

Article:

**Narratives of the Great Financial Crisis (GFC):  
Why I am out of step**

The Journal of  
**Financial  
Perspectives**

EY Global Financial Services Institute

November 2013 | Volume 1 – Issue 3



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# Executive summaries

## **Narratives of the Great Financial Crisis (GFC): Why I am out of step**

by **Charles A. E. Goodhart**, Emeritus Professor, Financial Markets Group, London School of Economics and Political Science

Economics is not a hard science, subject to controlled experiments. In their absence, economists construct narratives to explain events, often involving key sound bites. Among the sound bites of the recent financial crisis are the following: “separate the casino from the utility bank”; “protect the taxpayer; bail-in the bank creditor”; “moral hazard is ever present”; and “liquidate zombie banks and zombie borrowers.” This paper examines the accuracy of each of these sound bites and argues that they give a misleading picture of a far more complex reality. It suggests that most of the reason that the blame for the recent crisis was placed squarely at the doorstep of the investment bankers is that they are highly paid, which, in turn, has blinded many of the commentators on the real causes. The crisis was brought about by a massive and synchronized, but otherwise standard, retail bank-led, property bubble and bust. The author proposes that public funds should in fact be made available to rescue investment banks, which are significantly more interconnected and more difficult to separate into good and bad banks than retail banks.

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# Narratives of the Great Financial Crisis (GFC): Why I am out of step

**Charles A. E. Goodhart**

Emeritus Professor, Financial Markets Group, London School of Economics and Political Science

## **Abstract**

Economics is not a hard science, subject to controlled experiments. In their absence, we economists construct narratives to explain events, often involving key sound bites. Among the sound bites of the financial crisis are the following:

- ▶ “Separate the casino from the utility bank”
- ▶ “Protect the taxpayer; bail-in the bank creditor”
- ▶ “Moral hazard is ever present”
- ▶ “Liquidate zombie banks and zombie borrowers”

This paper argues that each of these sound bites give a misleading picture of a far more complex reality.

### **The importance of narrative**

In macroeconomics, we cannot undertake controlled experiments. It would be nice to do so. I would like to take a group, such as the readers of this paper, and reduce the money holdings of one half of the group by, say, £1,000, and increase the money holdings of the other part of the group by the same amount, and then see what happens in the next period. Perhaps fortunately for the people on whom such experiments might be unleashed, we economists are not allowed to do this. However, nature, politicians and surprise events unleash uncontrolled experiments on us from time to time; for example, the application of austerity to almost all economies in the Eurozone. But, unlike inanimate natural objects, such as atoms, we, individuals, learn and adapt in response to such uncontrolled experiments as are imposed upon us. It is, therefore, not necessarily true that the result of the first uncontrolled experiment will be like the outcome of the second such experiment as may be carried out, since we all will have learned in the meantime, and therefore our responses may differ, even when the initial shock is exactly the same in the two cases.

Hence, macroeconomics is not a hard science, in the sense that the natural sciences, such as physics and chemistry, are. Even so, we have to try to make sense of our macro context, with a view to trying to improve the welfare of everyone within the system. So, what we do, in the main, is to construct narratives of what has been happening, based more or less firmly on our existing theory and related to a set of empirical observations from the surrounding events. But both our theories and the available set of empirical observations are partial and limited. In this process of trying to make sense of what is happening, by some combination of theory and empirical observation, story-telling skills are valuable; especially so the ability to coin the memorable sound bite.

But I have become unhappy, out of step, with the dominant narratives and the sound bites that have developed and are commonplace about the causes of, and the cures for, the Great Financial Crisis (GFC).

### **“Separate the casino from the utility bank”**

The idea put forward in this sound bite is that investment banking is largely gambling, undertaking proprietary deals for largely personal gain in exotic instruments (with generally lower ethics and worse culture), while retail banking

provides services for the real economy. The suggestion is also made that it was the investment banking arms of (universal) banks that got us into trouble; and that only the retail part of banks is essential for the system to continue, and should therefore be the only segment of a bank to have taxpayer support in the case of extreme difficulties.

As an example, on the day when Fabrice Tourre, a trader at Goldman Sachs, was coming for trial on the grounds that he had fraudulently sold, or mis-sold, an exotic instrument that had been designed by a hedge fund trader taking the opposite position, in order to fail, one of the newspapers reported this with the following phrase: “This trial will show us whether the system was destroyed by the banks as a whole, or only by rogue traders within the banks.”

Most, if not all of this, is wrong. There is not space, or time, within this paper to talk at length about the real and valuable functions of investment banking. Suffice it to say, in the light of the tapes of the activities of the bankers at the Anglo-Irish bank, the idea that the ethics and culture of retail bankers is on a higher plane than those of investment bankers is at least questionable.

