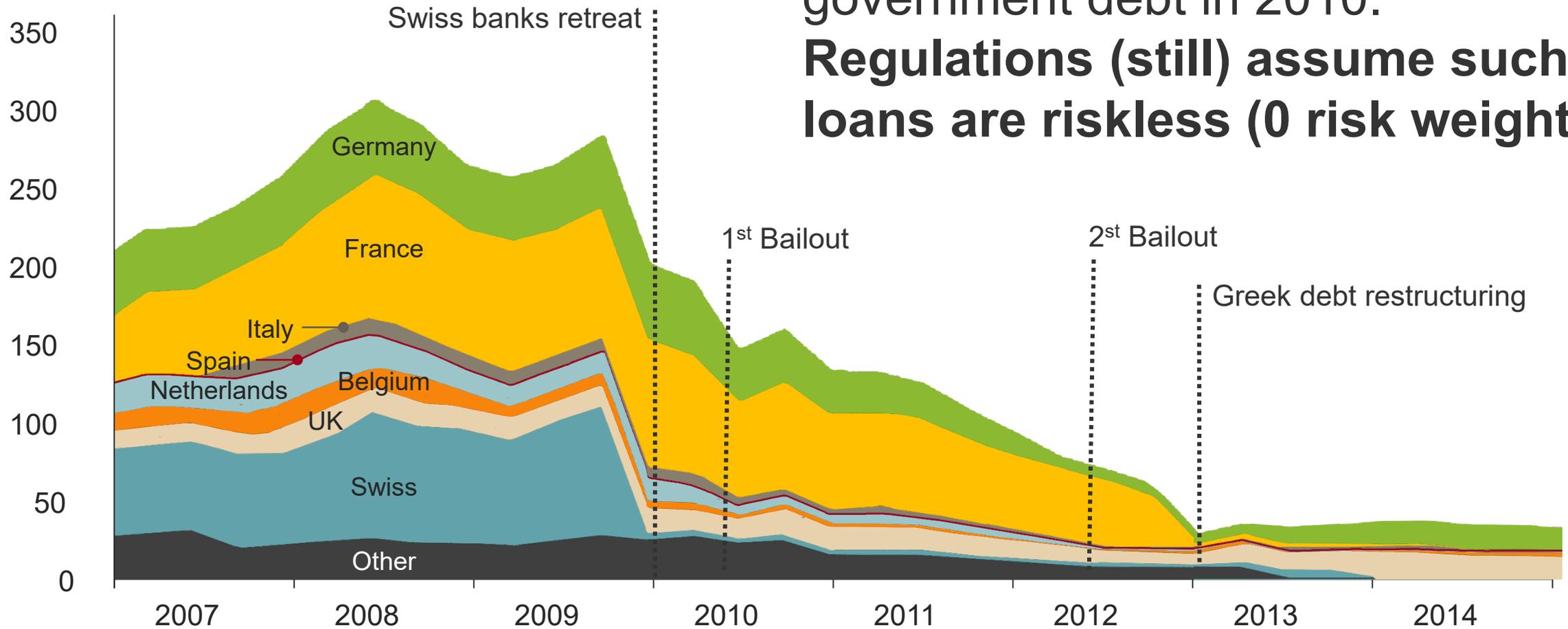
Thomas Hoenig, April 2013

Bad Regulations Matter

The Awful Case of Greece

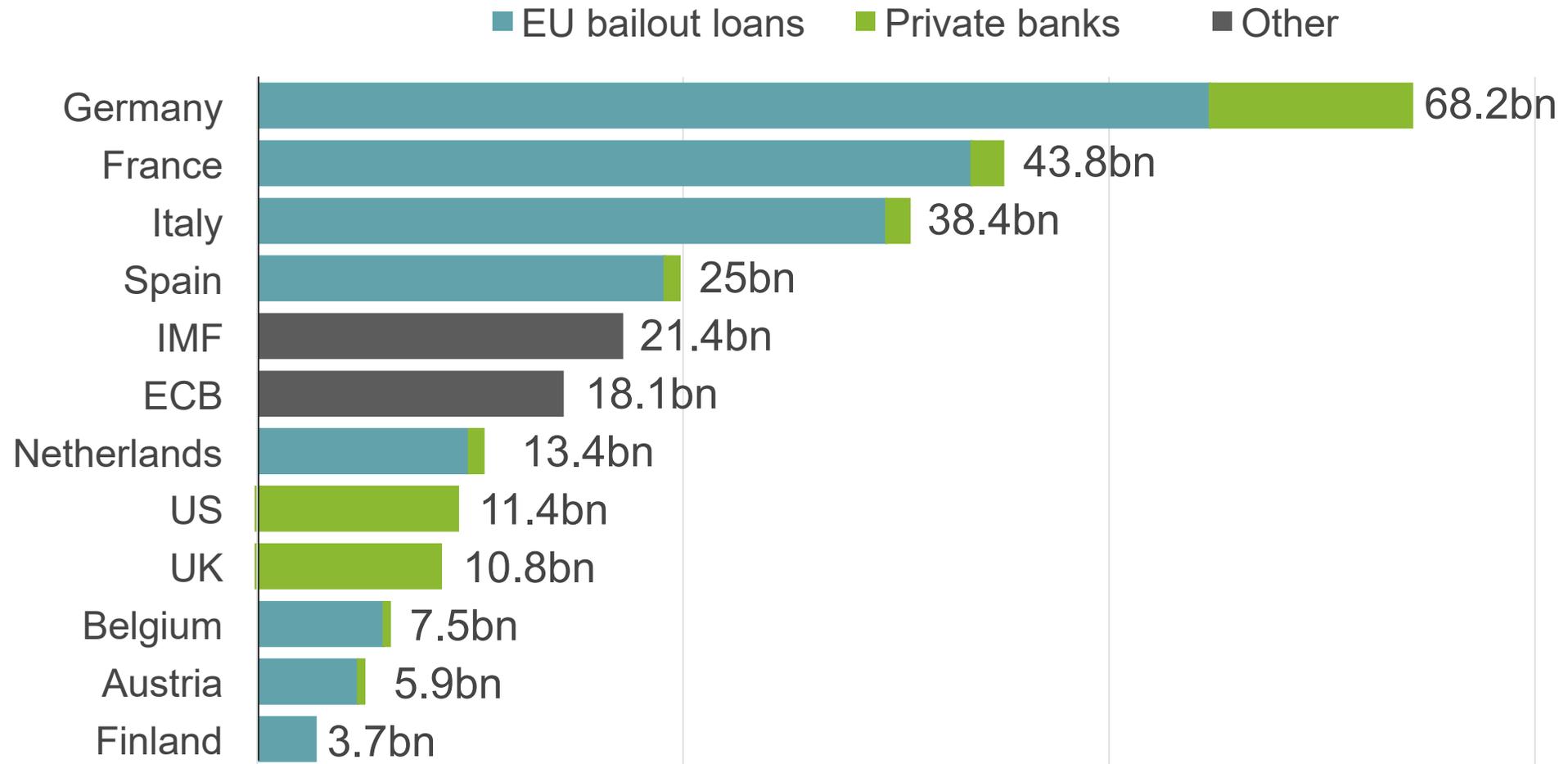
French banks owned 40% of Greek government debt in 2010.

