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**WHAT CAUSED THE CURRENT MESS IN  
BANKING? AND WHAT SHOULD WE DO TO FIX  
IT?**

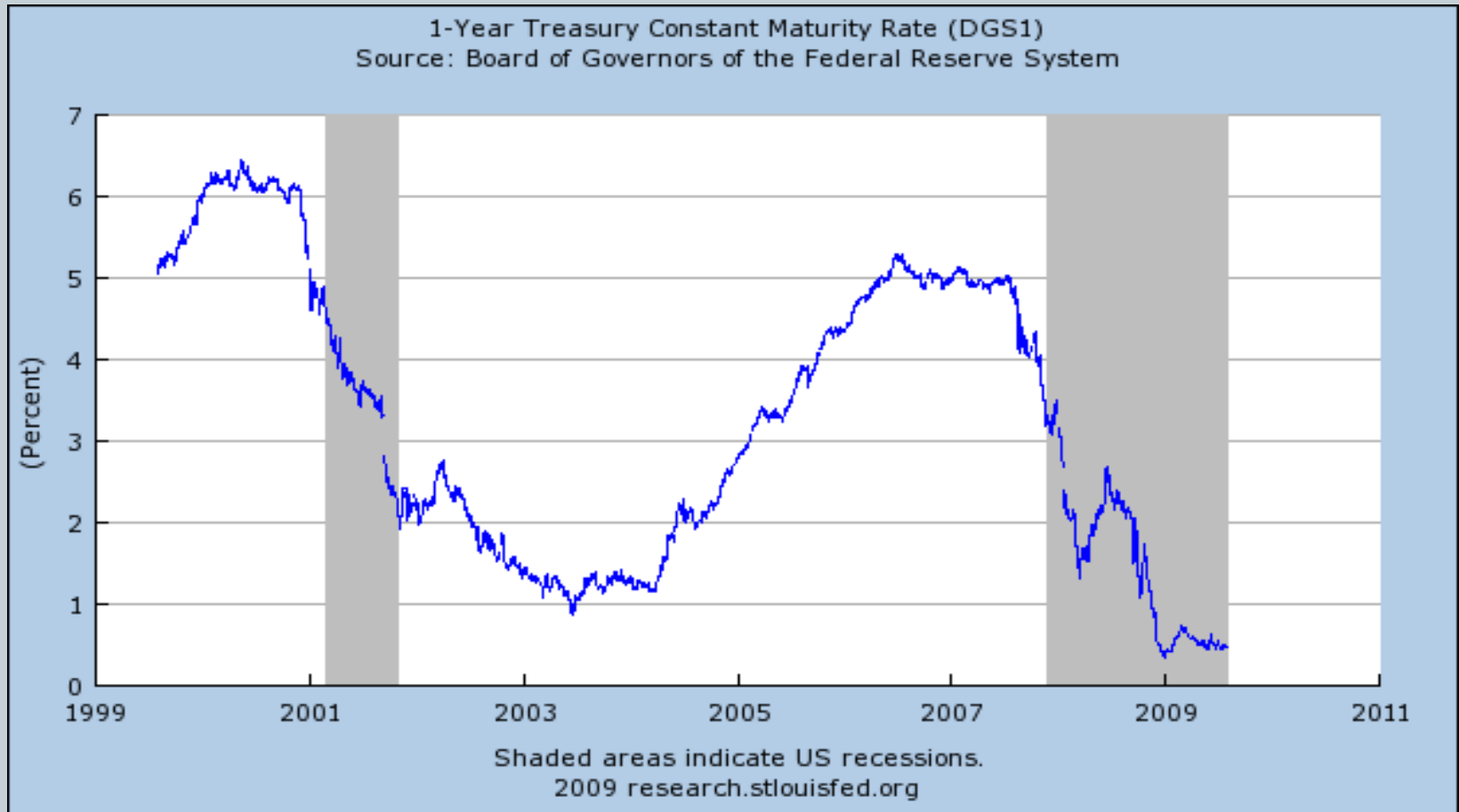
# Overview of Comments \*



- 1. What went wrong?
- 2. Who's to blame?
- 3. What do we propose to fix the mess?
- 4. What is actually going to happen with bank regln?

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- \* Comments based on work with Ravi Jagannathan, (*Economist's Voice*, 2009); Ravi Jagannathan and Sungkyu Kwak, (*Journal of Investment Management*, forthcoming) . Still, any errors in this essay are mine.

