

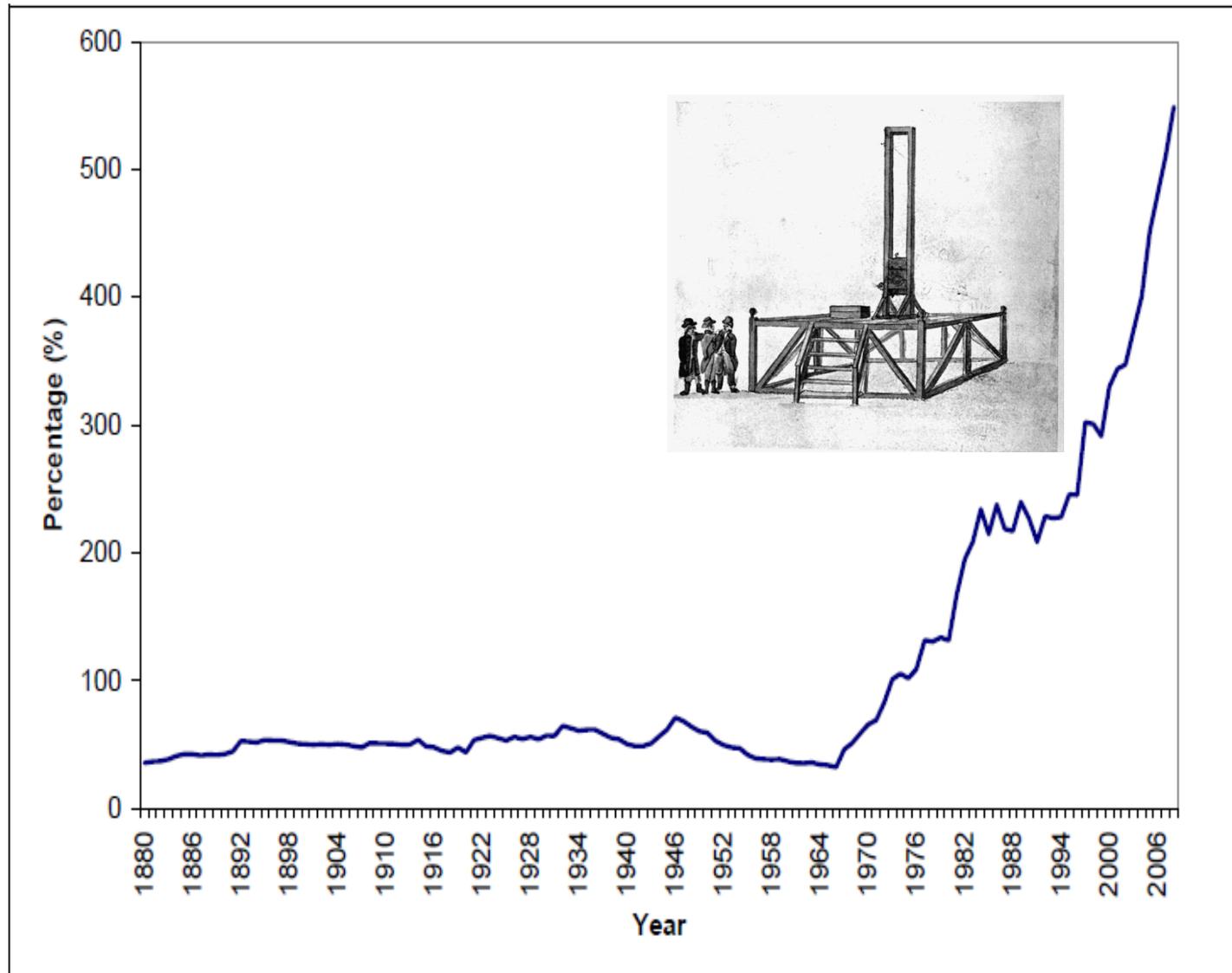
How did banks cause the global banking crisis?

Andrzej Sławiński



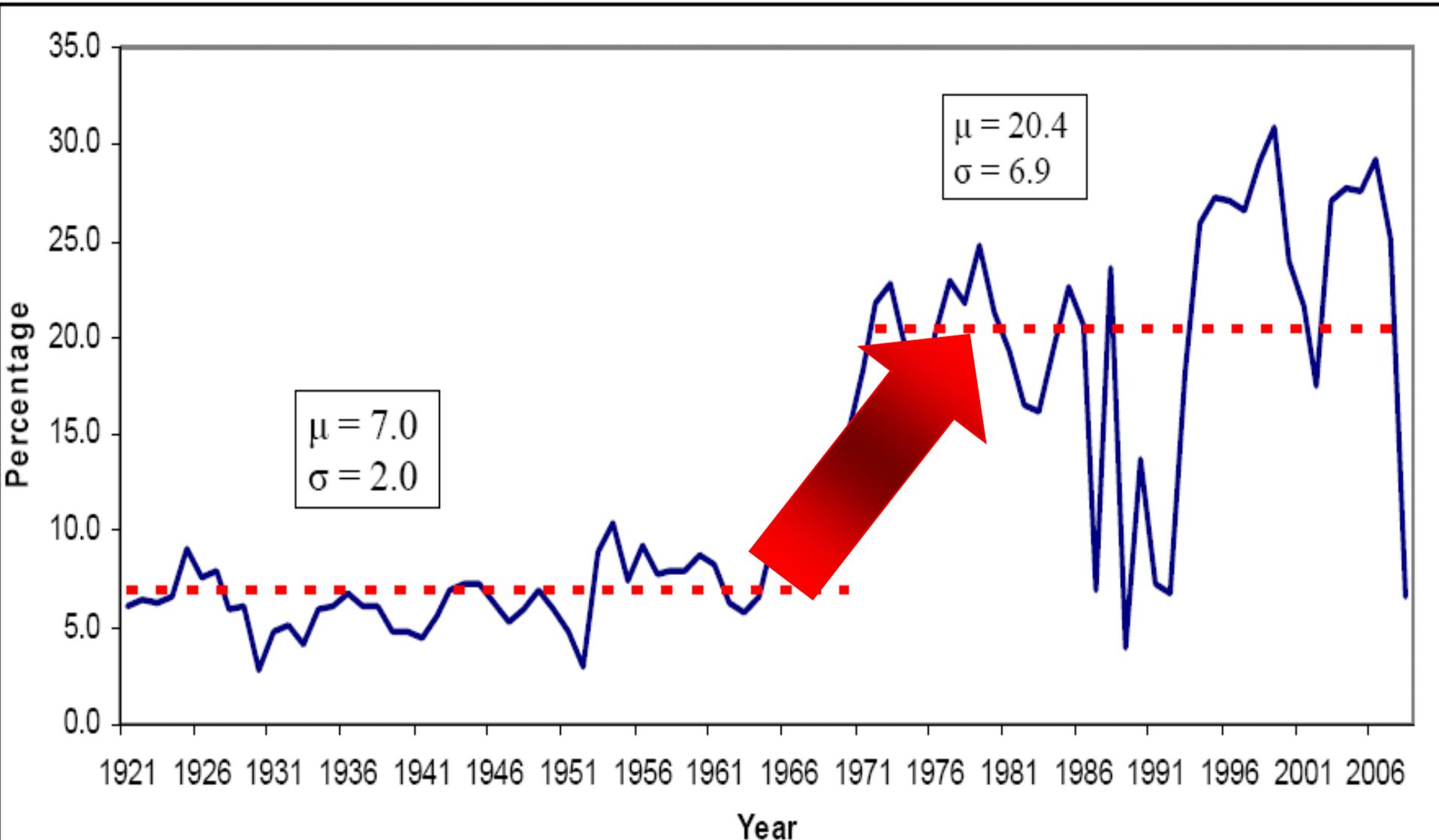
When did all this start?

The emergence of universal TBTF banks



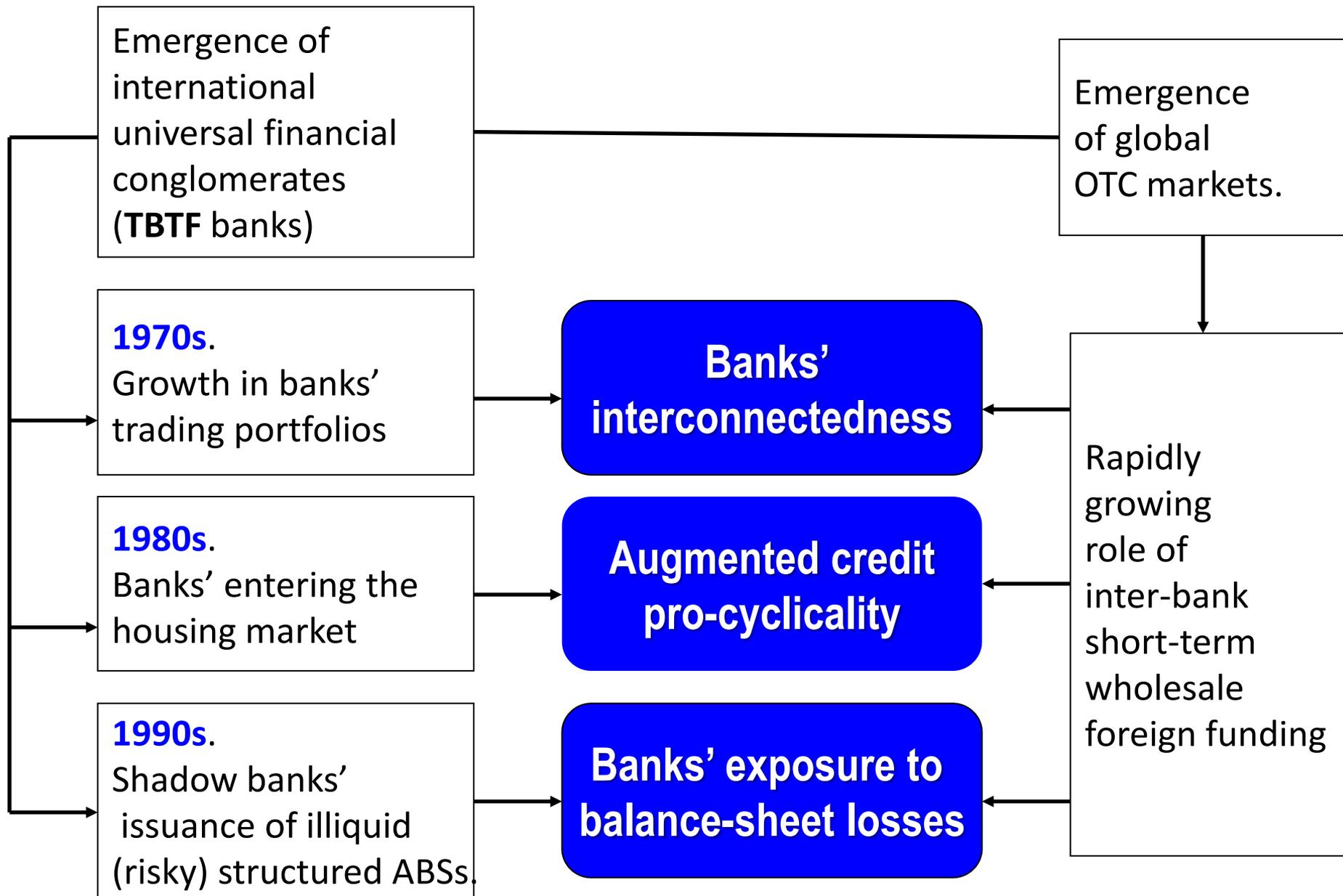
Source: A. G. Haldane, P. Alessandri, „Banking on the state”, Federal Bank of Chicago, 25 September 2009

...at the cost of increased risk taking



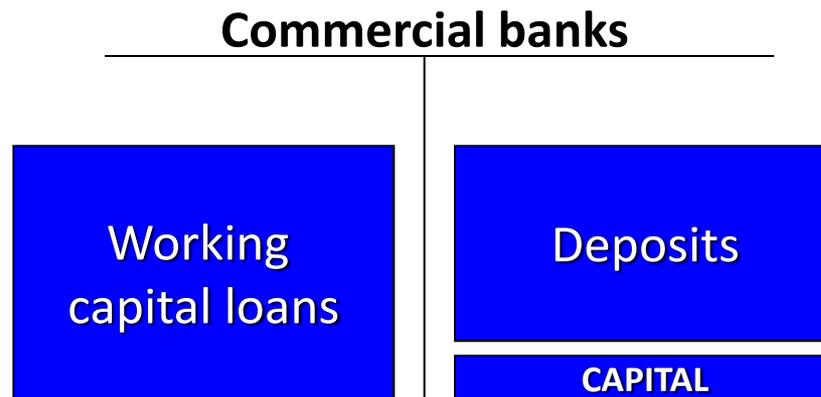
Source: A. G. Haldane, P. Alessandri, „Banking on the state”, Federal Bank of Chicago, 25 September 2009

The institutional causes of the global banking crisis



Commercial banking

- Money (households' and corporates' bank deposits) is created by loans (King, Plosser, 1984, Goodhart, 1994, 2009)
- Therefore, traditional (textbook) **commercial banks do not have to be interconnected.**



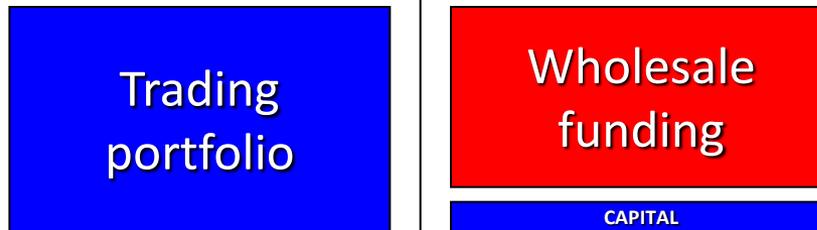
Commercial banking

Commercial banks

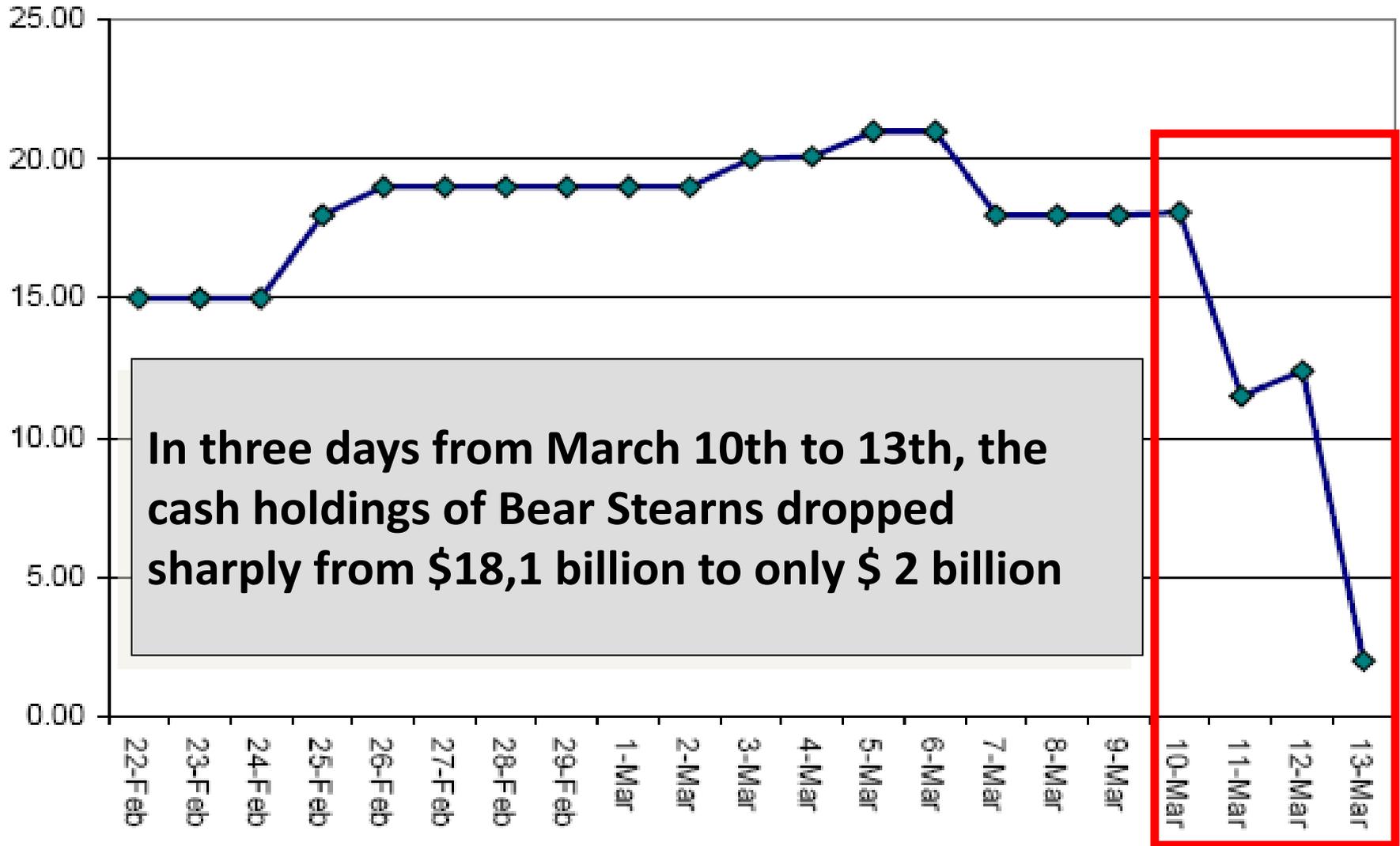
Trading portfolio	Wholesale funding
Loans	Deposits
	CAPITAL