Regulations (still) assume such loans are riskless (0 risk weight).



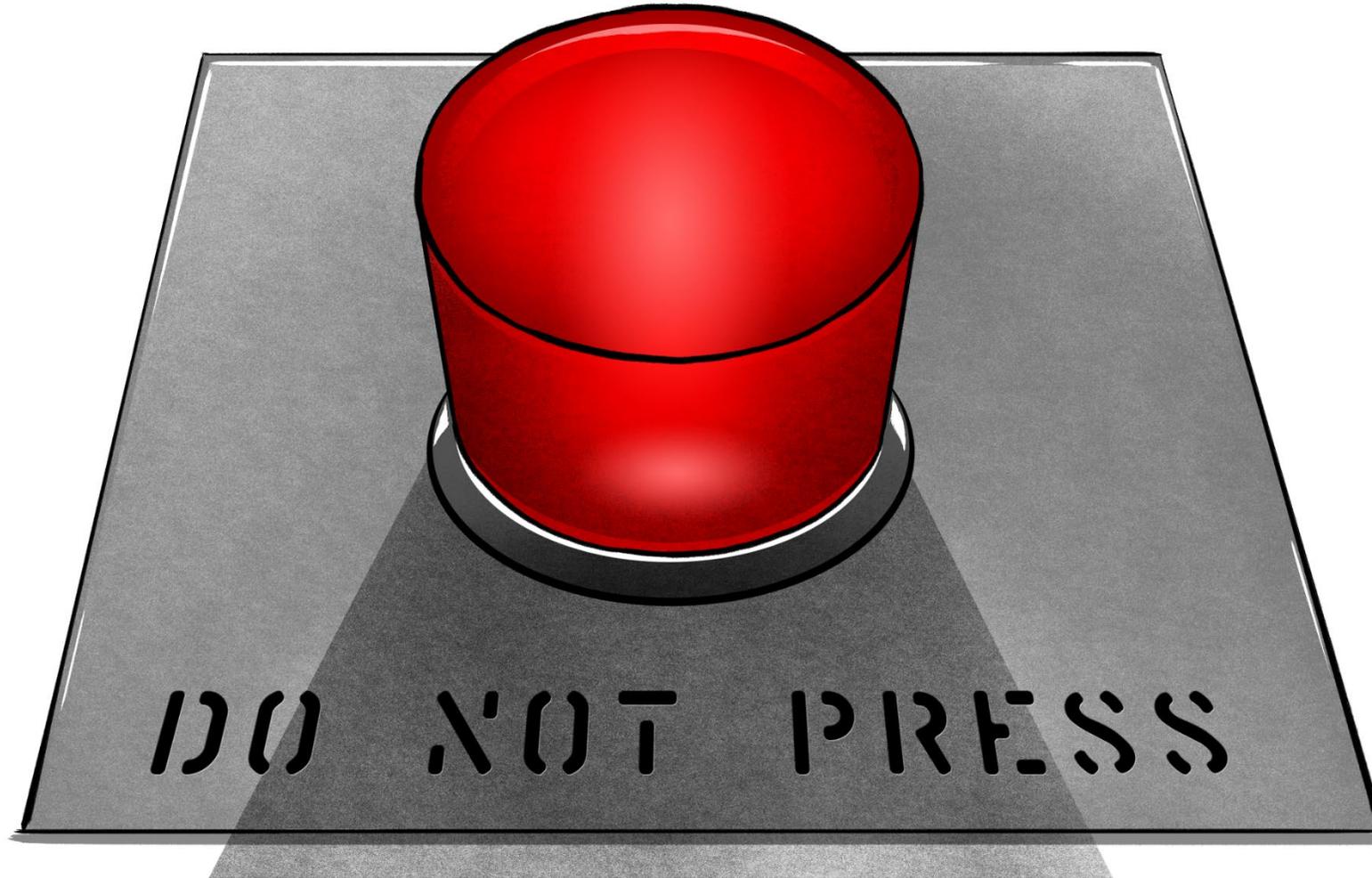
Who Owned Greek Government Debt, July 2015

Leading creditors (in euros)



Source: Open Europe, BIS, IMF, ECB

Loss-Absorbing Debt: Clever “Bail-in” or Fool’s Gold? WHY?