# 1. What Went Wrong? Too Much Liquidity



# What Went Wrong? 2



- **For several years (2001-04), too much liquidity in system, extremely low interest rates.**
  - **Not just due to Fed, but also inflows of foreign capital.**
- **Asset managers wanted apparently-risk-free investments with higher yields.**
- **The Quasi-banks accommodated. Mortgage bankers + packagers + investment banks + credit rating agencies. Trillions of seemingly-risk-free mortgage-related instruments.**
- **Incentives? Mortgage bankers? Packagers? Investment Banks? Rating Agencies (both of them)?  
===== deal flow.**

# What Went Wrong? 3



- As we all know, finally housing prices turned south, defaults skyrocketed, the assets turned out to be **far from “risk free.”** They also proved to be **highly illiquid.**
  - Complicated, multi-party, multi-tranched, impossible to unwind.
  - Even good asset-backed claims became illiquid.
- They had been marketed in large quantities all over the world.
- Thus a world-wide financial crisis “Made in America.”

# What went wrong? 4



- **Calendar of Events**

- June 2007, SEC began investigation of 12 CDO issuers;
- September 2007, **Northern Rock** emergency loan from the BofE
- November 2007, **Citigroup** raised \$7.5 billion from Abu Dhabi I
- December ,2007, the **Term Auction Facility (TAF)** is announced
- January 2008, **Economic Stimulus Act** signed into law;
- January 2008, Rating agencies threaten downgrade **Ambac, MBIA**
- February 2008, Britain nationalizes Northern Rock;
- March 2008, Bear Stearns receives emergency aid from the Fed
- March 2008, JP Morgan **purchase Bear Stearns at \$2/share.**

# What went wrong? 5



- **Why didn't smart traders make arbitrage profits by shorting asset-backed securities of various kinds?**
  - **1. Short holders must cover principle and interest in timely manner (costly).**
  - **2. Requires a lot of resources, patience, and thick skin.**
  - **3. Buy side fools kept buying and supporting prices.**
- **Anyway, it just didn't happen.**

## 2. Who's to blame?



- **The Congress**

- For creating Fannie and Freddie
  - ✦ and always pushing them **to lend a lot, lend cheap, and lend high-risk.**
- For repealing the Glass-Steagall Act. (e.g. passing the Gramm, Leach, Bliley Act of 1999).

## 2. Who's to Blame? 2



- **The Fed**

- Responsible for systemic risk, at least that's what everybody (including the Fed) thought.
- Now, they want (and apparently will get) responsibility for doing what they were supposed to be doing all along.

*“Since the mid-1990s, the Federal Reserve has devoted particular attention to .....supervision of the largest, most complex banking organizations, or LCBO.....the LCBO supervision program incorporates both a more continuous supervision process..... “*

Federal Reserve Bulletin (Feb, 2001).

## 2. Who's to blame?, 2a



- **The Fed**
- For keeping interest rates way to low for way to long.
- For allowing banks to hide junk assets in supposedly off-balance sheet affiliates.
  - ✦ **A policy that has always failed, when needed.**

## 2. Who's to Blame? 3



- **The SEC.**
- **For eliminating capital requirements on large (not all) investment banks at the worst conceivable time (2005-06).**
  - ✦ **Unbelievable.**

