

# Whatever's happened to Global Banking?

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After having failed to salvage a crisis-afflicted banking system by guaranteeing deposits, providing refinance against toxic assets and pumping in preference capital, governments in the US, UK, Ireland and elsewhere are being forced to nationalize their leading banks by buying into new equity shares. What is more, even staunch free market advocates like former Federal Reserve Chairman Alan Greenspan, who made the case for regulatory forbearance and oversaw a regime of easy money that fueled the speculative bubble (which he declared was just "froth"), now see nationalization as inevitable. In an interview to the *Financial Times*, Greenspan, identified by the newspaper "as the high priest of laissez-faire capitalism", said: "It may be necessary to temporarily nationalise some banks in order to facilitate a swift and orderly restructuring. I understand that once in a hundred years this is what you do."

This ideological leap has come at the end of a long transition during which the understanding of the nature of the problem afflicting the banks in these countries has been through many changes. Initially, when the subprime crisis broke, this was seen as confined to subprime markets and to institutions holding mortgage-backed securities. Since banks were seen as entities which had either stayed out of these markets or had transferred the risks associated with subprime mortgage loans by securitizing them and selling them on to others, the banking system, the core of the financial sector, was seen as relatively free of the disease.

In practice, however, the exposure of banks to these mortgage-backed securities and collateralized debt obligations was by no means small. Because they wanted to partake of the anticipated high returns or because they were carrying an inventory of such assets that were yet to be marketed, banks had a significant holding of these assets when the crisis broke. A number of banks had also set up special purpose vehicles for creating and distributing such assets which too were holders of what turned out to be toxic securities. And finally banks had lent to institutions that had leveraged small volumes of equity to make huge investments in these kinds of assets. In the event, the banking system was indeed directly or indirectly exposed to these assets in substantial measure.

It needs noting that even if the exposure of banks to these assets was a small proportion of the total amount in circulation, the effect of such assets turning worthless can be debilitating for the banks for two reasons. First, even if the proportion of derivative assets held by the banks was small, the value of that exposure tended to be high because of the large volume of such assets circulating in the system. Because securitization is geared to transferring risk off the balance sheet of the originator of the base asset, the tendency in the system is for the creators of such assets to discount risk and create large volumes of excessively risky credit assets, as happened in the subprime mortgage market. The effects of this tendency to sharply increase the volume of asset-based securities was aggravated by the easy money environment that was created by the Federal Reserve under Greenspan as part of an effort to keep a credit-financed boom going in the system.

Second, the equity base of most banks is relatively small even when they follow Basel norms with regard to capital adequacy. Banks can use a variety of assets to ensure such adequacy and the

required volume of regulatory capital can be reduced by obtaining assets with high ratings (which we now know are not an adequate indicator of risk). This results in the available regulatory capital being small relative to the risky asset-backed securities held by the banks.

The difficulty with these kinds of bad assets is that they are valued on marked-to-market principles, implying that since these assets are not all being traded, there is a lag in the recognition of the losses suffered through holding such assets. In the US, the process of price discovery began a long time back when in August 2007 Bear Stearns declared that investments in one of its hedge funds set up to invest in mortgage backed securities had lost all its value and those in a second such fund were valued at nine cents for every dollar of original investment. What was noteworthy was that Bear Stearns was a highly leveraged institution holding assets valued at \$395.4 billion in November 2007 on an equity base of just \$11.8 billion. Thus it was not just that the assets held by the bank were bad, but that there were many other institutions, including banks, that were exposed to bad assets through their relationship with Stearns. Yet they were slow in recognizing their potential losses.

On March 14, 2008, Bear Stearns was put on life support with what appeared to be an unlimited loan facility for 28 days delivered through Wall Street Bank J.P. Morgan Chase. That life support came when it became clear that, faced with a liquidity crunch, Bear Stearns would have to unwind its assets by selling them at prices that would imply huge losses. This would have had spin off effects on other financial firms since the investment bank had multiple points of interaction with the rest of the financial community. Besides being a counter party to a range of transactions that would turn questionable, its efforts to liquidate its assets would affect other investors holding the same or related securities and derivatives through a price decline. Fearing that the ripple effects would lead to a systemic collapse, the Fed, in collaboration with JP Morgan, sought to prop up the investment bank. The *Financial Times* quoted an unnamed official who reportedly declared that Bear Stearns was too “interconnected” to be allowed to fail at a time when financial markets were extremely fragile.

However, this lesson had not been learnt in full. When in September last year, troubled Lehman Brothers Holdings Inc., the fourth largest investment bank on Wall Street came to the table with requests for support, it was refused the same. The refusal of the state to take over the responsibility of managing failing firms was supposed to send out a strong message. Not only was Lehman forced to file for bankruptcy, but a giant like Merrill Lynch that had also notched up large losses due to sub-prime related exposures decided that it should sort matters out before there were no suitors interested in salvaging its position as well. In a surprise move, Bank of America that was being spoken to as a potential buyer of Lehman was persuaded to acquire Merrill Lynch instead, bringing down two of the major independent investment banks on Wall Street.