Governments in Europe Find Workarounds to Bail Out Ailing Banks

State injections into banks in Germany and Italy continue to protect investors over taxpayers



The Italian government granted a lifeline to ailing Banca Popolare di Bari in mid-December. PHOTO: GUGLIELMO MANGIAPANE/REUTERS

“Heroic Savior” Button



“ The omission of off-balance sheet items in the standard measures implies a substantial underestimation of bank leverage [indebtedness]

Off-balance sheet funding is higher now than in 2007

”

“Leverage, a Broader View,” Singh and Alam, IMF, March 2018

■ December 18, 2019, 9:01 PM PST

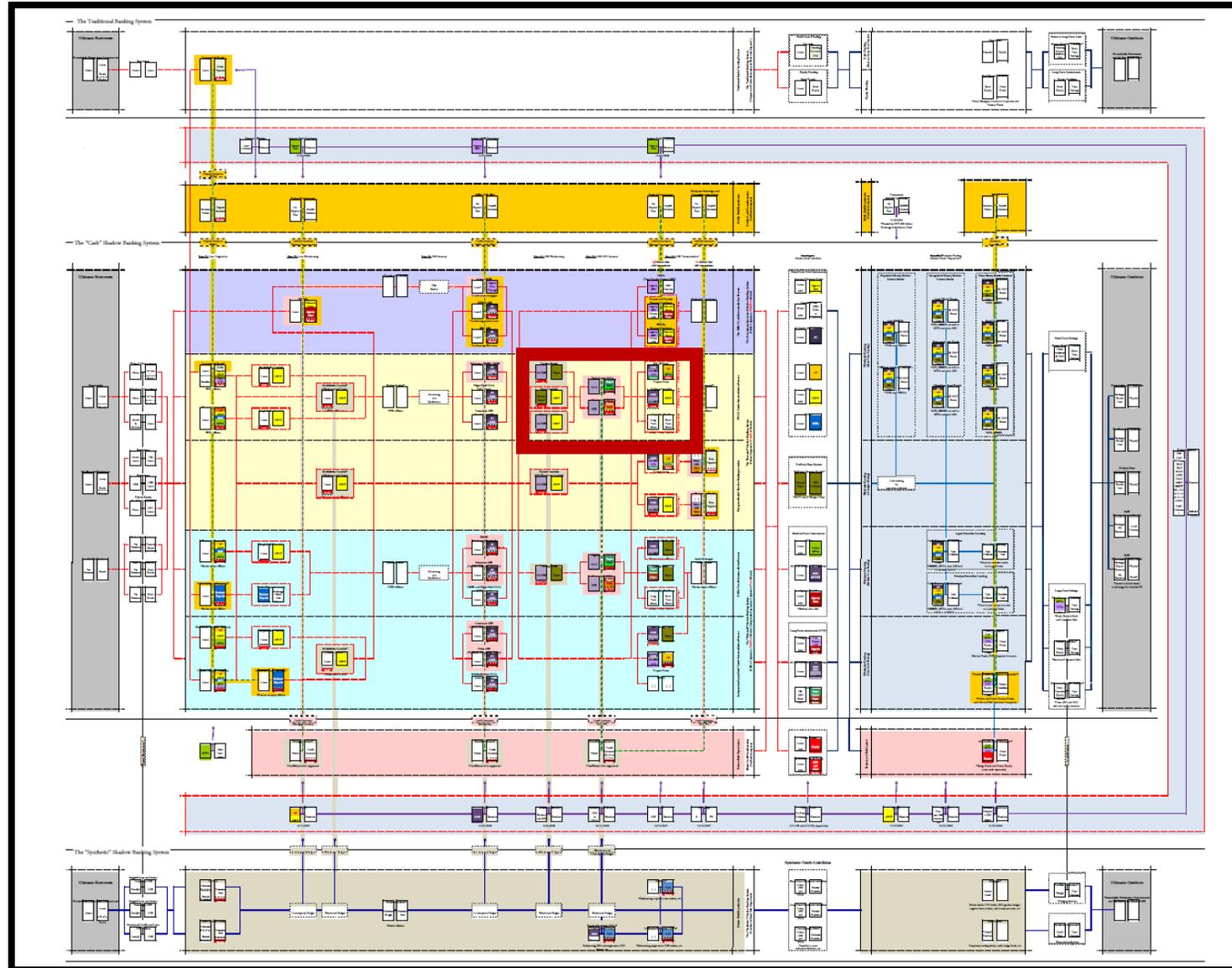
Wall Street Magic Tricks Make Banks Look Safer Than They Are

- Increased scrutiny hasn't put an end to accounting sleight-of-hand.