# Who's to Blame? 4

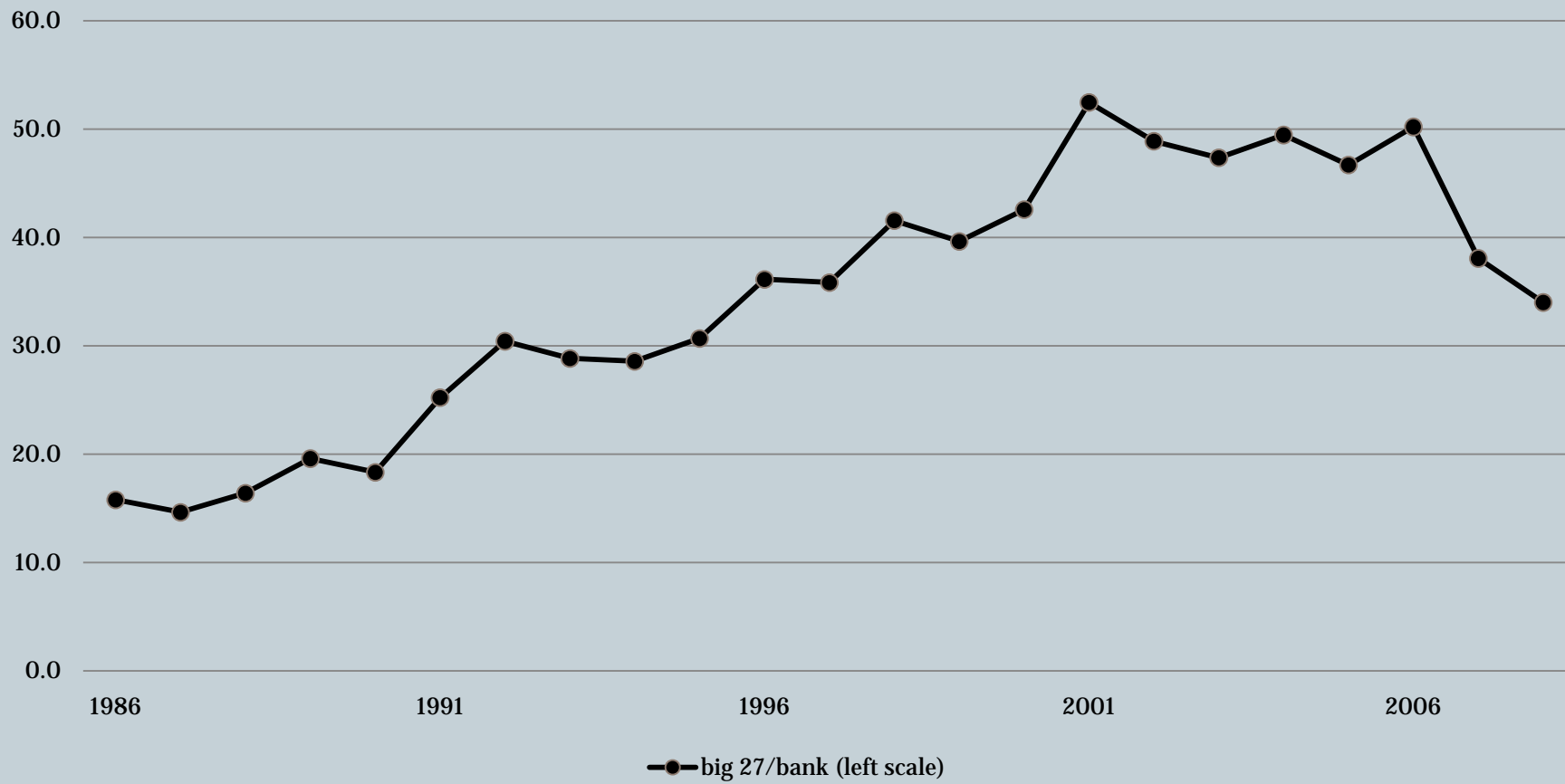


- **Large Banks**
- **For massively succumbing to moral hazard incentives created by the Too-Big-to-Fail policy.**

