# Economic Growth: Institutional Foundations

## II. Financial Institutions after the Financial Crisis

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# Summary

- Role of Financial Sector: “Financial Intermediation”
- Evolving Function of Banks
- Dodd-Frank’s Approach to Financial Stability
- “Too Big Too Fail”

# Function of the Financial Sector: Financial Intermediation

- Shuttling funds between suppliers (savers/investors) and users (individuals/businesses).
- Money is not just stuffed in the mattress; buried in the backyard but recycled through the economic system
- Goal: funds are put to economically productive use; savers/investors get a fair return; social welfare is improved overall

# Core problems with banking regulation

- Traditional model for large banks replaced by more complex banking model
- Credit-extension for many of largest businesses occurs primarily through issuance of debt securities
- “Risk management” by banks for own account and to serve clients entails use of financial instruments – “derivatives” – that create special risks
- Size and diversity in bank’s business may contribute both to safety and to systemic risk

# Banks

**Traditional Banking Model**

1) Bank provides “liquidity” to “depositors”

2) Bank provides credit to businesses and consumers

-- for example, loans to fund new equipment purchase by business; mortgages or credit cards for consumers

- Function redescribed more technically:

--“credit intermediation”

-- consisting of 3 “transformations”

# 3 Transformations

i. “liquidity transformation”

immediately redeemable liabilities (deposits) “transformed” into assets (loans) not readily convertible to cash at full value

ii. “maturity transformation”

short-term liabilities (deposits) transformed into long-term assets (loans)

iii. “risk transformation”

“Safe” liabilities (deposits) transformed into “risky” (meaning, riskier) assets (loans)

# Reducing Risks

How does Bank reduce/control risks of these 3 Transformations?

- -- liquidity risks

  risk: value shortfall in immediate sale

  control: “fractional reserves”; “capital”

- -- maturity risks

  risk: increase in market interest rates

  control: maturity structure of loans; capital

- -- credit risks

  Risk: non-payments by borrowers

  control: screening borrowers; on-going monitoring of borrowers; diversification; capital)

# Government role in reducing risks

- Banks individually face “run risk” because of liquidity and maturity mismatches
- Run at single bank may have spillover effects to other banks – “systemic effects”
- Story of the Great Depression: banks were not that large, but depositors lost faith in banking system generally

# Government role in reducing risks

**Therefore:**

Explicit

-- Federal Reserve as Lender of Last Resort

**--** Deposit Insurance

Implicit

**--** US Government as protector of financial system

# The new banking model: “originate and distribute”

- Traditional model: banks “originate” (a loan or a mortgage) and “hold” on the balance sheet, exposing the bank to the 3 “transformation risks” and requiring more capital as lending activity grows
- New model: banks “originate” (a loan or a mortgage) and then “distribute” (resell) to a lower-cost risk bearer.

# “Originate and Distribute”: potential advantages

- Example: bank provides a 15 year fixed-rate mortgage. If market interest rates go up, the bank will have to increase the interest paid to depositor, who otherwise will go elsewhere. But this will reduce the bank’s profits, which depend on the “spread” between the rate paid on deposits and the rate received on loans. But the beneficiary of a pension fund may be locked in, and the fund may need to make a fixed payment and thus is unaffected by the interest rate change. So the pension fund may be a superior risk bearer for that kind of obligation.
- The Bank collects a fee and passes the risk to someone else.

# “Originate and distribute”: problems in the run-up to the Financial Crisis

- Problem: because the bank does not retain credit risk, its incentive to originate high-quality loans is diminished.
- Problem: credit risk may be shifted within the financial sector, not outside of it
- -- “off-balance sheet” entities come on balance sheet in the financial crisis

# Evolving Role of Banks

- Creation of Universal Banks:

  1) Historically in the US, separation of "commercial banking" from "investment banking." Glass-Steagall, 1933. Banks extended credit; Investment Banks underwrote stocks and traded securities.

  2) Prior banking model: undermined by extent to which large investment grade companies by-passed banks to issue debt securities into the market

# Evolving Role of Banks, 2

3) Competitive pressures led to expansion of banking powers through regulatory and legislative action to permit banks to affiliate with investment banks and to provide broad range of “financial services”

# Problems

1) "Social safety net" protections for bank in traditional role were extended to universal banks

-- deposit insurance; access to Fed discount window; implicit US government backstop

2) Innovations designed to reduce risks that added risks in financial distress

i. "Securitization"

ii. "Derivatives"

# Problems

3) “Non-bank banks” that performed banking functions *without* social safety protections and without bank-like regulatory oversight

# The Financial Crisis

1) Housing bubble

-- most banking crises are related to housing bubbles (why? – housing as unique good; as price increase may produce *more* demand)

2) Way that innovations (securitization) permitted growth of housing bubble and created instability when bubble collapsed

-- opacity/rigidity

3) Way that innovations (derivatives) connected financial institutions and created contagion

-- counterparty risk/opacity

# The strategy of Dodd-Frank

- 1) Make it less likely for "Systemically Important Financial Institutions" (not limited to banks) to fail ("SIFI")
  -- i. More capital; less leverage
  -- ii. Tighter supervision; "stress tests"
- 2) Provide a procedure for the wind-up of a failed SIFI that
  – i. Impose losses on creditors
  – ii. Minimize systemic disruption
  – To create greater discipline on banking activity *ex ante*; to share costs of failure *ex post*
  – **No more bailouts. (Compare Bear Stearns; AIG)**

# The strategy of Dodd-Frank, 2

- 3. Restructure certain financial markets to reduce contagion risks

-- Most Derivatives to be traded through "Central Clearing Parties" rather than "Over the Counter" to minimize direct counterparty risk

4. Reduce the scope of activities by SIFI

-- "Volcker Rule" (no proprietary trading/no sponsorship of hedge funds or private equity funds)

-- Culture change?

-- Avoid use of social safety net for proprietary risk-taking

# Further Reform: Break Up the Banks?

**Main target: large, systemically important banks, "Global Universal Banks"**

- **Banks are still "Too Big to Fail"**

  -- Notwithstanding Dodd-Frank, failure of SIFI entails high economic risks. Risk-averse (and perhaps industry-captured) regulators will flinch and bail-out a large bank: "bail-out in waiting"

# Break Up the Banks?, 2

- **TBTF increases bank risk-taking**

-- Creditors will reduce monitoring; banks (as before) have incentives to add-on risks and to evade risk-control measures

-- TBTF reduces cost of funding for largest banks, meaning they can acquire more assets, engage in more activities, which increases cost of failure and magnifies TBTF

# Break Up the Banks?, 3

- **Large Banks are too Complex to Manage**

-- Eg, JPMC/London Whale: large (in kind, potentially ruinous) losses imposed by small (in people headcount) London office ineffectively monitored from NYC

- **Large Banks have too much Political Power to Regulate**

-- Eg, "regulatory sine curve"; revolving door; campaign contributions

# Break up the Banks?, 4

**Counter**

- "Breaking up the Banks" will not eliminate TBTF because resulting smaller banks will still be so large that a failure will have unpredictable systemic effects, meaning regulators are likely to protect
- Global Universal Banks create special economic value because of global nature of economic activity

# Break up the Banks?, 5

- Global Universal Banks may be a US comparative advantage in world economy

  -- US as issuer of reserve currency

  -- US banks not oversized relative to US domestic economy, so US protection is credible (compare: UK, Switzerland)

# Break up the Banks?, 6

- Better regulation can credibly reduce systemic risks