By Vernon Silver and Yalman Onaran

Shadow Banking

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

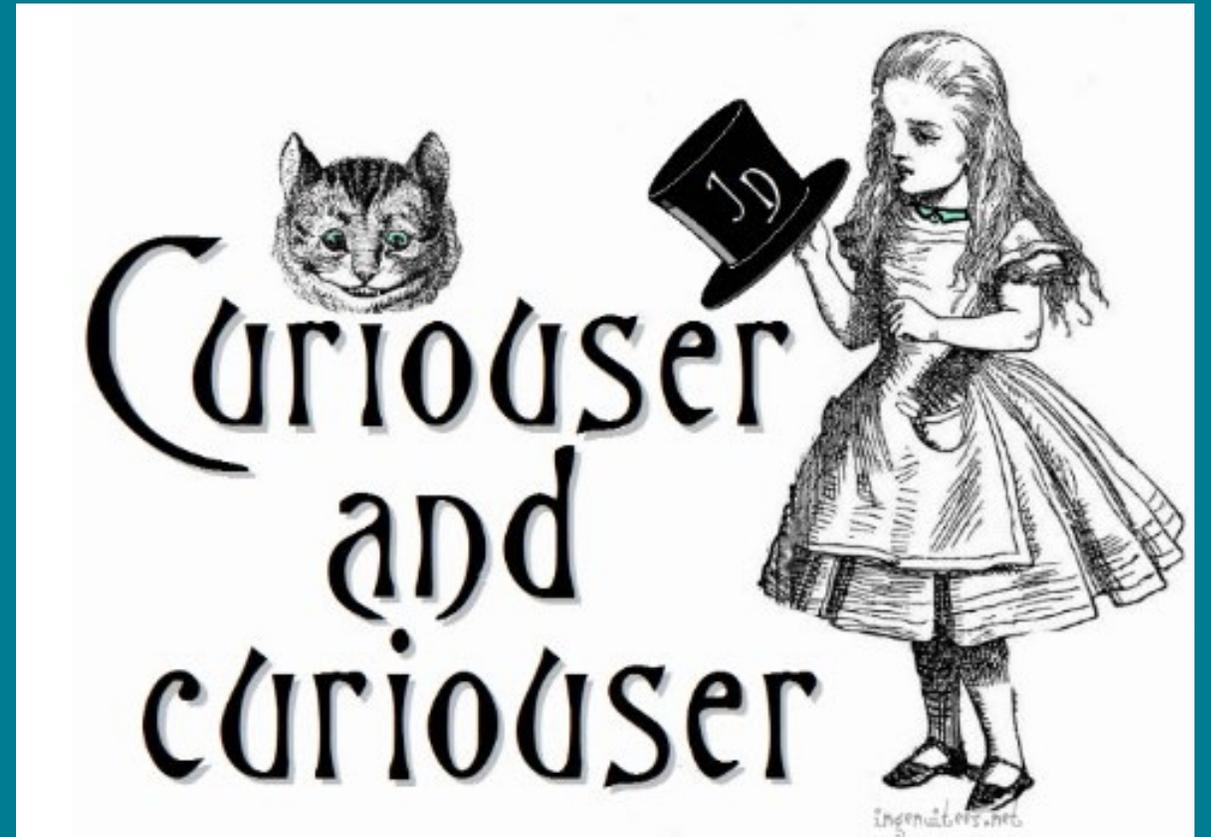


Financial “Innovation” and Regulatory Arbitrage



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

Into the rabbit hole...
...and the toxic mix of
confusion and politics





“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 funding with
consumers we don’t
have debt...”

HUH??

Wells Fargo Bank CEO, 2013

“

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

”

“



”

“

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

Steve Bartlett, Financial Services Roundtable, Sept 2010

”

“

Every dollar that is printed is one
less dollar in the economy.

Steve Bartlett, *Entrepreneur*, Sept 2010

”

“

This rule will keep
billions out of the Economy

Tim Pawlenty, Financial Services Roundtable, July 2015

”

“



”

“

By relaxing capital requirements, central bankers have aimed to keep credit flowing to businesses and households and mitigate the economic turmoil....

The freed-up capital provides lenders with the capacity to make an extra \$5tn of loans globally.

”

“Regulators free up \$500bn capital for lenders to fight virus storm,”
Martin Arnold *Financial Times*, April 5, 2020