This was, however, only part of the problem that Lehman left behind. The other major issue was the impact its bankruptcy would have on its creditors. Citigroup and Bank of New York Mellon were estimated to have an exposure to the institution that was placed at upwards of a staggering \$155 billion. A clutch of Japanese banks, led by Aozora Bank, were owed an amount in excess of a billion. There were European banks that had significant exposure. And all of these were already faced with strained balance sheets. Soon trouble broke in banking markets with a spurt of bank failures seeming inevitable. Though indications of this problem emerged at least a year-and-a-half ago, what was surprising was that the full import of the problem at hand was not recognized. In the US, and

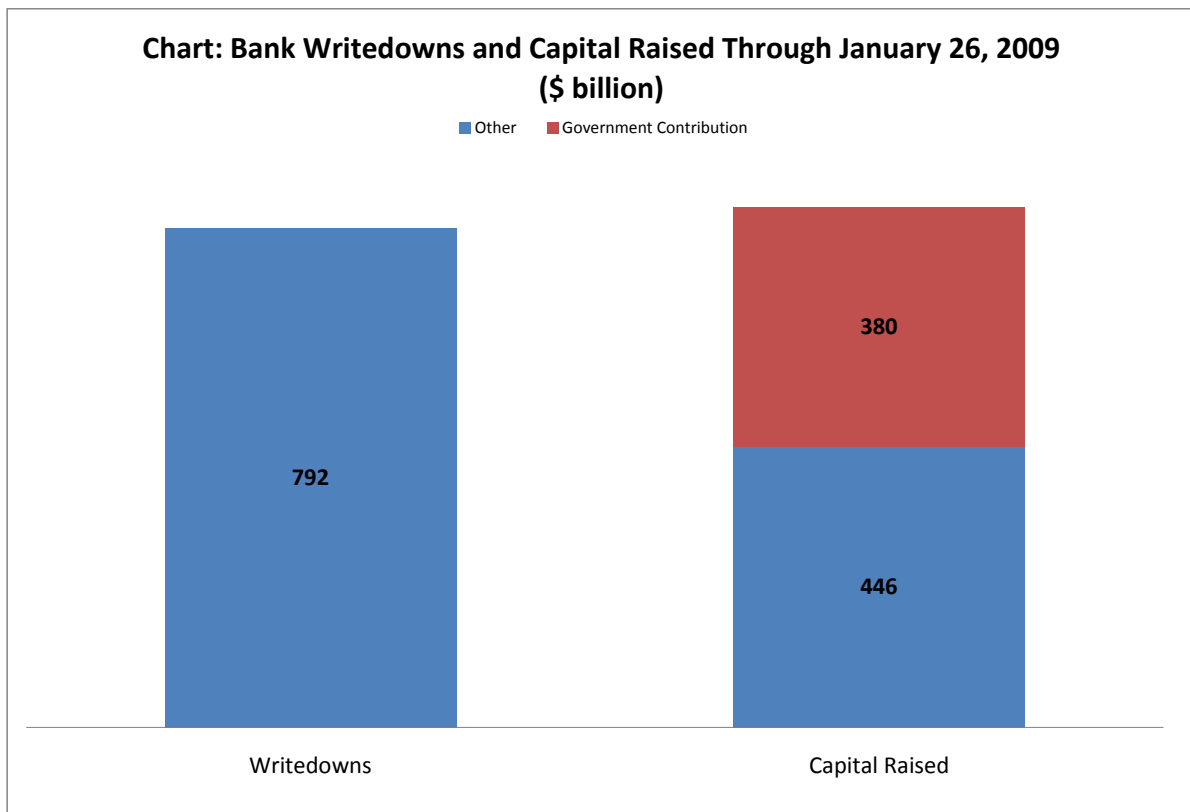
elsewhere in the world, the problem confronting the banks was seen as two-fold: ensuring adequate access to liquidity so that they are not victims of a run; and, cleaning up their balance sheets by writing off or getting rid of their bad assets.

In what followed, central banks pumped huge amounts of liquidity into the system and reduced interest rates. In the US, the Federal Reserve offered to hold the worthless paper that the banks had accumulated and provide them credit at low interest rates in return. But the problem would not go away. By then every institution suspected that every other institution was insolvent and did not want to risk lending. The money was there but credit would not flow through the pipe with damaging consequences for the financial system and for the real economy.

It was at this point that it was realised that what needed to be done was to clear out the bad assets with the banks. Among the smart ideas thought up for the purpose was the notion of splitting the system into 'good' and 'bad' banks. If a set of bad banks could be set up with public money, and these banks acquired the bad assets of the banks, the balance sheets of the latter, it was argued, will be repaired. The bad banks themselves can serve as asset reconstruction corporations that might be able to sell off a part of their bad assets as the good banks get about their business and the economy revives.

