DIMITRIS N. CHORAFAS

# BANKS, BANKERS, AND BANKRUPTCIES UNDER CRISIS

## Understanding Failure and Mergers During the Great Recession

Banks, Bankers, and Bankruptcies under Crisis

**Also by Dimitris N. Chorafas**

*The Changing Role of Central Banks* (2013)

*Breaking Up the Euro: The End of a Common Currency* (2013)

*Household Finance: Adrift in a Sea of Red Ink* (2013)

*Quality Control Applications* (2013)

*Basel III, the Devil, and Global Banking* (2012)

*Sovereign Debt Crisis: The New Normal and the New Poor* (2011)

*Business, Marketing, and Management Principles for IT and Engineering* (2011)

*Energy, Environment, Natural Resources and Business Competitiveness* (2011)

*Education and Employment in the European Union: The Social Cost of Business* (2011)

*Cloud Computing Strategies* (2011)

*The Business of Europe Is Politics* (2010)

*Risk Pricing* (2010)

*Capitalism without Capital* (2009)

*Financial Boom and Gloom: The Credit and Banking Crisis of 2007–2009 and Beyond* (2009)

*Globalization's Limits: Conflicting National Interests in Trade and Finance* (2009)

*IT Auditing and Sarbanes-Oxley Compliance* (2009)

*An Introduction to Derivative Financial Instruments* (2008)

*Risk Accounting and Risk Management for Professional Accountants* (2008)

*Risk Management Technology in Financial Services* (2007)

*Stress Testing for Risk Control Under Basel II* (2007)

*Strategic Business Planning for Accountants: Methods, Tools, and Case Studies* (2007)

*International Financial Reporting Standards (IFRS): Fair Value and Corporate Governance* (2006)

*Wealth Management: Private Banking, Investment Decisions and Structured Financial Products* (2006)

*The Management of Bond Investments and Trading of Debt* (2005)

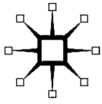
*The Management of Equity Investments* (2005)

# Banks, Bankers, and Bankruptcies under Crisis

## Understanding Failures and Mergers during the Great Recession

*Dimitris N. Chorafas*

palgrave
macmillan



BANKS, BANKERS, AND BANKRUPTCIES UNDER CRISIS
Copyright © Dimitris N. Chorafas, 2014.
Softcover reprint of the hardcover 1st edition 2014 978-1-137-43698-6

All rights reserved.

First published in 2014 by
PALGRAVE MACMILLAN®
in the United States—a division of St. Martin's Press LLC,
175 Fifth Avenue, New York, NY 10010.

Where this book is distributed in the UK, Europe and the rest of the world, this is by Palgrave Macmillan, a division of Macmillan Publishers Limited, registered in England, company number 785998, of Houndmills, Basingstoke, Hampshire RG21 6XS.

Palgrave Macmillan is the global academic imprint of the above companies and has companies and representatives throughout the world.

Palgrave® and Macmillan® are registered trademarks in the United States, the United Kingdom, Europe and other countries.

ISBN 978-1-349-49368-5 ISBN 978-1-137-43699-3 (eBook)
DOI 10.1057/9781137436993

Library of Congress Cataloging-in-Publication Data

Chorafas, Dimitris N.
Banks, bankers, and bankruptcies under crisis : understanding failures and mergers during the great recession / Dimitris N. Chorafas.
pages cm
Includes index.
1. Banks and banking, 2. Banks and banking—Corrupt practices. 3. Financial institutions—Corrupt practices. 4. Global Financial Crisis, 2008–2009. I. Title.

HG1615.C51946 2014
332.1—dc23 2014002967

A catalogue record of the book is available from the British Library.

Design by Newgen Knowledge Works (P) Ltd., Chennai, India.