Rather more important, the GFC did not arise from dealings in exotic derivative instruments. It was, instead, driven by the expansion of credit to finance a property bubble, both in commercial real estate (CRE) and in housing mortgages. Indeed, the derivatives book of Lehman Brothers was actually profitable; what drove Lehman's into bankruptcy was rather their stock (warehouse) of mortgage-based securities (MBS). Fuld, the CEO of Lehman Bros, had not expected housing prices and the valuation of MBS to fall as far as they did; he thought that purchasing further MBS at a time when these were showing price weakness would actually be profitable for his company.

What securitization, e.g., of such MBS, did was to spread the subprime crisis outside of the U.S. into Europe, via regulatory arbitrage. The capital requirement constraint that bit into the U.S. was the simple leverage ratio, since they had not adopted Basel II in detail. Whereas the capital requirement constraint that bit into Europe was the Basel II capital requirement (CAR), which was based on risk-weighted assets (RWA). Securitization allowed mortgages, especially the lower-rated mortgages, such as subprime, to be reconstructed into tranches with differing

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exposures to default, and differing credit ratings. The higher quality tranches had a much higher credit rating, AAA, and could, therefore, be held in very large quantities by European banks without needing RWA capital involvement. Meanwhile, the American banks could hold the lower-quality tranches, i.e., the Mezzanine and equity (toxic) tranches, since the higher RWA did not have any effect on leverage. Thus, the European banks frequently had a leverage ratio of 40:1 or 50:1 in 2007, whereas the American banks had a much lower leverage ratio, perhaps 30:1 or lower, while the average risk weighting of the assets held by the American banks was considerably higher than that of the European banks.

It was the (botched) failure of Lehman Brothers, a pure investment bank, that caused the crisis. This was partly because the American authorities were careful to arrange the process of liquidation to allow the American parts of Lehman Brothers to be in a condition where they could continue to function. In contrast, the American liquidators paid virtually no attention to what might happen to Lehman International Europe bank, which was in London, or Lehman's in Japan. It was the chaotic failure of Lehman subsidiaries abroad that did a great deal of the damage. When the British liquidator, Tony Lomas, went into Lehman Bros in London on the Monday morning, there was no money, virtually no continuing utilities, such as electricity, and all the staff had been fired, including the IT staff, so he had no way of finding out where or what information might be stored.

Anyhow, investment banks are much more interconnected than retail banks, so the latter are much easier to liquidate, i.e., to separate into good/bad banks, and to sell the good bank together with the retail deposits to some other bank, or even to re-establish it and start it up as a public-sector, nationalized bank. The likely externalities and spillovers are certainly going to be much greater in the aftermath of the failure of an investment bank than that of a retail bank. So, the economic arguments would imply that if there are to be public sector, taxpayer bailouts, these should be of investment banks, not of retail banks. It is the political arguments that direct bailouts to the retail bank.

Meanwhile, the separation between investment banking and retail banking that has been proposed by the Independent Commission on Banking (the Vickers Commission), and has been widely applauded by most commentators, will lead to less

diversification, and to an even greater focus of retail banks on risky property-related lending (CRE) and residential mortgages. Most of the banking crises, at least in developed countries, in the last 30 years have been related to excessive leverage in pursuit of property lending. The Glass/Steagall division will make the next property-lending boom/bust cycle even more likely, probably to arrive in about 15 years.

There is a common fallacy that banks take deposits from the personal sector in order to lend to the company sector. In fact, as Adair Turner (2010) has shown, whereas most deposits still come from the personal sector, the majority of lending is also to the personal sector, mainly for house purchase. Furthermore, such lending as there is to the company sector is usually also either property related, to construction or property developing companies, or collateralized on the basis of property. A large proportion of SME lending is collateralized in this way.

Hence, this separation is not likely to make the banking system safer; indeed it might actually exaggerate the risks within the system. For example, it will remove stable deposit funding from investment banks, and make them even more reliant on wholesale funds from informed counterparties – often other banks themselves that are more likely to run at the very first sign of fragility. Thus, the asset side of retail banks will become more concentrated and riskier, while the liability side of investment banks is also likely to become subject to greater risk and potentiality for runs.

Several economic commentators have recognized that the reforms, so far, have done relatively little to diminish the inherent weaknesses of the banking system. Some of them, such as Larry Kotlikoff and Michael Kumhof, have argued for further stronger restraints on the functions and structure of banks; by, for example, limiting the availability of transaction balances to narrow banks and requiring all risky assets to be held either on the basis of long-term fixed-interest liabilities or of equity. Although the logic of their position is understandable, their proposals are so radical and restrictive that they are unlikely to be acceptable, at least for the time being. There are, in my view, better ways to make the banking and financial systems safer, but this is not the place to go into such alternative proposals.