Investment banking

Investment banks



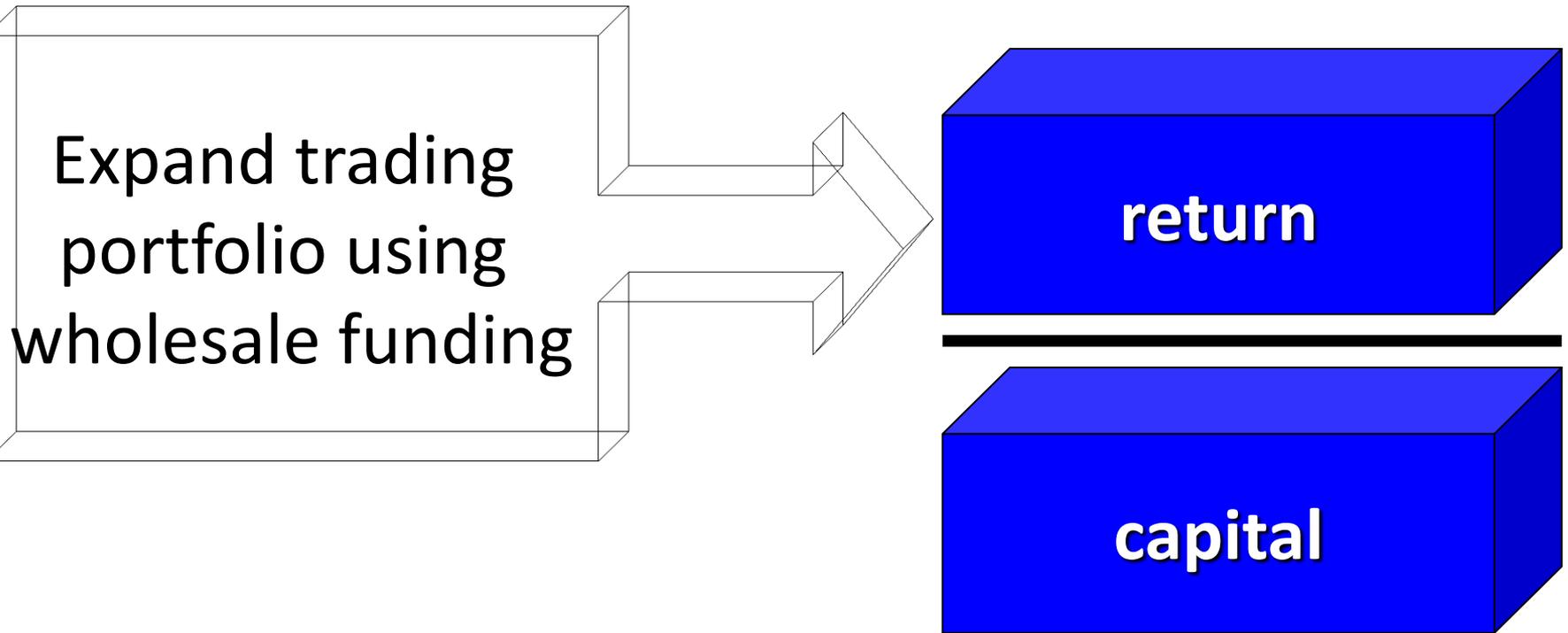
Bear Stearns Liquidity Pool (US\$ billions) (Source: SEC)



Lehman Brothers

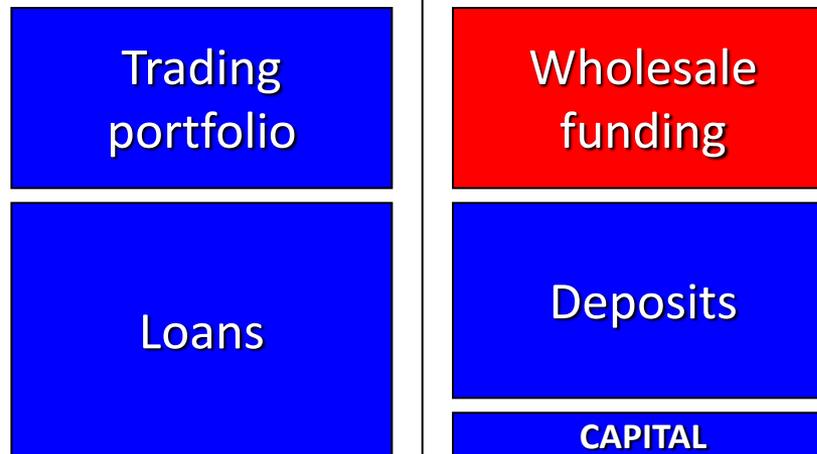
Securities 45% growing share of structured ABS (e.g. CDO)	REPO 37%
Reverse REPO 44%	Short sales 42%
Short-term claim/ cash 11%	Long-term bonds 18%
	Capital 3%

How to increase the ROE?



Universal banking

Universal banks



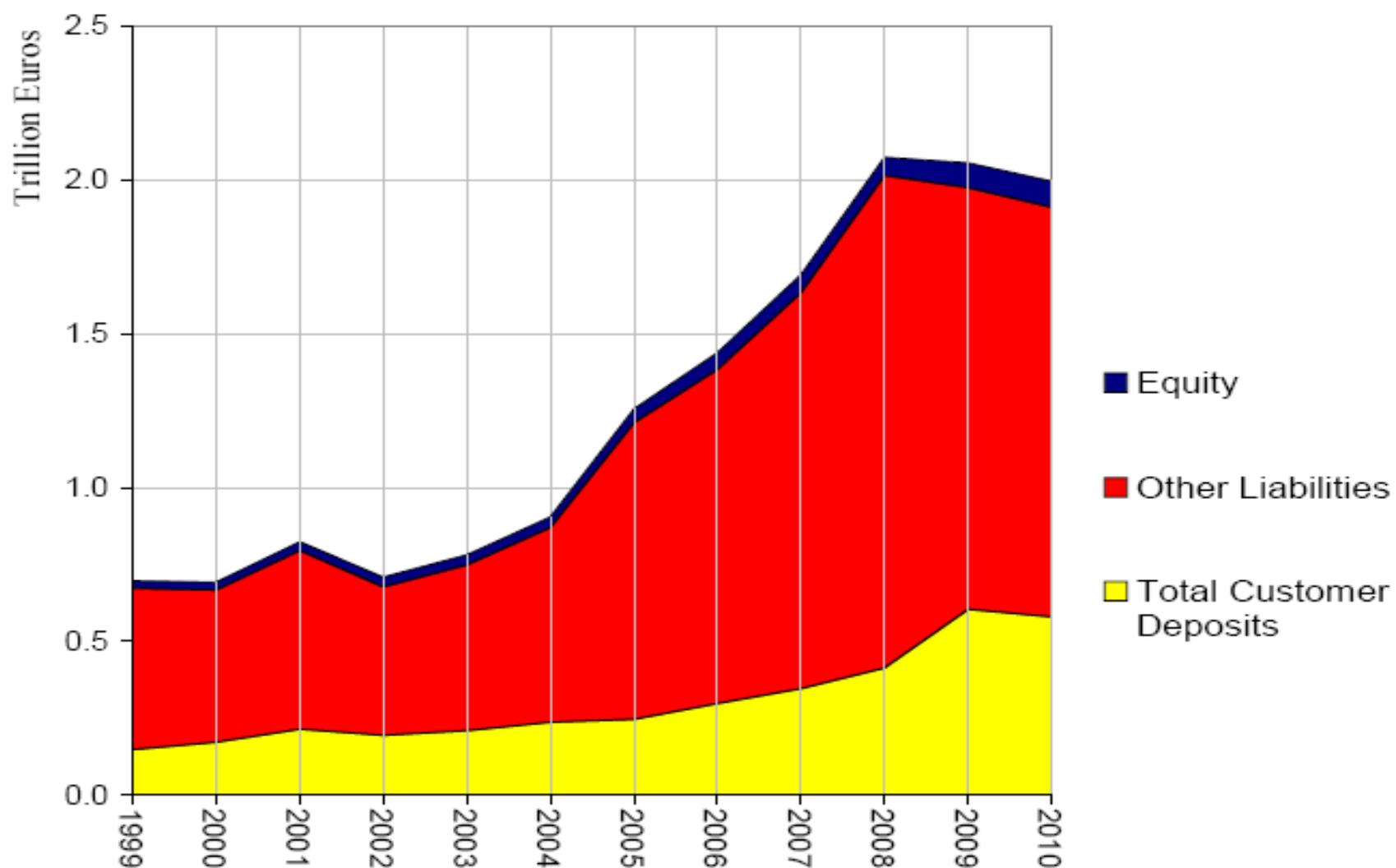


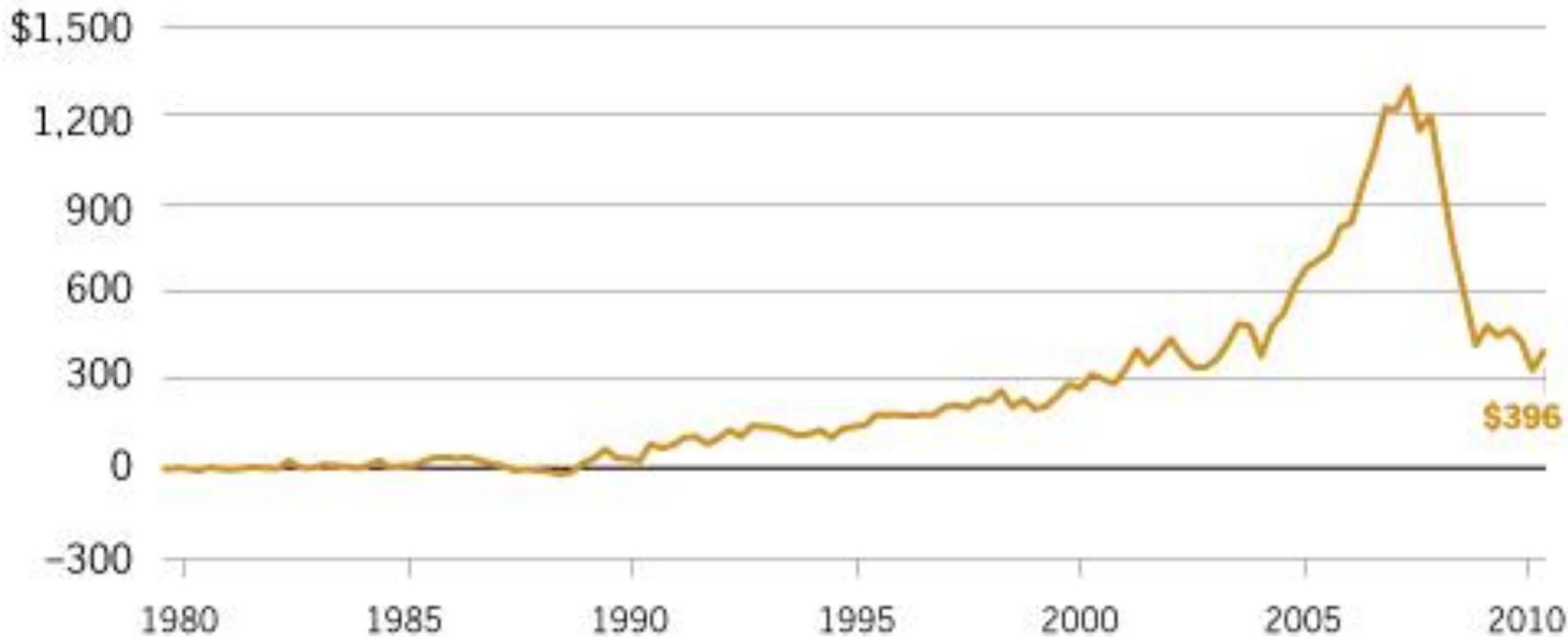
Figure 6: BNP Paribas total liabilities (Source: Bankscope)

Hyun Song Shin, Adapting Macroprudential Policy to Global Liquidity Conditions, Central Bank of Chile Annual Conference, Santiago de Chile, 17-18 November 2011

Repo Borrowing

Broker-dealers' use of repo borrowing rose sharply before the crisis.

IN BILLIONS OF DOLLARS

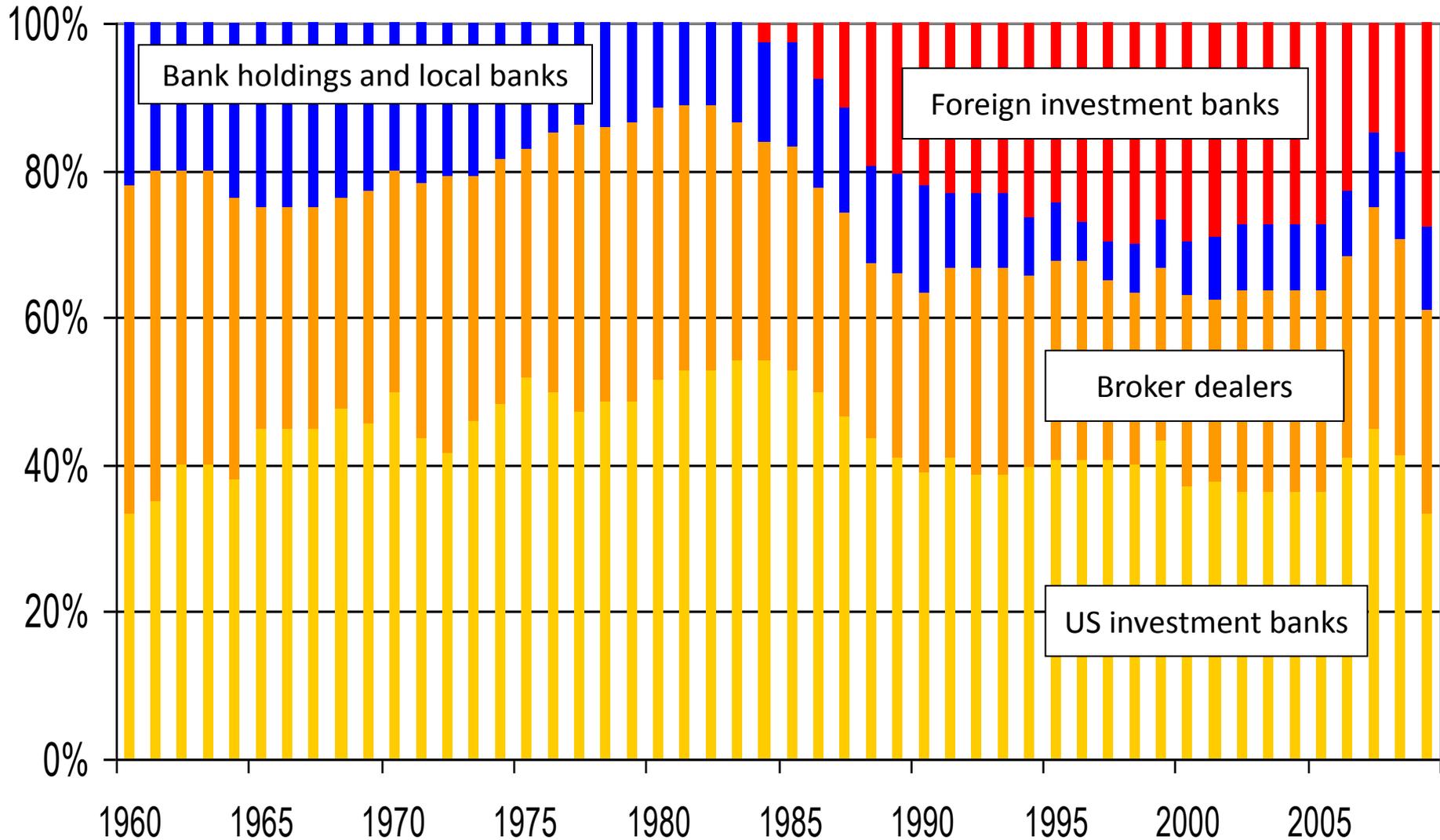


NOTE: Net borrowing by broker-dealers.
SOURCE: Federal Reserve Flow of Funds Report

<http://fcic.law.stanford.edu/resource/graphics>

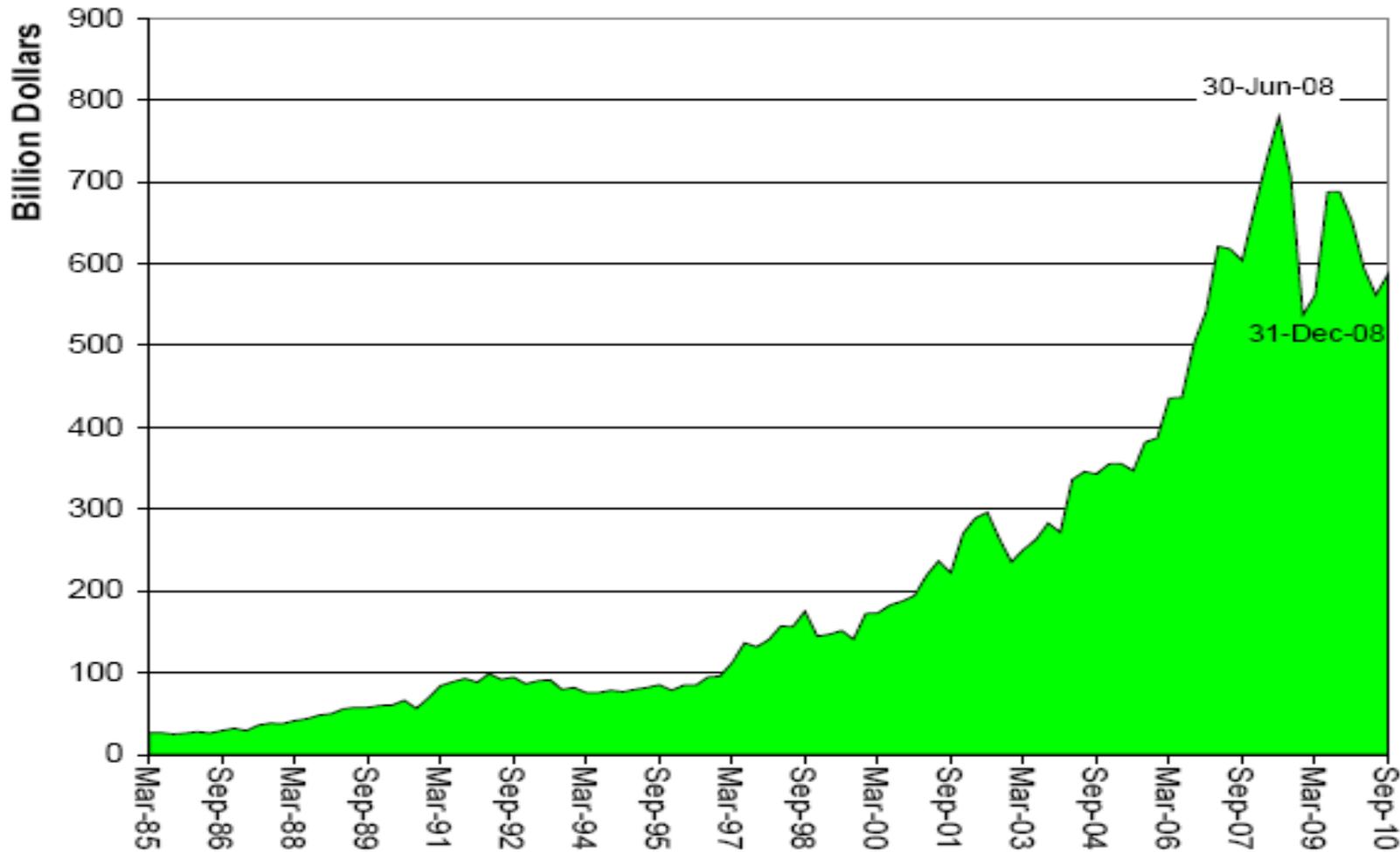
Central banks: innocent culprits?