First edition: July 2014

10 9 8 7 6 5 4 3 2 1

# Contents

*List of Figures and Tables* ix

*Preface* xi

1 Banks "Too Big to Fail" 1
1. Large and Complex Banking Groups 1
2. Big Bank Bailouts and Bail-ins 5
3. Small Is Beautiful 10
4. The Case of "Stickier" Deposits and of Living Wills 14
5. *If* Risk Control Is Ineffective, *Then* Hopeless Cases Should Go Bankrupt 18

2 Banks and Regulators 23
1. Basel III 23
2. The Leverage Ratio 28
3. Liquidity Coverage Ratio 32
4. Should the Glass-Steagall Act Be Reintroduced? 36
5. The Role of the CIO Must Be Rethought 39

3 Banking Practices and the Evolution of Trading Rules 43
1. Shadow Banking 43
2. Risky Securitizations Get a New Life 46
3. The Volcker Rule 49
4. Bank Consolidation: An Elephant in a Glass House? 53
5. OTC Derivatives and CCPs 56
6. The Increase in Legal Risk 61

4 Euroland's Banking Union and Its Stress Tests 65
1. The Rush for a Banking Union 65
2. The Difference between Theory and Practice 69
3. ECB's Single Supervisory Mechanism 72
4. The Cocktail of Stress Testing and Politics 76
5. A Vicious Cycle of Sovereign–Big Banks Alliance 80
6. Risk Premiums and the Rescue Fund 83

5 Lehman Brothers and Bear Stearns 87
1. Case Studies Are the Best Way to Examine "How" and "Why" the Bankruptcies Took Place 87
2. Lehman Brothers 90
3. Who Could Provide Assurances on Counterparty Risk? 93
4. How Dependable Can a Broker's Investment Conclusions about an LCBG Be? 97
5. Bear Stearns 101
6. The End of Bear Stearns 105

6 American International Group 109
1. Corporate Bankruptcies Are a Part of Business Life 109
2. The American International Group Was More Than an Insurer 113
3. Regulatory Authorities Had Not Performed Their Duties 117
4. Lessons Taught by AIG's Debacle 120
5. Bonuses, Counterparties, and Public Money 124

7 Federal National Mortgage Association and Federal Loan Mortgage Association 127
1. Mortgages, Uncle Sam, and the Hedge Funds 127
2. Can Mutual Agreements Cope with Risk? 131
3. Eventually Comes the Day of Reckoning 135
4. The Piercing of Government-Sanctioned Secrecy in 2003 was a Precursor to Bad News 138
5. The Markets Did Not Know What to Think of Fannie and Freddie 143
6. Fannie and Freddie Fall off the Cliff 147

8 Citigroup 151
1. A Bank That Found Its Dual Origin in Reputation and Conservatism 151
2. Expansion under the Citibank Banner 156
3. Citigroup: Merger with Travelers and Struggle in Boardroom 160
4. Uncle Sam Comes to the Rescue 163
5. A Year after the Sovereign Acted as Chief Savior 167

9 British Banks at the Edge 173
1. The British Socialists Bailouts 173
2. Royal Bank of Scotland 176
3. The RBS Way to Disaster 180
4. Lloyds, HBOS 184
5. Overextended British Banks 187
6. Ireland's Nemesis: The Anglo Irish Bank 190

10 Euroland's Banks 193
1. The Need to Banish the Threat from Zombie Banks 193
2. Commerzbank and Hypo Real Estate 197
3. IKB, WestLB, and Sachsen LB 201
4. Monte dei Paschi di Siena 206
5. Government Bailouts Help in Hiding the Losses 209
6. BNP Paribas, Société Générale, Crédit Agricole, and Caisse d'Epargne 213

11 The Challenges Japan Faced with Its Banking Industry 217
1. The Years of the Banking Disaster 217
2. Japan's Intensifying Banking Crisis 221
3. Japanese Banks in Southeast Asia 224
4. Japanese Banks, Economic Deflation, and Creative Accounting 227
5. Deferred Tax Assets 231

12 Japanese Banks That Bled in a River of Red Ink 235
1. Daiwa Bank, Nippon Trust & Banking, Sumitomo Bank 235
2. Mitsubishi-Tokyo and the Hokkaido Banks 239
3. Mizuho, Industrial Bank of Japan, Fuji, and Dai-Ichi 242
4. UFJ and Resona 246
5. Long-Term Credit Bank and Its Resurrection as Shinsei Bank 250

