How Banking Undermines Democracy

Anat Admati
Stanford University

Stanford Center for Development, Democracy and the Rule of Law
January 11, 2024
My daughter came home from school one day and said, ‘daddy, what’s a financial crisis?’ And without trying to be funny, I said, ‘it’s the type of thing that happens every five, seven, ten years.’

Jamie Dimon, January 2010
(to Financial Crisis Inquiry Commission)
Narratives Inform Policy

Was the 2007-2009 financial crisis like a natural disaster or a sudden shock?

What about SVB, First Republic and Credit Suisse (spring 2023)?
The Perennial Narratives in Banking

A Liquidity Problem?

“A Classic Bank Run?”
Dodd Frank Act, July 21, 2010: No More Bailouts. Period!!!
(lengthy applause)
The financial crisis was avoidable
Widespread failures in financial regulation
Breakdown in corporate governance
Explosive and excessive borrowing.
Lack of transparency
Widespread breaches in accountability at all levels.
The financial crisis reflected failures of democratic governance.

The same forces continue to undermine democracies.

“Democratic recession” is related to “crisis of democratic capitalism”
CRASHED
How a Decade of Financial Crises Changed the World
Adam Tooze
Winner of the Lionel Gelber Prize
Author of THE DELUGE

THE CRISIS OF DEMOCRATIC CAPITALISM
MARTIN WOLF
The Banking Crisis of 2023
How Banking Undermines Democracy

Banking institutions enjoy extraordinary privileges and exploit symbiotic relations with governments and others with power.

Democratic discourse and policy are corrupted by confusion, deception, willful blindness, and money, resulting in rules that tolerate and even encourage recklessness.

People in banking distort and break rules (varieties of “rule of law”) with impunity.
Power in Finance: People, Institutions, and Markets

Non-Financial Institutions and Markets ("Real Economy")
Including media

Individuals

Financial Institutions and Markets

Governments and their Institutions
Power in Finance: People, Institutions, and Markets

- Financial Institutions and Markets
- Central Banks
- Governments and their Institutions
- Non-Financial Institutions and Markets ("Real Economy") Including media
- Individuals
Power in Finance: People, Institutions, and Markets

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Diagram illustrates the interconnectedness of different sectors in the financial ecosystem.
One Key Problem: Excessive Borrowing

Debt has a dark side, but banks do not experience it properly.
Kate takes a mortgage to buy a house

$400,000 - $380,000 = $20,000
$420,000 - $380,000 = $40,000

5%

100%

$40,000
$20,000
$440,000 - $380,000 = $60,000

10%

200%

$60,000

$20,000
$380,000 - $380,000 = $0

-5%

$20,000

$0

-100%
Historical Equity/Asset Ratios in US and UK

Mid 19th century: 50% equity, unlimited liability

After 1940s, limited liability everywhere in US

“Safety nets” expand

Equity ratios decline

“Banking on the State,” Alessandri and Haldane, 2009 https://www.bis.org/review/r091111e.pdf?frames=0
Recall: Total Liabilities and Equity of Barclays 1992-07

Hyun Song Shin, "Global Banking Glut and Loan Risk Premium," IMF Annual Research Conference, November 10-11, 2011; Figure 22.
Zombie (Insolvent) Borrowers: Opaque and Dysfunctional
Don't worry, this is being done in accordance with generally accepted accounting principles.
KPMG Gave SVB, Signature Bank Clean Bill of Health
Weeks Before Collapse

Accounting firm faces scrutiny for audits of failed banks

By Jonathan Weil and Jean Eaglesham
Updated March 13, 2023, 12:21 pm ET

Silicon Valley Bank failed just 14 days after KPMG LLP gave the lender a clean bill of health. Signature Bank went down 11 days after the accounting firm signed off on its audit.

A Silicon Valley Bank branch in Wellesley, Mass., before opening on Monday morning.
PHOTO: STEVEN SENNE/ASSOCIATED PRESS
“The unfathomable nature of banks’ accounts make it impossible to know which are sound. Derivatives positions, in particular, are difficult for outside investors to parse.”

Paul Singer (Elliot Management), January 2014

“Investors can’t understand the nature and quality of the assets and liabilities... The disclosure obfuscates more than it informs.”