Fed's primarily dealers



Central banks: innocent culprits?

Interoffice assets of foreign bank branches in U.S. (Source: Federal Reserve)



Hyun Song Shin, Adapting Macroprudential Policy to Global Liquidity Conditions, Central Bank of Chile Annual Conference, Santiago de Chile, 17-18 November 2011

How to increase the ROE?

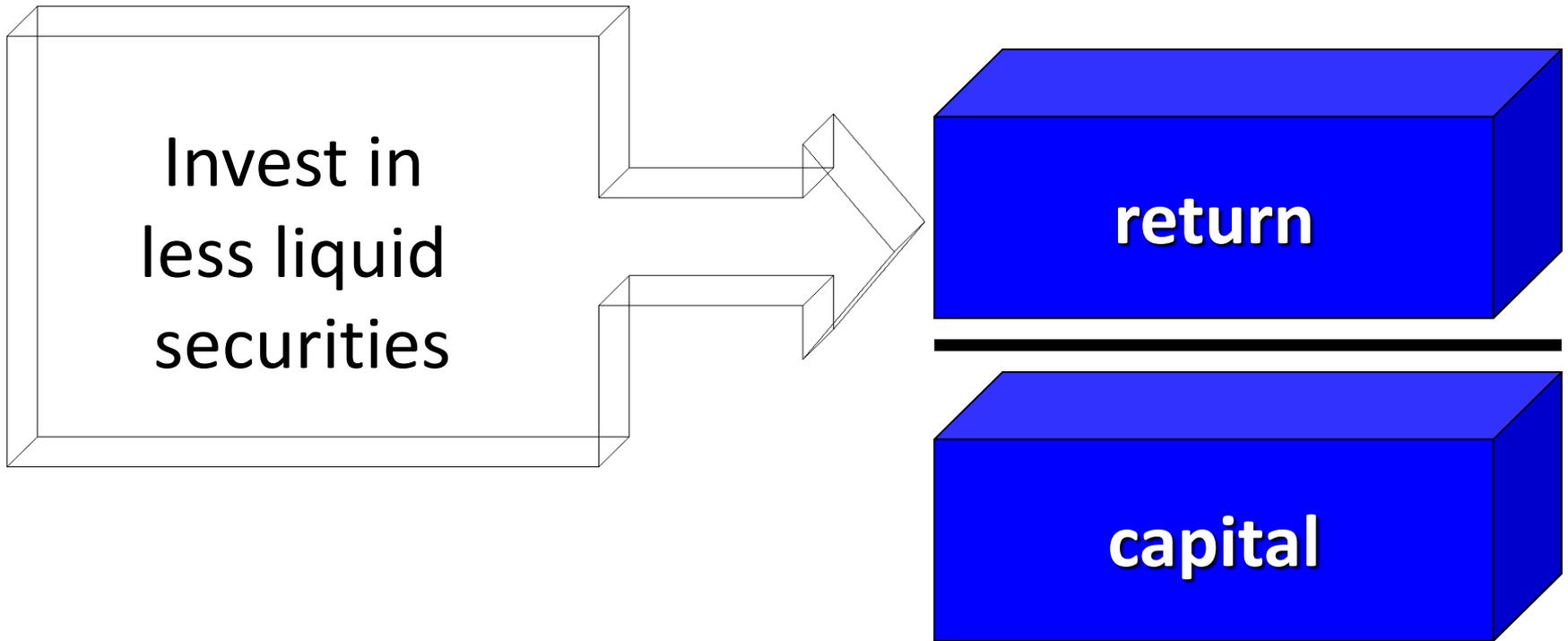
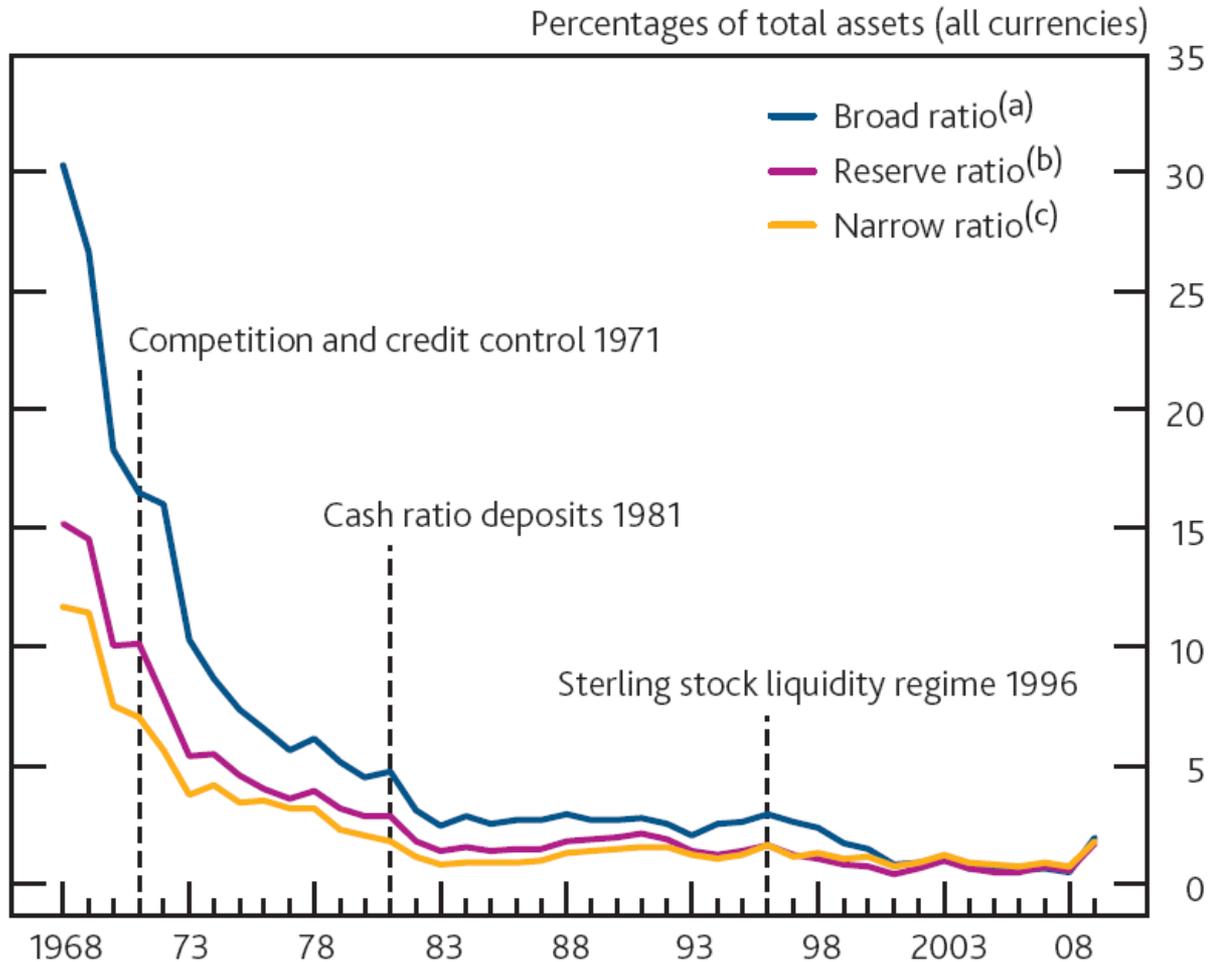


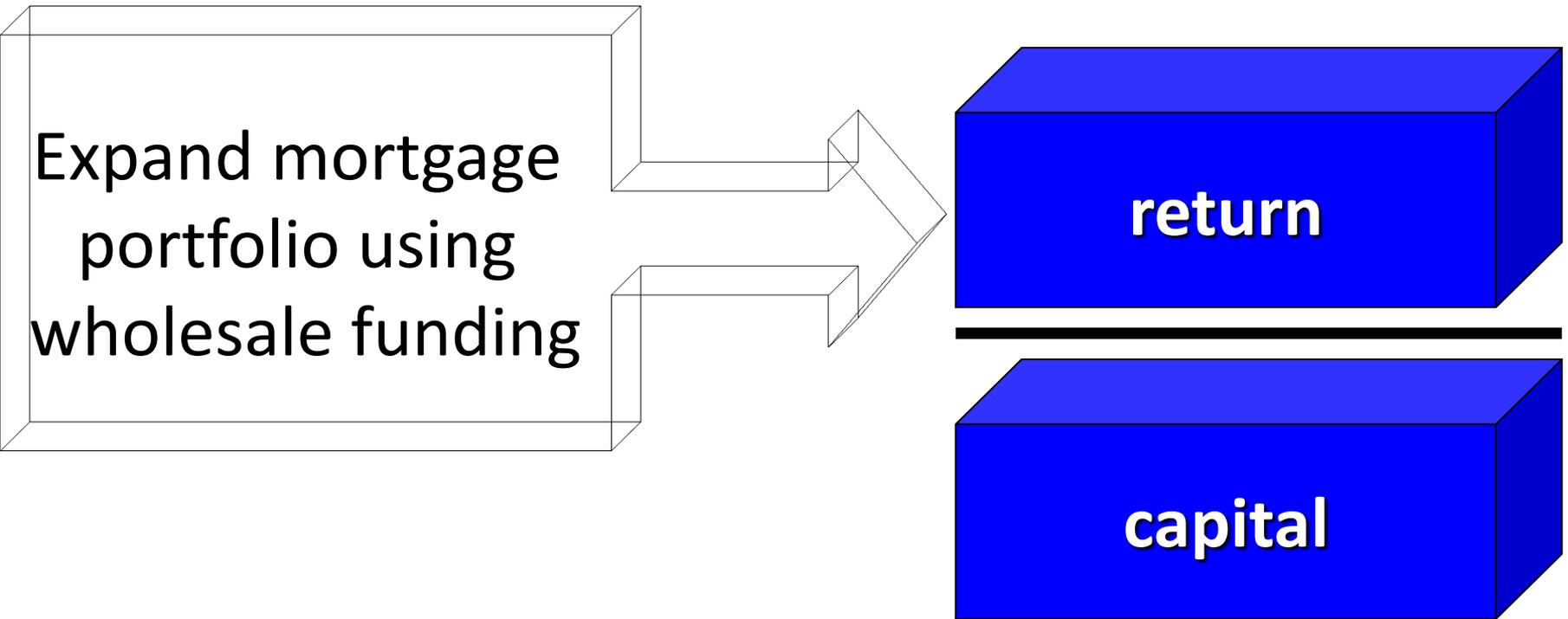
Chart 1.2 Sterling liquid assets relative to total asse holdings of UK banking sector



Sources: Bank of England and Bank calculations.

- (a) Cash + Bank of England balances + money at call + eligible bills + UK gilts.
- (b) Proxied by: Bank of England balances + money at call + eligible bills.
- (c) Cash + Bank of England balances + eligible bills.

How to increase the ROE?



Banks enter mortgage lending (1990s)

Universal banks

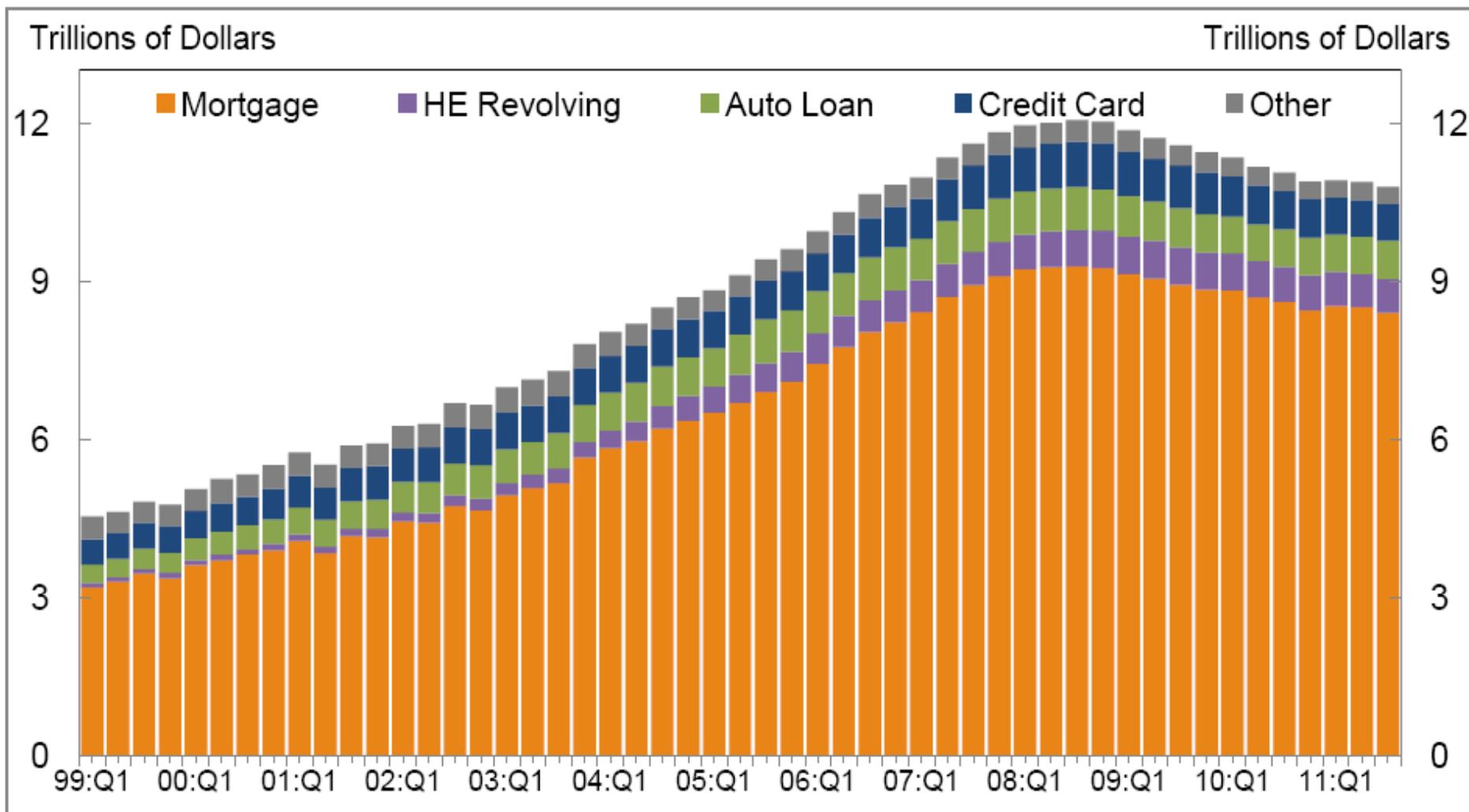


http://pl.123rf.com/photo_13945218_domy-w-masowej-produkcji-niebieski-bialy.html

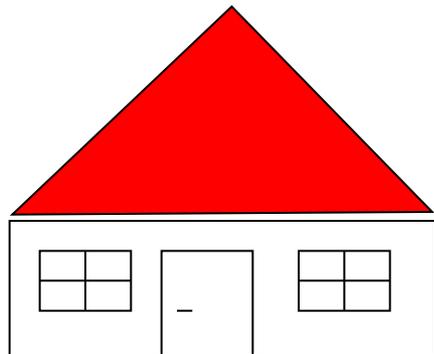


- **strong procyclicality**
- the 'lean against the wind' policy might be neutralized by the deterioration of lending standards

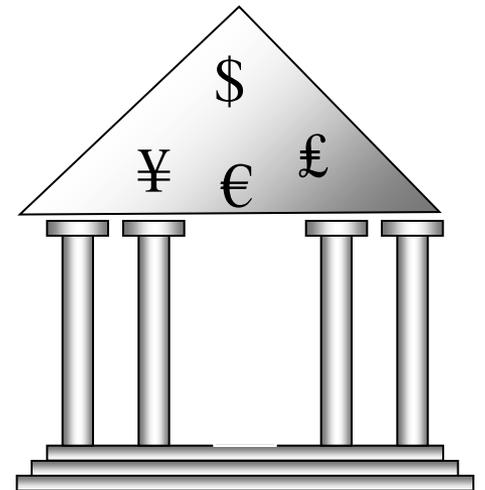
Figure 2: Total Household Debt and Its Composition



Sources: Board of Governors of the Federal Reserve System, Flow of Funds accounts; FRBNY Consumer Credit Panel.