**“Protect the taxpayer; bail-in the bank creditor”**

By far the largest cost to the taxpayer, over the course of the GFC, arose not from the use of taxpayer funds to recapitalize a failing bank, but from the failure to do so, i.e., in the case of Lehman Brothers. The American authorities had had a forewarning, in the case of Bear Stearns, in the previous spring, of what might happen should a large investment bank get into difficulties. At that time, they had negotiated a merger of Bear Stearns with JPMorgan Chase. But they should have used the available intervening time to work out a plan B, should, in the case of another bank, such as Lehman's, there might be no other bank prepared or willing to accept a merger with the failing bank. This failure to prepare an alternative plan B had calamitous results.

When taxpayer funds have been sensibly used to recapitalize banks, they have not only prevented disaster but have even often ultimately resulted in an accounting profit, as has been the case with TARP in the U.S. and in the earlier Scandinavian financial crisis in Sweden in 1991.

But such recapitalization needs to be done swiftly and decisively. This was not the case with the Royal Bank of Scotland (RBS). For political reasons, the then Labour Government did not want to nationalize RBS, although it then injected a vast majority of the ownership equity. As a result, it has never been entirely clear whether RBS should be run as a public-sector bank or as a private-sector bank. Its objectives were mixed and uncertain. It has, therefore, been much more difficult to manage and to be clear how it should be reorganized.

Moreover, without a proper funding backstop, stress-tests (for example, the Asset Quality Review, which the ECB is supposed to be carrying out next year) are castrated. Without such a backstop for recapitalization, any bank whose capital falls below the required limit is likely to face much higher funding costs, and even perhaps a run. So, there is pressure on those conducting the testing to show results that indicate that no bank at all has missed their requirements. But in that case, the audience will not believe the results of the stress tests, and will try to work out for themselves which banks they believe to be fragile.

The current intellectual fad is to propose that there should be a shift from taxpayer bailout of any failing banks to creditor bail-in. In my view, this would be a categorical error, though I realize that

I am in the minority in this respect. Let me explain the reasons for this view.

1. The burden of loss from the failure is in no way going to be reduced. It will fall on a more concentrated group (of creditors), rather than on a more widely dispersed group (of taxpayers).
2. There will be exemptions of favored creditors, perhaps often extensive. In the case of Cyprus, the haircut on uninsured deposits was withdrawn, i.e., not imposed, in the case of charities and public-sector institutions, such as hospitals and municipalities. The meeting of the Eurogroup finance ministers proposed that there should be no such penalty on either persons or SMEs holding such large uninsured deposits. This means that the burden is likely to fall, almost entirely, on holdings of such assets by other financial intermediaries (banks will not be allowed to hold large amounts of such claims on other banks). Why it should be preferable to penalize investors in pension funds and in insurance companies, rather than taxpayers more generally, is far from clear.
3. Unfavored creditors can, and will, flee. Taxpayers cannot. The relative burden on taxpayers has been democratically reviewed; not so on creditors. There will always be hard cases, as indeed illustrated in the recent case of the Co-op Bank.
4. In order to ensure that there are sufficient creditors, so as to bail them in case of difficulties, banks will have to be forced to hold a sufficient proportion of “bail-inable” liabilities. This will raise funding costs throughout, but could raise the funding costs of weaker banks dramatically. The whole exercise of proposing creditor bail-in is likely to enhance the procyclicality of the system as a whole. Funding costs for weak banks, and banks in fragile countries, will rise much more steeply and much more rapidly during periods of pressure, under a system of bail-in, than when there was some expectation of taxpayer bailout. The exercise will exacerbate the depth and length of downturns and busts. In particular, the failure of the Banking Union, in the sense that there is now much less support likely either from the taxpayer or from banks in stronger countries, for those in weaker countries, is likely to mean that the weakness and increasing unemployment of the Southern Mediterranean states in Europe is likely to be prolonged and extended. The failure of the Banking Union means that the doom loop remains intact. Creditor bail-in is a way of continuing to focus on the weakness of the Eurozone peripheral countries within those same countries.

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### **“Moral hazard is ever present”**

But would not continuing reliance on taxpayer bailout encourage further risk-taking, i.e., lead to moral hazard? Yes, in principle, but that actually did not happen in 2008, as several articles [Fahlenbrach and Stulz (2009); Foote et al. (2012)] have shown. The bankers, again for example Dick Fuld, did not believe that they were taking risks by investing in mortgage-backed securities. Nor did the credit rating agencies, and nor did the markets, where CDS values had fallen to their lowest level, implying virtually no risk of default, in the early summer of 2007. For the previous 50 years in the U.S., if you held a regionally well-diversified portfolio of MBS, there was very little risk of significant falls in values, because housing prices, diversified over the U.S. as a whole, had never fallen significantly during that period. If you ran an econometric model, using those same 50 years, the expectation that housing prices might fall by more than 5%, on such a regionally diversified portfolio, was estimated to be a standard deviation of above 2, i.e., a most unlikely event.