Kevin Warsh, January 2013
The Interconnected System
IMF Financial Stability Report 10/2014

Lenders

Banks

Borrowers

Deposits

Loans

Money

Money

Money

Money

Credit & liquidity puts

Monoline insurance

RMBs

CDOs

SIVs & ABCP

Money market mutual funds

Nonbank mortgage originators

RMBSs

Securities

Money

Super seniors

Credit insurance

Credit insurance

Commercial paper

Monoline insurance

CDOs

SIVs & ABCP

Money market mutual funds

Nonbank mortgage originators

Money

Loans

Money

Loans

Money

Loans

Money

Loans

Money

Money

Short-term funding
What if Wealthy Aunt Claire Ensures that Kate Never Defaults?

Cheap mortgage

No down payment (initial equity) required

Why not buy a huge mansion with no down payment? only upside!!

Equity is “expensive” for Kate!! Money machine with zero equity if possible.
The Financial System has “Uncle Sam” (in many forms)

Deposit insurance (FDIC)
- Expanded scope in crisis
- Guarantees to non-deposit debts
- Loss sharing agreements in resolution

Central banks (Fed etc)
- “Liquidity” and “lender of last resort” facilities support banks, money market funds, others, including insolvent institutions
- Subsidized loans (Fed committed $7.7 trillions in cheap loans to 407 banks; LTRO in Europe)
- Asset purchases (also during Covid)
- Low interest rates if the system weakens (“Greenspan put”)

Department of the Treasury
- Direct investments to prevent default, e.g., Troubled Asset Relief Program (TARP), Citi, Greek government bailouts
- Guarantees and loss sharing with central banks (Covid and 2023)
Federal Deposit Insurance Corporation (FDIC in US)

Established in 1933 after numerous bank failures in early 1930s

Explicitly guarantees deposits up to $250,000 per depositor per bank, but oftentimes all depositors get bailed out.

Banks pay fees to FDIC

FDIC is a “receiver” of failed banks and handles “systemic resolution” Dodd Frank Act.

FDIC supervises some banks
The FDIC program enabled issuance of $28 billion for Goldman, over $40 billion each for Bank of America and JPMorgan Chase, $23 billion for Morgan Stanley $23 with the equivalent of AAA ratings. FDIC will cover the bonds if the banks fail.

The program does not come with the compensation and other regulatory conditions attached by Congress to the $700 billion bailout.

“I don’t know how you measure that subsidy,” said Mark Zandi, the chief economist at Moody’s Economy.com. “That’s why they say it’s invaluable. It’s an infinite subsidy.”
Loans 700B vs $1.06T
Deposits = $1.1T vs $2.46T

Equity (book): $184B vs $294B

More off-balance-sheet loan-related commitments in 2021

Smaller difference with IFRS (about $0.5T)
Now: JPMorgan Chase has about $2.4 trillion in deposits, and total assets of $3.9 trillion (under US accounting rules GAAP)
Joint Press Release

March 12, 2023

Joint Statement by Treasury, Federal Reserve, and FDIC

Department of the Treasury

Board of Governors of the Federal Reserve System

Federal Deposit Insurance Corporation

After receiving a recommendation from the boards of the FDIC and the Federal Reserve, and consulting with the President, Secretary Yellen approved actions enabling the FDIC to complete its resolution of Silicon Valley Bank, Santa Clara, California, in a manner that fully protects all depositors. Depositors will have access to all of their money starting Monday, March 13. No losses associated with the resolution of Silicon Valley Bank will be borne by the taxpayer.

We are also announcing a similar systemic risk exception for Signature Bank, New York, New York, which was closed today by its state chartering authority. All depositors of this institution will be made whole. As with the resolution of Silicon Valley Bank, no losses will be borne by the taxpayer.

Finally, the Federal Reserve Board on Sunday announced it will make available additional funding to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors.

No more bailouts???
SVB Couldn’t Ignore Its Losses, But the Fed Can

By Matt Levine

Matt Levine is a Bloomberg Opinion columnist. A former investment banker at Goldman Sachs, he was a mergers and acquisitions lawyer at Wachtell, Lipton, Rosen & Katz; a clerk for the U.S. Court of Appeals for the 3rd Circuit; and an editor of Dealbreaker.
And Now, a Credit Suisse Bailout

The weekend shotgun marriage with UBS shows how post-2008 regulation failed again.