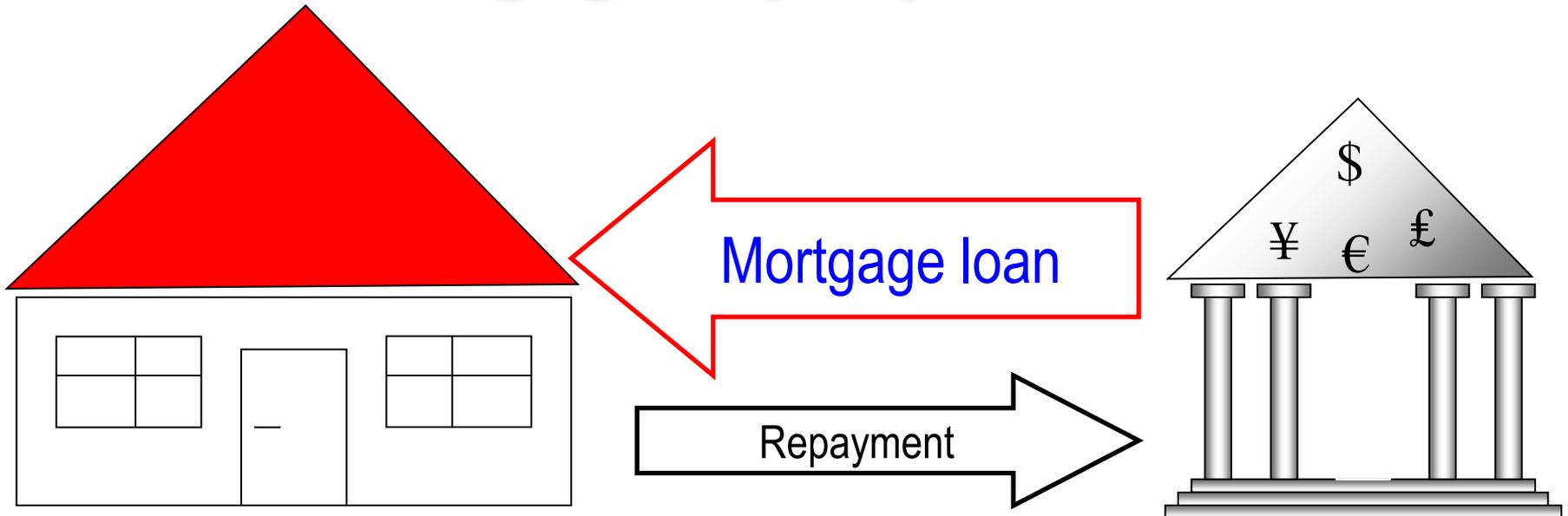


Mortgage loan

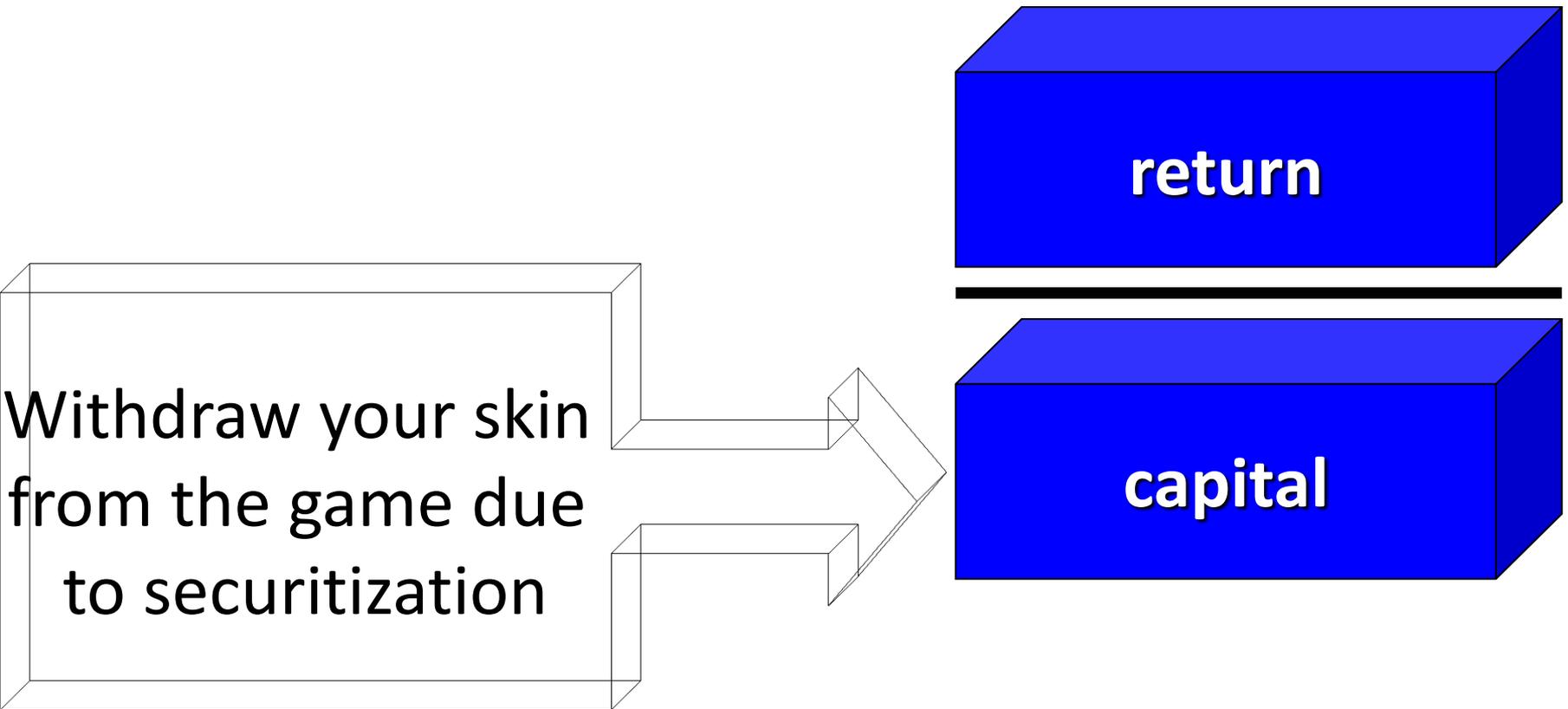




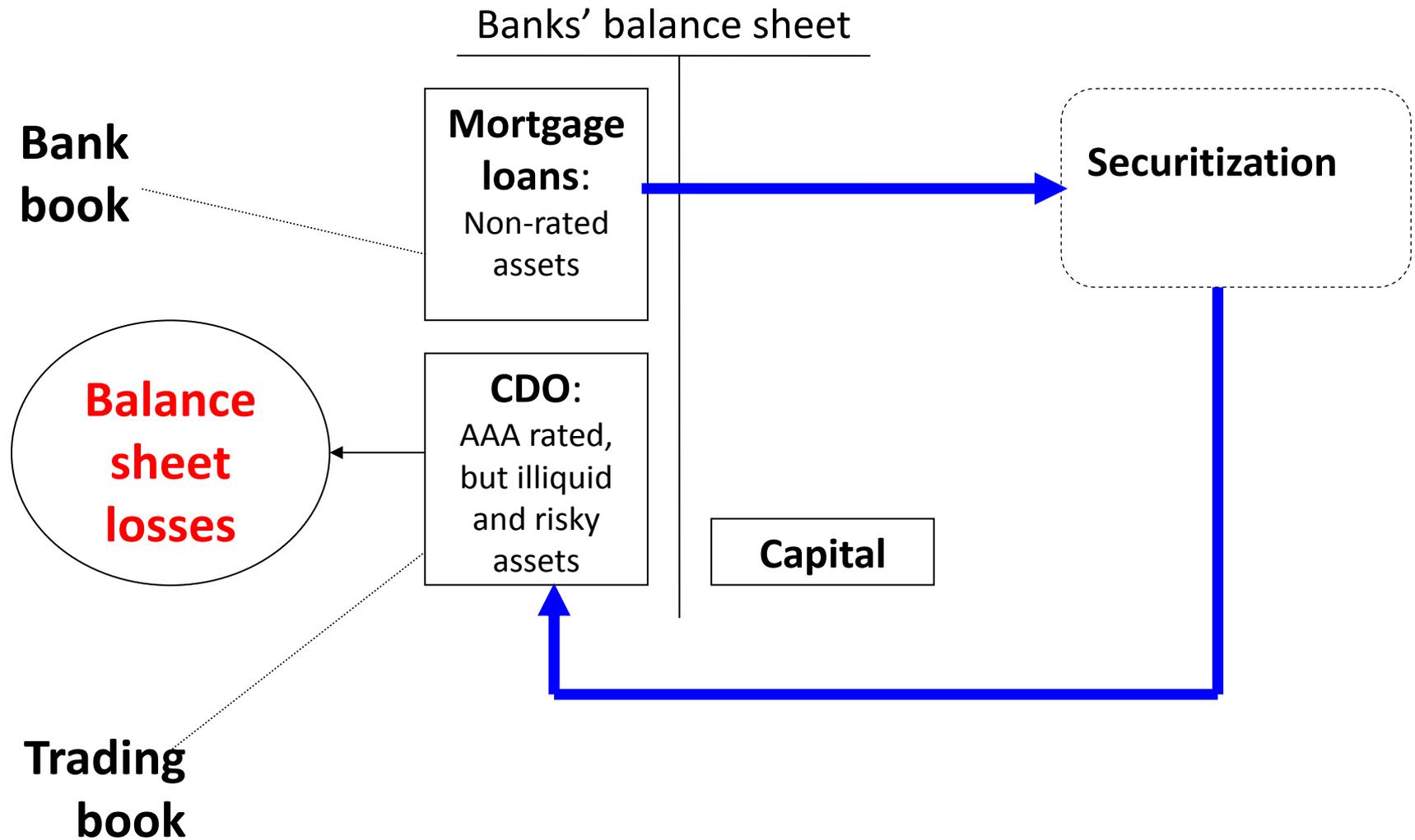
Mortgage Equity Withdrawal



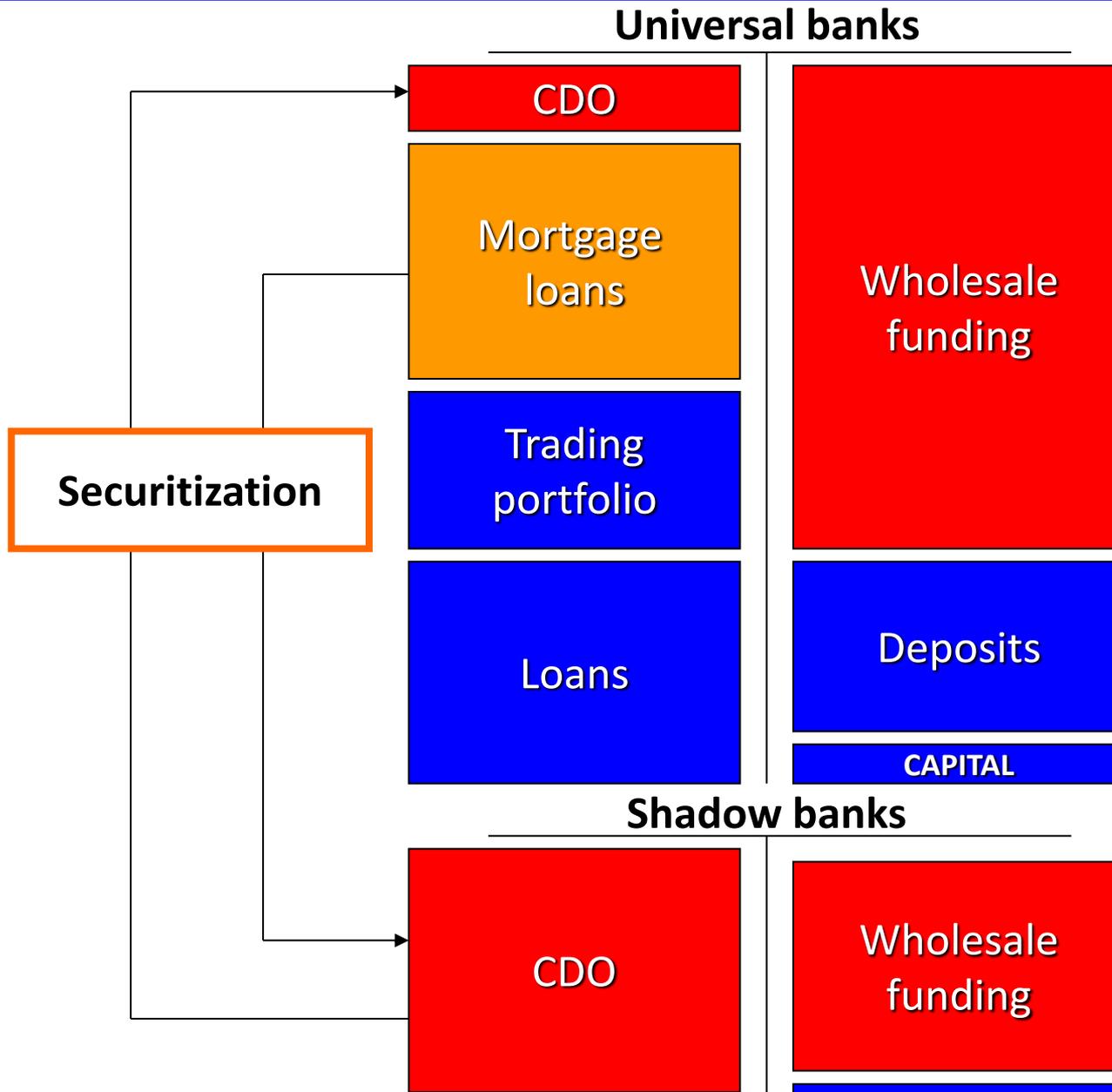
How to increase the ROE?

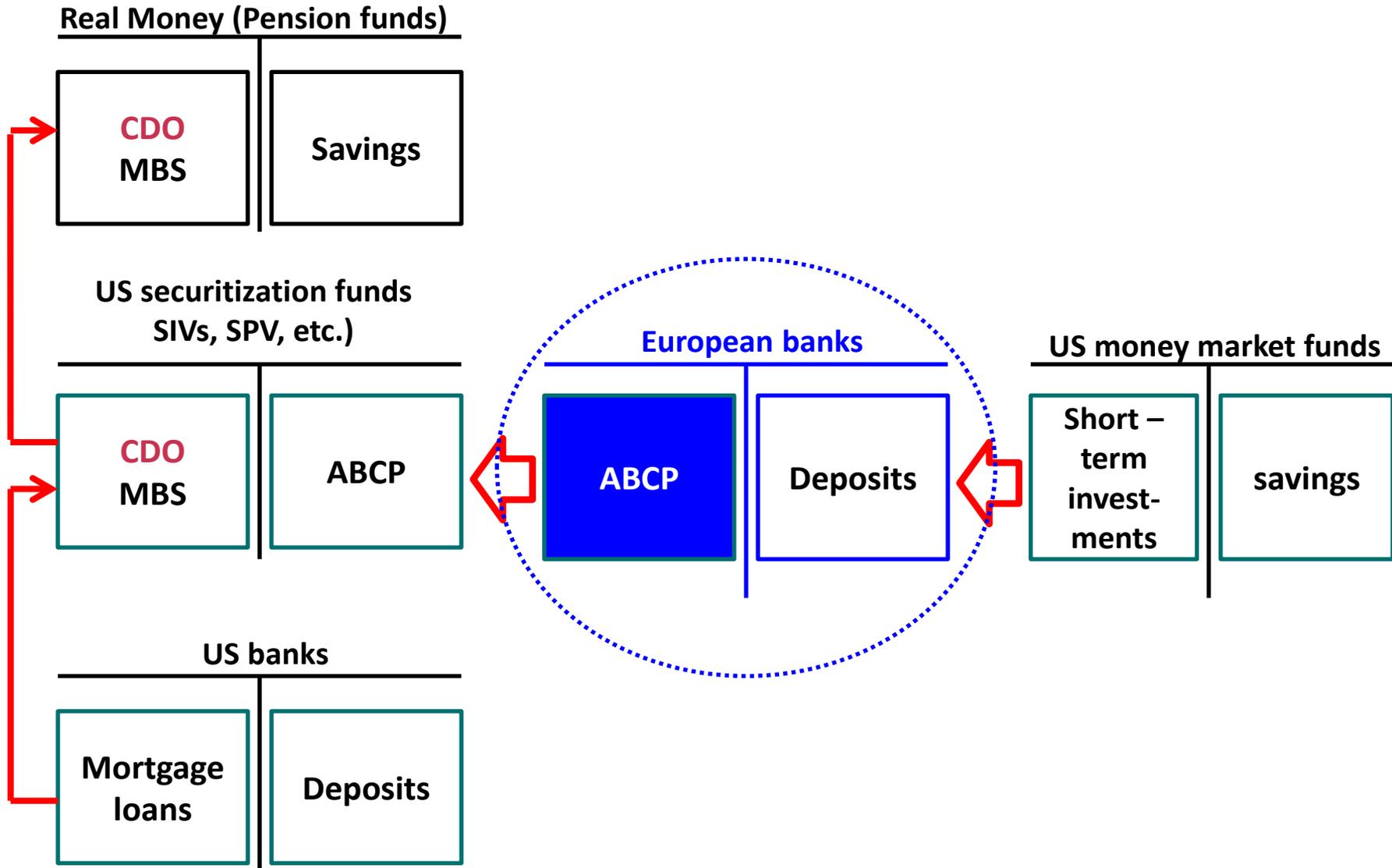


From regulatory arbitrage to balance sheet losses

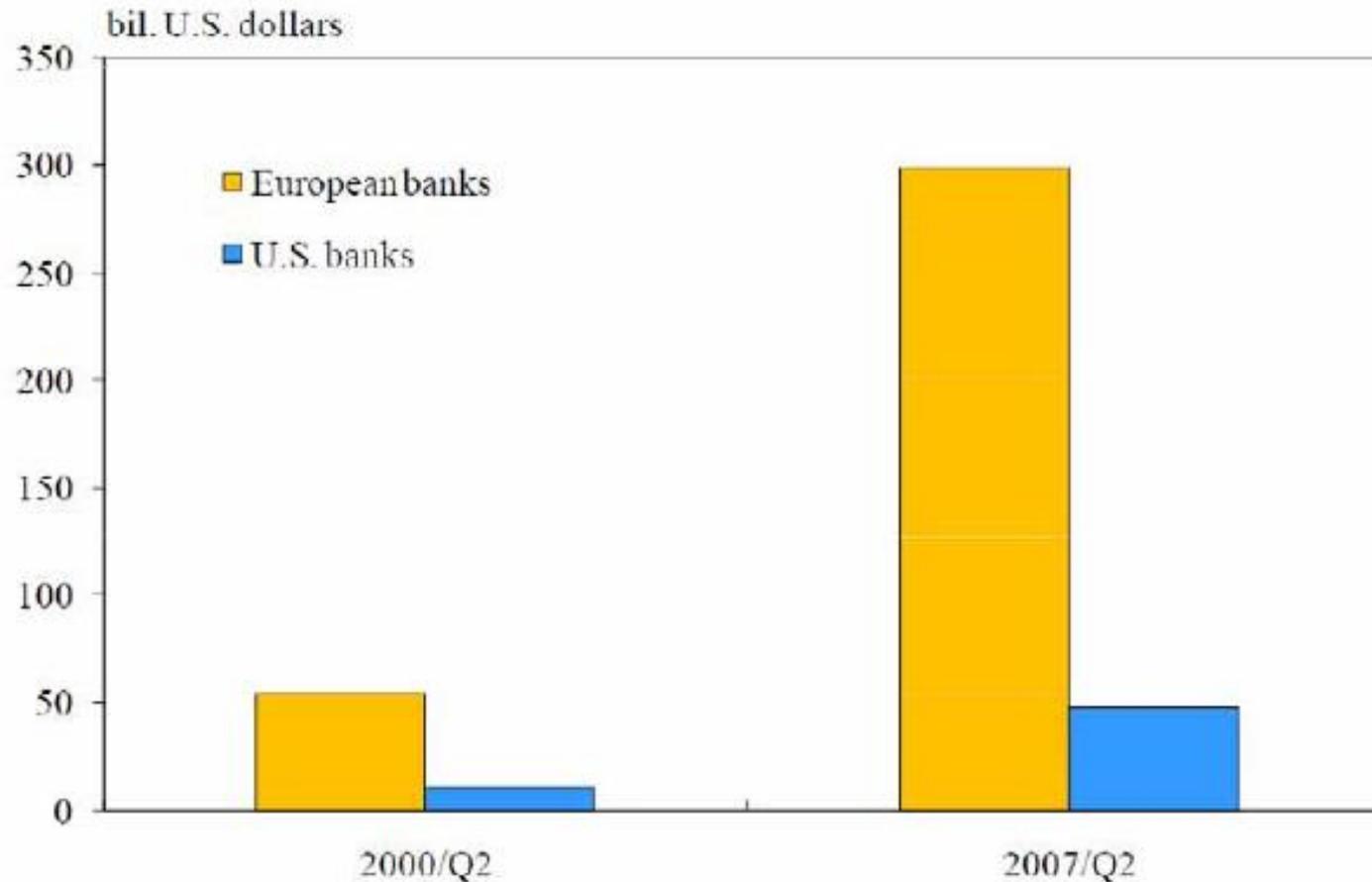


The rise of shadow banking





ABCP Vehicles Sponsored by Banks



Note: These bank-sponsored vehicles are those rated by Moody's.
Source: C. Arteta, M. Carey, R. Correa, and J. Kotler (2010).