“

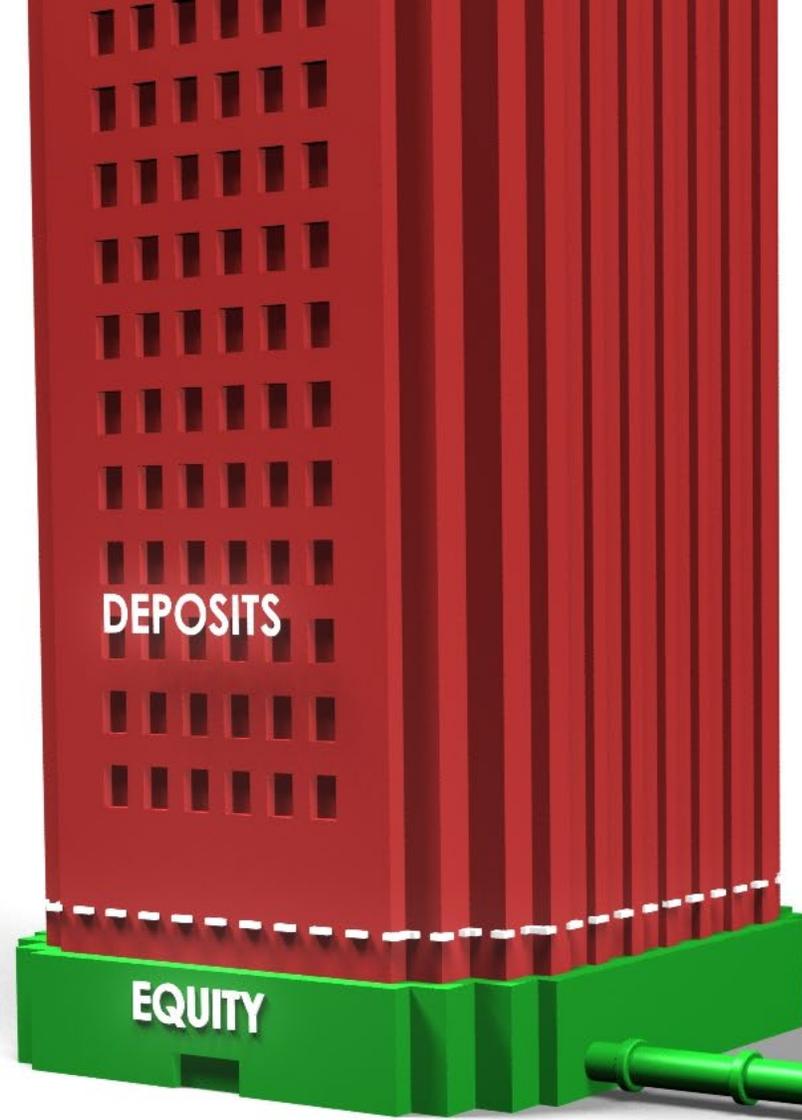
By relaxing capital requirements, central bankers have aimed to keep credit flowing to businesses and households and to avert a credit crunch and a sharp downturn in the economy....

The freed-up capacity to make loans is being used to buy government securities, not to lend to businesses and households. The freed-up capacity to make loans is being used to buy government securities, not to lend to businesses and households.

“Regulators have been misled by the fact that the economy is in a storm,”

”





DEPOSITS

EQUITY

DIVIDENDS

SHAREHOLDERS



A Distinction without a Difference



Credit



Debt



“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)

Ensuring the “Right” Investments are Made



Which investments are good for society?

How best to fund investments?

Why subsidize debt when there are alternatives (e.g., equity for corporations)?

Do heavily indebted corporations, including banks, make good decisions for society?



“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

01

“Banks are where the money is;” everyone needs banks

04

“National champions”

02

Guarantees appear free, the social cost is invisible

05

Central banks support governments and private banks

03

Banks seem sources of funding, not risk

06

Willful ignorance or confusion

Banks get away with inefficient recklessness

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**



“It is difficult to get a man
to understand something
when his salary
depends on not understanding it.”

Upton Sinclair, 1934

“

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

Excuses, Diversions and More Flawed Claims

“ Much has been done
The banks are very strong
Now is not the time
There will be “unintended consequences”
There are tradeoffs
We must maintain a level playing field
etc., etc....

“The Parade of Bankers New Clothes Continues: 34 Flawed Claims Debunked,” Admati and Hellwig, revised 2019
<https://admati.people.stanford.edu/publications/parade-bankers-new-clothes-continues-34-flawed-claims-debunked>

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

What about misconduct, fraud,
money laundering?