By The Editorial Board  

March 19, 2023 5:10 pm ET
Zombie” is an apt moniker for Credit Suisse, now that it's crystal clear that without intervention, the bank would have been history last fall. Outflows were even greater than the bank admitted.
Credit Suisse: Too big to manage, too big to resolve, or simply too big?
Anat Admati | Martin Hellwig | Richard Portes - 8 May 2023

When will they ever learn? The US banking crisis of 2023
Anat Admati | Martin Hellwig | Richard Portes - 18 May 2023
… into a rabbit hole…

…and the toxic mix of confusion and politics
Basel Committee on Banking Supervision

Committee of banking supervisory authorities: established 1974 by G-10

Goal: improve quality of banking supervision worldwide

Non-binding recommendations

Pillar I (Capital/liquidity minimal rules)
Pillar II (Supervisory practices)
Pillar III (Disclosure requirements)

Basel Accords

Basel I (1988)
Credit risk and risk-weighting of assets

Allowing banks to take additional risks

Basel III (2010)
Response to 2008 financial crisis

Basel III revisions (2017)

“Final” Rules pending in many jurisdictions (“Basel III Endgame” in US)
Basel II: A spectacular failure
Basel III: An inadequate tweak
(“a well-intended illusion”)
<table>
<thead>
<tr>
<th>Basel II</th>
<th>Basel III</th>
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<tbody>
<tr>
<td>“Common equity Tier 1 capital” to risk-weighted assets (RWA): 2%</td>
<td>“Common Equity Tier 1 Capital” to risk-weighted assets (RWA): 4.5%</td>
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<tr>
<td></td>
<td>• Plus 2.5% conservation buffer</td>
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<td>• Plus 1.5% “Tier 1” to RWA</td>
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<tr>
<td></td>
<td>Leverage Ratio: “Tier 1” to total assets</td>
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<tr>
<td></td>
<td>• Basel III: 3%</td>
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<td>• US: BHC: 5%, insured banks: 6%</td>
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<tr>
<td>“Tier 2” (loss-absorbing debt)</td>
<td>“Tier 2”/TLAC (loss-absorbing debt).</td>
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Fallacies, Irrelevant Facts and Myths in the Discussion of Capital Regulations: Why Bank Equity is Not Socially Expensive

August 2010
(revised 2013)

Anat Admati, Peter DeMarzo, Martin Hellwig and Paul Pfleiderer
“Tripling almost nothing does not give one very much.”

“Sir, Basel III bank regulation proposals that Group of 20 leaders will discuss fail to eliminate key structural flaws in the current system.

If at least 15% of banks’ total assets were funded by equity, the social benefits would be substantial.
And the social costs would be minimal, if any.

Temporarily restricting bank dividends is an obvious place to start.”


(Letter from 20 academics, Financial Times, November 8, 2010)
https://www.ft.com/content/63fa6b9e-eb8e-11df-bbb5-00144feab49a
Healthy banking system is the goal, not profitable banks

NOVEMBER 8 2010

From Prof Anat Admati and others.

Basel III bank regulation proposals that Group of 20 leaders will discuss fail to eliminate key structural flaws in the current system. Basel III is far from sufficient.

Hiking capital and liquidity requirements further could have significant negative impact on the banking system, on consumers and on the economy.

The writer is Citigroup chief executive

https://www.ft.com/content/63fa6b9e-eb8e-11df-bbb5-00144feab49a and https://www.ft.com/content/6a490e8a-ed03-11df-9912-00144feab49a
“A must-read for concerned citizens, *The Bankers’ New Clothes* should be studied and memorized by lawmakers and regulators so they won’t be duped by false claims in the future.”

Eugene Fama, 2013, (Nobel Memorial Prize winner)
“Banks are not special, except for what they are allowed to get away with…. The model is intellectually bankrupt. The reason that this is not more widely accepted is that bankers are so influential, and the economics are so widely misunderstood.