Maasaki Shirakawa (2012) Japan-US Economic Relations – What We Can Learn From Each Other, Speech at the Japan Information and Culture Center, Washington DC, 19 April,

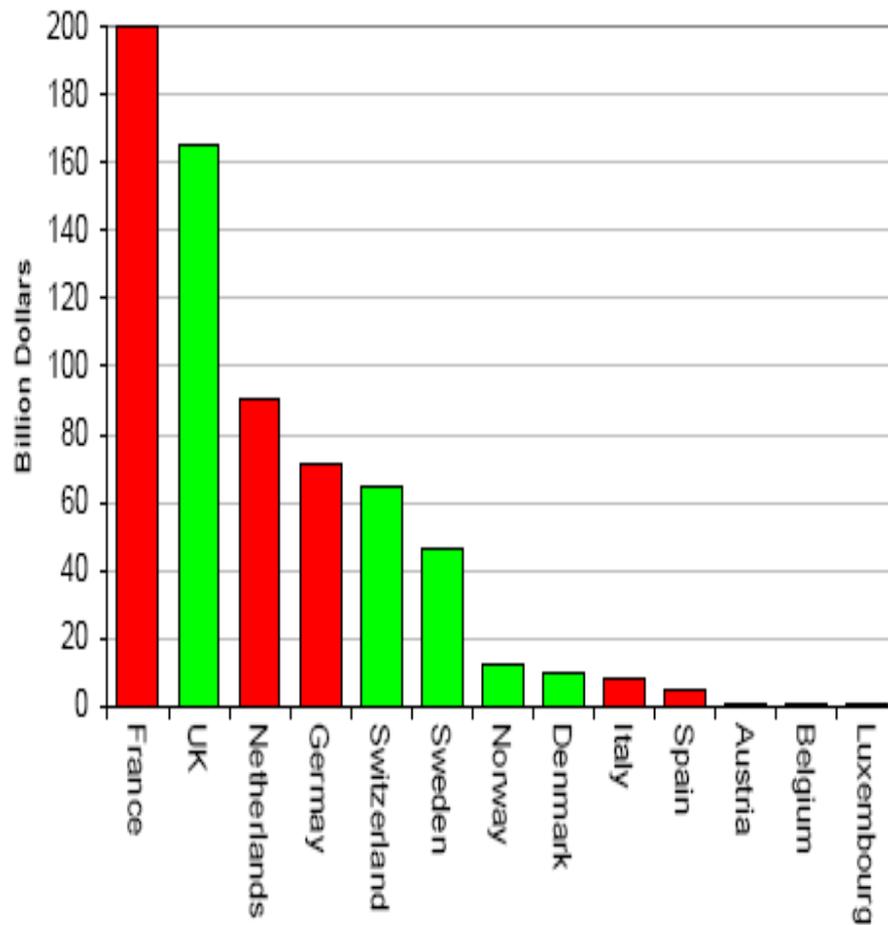


Figure 15. Amounts owed by European banks to US prime money market funds, classified by nationality of borrowing bank (end-June 2011) (Source: IMF GFSR September 2011, data from Fitch)

Hyun Song Shin, Global Banking Glut and Loan Risk Premium, 12th Jacques Polak Annual Research Conference, 10-11 November 2011

How to increase the ROE?

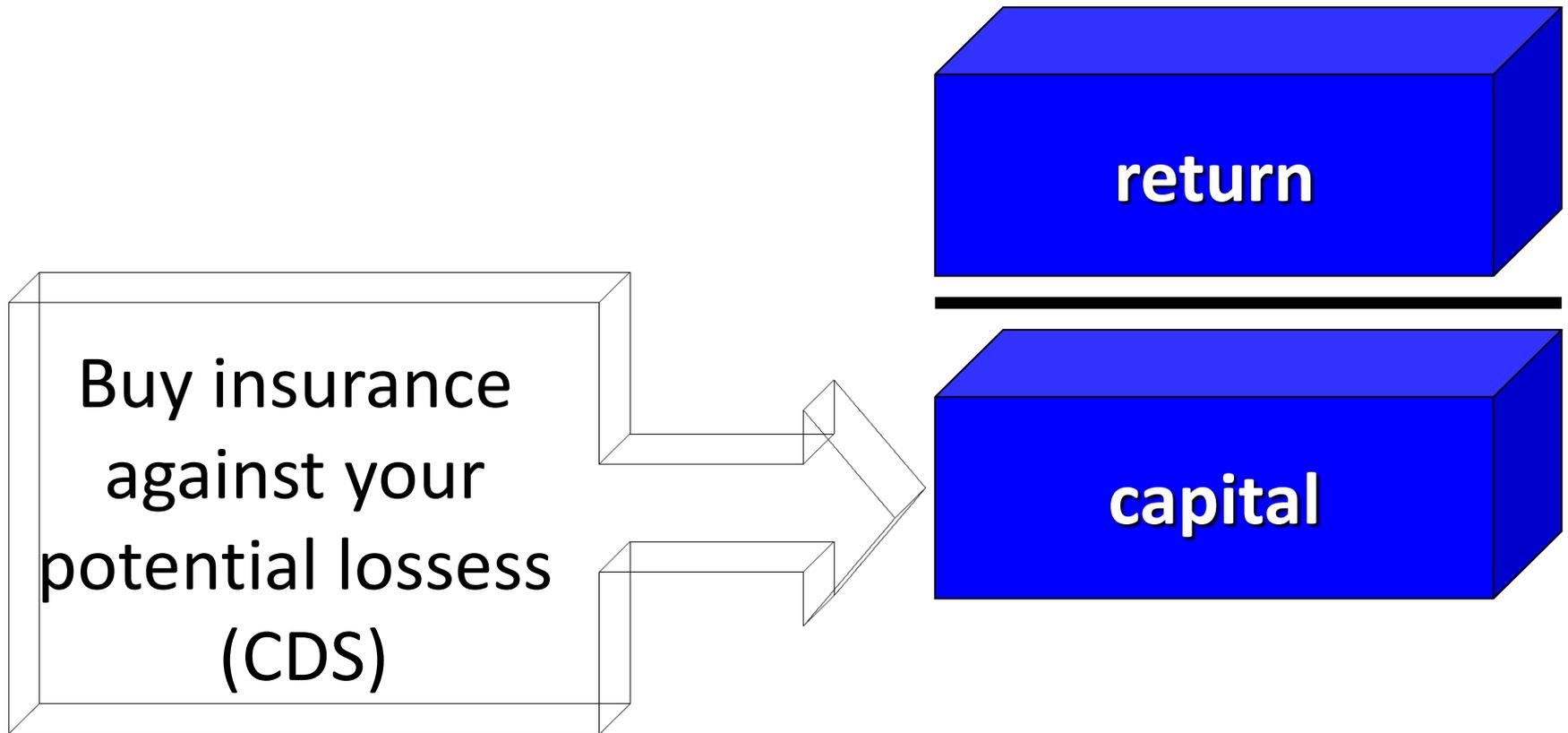
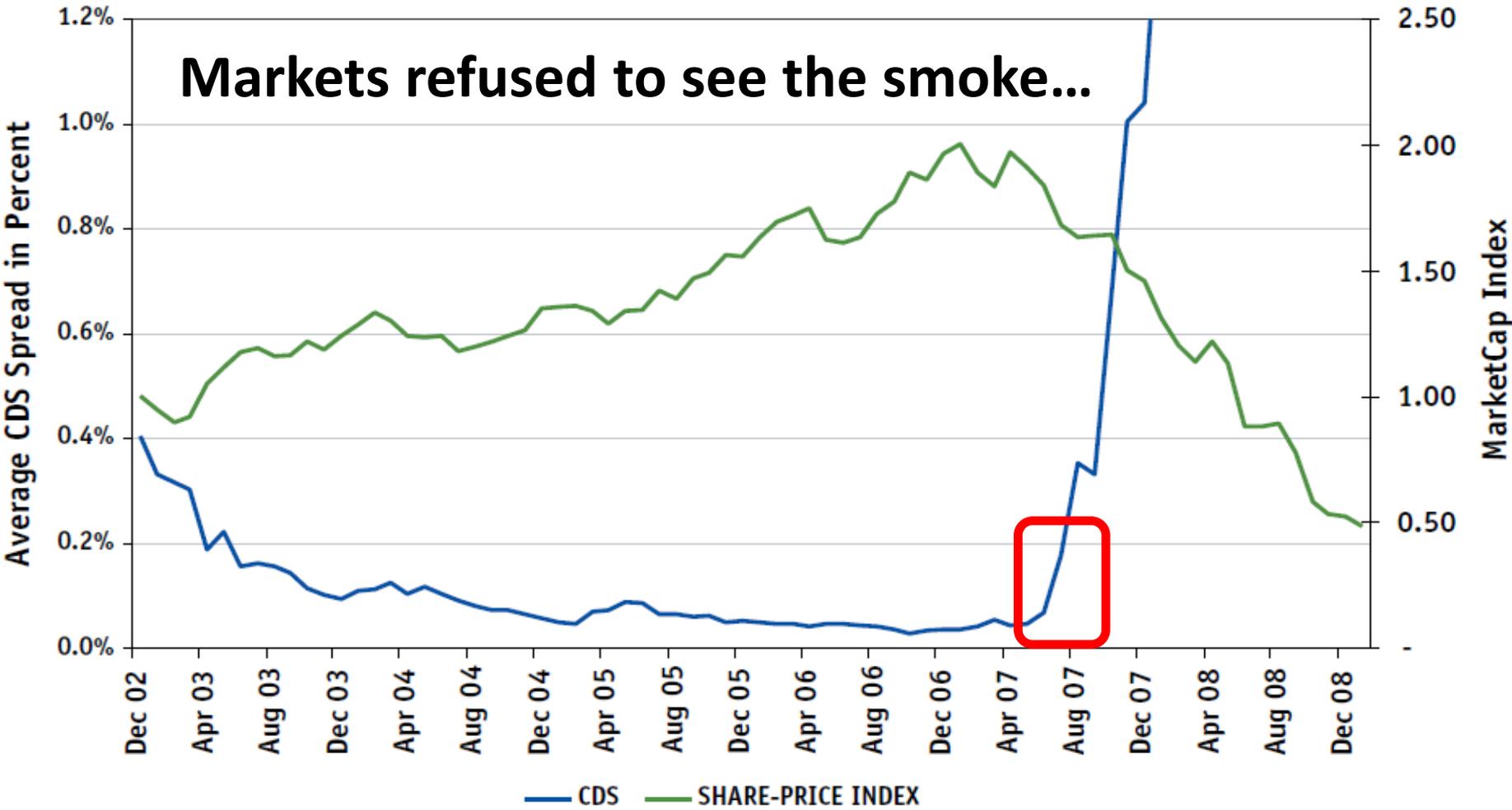


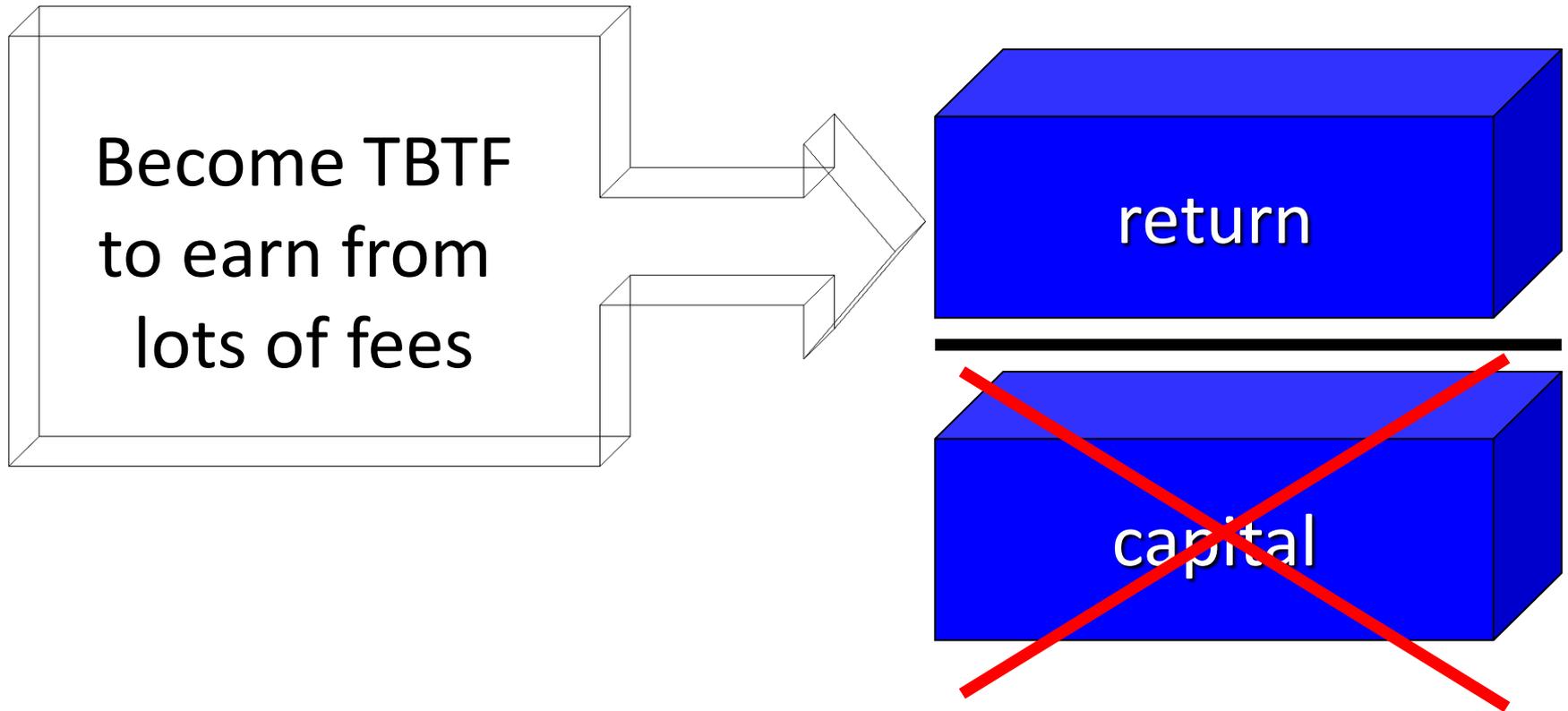
Exhibit 1.27: Composite Time Series of Select Financial Firms' CDS and share prices



Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS

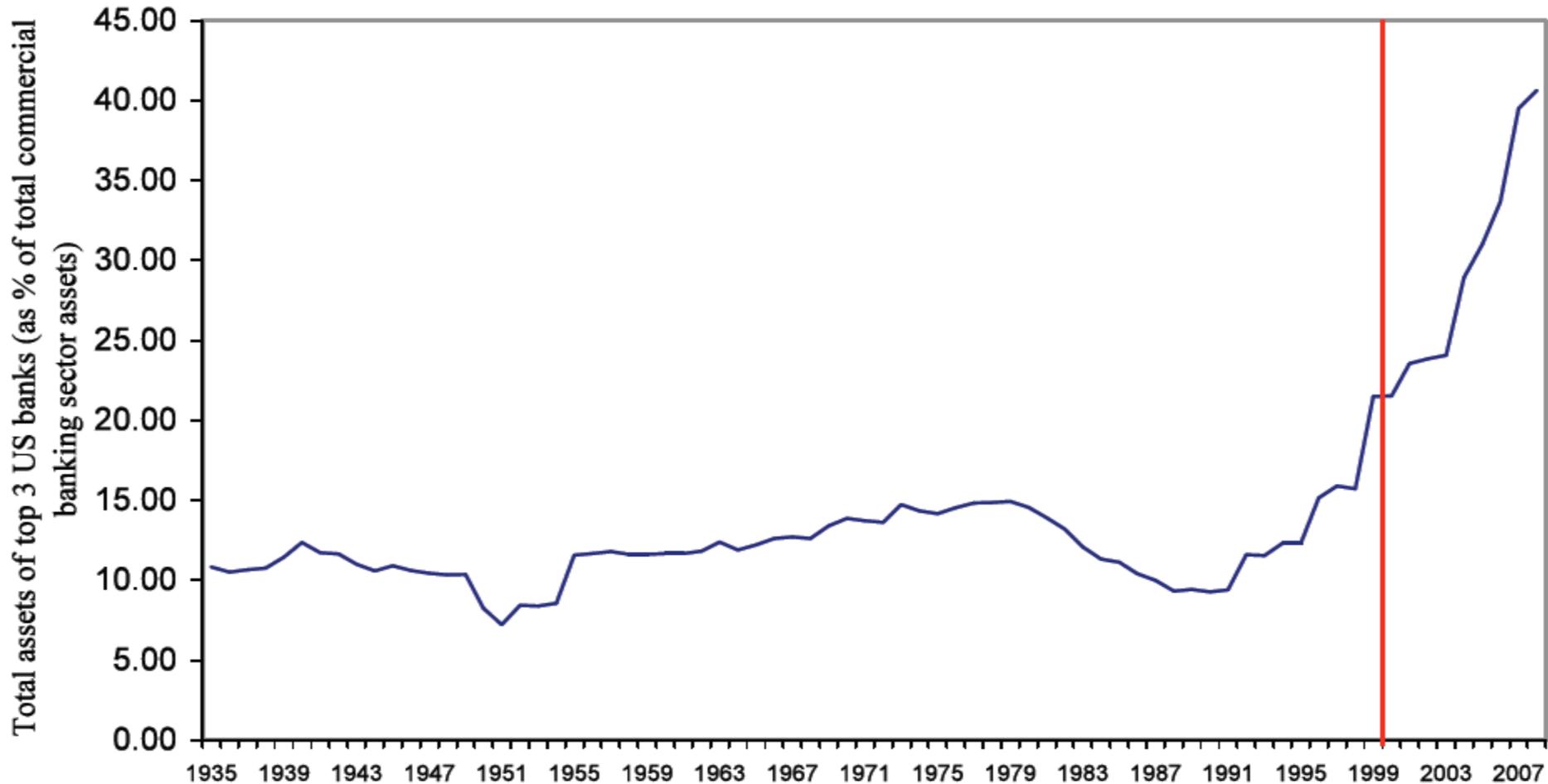
The Turner Review. A regulatory response to the global banking crisis,
 Financial Services Authority, March 2009, p. 46

How to increase the ROE?