Danske's €200bn 'dirty money' scandal

Financial Times, October 2, 2018



DARK TOWERS



**DEUTSCHE BANK,
DONALD TRUMP, AND AN
EPIC TRAIL OF DESTRUCTION**

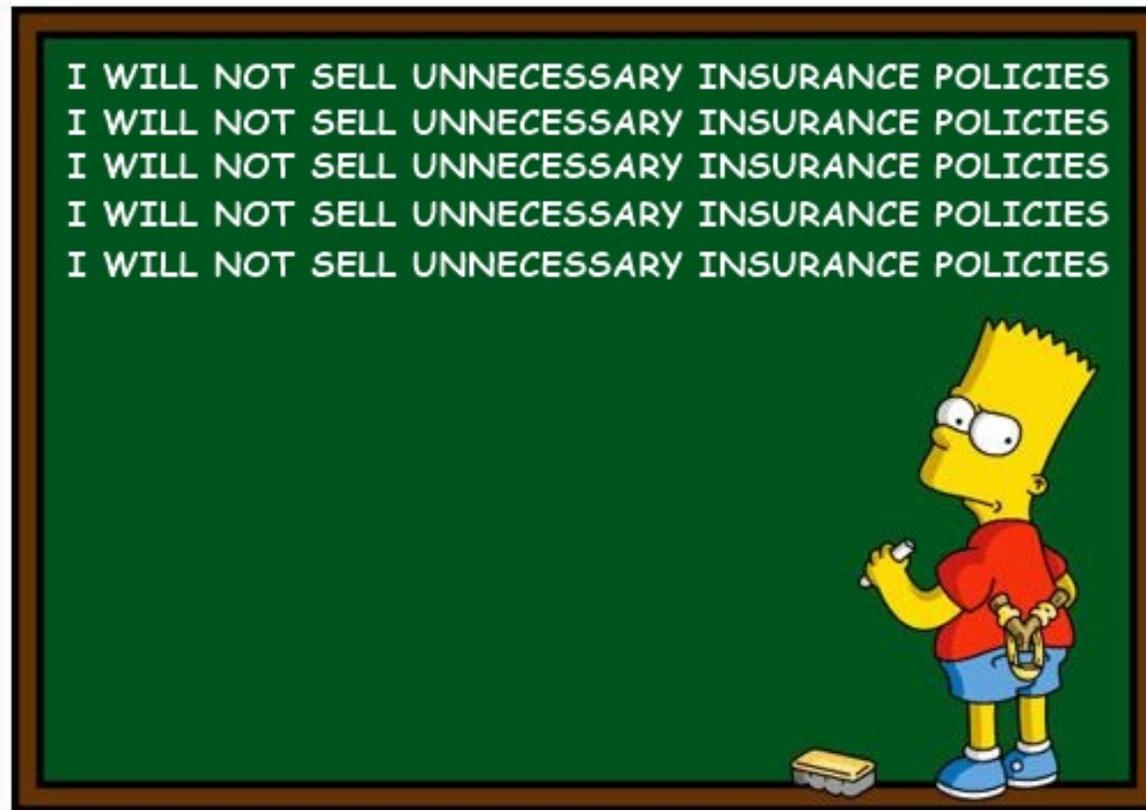
DAVID ENRICH

FINANCE EDITOR, *THE NEW YORK TIMES*

“When employees cooked up schemes to launder money, violate sanctions, manipulate markets, avoid taxes or mislead customers, there were few internal checks and balances to detect or stop such behavior. In the rare instances when employees voiced concerns, they were often ignored and were sometimes punished.”

“Wells Fargo Hit with \$1 Billion Fines Over Home and Auto Loan Abuses”
NPR, April 20, 2018

“Wells Fargo Agrees to Pay \$575 Million to Resolve State Investigations”
New York Times, December 28, 2018



Is the justice system working?

Bad and Inadequate Rules Feed Recklessness



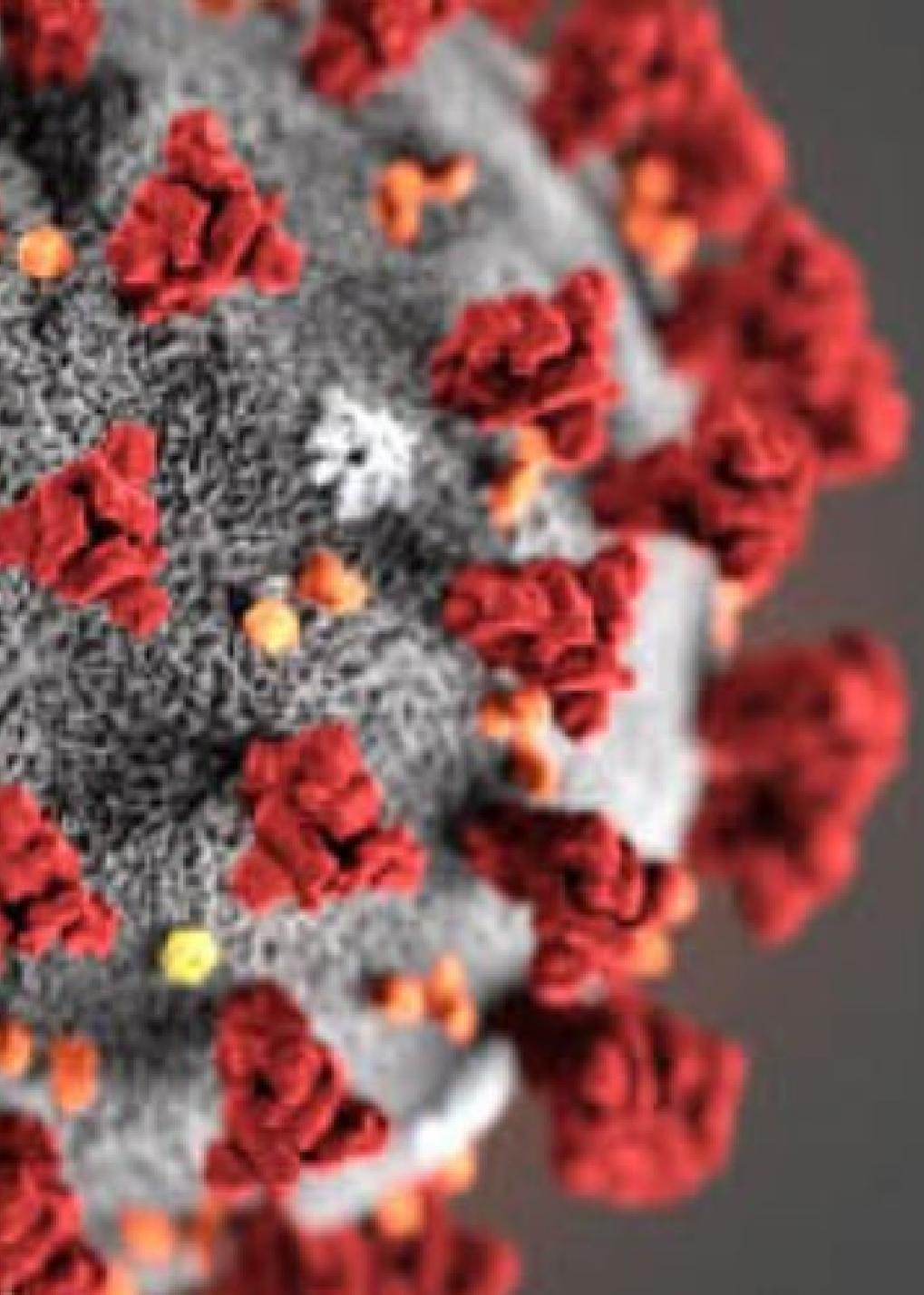
Debt (tax) subsidies

Excessive exemptions from
bankruptcy to “repos” and derivatives

Corporate opacity (disclosure rules)

Rules that are too complex and costly
relative to benefits (living wills, LCR)

Effective Immunity to executives



COVID-19

Novel Coronavirus



“The [post-2008] great experiment in ultra-loose monetary policy is intensely morally hazardous.... unconventional central bank policies may simply set the stage for the next boom and bust cycle, fueled by ever declining credit standards and ever expanding debt accumulation.”