# Who's to Blame? 5



**Figure 2. Market Capitalization,**

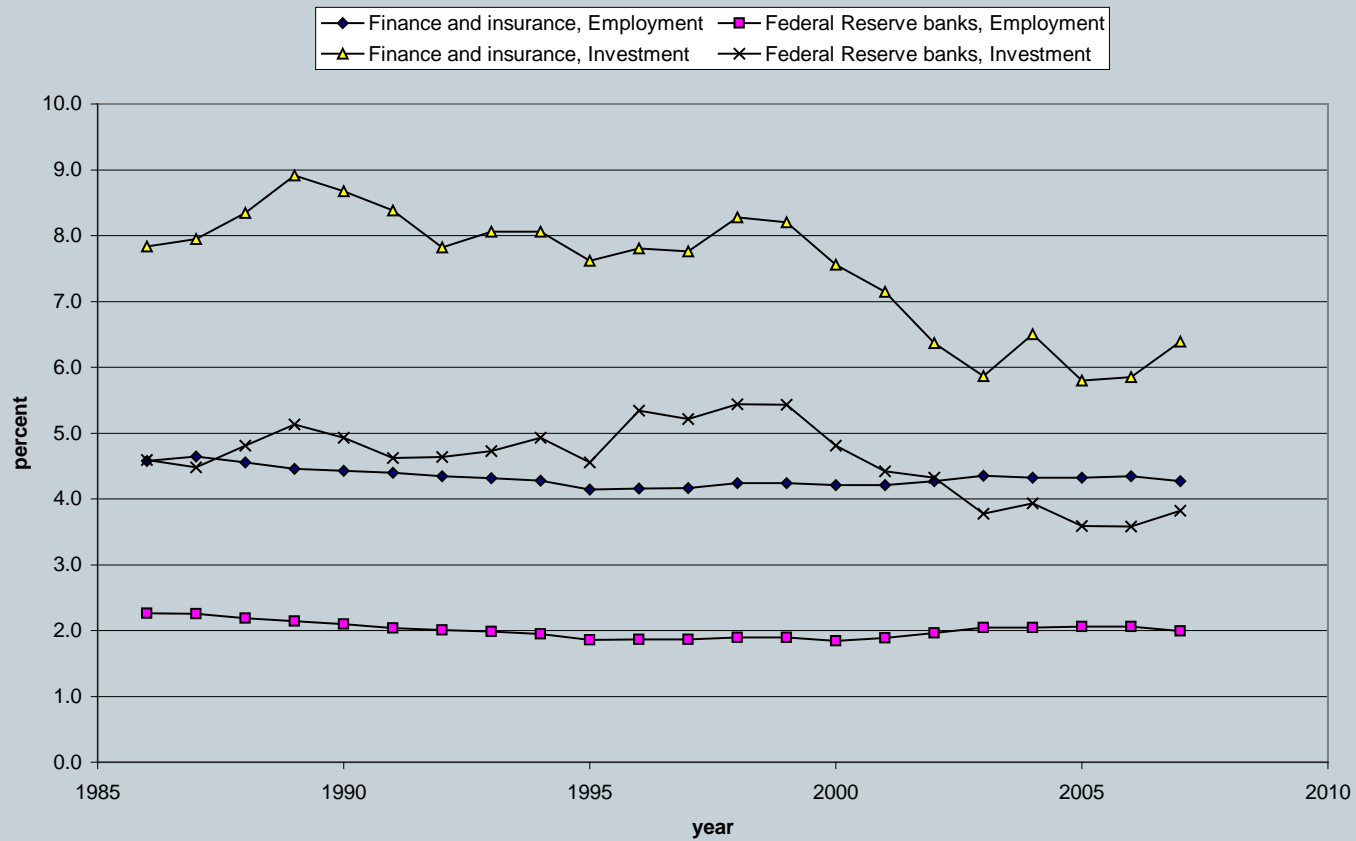


# Who's to Blame? 6

## Real Factor Inputs, Banks



Figure 5. Employment and Investment in Real Capital



# 3. What do we Propose to Fix the Mess? (B & J, 2009)



- **Proposal 1. Size Limits on banks.**
  - Include off-balance-sheet guarantees
  - Indexed.
  - Talk about ~ \$150 billion to “begin discussion”
  - No grandfathering. Timely spin off mandatory.
  - Others have similar proposals: Reich (2008), Schultz (2008), O’Driscoll (2009), Johnson (2009).
  - Recently, even Volcker and Greenspan.

# 3. What Do We Propose to Fix the Mess?



- Proposal 2. Firms that perform fundamental banking functions must be chartered and regulated as banks.
  - *“If it swims, flies and quacks, it should be deemed “duck” and dealt with as such. No exceptions. This will be difficult to implement in practice.”*
- Two criteria defining a bank come from basic banking theory.
  1. Does the firm issue transaction-able liabilities?
    - ✦ **E-bay. Money market mutual funds with checking feature.**

# What do we Propose?



- 2. Does it predominantly hold or guarantee risky financial assets and fund with liquid debt liabilities that can be redeemed at face value on short notice?
  - *AIG, Fannie Mae, Freddie Mac, state chartered loan companies, most investment banks, and possibly General Electric Credit and the captive auto finance companies.*

# What Do we Propose?



- **Our recommendations have been described as a “massive expansion of regulatory scope.”**
  - However, they are essential if size caps are to be effective.
  - We believe, they are fair. If two firms perform the same functions, they should have the same regulatory treatment.
    - ✦ In past, bank regulatory agencies have exceptionally poor track record in closing such loop-holes.

# 4. What is Actually Going to Happen? (As I see it.)



- **Not really a lot.**

- The new consumer finance agency has already been beaten into insignificance by the lobbyists.
  - ✦ Big bank lobby (states rights). Small bank lobby (>\$10 bil.), Car dealer lobby (tied sales). Insurance lobby (title and mortgage insurance).
- Fed may get some new powers regarding systemic risk, but operationally it already had most of them.
- The high concentration of US financial intermediation was greatly worsened by the crisis (shotgun weddings).
  - ✦ No intent of changing that, so far as I can tell.

# A Chance For Real Reform Wasted?



- *“Now we have reached a point where we almost have to rebuild the whole thing .....*”
- *“....Do we really want a financial system with a few big universal banks, riddled by internal conflicts and contradictions, and yet too big to fail? “*
  - ✦ *(Rogoff, 2008).*