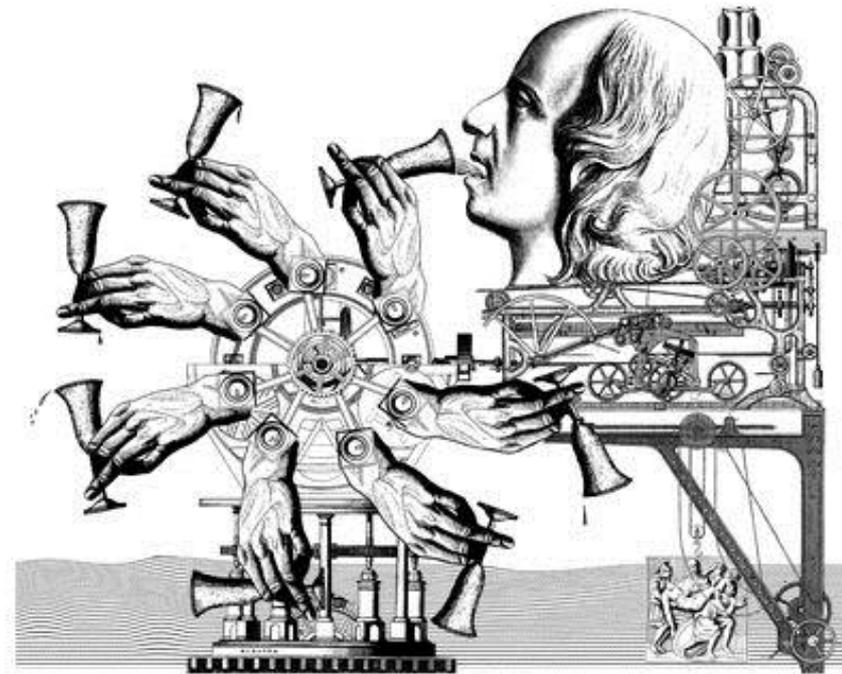
What is producing lobbyists?

Concentration of the US banking system



The fun of being TBTF (a subsidized financial conglomerate)

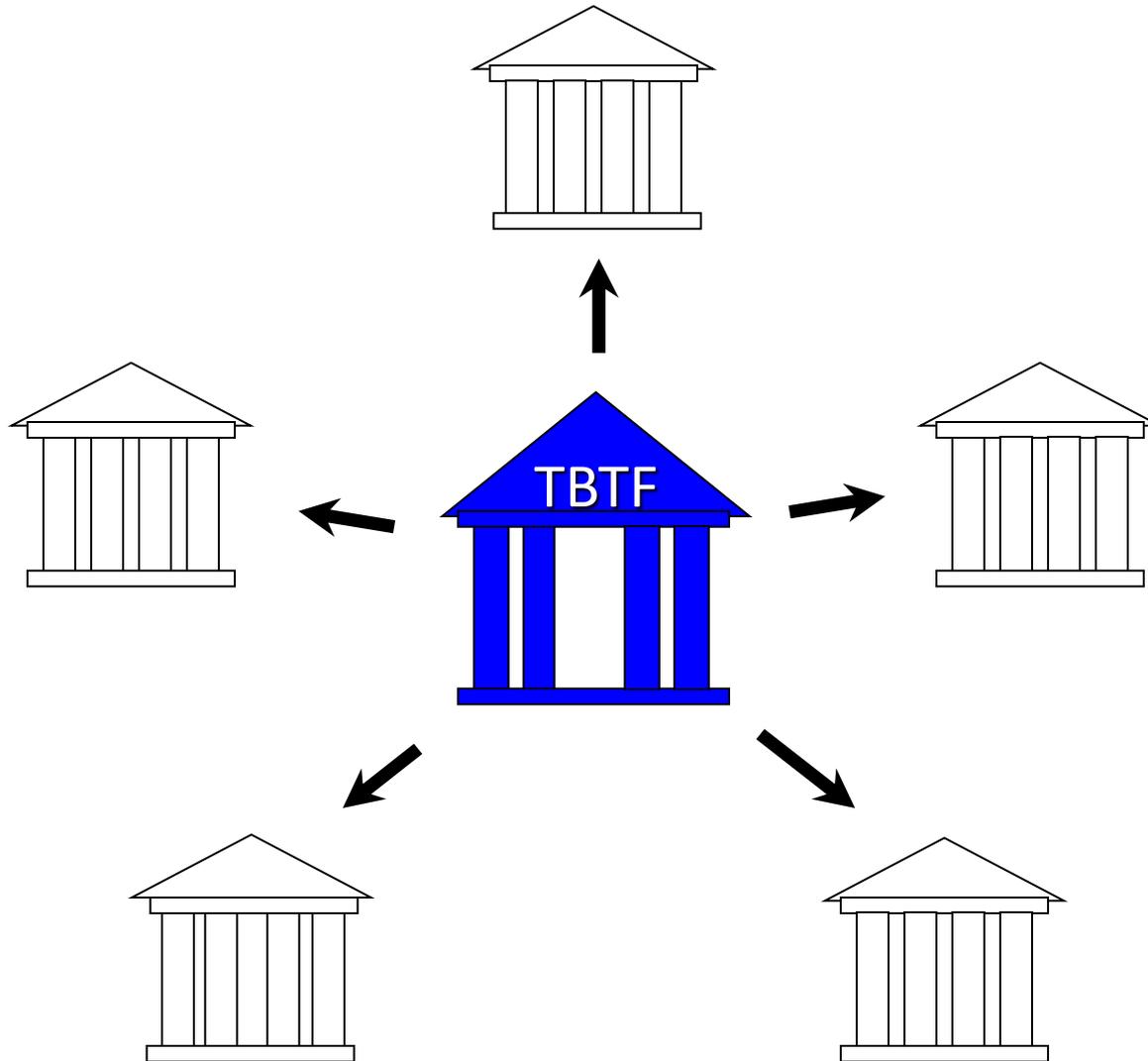
- Lower costs of borrowing
- Possibility to take larger risk
- Informational edge (flows)
- Prime brokerage



- *„There was absolutely no incentive for risk departments to run severe stress tests and show this to the management,*
- *because in that event the authorities would have to step-in anyway to save a bank”.*

Andrew Haldane, Why banks failed the stress tests,
BIS Review 18/2009

Prime brokerage



Robert Freeman, head of arbitrage at Goldman Sachs:

*“When I was younger, I loved to go to Las Vegas to gamble. But now it is not a fun anymore. I guess I’ve been in this business too long. **I am used to having an edge**”*

- „Wall Street’s edge is **knowledge and integration**. The large investment banks know more than any other institutions and organizations about the economy.
- Through their asset management and retail investors arms they **can sense the mood of savers before it translates into marketplace action**.
- Through their broker-dealer businesses they have their fingers on the pulse of market movements as they happen, tracking prices formations and **customers flows**.
- Through their corporate advisory departments they **can learn** of strategic **changes in the way the business world is thinking**.
- Through diverse groups of businesses such as consumer credit and insurance they **are able to anticipate significant changes** in the real economy.
- **Integration** as practiced by the world’s big investment banks is what converts **knowledge** into **The Edge**

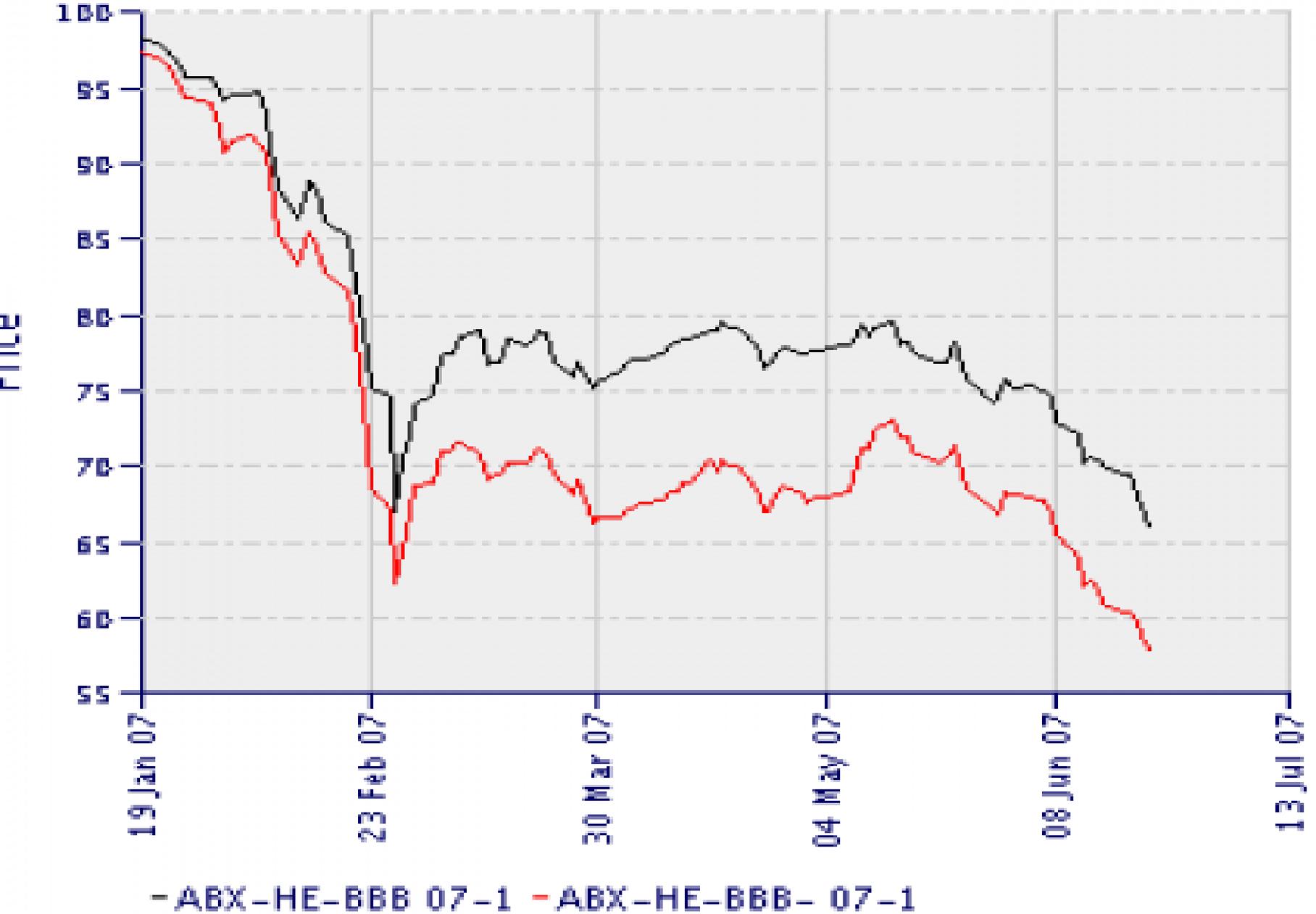
What is the social utility from preserving
Humpty Dumpty banks?

Maybe Alice would know.