William White, Bank of International Settlements
in “The Seeds of the Next Debt Crisis,” *Financial Times*, March 3, 2020

Here's what could really sink the global economy: \$19 trillion in risky corporate debt



By [Julia Horowitz](#), [CNN Business](#)

Updated 8:29 AM ET, Sat March 14, 2020

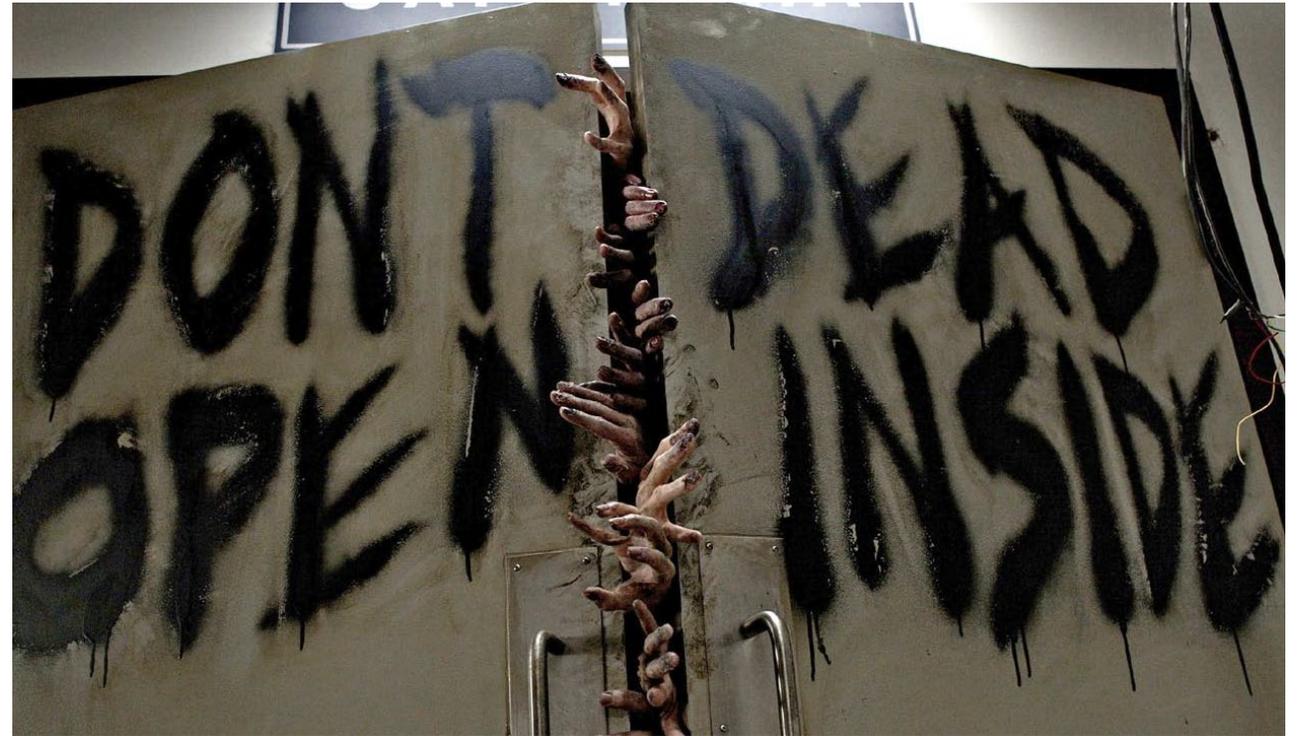
In its most recent financial stability report, the IMF raised the alarm about piles of risky corporate debt, which could amplify problems and deepen the next recession.

The group conducted a stress test based on a hypothetical economic shock that's half as severe as the 2008 global financial crisis. The results suggested that corporate debt worth \$19 trillion from eight countries — China, the United States, Japan, the United Kingdom, France, Spain, Italy and Germany — is at risk of default. That would be 40% of all corporate debt. A wave of defaults, or even a series of rating downgrades and repricing, would shake the financial system.

<https://www.cnn.com/2020/03/14/investing/corporate-debt-coronavirus/index.html>

Governments and Central Banks Response

Does propping up zombie banks and corporations help “transmission?”
“Liquidity supports” and asset purchases benefit asset owners/investors



Economics, Law and Finance Professors from Major Universities Write to Congress : “Bail Out People Before Large Corporations”

Posted on March 24, 2020 by ProMarket writers



“Bailouts allow investors to keep all the profits in good times without bearing the losses in bad times. Instead, bailouts impose losses on taxpayers, including those most in danger of losing their paychecks,” over 230 leading economists argue in a letter to Congress regarding the \$2 trillion package that’s meant to mitigate the economic impact of the coronavirus outbreak.

