

A dark teal rectangular logo with white text. The text reads "ME AND EARL" on the top line, "AND THE DYING" on the second line, and "GIRL" on the third line.

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The Opinion Pages | OP-ED CONTRIBUTOR

# We're All Still Hostages to the Big Banks

By ANAT R. ADMATI AUG. 25, 2013

STANFORD, Calif. — NEARLY five years after the bankruptcy of Lehman Brothers touched off a global financial crisis, we are no safer. Huge, complex and opaque banks continue to take enormous risks that endanger the economy. From Washington to Berlin, banking lobbyists have blocked essential reforms at every turn. Their efforts at obfuscation and influence-buying are no surprise. What's shameful is how easily our leaders have caved in, and how quickly the lessons of the crisis have been forgotten.

We will never have a safe and healthy global financial system until banks are forced to rely much more on money from their owners and shareholders to finance their loans and investments. Forget all the jargon, and just focus on this simple rule.

Mindful, perhaps, of the coming five-year anniversary, regulators have recently taken some actions along these lines. In June, a committee of global banking regulators based in Basel, Switzerland, proposed changes to how banks calculate their leverage ratios, a measure of how much borrowed money they can use to conduct their business.

Last month, federal regulators proposed going somewhat beyond the internationally agreed minimum known as Basel III, which is being phased in. Last Monday, President Obama scolded regulators for dragging their feet on implementing Dodd-Frank, the gargantuan 2010 law that was supposed to prevent another crisis but in fact punted on most of the tough decisions.

Don't let the flurry of activity confuse you. The regulations being proposed offer little to celebrate.

From Wall Street to the City of London comes the same wailing: requiring banks to rely less on borrowing will hurt their ability to lend to companies and individuals. These bankers falsely imply that capital (unborrowed money) is idle cash set aside in a vault. In fact, they want to keep placing new bets at the poker table — while putting taxpayers at risk.

When we deposit money in a bank, we are making a loan. JPMorgan Chase, America's largest bank, had \$2.4 trillion in assets as of June 30, and debts of \$2.2 trillion: \$1.2 trillion in deposits and \$1 trillion in other debt (owed to money market funds, other banks, bondholders and the like). It was notable for surviving the crisis, but no bank that is so heavily indebted can be considered truly safe.

The six largest American banks — the others are Bank of America, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley — collectively owe about \$8.7 trillion. Only a fraction of this is used to make loans. JPMorgan Chase used some excess deposits to trade complex derivatives in London — losing more than \$6 billion last year in a notoriously bad bet.

Risk, taken properly, is essential for innovation and growth. But outside of banking, healthy corporations rarely carry debts totaling more than 70 percent of their assets. Many thriving corporations borrow very little.

Banks, by contrast, routinely have liabilities in excess of 90 percent of their assets. JPMorgan Chase's \$2.2 trillion in debt represented some 91 percent of its \$2.4 trillion in assets. (Under accounting conventions used in Europe, the figure would be around 94 percent.)

Basel III would permit banks to borrow up to 97 percent of their assets. The proposed regulations in the United States — which Wall Street is fighting — would still allow even the largest bank holding companies to borrow up to 95 percent (though how to measure bank assets is often a matter of debate).

If equity (the bank's own money) is only 5 percent of assets, even a tiny loss of 2 percent of its assets could prompt, in essence, a run on the bank. Creditors may refuse to renew their loans, causing the bank to stop lending or

to sell assets in a hurry. If too many banks are distressed at once, a systemic crisis results.

Prudent banks would not lend to borrowers like themselves unless the risks were borne by someone else. But insured depositors, and creditors who expect to be paid by authorities if not by the bank, agree to lend to banks at attractive terms, allowing them to enjoy the upside of risks while others — you, the taxpayer — share the downside.

Implicit guarantees of government support perversely encouraged banks to borrow, take risk and become “too big to fail.” Recent scandals — JPMorgan’s \$6 billion London trading loss, an HSBC money laundering scandal that resulted in a \$1.9 billion settlement, and inappropriate sales of credit-card protection insurance that resulted, on Thursday, in a \$2 billion settlement by British banks — suggest that the largest banks are also too big to manage, control and regulate.

NOTHING suggests that banks couldn’t do what they do if they financed, for example, 30 percent of their assets with equity (unborrowed funds) — a level considered perfectly normal, or even low, for healthy corporations. Yet this simple idea is considered radical, even heretical, in the hermetic bubble of banking.

Bankers and regulators want us to believe that the banks’ high levels of borrowing are acceptable because banks are good at managing their risks and regulators know how to measure them. The failures of both were manifest in 2008, and yet regulators have ignored the lessons.

If banks could absorb much more of their losses, regulators would need to worry less about risk measurements, because banks would have better incentives to manage their risks and make appropriate investment decisions. That’s why raising equity requirements substantially is the single best step for making banking safer and healthier.

The transition to a better system could be managed quickly. Companies commonly rely on their profits to grow and invest, without needing to borrow. Banks should do the same.

Banks can also sell more shares to become stronger. If a bank cannot

persuade investors to buy its shares at any price because its assets are too opaque, unsteady or overvalued, it fails a basic “stress test,” suggesting it may be too weak without subsidies.

Ben S. Bernanke, chairman of the Federal Reserve, has acknowledged that the “too big to fail” problem has not been solved, but the Fed counterproductively allows most large banks to make payouts to their shareholders, repeating some of the Fed’s most obvious mistakes in the run-up to the crisis. Its stress tests fail to consider the collateral damage of banks’ distress. They are a charade.

Dodd-Frank was supposed to spell the end to all bailouts. It gave the Federal Deposit Insurance Corporation “resolution authority” to seize and “wind down” banks, a kind of orderly liquidation — no more panics. Don’t count on it. The F.D.I.C. does not have authority in the scores of nations where global banks operate, and even the mere possibility that banks would go into this untested “resolution authority” would be disruptive to the markets.

The state of financial reform is grim in most other nations. Europe is in a particularly dire situation. Many of its banks have not recovered from the crisis. But if other countries foolishly allow their banks to be reckless, it does not follow that we must do the same.

Some warn that tight regulation would push activities into the “shadow banking system” of money market funds and other short-term lending vehicles. But past failures to make sure that banks could not hide risks using various tricks in opaque markets is hardly reason to give up on essential new regulations. We must face the challenge of drawing up appropriate rules and enforcing them, or pay dearly for failing to do so. The first rule is to make banks rely much more on equity, and much less on borrowing.

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