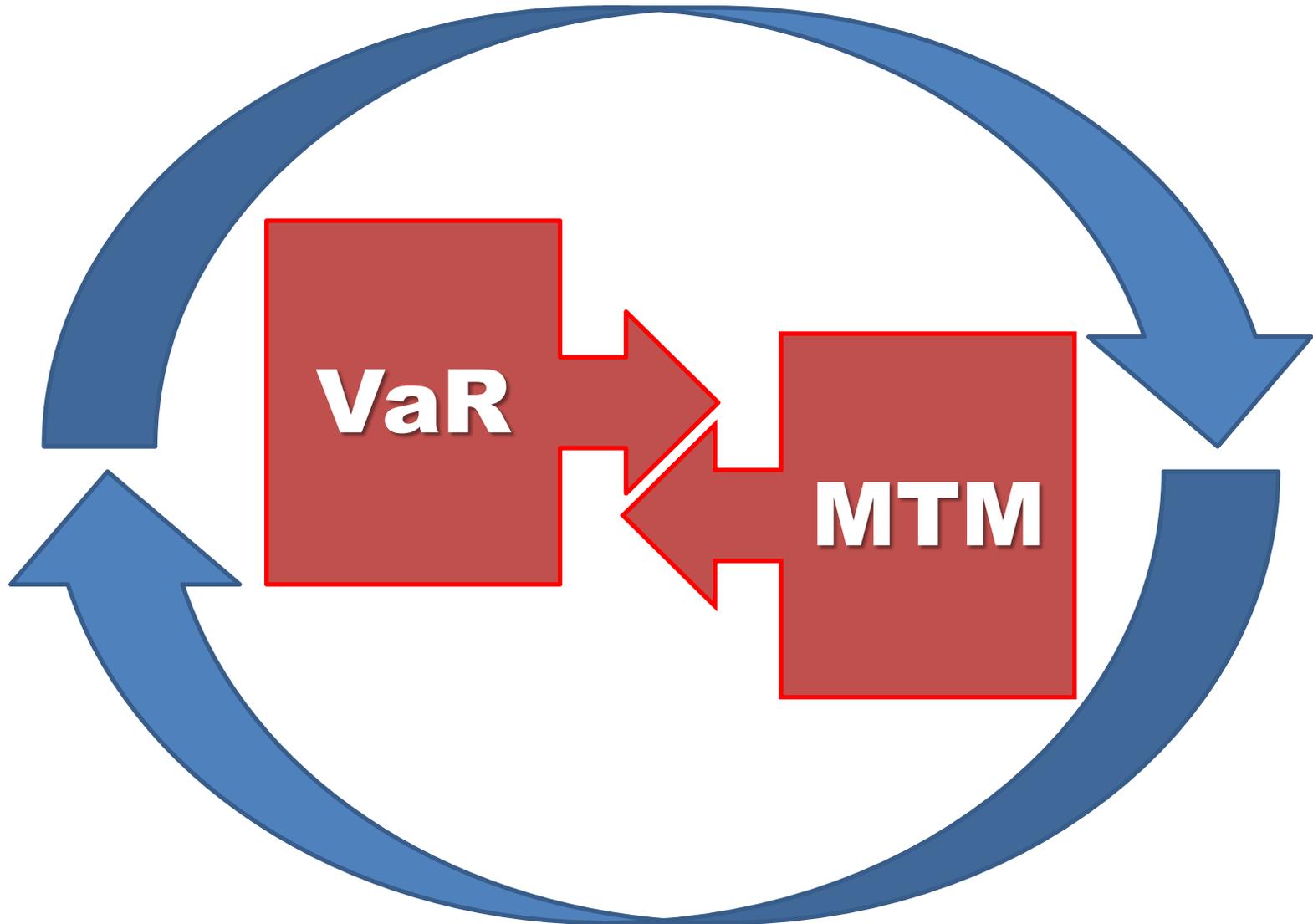




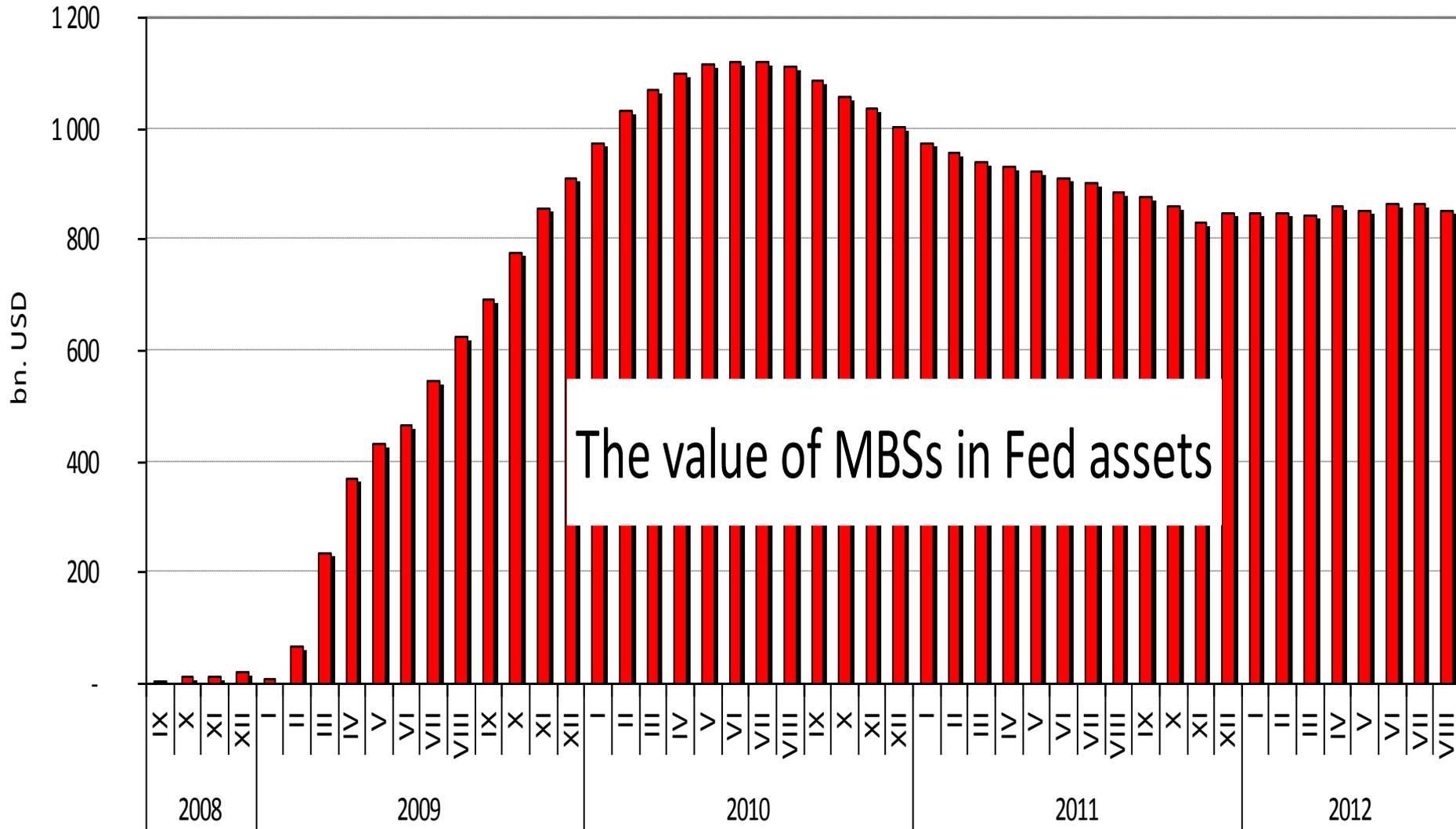
CDO market



The feedback loop of fire sales



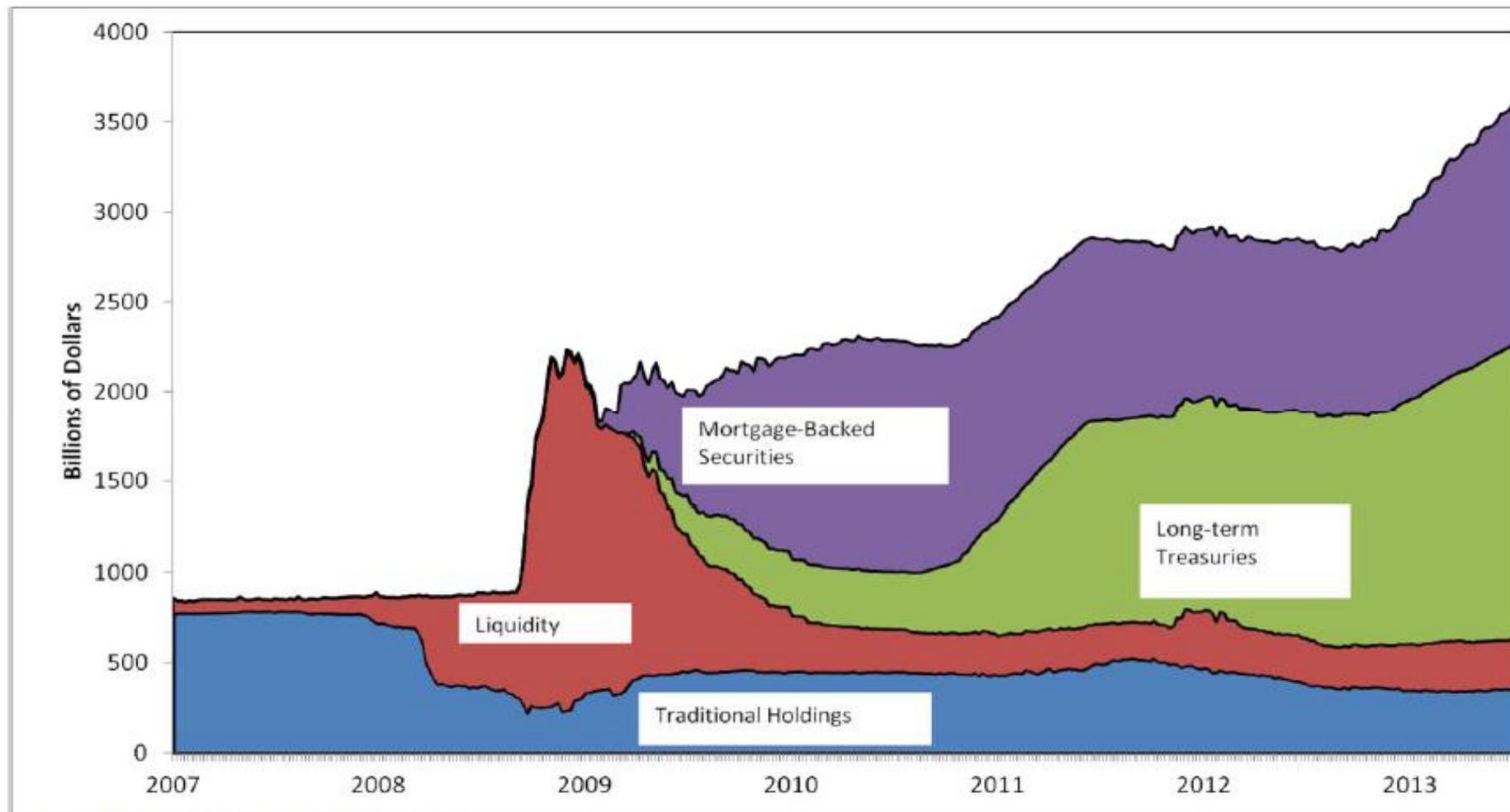
The Fed's intervention



**How did central banks
react to the crisis?**

Figure 9. Federal Reserve Bank Assets by Major Category, 2007-2013

Billions of dollars



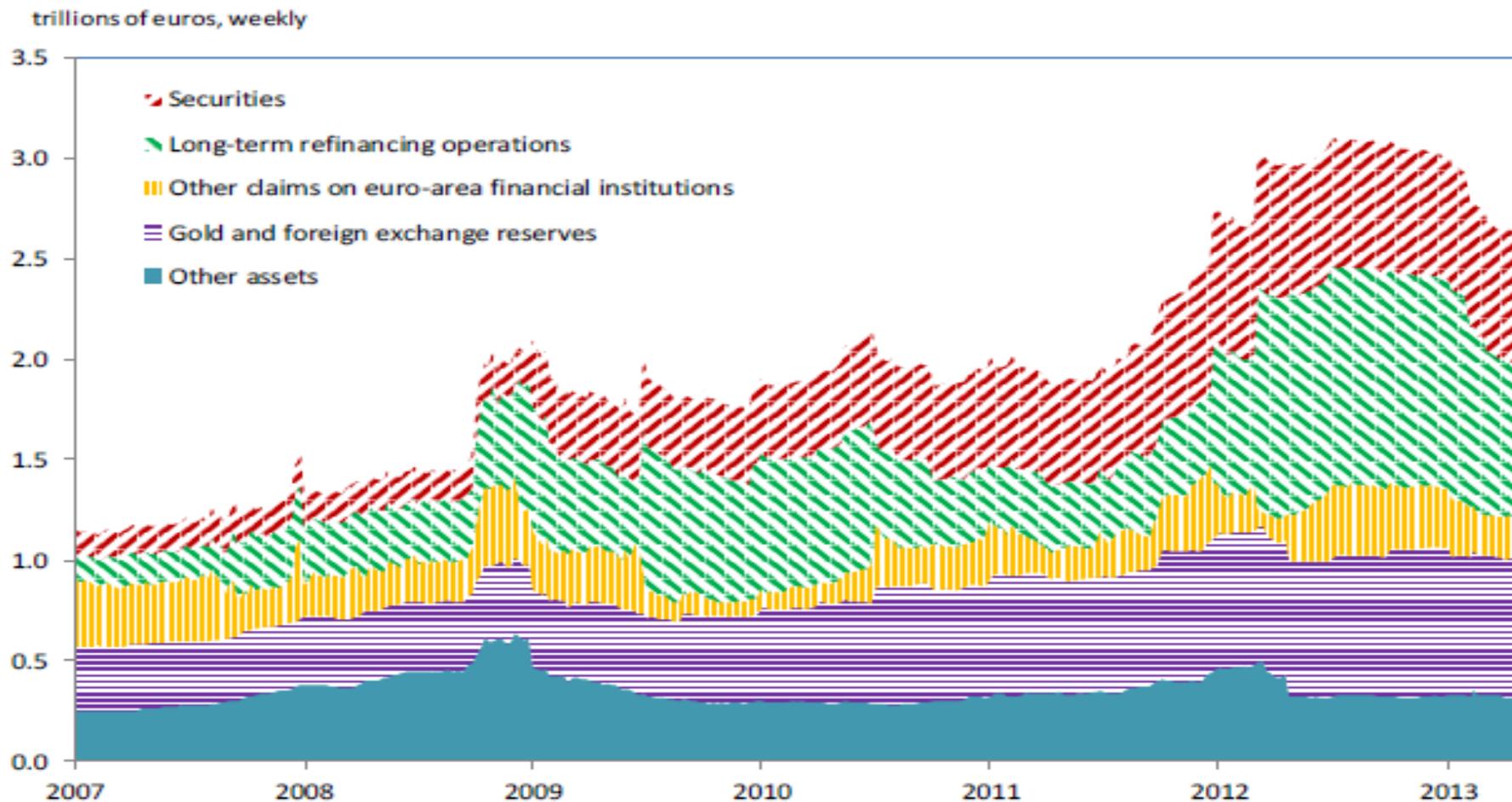
Source: Cleveland Federal Reserve.

http://www.clevelandfed.org/research/data/credit_easing/index.cfm

Martin Neil Baily, Barry Bosworth (2013) . The United States Economy: Why such a Weak Recovery?" The Brookings Institution.

ECB Mainly Lends to Banks

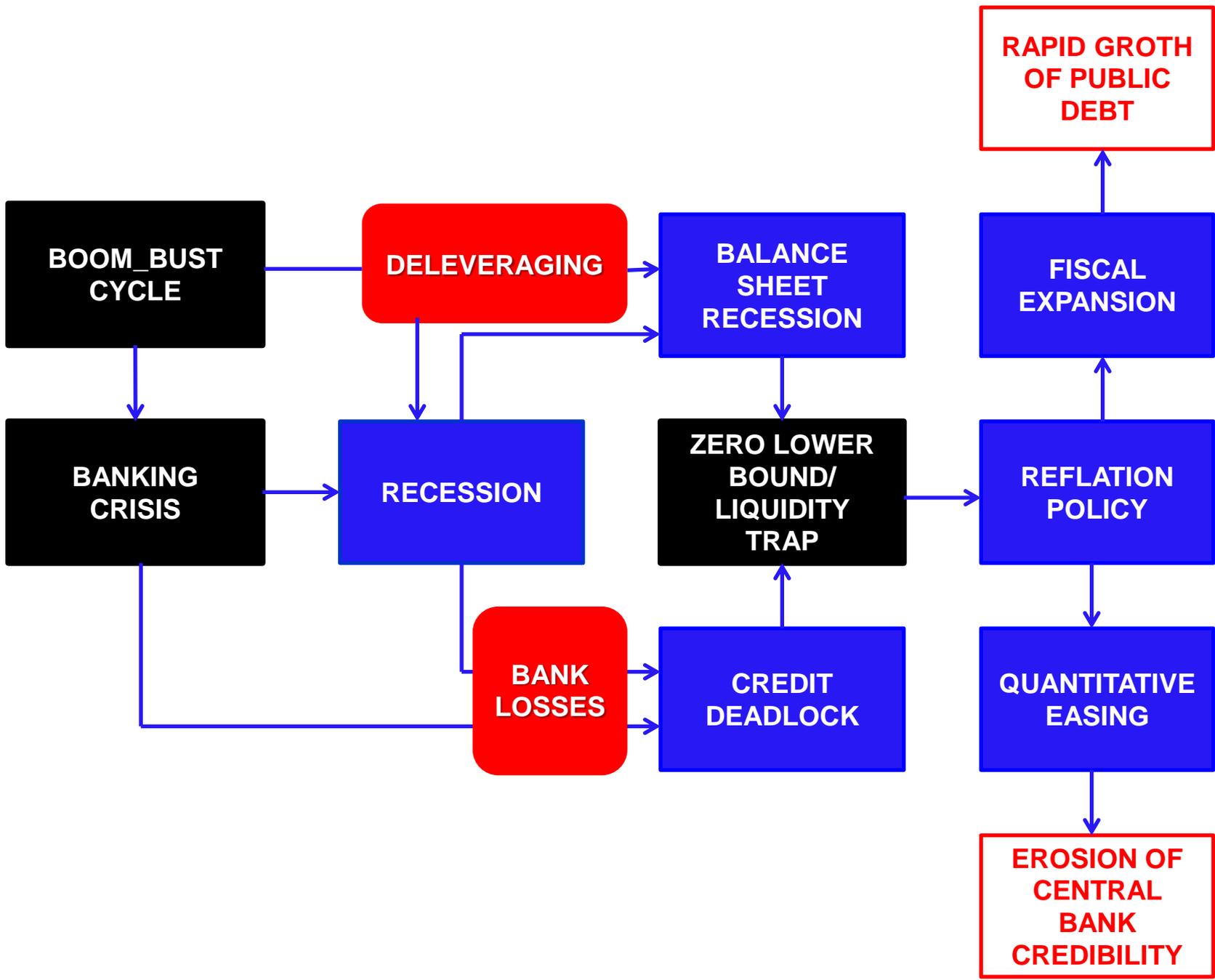
Figure 3.6b European Central Bank assets, 2007-13

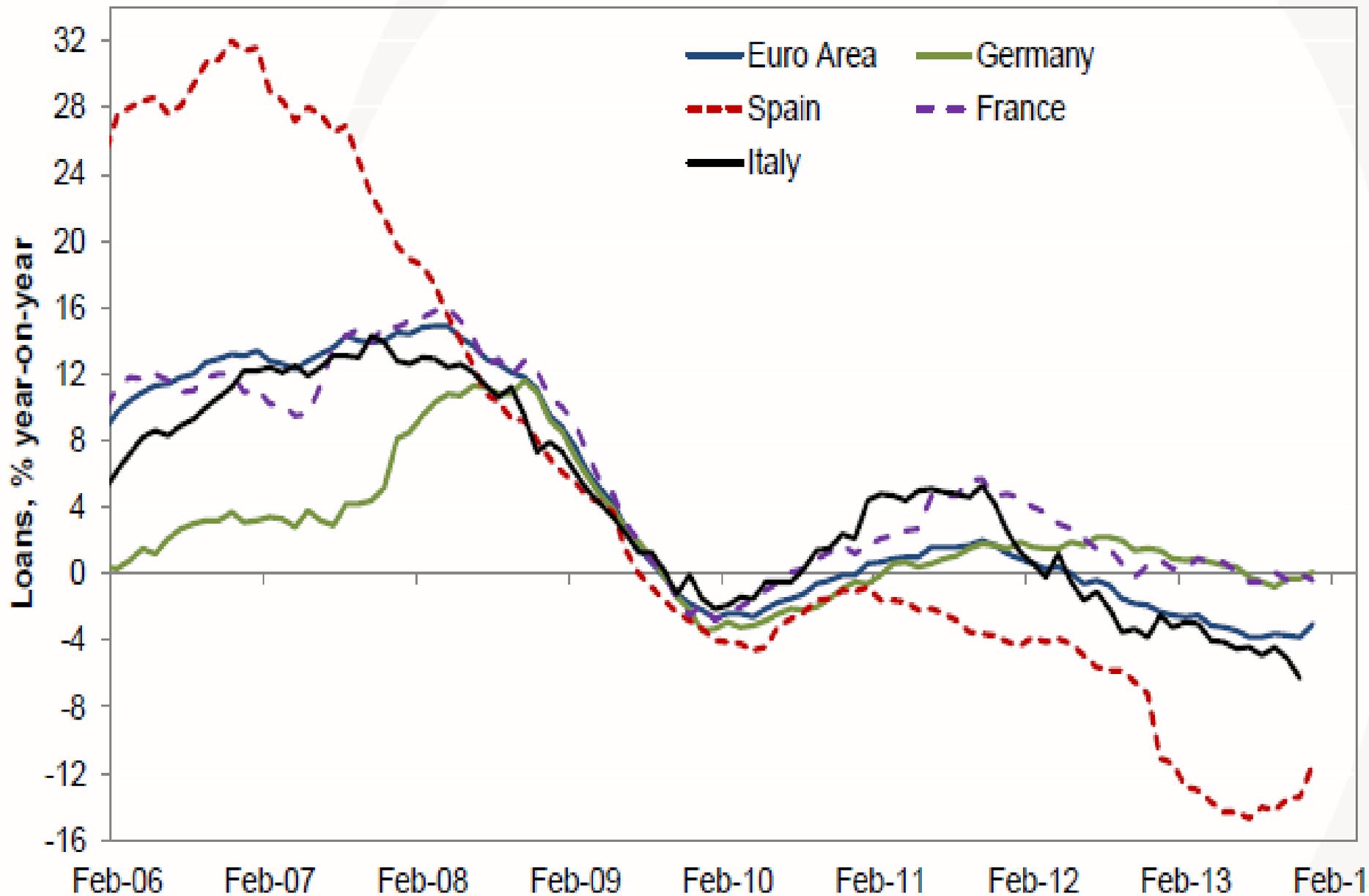


Joseph Gagnon, E. Marc Hinterschweiger (2012). „Responses of central banks in advanced economies to the global financial crisis”. Paterson Institute For International Economics <http://www.iie.com/publications/papers/gagnon20131011ppt.pdf>

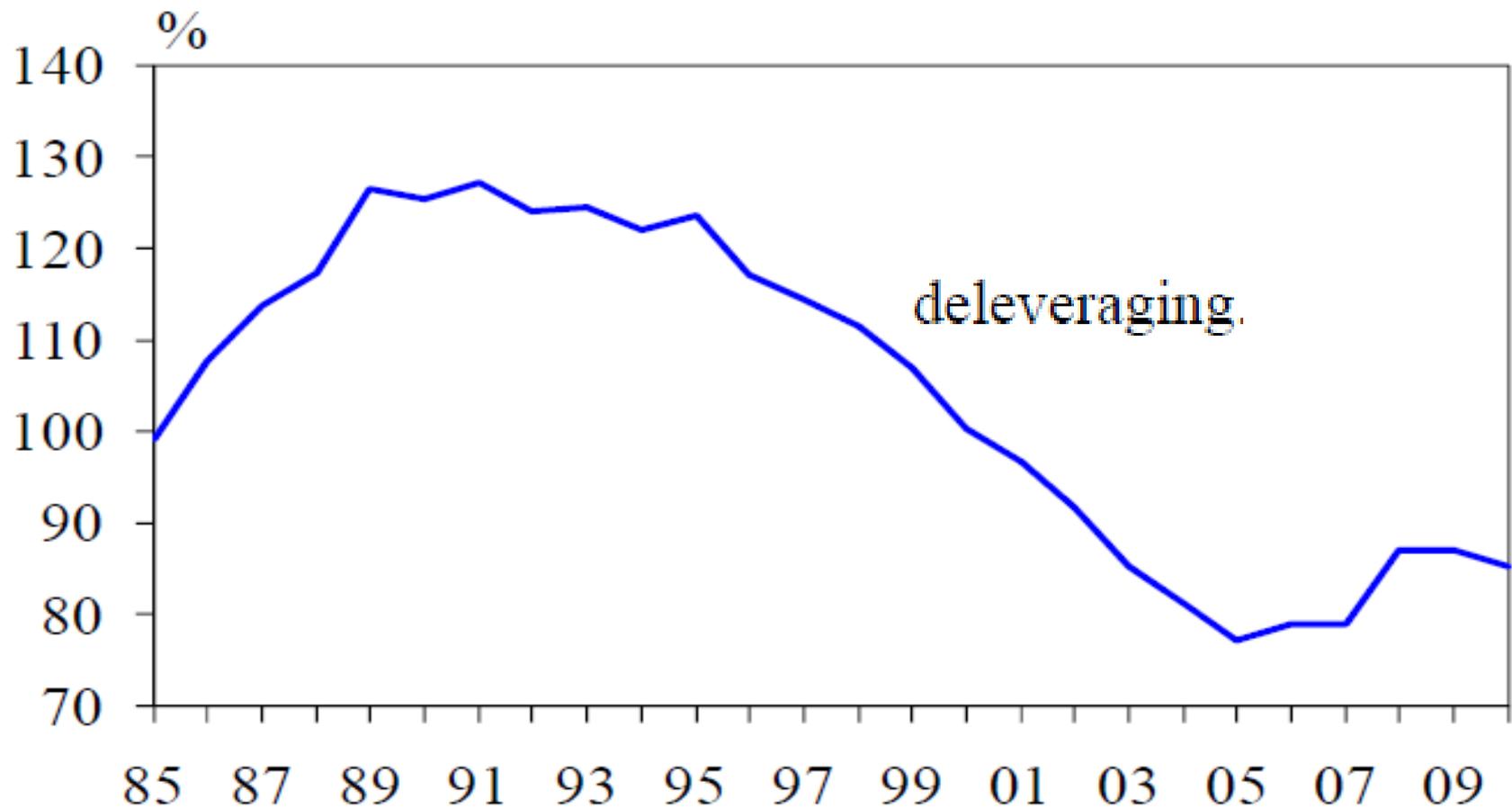
Why does QE disappoint?