<https://promarket.org/economics-and-finance-professors-from-major-universities-write-to-congress-bail-out-people-before-large-corporations/>

Fed Vow Boosts Debt Binge as Borrowers Cut Thousands of Jobs

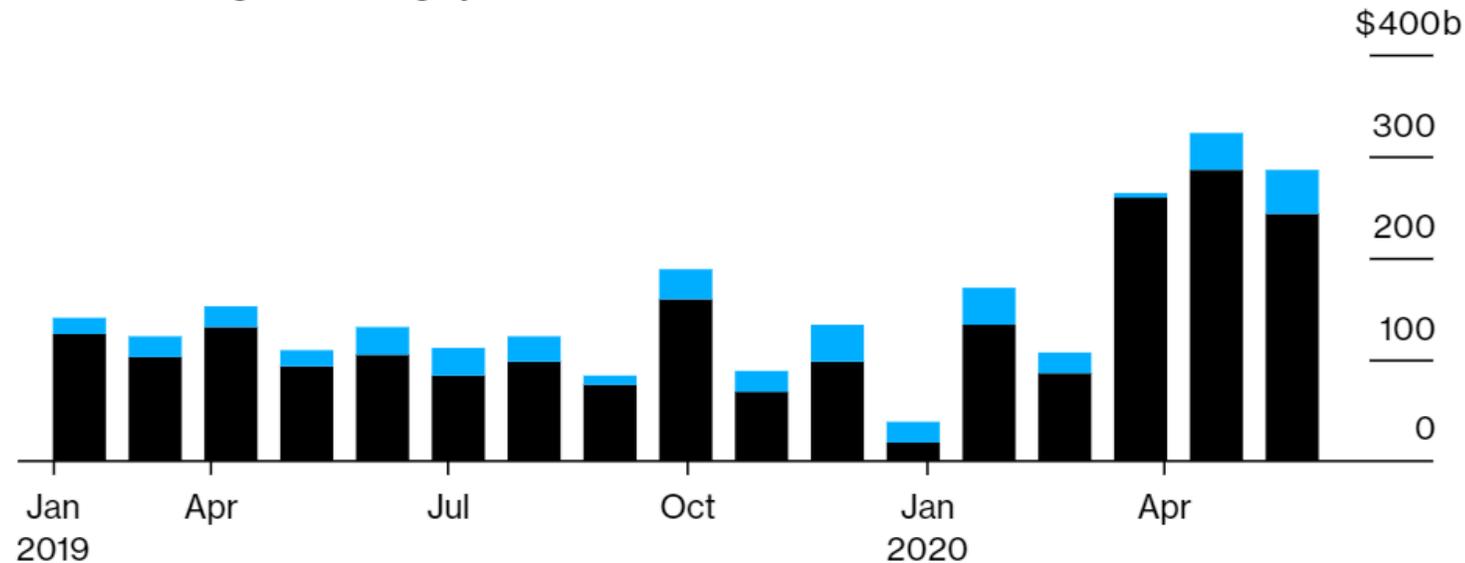
By [Bob Ivry](#), [Lisa Lee](#), and [Craig Torres](#)

June 5, 2020, 1:00 AM PDT Updated on June 5, 2020, 6:50 AM PDT

Trillion-Dollar Spigot

Corporate bond sales surged after the Fed announced purchasing plans on March 23

■ Investment grade ■ High yield



Markets

America's Zombie Companies Are Multiplying and Fueling New Risks

By [Lisa Lee](#) and [Michelle F Davis](#)

May 19, 2020, 3:00 AM PDT

- ▶ The Fed's credit-market support is staving off bankruptcies
- ▶ Yet it may also be setting the economy up for long-term pain

<https://www.bloomberg.com/news/articles/2020-05-19/america-s-zombie-companies-are-multiplying-and-fueling-new-risks?sref=pRRDzl9L>

Too Big to Fail: The Entire Private Sector

By [Matt Phillips](#) May 19, 2020

<https://www.nytimes.com/2020/05/19/business/too-big-to-fail-wall-street-businesses.html>

ECB pushes for eurozone bad bank to clean up soured loans

Brussels opposes idea despite fears the pandemic will trigger new NPL surge

Martin Arnold in Frankfurt and **Javier Espinoza** in Brussels APRIL 19 2020

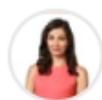
The plan to deal with debts left over from the 2008 financial crisis is being pushed by senior ECB officials, who worry the [coronavirus](#) pandemic will trigger another surge in [non-performing loans](#) (NPLs) that risks clogging up banks' lending capacity at a critical time.

But the idea faces stiff opposition within the European Commission, where officials are reluctant to waive EU rules requiring state aid for banks to be provided only after a resolution process imposes losses on their shareholders and bondholders.



European Central Bank takes its pandemic bond buying to 1.35 trillion euros to try to prop up economy

PUBLISHED THU, JUN 4 2020 7:46 AM EDT | UPDATED THU, JUN 4 2020 9:59 AM EDT



Silvia Amaro
@SILVIA_AMARO

SHARE    

“Now is Not the Time” to Regulate (or Reform)



*“No, Tuesday is out. How about never ---
is never good for you?”*

Kick the Can Down the Road



Don't Allow Dominos to Fall



Extend and Pretend

Entrenched system, bad habits: Can this time be different?

transylvina



Feldman

Thank you!

More at

<https://admati.people.stanford.edu/>