“Why Bankers are Intellectually Naked,” Martin Wolf, Financial Times, March 17, 2013
THE BANKERS' NEW CLOTHES

What's Wrong with Banking and What to Do about It

ANAT ADMATI & MARTIN HELLWIG

NEW AND EXPANDED EDITION

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https://press.princeton.edu/books/paperback/9780691251707/the-bankers-new-clothes
2014 vs 2024
200 additional pages
The Parade of Bankers New Clothes Continues…

44 Flawed Claims Debunked (1/2024)

Flawed Claims Grouped

1. Basics about Bank Capital and Bank Funding
2. “Banks are Special”
3. Economic Effects of Higher Bank Equity Requirements
4. “Bank Regulation and Supervision are Already Tough”
5. “No More Bailouts!”
6. More radical approaches?
7. Politics of Bank Regulation and Global “Competitiveness”

“Because we have substantial self-funding with consumer deposits, we don’t have a lot of debt...”

John Stumpf, Wells Fargo Bank CEO, 2013

“Because we have substantial self-funding with consumer deposits, we don't have a lot of debt…"

John Stumpf, Wells Fargo Bank CEO, 2013

“This rule will keep billions out of the economy.”

Tim Pawlenty (ex Congress), Financial Services Roundtable, July 2015
“This rule will keep billions out of the economy.”

Tim Pawlenty (ex Congress), Financial Services Roundtable, July 2015

NONSENSE
“More equity … has negative effects for all.”

Josef Ackermann
CEO of Deutsche Bank
November 2009
"More equity ... has negative effects for all."

Josef Ackermann
CEO of Deutsche Bank
November 2009

FALSE!!
“Just about whatever anyone proposes... the banks will claim that it will restrict credit and harm the economy.... It’s all bullshit.”

Paul Volcker (1927-2019), January 2010
(From The Payoff: Why Wall Street Always Wins, Jeff Connaughton, 2012)
“Banks are still the most powerful lobby on Capitol Hill. And they frankly own the place.”

Senator Richard Durbin (D-III), 2009
When the President signed the financial reform law, that was half time.

Scott Talbott, Chief Lobbyist
Financial Services Roundtable
Citigroup Becomes the Fall Guy in the Spending Bill Battle

BY MICHAEL CORKERY  DECEMBER 12, 2014  1:57 pm

Citibank's offices in Midtown Manhattan. Timothy A. Clary/Agence France-Presse — They are calling it the Citigroup Shutdown.
The “Level Playing Field” Mantra
(Chapter 12: “Politics of Banking”)

Is fairness in sports a proper analogy for rules of economic “game”? NO!

Should taxpayers subsidize sectors or corporations to win cross-jurisdictional “competition” as “national champions” while causing harm? NO!

Race to the bottom dynamics

Recall Icelandic and Irish banks
Agencies request comment on proposed rules to strengthen capital requirements for large banks

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

Agencies request comment on proposed rule to require large banks to maintain long-term debt to improve financial stability and resolution

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency

https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230727a.htm
An initiative of the Bank Policy Institute

STOP BASEL ENDGAME

The federal government’s Basel Endgame proposal will have real costs for everyday Americans. These capital requirements will create a drag on our economy for years to come — and will hurt working families and small businesses.
To learn more, please visit StopBaselEndgame.com.
A Fallacious “Explainer”

How Capital Works

When capital requirements are set excessively high, it makes it much harder to secure a loan or credit—this is especially true for working families and small businesses.

https://stopbaselendgame.com/capital-101/
Nonsense and Politics Persist: Public Theater, Weaponized Details
“Let's translate [Basel III Endgame] for the average American... It is simply requiring more capital on the sidelines, which then means fewer dollars to lend to small businesses, first-time homebuyers, car loans... to Americans who need desperately to be engaged in the process of achieving the American Dream.”

Ranking Member Tim Scott (R-SC)
Senate Banking Committee Hearing, Dec 6, 2023
“Let’s translate [Basel III Endgame] for the average American... It is simply requiring more capital on the sidelines, which then means fewer dollars to lend to small businesses, first-time homebuyers, car loans… to Americans who need desperately to be engaged in the process of achieving the American Dream.”