Ratio of Debt to Nominal GDP¹

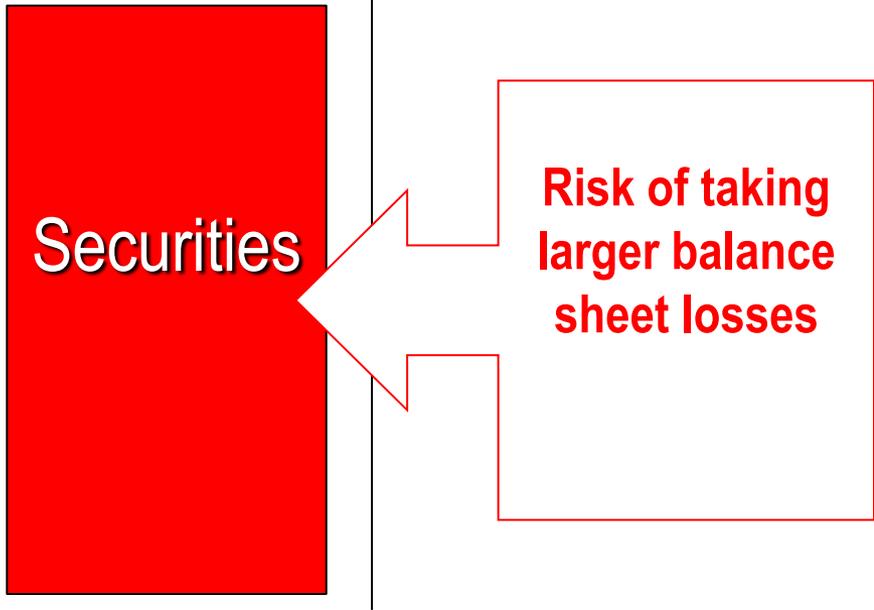


Notes: 1. Debt is the sum of loans and securities (other than equities) in private non-financial corporations.

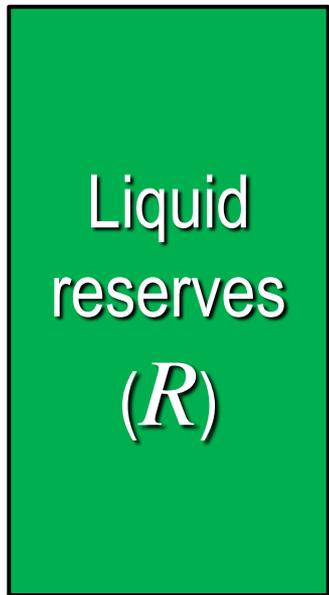
Commercials banks

Securities

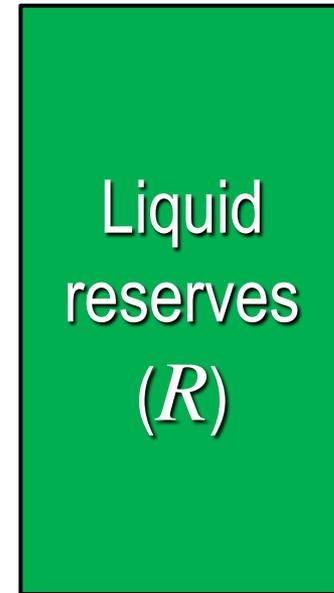
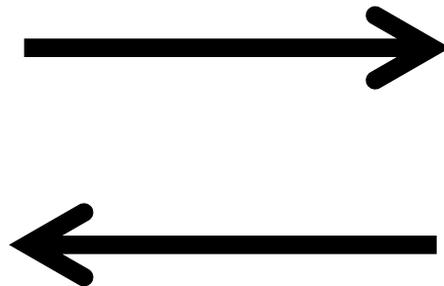
**Risk of taking
larger balance
sheet losses**



Commercial banks



Central bank

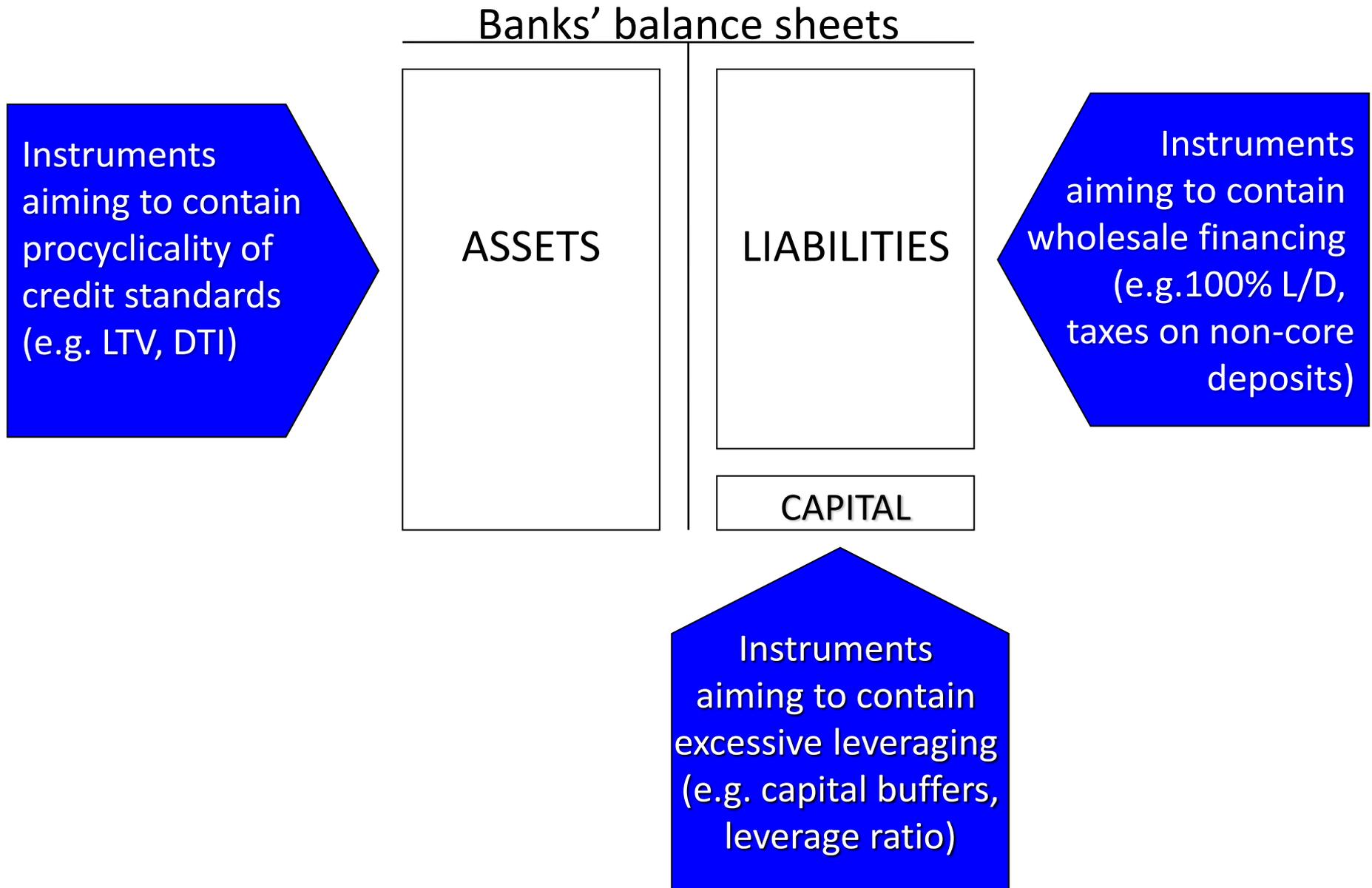


Can it be a solution?

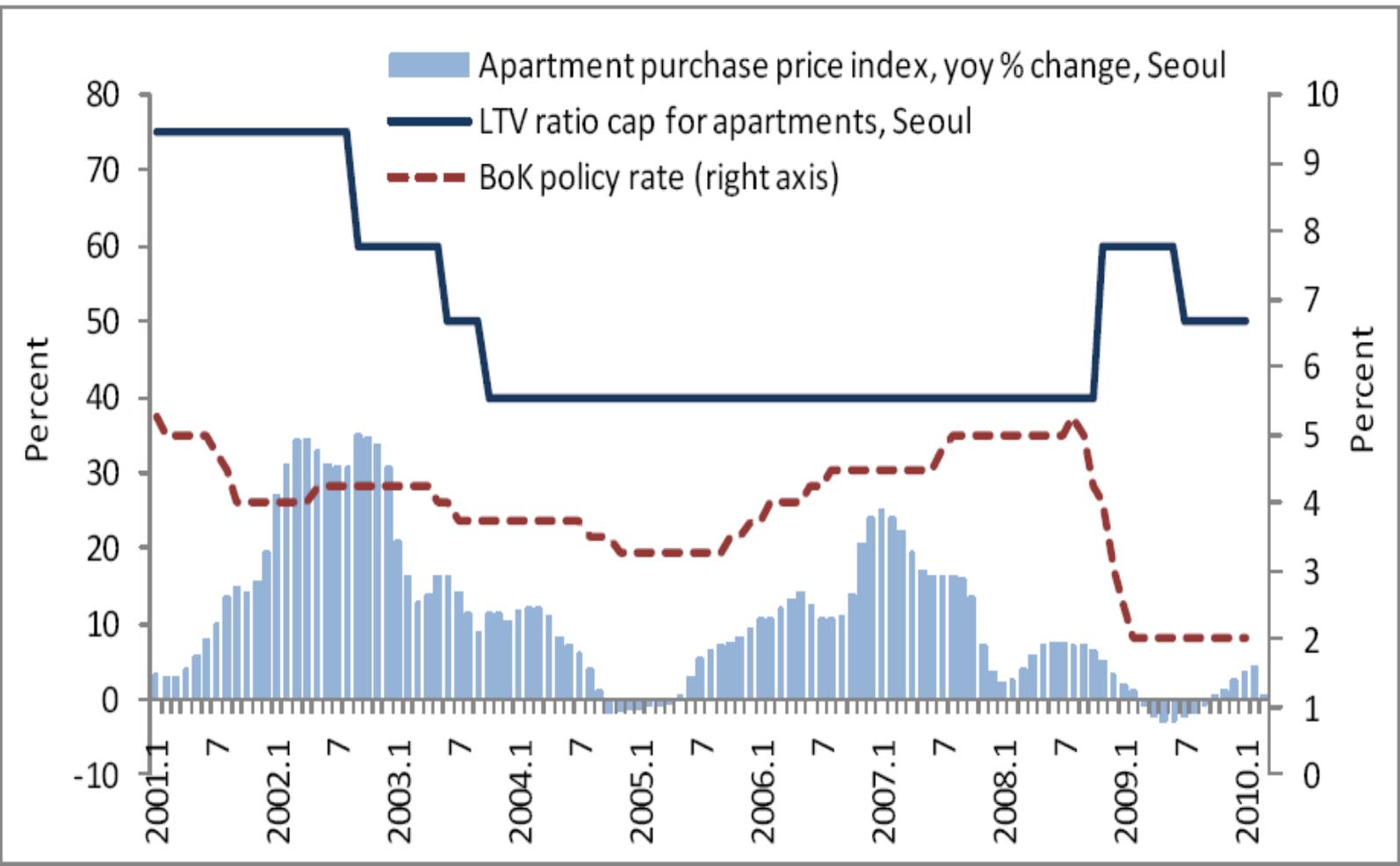


**Macroprudential policy: the
second tool of stabilization policy**

Macro-prudential tools for containing procyclicality



Korea: Change in Apartment Price Index and LTV Cap in Seoul and Bank of Korea Policy Rate



Source: Chang (2010)

Ren H. (2011). „Countercyclical Financial Regulation”, Policy Research Working Paper no. 5823, World Bank, October

Potential conflicts between monetary and macro-prudential policies

Table 2 Likely instances of conflicts between monetary and macro-prudential policies

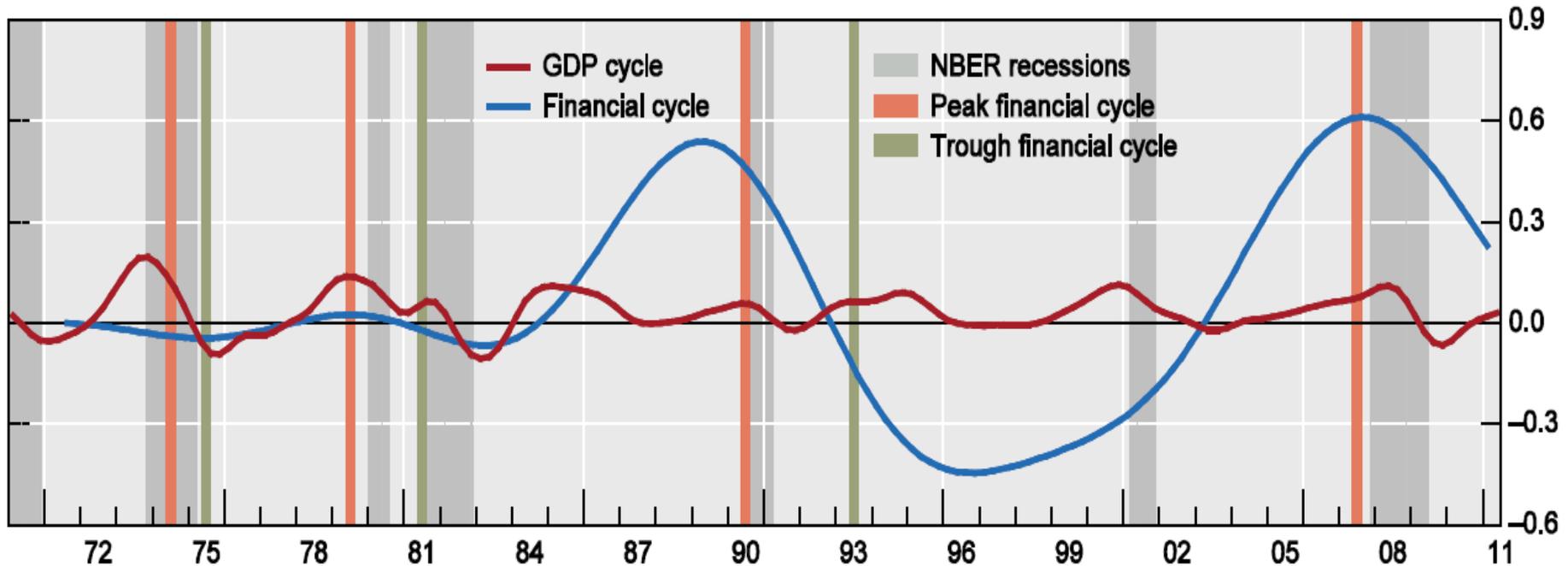
	Inflation above target	Inflation close to target	Inflation below target
Financial exuberance (boom)	Complementary	Independent	Conflicting
No imbalance	Independent	Independent	Independent
Financial deflation (bust)	Conflicting	Independent	Complementary

Source: Beau D., Clerk L., Mojon B. (2011). "Macro-prudential policy and the conduct of monetary policy", *Occasional Paper* no. 8, Bank of France.

Monetary policy must deal with the business cycle.

Macroprudential policy should deal with the financial cycle

The financial and business cycles in the United States



Orange and green bars indicate peaks and troughs of the financial cycle measured by the combined behaviour of the component series (credit, the credit to GDP ratio and house prices) using the turning-point method. The blue line traces the financial cycle measured as the average of the medium-term cycle in the component series using frequency-based filters. The red line traces the GDP cycle identified by the traditional shorter-term frequency filter used to measure the business cycle.

Source: Borio (2012), *The financial cycle and macroeconomics. What have we learnt*, BIS Working Papers 395

There is no reliable aggregate indicator (of systemic risk) to be followed

- „Systemic risk has so far resisted a formal definition and qualification.
- It is unrealistic to expect that a single measure of systemic risk will suffice. A more plausible alternative is a collection of measures, each designed to capture a specific risk exposure.” (Lo, 2008)

- „Banks **first response** to the crisis? It was **deny** the very need of reform.
- The **next phase** was the “**level playing field**” the rallying cry. The lobby reasoned that global standard would be **difficult to achieve**. The strategy was partially successful. The standards agreed were modest.
- Initial **proposals were watered down**. Best of all, the deadline for implementation was **set for 2019** – a date so distant as to be irrelevant to any banker’s career and so extended as to be vulnerable to lots more lobbying”.

Robert Jenkins (Member of the Financial Policy Council of the Bank of England – **former lobbyist**), *Lessons in lobbying*, Remarks at the third Gordon Midgley Memorial Debate, London, 22 November 2011

- *„They are working furiously against reform. **Fear is their tactic.***
- *They say reform would stifle innovation.*
- *They say reform would impede the ability of our country to grow and compete in the global economy”*

How did banks cause the global banking crisis?