Moreover, moral hazard should relate to the individual taking the decisions, i.e., to the banker, not to the institution, i.e., the bank. Liquidating the bank would have little effect on the decisions of the banker should the bankers' expected pay-offs, i.e., his remuneration, remain the same whether the bank was liquidated or not. Moral hazard would be reduced by making the banker, not the bank, suffer from failure, for example by removing some part, or all, of the limited liability protection for top decision-making bankers.

But even so, if banks, particularly the large investment banks, were always to be supported by taxpayer bailout, would that not give larger banks an unfair advantage, and remove interest rate signals about their impending fragility? But why not rely on equity signals, because no one is proposing to remove the potential loss to equity holders, and then also require much more equity, as advocated by Admati and Hellwig (2013). Indeed, a banking system where banks were required to hold much more equity, relative to debt, would be much safer; and in other respects would have few disadvantages. The real issue, however, is not that the equilibrium state would be much preferable, with a much higher share of equity, but how to get from here to there. The problem is one of achieving dynamic transition from a low-equity to a high-equity equilibrium state, rather than residing in a comparison of the two states.

### **“Liquidate zombie banks and zombie borrowers”**

Raising required equity ratios, without having a means of forcibly recapitalizing such banks (e.g., via taxpayers), at the same time as bankers continue to focus on the return on equity (RoE), will just lead to undercapitalized banks and deleveraging. Particularly at a time when banks' market equity prices are low relative to book values, raising new equity will dilute existing shareholder value and transfer value from equity holders to bondholders. Hence, bank CEOs and other managers are only going to raise new equity when they have absolutely no other alternative.

Without having a means to force banks to raise new equity and not having the funds to recapitalize them themselves, regulators are having to connive, and to wink, at the continued existence of banks whose equity holdings are well below the higher ratios that are now generally desired. In effect, regulators themselves are practicing voodoo in order to bring zombie banks into (dismal) existence. There is increasing covert domestic political protection for each country's banks. The banks in each country are being pressured to reduce leverage by cutting back on lending abroad or by selling assets situated abroad. The implicit agreement is that if domestic banks are prepared to go on increasing lending, either to the government or to the private sector, within each country, then the government and the monetary authorities there will do their best to protect them from failure or other outside interference.

But in any case, liquidation of such banks would just have made everything worse. In such a context, foreign banks are unlikely to come in to pick up the pieces, and in most cases, the other domestic banks are incapable of doing so. The forced sale of assets would have driven down asset values more generally. Why would any of this have helped other banks? Or the domestic economy?

If we assume, as surely we must, that the GFC is finite and temporary, then borrowers, like banks, will recover at some stage. Forbearance, at least up to a point, is good, not bad. In the U.K., foreclosures, for example on housing, and company failures have been comparatively low during the course of the depression. Why crystallize losses when you do not have to do so? By doing so, it drives down asset values, raises unemployment, and worsens the debt and extent of the depression. A problem of securitization in the U.S. was that the securitized mortgages were so comingled that it was almost impossible to undertake forbearance on an

individual (securitized) mortgage. Consequently, it was very difficult to find any alternative to foreclosure; though had as much initiative and thought gone into the reform of housing finance as went into the reform of banking finance, the outcome in the U.S. might have been better. Anyhow, this problem did not match, fortunately, in the U.K. In my view, the extent of forbearance shown by U.K. banks to U.K. borrowers in temporary difficulties has been one of the unsung, and unrecognized, success stories of this recent depression.

Why be any more brutal than you have to be, either in fiscal austerity or in driving borrowers into bankruptcy? What, to my mind is remarkable, is how many of those who, with considerable justification, believed that the degree of fiscal austerity in Europe was excessive, at the same time believe that it would have been better had banks fully recognized the current declines in values and foreclosed on those borrowers who were currently in difficulties. Of course, if a bank believes that the borrower can never recover, even when the economy does, then it will, and should, consider how best to recognize such failure in an orderly fashion. But with the recovery, both borrowers and banks are likely, one must hope, to do better, and eventually to manage to meet their debts. Premature foreclosure, like premature austerity, does not do any good to the economy more widely.

### Conclusion

If investment bankers had been paid at roughly the same rate as academic professors or leading journalists, the discussion on the causes of the GFC would have been much more rational and balanced. An, entirely understandable, fury at such "obscene" remuneration has, however, led to distortions in such narratives, with the blame game zeroing in on that target. This has blinded too many people to the underlying cause of the GFC, which has been a massive and synchronized, but otherwise bog-standard, retail bank-led property bubble and bust. Those who cannot learn from history will be doomed to repeat it. Roll on the next property bubble and bust in the late 2020s.

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EYG No. EK0210



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ISSN 2049-8640