Ranking Member Tim Scott (R-SC)  
Senate Banking Committee Hearing, Dec 6, 2023

FALSE!!
Politics of Banking: Are We Hostages?
Symbiotic relations of banks, governments, and others

“Banks are where the money is;” everyone needs banks

Guarantees appear free, their social cost is invisible

Banks seem sources of funding, not risk

“National champions”

Central banks bail out banks and governments

Willful ignorance or confusion

No political will to set and enforce proper rules

Banks get away with recklessness and even lawlessness
It Takes a Village to Maintain a Dangerous System

Many enablers

- Bankers and other financial sector employees
- Institutional investors
- Executives and boards of financial firms
- Auditors and rating agencies
- Lawyers and Consultants
- Supervisors and regulators
- Central bankers
- The media
- Politicians
- Others, including academics

https://adm41.people.stanford.edu/publications/it-takes-village-maintain-dangerous-financial-system
Seven years after the collapse of Lehman Brothers, it is often said that nothing was learned from the crash. This is too optimistic. The big banks have surely drawn a lesson from the crash and its aftermath: that in the end there is very little they will not get away with.
Banks have paid $321 billion in fines since the crisis (but they’ve made almost $1 trillion) | CNBC, March 17, 2017
### JPM Chase Rap Sheet

#### Violation Tracker Current Parent Company Summary

**Current Parent Company Name:** JPMorgan Chase  
**Ownership Structure:** publicly traded (ticker symbol NYSE: JPM)  
**Headquartered in:** New York  
**Major Industry:** financial services  
**Specific Industry:** banking & securities  
**Penalty total since 2000:** $38,995,648,319  
**Number of records:** 267

<table>
<thead>
<tr>
<th>TOP 5 OFFENSE GROUPS (GROUPS DEFINED)</th>
<th>PENALTY TOTAL</th>
<th>NUMBER OF RECORDS</th>
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<tr>
<td>financial offenses</td>
<td>$26,626,159,167</td>
<td>115</td>
</tr>
<tr>
<td>consumer-protection-related offenses</td>
<td>$8,619,119,178</td>
<td>63</td>
</tr>
<tr>
<td>competition-related offenses</td>
<td>$2,458,674,791</td>
<td>27</td>
</tr>
<tr>
<td>government-contracting-related offenses</td>
<td>$614,000,000</td>
<td>1</td>
</tr>
<tr>
<td>employment-related offenses</td>
<td>$522,408,672</td>
<td>46</td>
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</table>

[https://violationtracker.goodjobsfirst.org/parent/jpmorgan-chase](https://violationtracker.goodjobsfirst.org/parent/jpmorgan-chase)
JPMorgan Chase had access to Madoff’s transactions for 20 years yet failed to file “suspicious activities report” until after Madoff confessed.

[JPMC compared to the Gambino crime family; also enabled Jeffrey Epstein.]
How Banking Undermines Democracy

The system endangers and harms
Markets and laws fail to control recklessness, perversely rewarding it

Why?
Confusion and deception
Power imbalances
Politics
Capitalism, laws, and the need for trustworthy institutions

Anat R Admati

Oxford Review of Economic Policy, Nov. 2021 Volume on Capitalism (“What has gone wrong with capitalism, what needs to change and how to fix it” in 5,000 words)

In recent decades, the forces of ‘free-market capitalism’ have undermined and overwhelmed democratic institutions, leading to intertwined crises in both capitalism and democracy. Deception and the manipulation of beliefs often distort both markets and political systems.
Agnotology—the study of ignorance—provides a new theoretical perspective to broaden traditional questions about "how we know" to ask: Why don't we know what we don't know?

[Answer: The corruption of knowledge can be a source of economic and political power; influence is commercialized. E.g., tobacco, opioids, climate...]
Market forces in the global economy undermine Democracies;

*Banking is an important example of the challenge*

- The banking system is dangerous, distorted, poorly regulated and often lawless
- **Problems persist** because of insufficient political will, willful blindness, and narratives that create and perpetuate confusion
- **It takes a village** to maintain this system; central banks are among many enablers
- **Banking illustrates broader challenges** for democracies dealing with private institutional power

[https://gsb-faculty.stanford.edu/anat-r-admati/](https://gsb-faculty.stanford.edu/anat-r-admati/)