This idea missed the whole point, because it did not take account of the price at which the bad assets were to be acquired. If they were acquired at par or more, it would amount to blowing taxpayers' money to save badly behaved bank managers, since the assets were likely to be worth a fraction of what they were actually bought for. On the other hand, if some scheme such as a reverse auction (or one in which sellers bid down prices to entice the buyer to acquire their assets) is used to dispose of the bad assets, then the prices of these assets would be extremely low and good banks would incur huge losses which they would have to write down leading to insolvency. The only way out it appeared was if these banks just wrote down their assets and were saved from bankruptcy by the government through recapitalisation or the injection of equity capital into them. Additional equity injection leading to nationalization seemed unavoidable. What is more as the dimensions of the problem needing resolution became clear the extent of the nationalization required seems substantial.

In its update to the Global Financial Stability Report for 2008, issued on January 28, 2009, the IMF has estimated the losses incurred by US and European banks from bad assets that originated in the US at \$2.2 trillion. Barely 2 months back it had placed the figure at \$1.4 trillion. Loss estimates seem to be galloping and we are still counting. The IMF estimates that these banks that have already obtained much support including capital would need further new capital infusions of around half a trillion. With that much and perhaps more capital going in, public ownership of banking would be near total in some countries. By late January 2006, Bloomberg estimates, banks had written down \$792 billion in losses and raised \$826 billion in capital, of which \$380 billion came from governments.



Though the problem originated in the US, nationalization occurred first in Iceland (where the need was immediate), in Ireland starting with Anglo Irish Bank and expected to be necessary in the case of Bank of Ireland and Allied Irish Banks and in the UK were Royal Bank of Scotland and Lloyds Group are now under dominant public control, and others are expected to follow. However, even here the willingness to declare the process as nationalization is still lacking. In the US, the government initially found ways of providing capital but not demanding a say. But this proved disastrous, since it became clear that old habits of managers used to being paid to speculate die hard. Huge salaries and bonuses were being paid out of money meant to save dying banks. So intervention became necessary and is part of the plank being espoused by President Barack Obama. Yet, when the threat of inevitable nationalization resulted in a sharp fall in the share values of the likes of Bank of America and Citigroup, that are surviving on government money, White House spokesman Rober Gibbs told reporters that “The President (Barack Obama) believes that a privately held banking system regulated by the government” is what the US should have.

What is missed is that the inevitability of public ownership that is now being recognized stems from a deeper source. The problems that drove the system to inevitable nationalization arose because of the transition in banking from a structure that was based on a “buy-and-hold” strategy (where credit assets were created and held to maturity) to one that relied on a “originate-and-sell” strategy in which credit risk was transferred through a layered process of securitisation that created the so-called toxic assets. The deregulation of banking was crucial for this transition. It permitted securitisation and also allowed a geographically extensive banking system to create credit assets far in excess of what would have been the case in a more regulated system, so that they could be packaged and sold. The role of banks as mere agents for generating the credit assets that could be packaged into products meant that risk was discounted at the point of origination, since banks felt

that they were not holding the risks even while they were earning commissions and fees. This transition was made possible by the process of deregulation that began in the 1980s and culminated in the Gramm-Leach-Bliley Modernization of Act of 1999, which completely dismantled the regulatory structure and the restrictions on cross-sector activity put in place by Glass-Steagall in the 1930s.

Why did deregulation occur, when a system regulated by Glass-Steagall and all it represented served the US well during the Golden Age of high growth in the US? It did because implicit in the regulatory structure epitomised by Glass -Steagall was the notion that banks would earn a relatively small rate of return defined largely by the net interest margin, or the difference between deposit and lending rates adjusted for intermediation costs. Thus, in 1986 in the US, the reported return on assets for all commercial banks with assets of \$500 million or more averaged about 0.7 per cent, with the average even for high-performance banks amounting to merely 1.4 per cent. This outcome of the regulatory structure was, however, in conflict with the fact that these banks were privately owned. What Glass-Steagall was saying was that because the role of the banks was so important for capitalism they had to be regulated in a fashion where even though they were privately owned they would earn less profit than other institutions in the financial sector and private institutions outside the financial sector. This amounted to a deep inner contradiction in the system which set up pressures for deregulation. Those pressure gained strength during the inflationary years in the 1970s when tight monetary policies pushed up interest rates elsewhere but not in the banks. The result was a flight of depositors and a threat to the viability of banking which was used to win the deregulation that gradually paved the way for the problems of today. What became clear was that Glass-Steagall type of regulation of a privately owned banking system was internally contradictory. It would inevitably lead to deregulation. But as we know now such deregulation seems to inevitably lead back to nationalisation. So what capitalism needs for its proper functioning is a publicly owned banking system. That implies that the current move to “inevitable” nationalisation cannot be just “temporary” as Greenspan wants it to be.