*Notes* *253*

*Index* 263

This page intentionally left blank

# Figures and Tables

## Figures


| | | |
|---|---|---|
| 2.1 | The definition of regulatory capital by Basel III | 26 |
| 3.1 | Repurchase agreement through a central counterparty | 57 |
| 4.1 | Risk exposure with extreme events and the long leg of unexpected losses distribution | 77 |
| 6.1 | The AIG empire of diversified subsidiaries | 114 |
| 9.1 | Market capitalization of the Royal Bank of Scotland equity | 182 |
| 11.1 | Nikkei index and the Japanese banking industry | 228 |
| 12.1 | MTFG and UFJ share prices do not reflect financial health | 247 |


## Tables


| | | |
|---|---|---|
| 11.1 | DTA and consolidated Tier-1 capital among the five major Japanese banks in third quarters of 2003 and 2004 (in billion yen) | 233 |
| 12.1 | Consolidated net losses of Japanese big banks | 243 |

This page intentionally left blank

# Preface

While, like history at large, economic history never exactly repeats itself, what has happened in the past is highly relevant to the present and to the future. One of past events' main contributions is that they teach what *not to do* to avoid the severe penalties that go with actions that have been tried and failed. This is, for instance, the case of banks that have been growing too fast on loose governance policies, creating a bubble that burst reversing economic growth.

This book is the product of findings in my research. It is written for academics and for professionals dealing with the financial industry and its instruments: bankers, investors, analysts, traders, risk controllers, auditors, and managers of institutions as well as consultants and regulators. After explaining the new developments in prudential regulations and what Basel III might be worth, this book brings to the reader's attention—through case studies—courses of action that imposed economic pain magnified by leverage, lack of transparency, illiquidity, and insolvency, and also by sovereigns acting as chief saviors.

Part of the risks associated with the banking industry derives from the fact that its distress spreads like a brushfire. A sudden stop in lending creates major challenges for small and medium enterprises (SMEs)—the most important employers in any economy—as they find themselves confronted with higher borrowing costs or even with no access to credit.

Then there is the case of novel products deprived of any value to society—like the subprimes—as well as scandals. Some lenders, and the men running them, are used to a binary option: *feat* or *bankruptcy*. They are betting that the latter will be avoided by the benevolence of the sovereign who, particularly in the case of big banks, would use public money to pull up self-wounded institutions from under.

Theoretically, good financial figures published after the most recent economic and banking crisis indicate that the salvaged Large and Complex Banking Groups (LCBGs) are on the road to recovery. But in reality this may well be a fata morgana. Like any other document financial reporting is subject to creative accounting and "good profits" could

only indicate that the books have been cooked to allow senior executives to shower themselves with undeserved bonuses.

A bad practice that has established itself over the last couple of decades in the banking industry is to base salaries and bonuses on recognized but not realized gains. Profits that are simply "recognized" may, in the end, prove elusive.

Moreover, like a battleship, large and complex banking groups, similar to those that failed in Japan in the 1990s as well as in America and Europe in 2008 and thereafter, cannot turn around on a coin. No matter how much money is thrust upon them, they cannot get back to health at short notice, rid themselves of their toxic waste, or build reserves while still suffering under mountains of bad loans and of derivatives that are under water.

"Good news" about LCBGs that have been hanging on a fork is nothing more than creative accounting. It is not serious business, and the fact that it takes place speaks volumes about the efforts to mask the sick state of some big banks. Profitability in a financial institution's core businesses does not improve just because something has not yet gone wrong. Neither is the flooding of the market with newly minted money by the central bank the elixir for a prosperous economic life. Quite to the contrary, it may be a bad recipe, as throwing money at the problem keeps alive zombie banks.

Analysts who know what they are talking about don't fail to notice that bad-loan write-offs don't necessarily indicate that the worst of their woes is over. While on paper, the curve of bankruptcies and near-bankruptcies may seem to have bent, in several quarters financial and managerial problems are still growing beneath the surface. Many companies are kept alive by government loan guarantees and other financial help. Banks may also be bailing out their worst borrowers by:

- Forgiving debt, and
- Taking equity in lieu of repayment.

The only way to find out what is really happening is by placing more emphasis on a realistic assessment of the quality of a bank's loans; in paying much more attention to lending standards, including counterparty risk; and in examining how well an institution is controlling market risk to avoid the Himalaya of toxic waste that has brought down many LCBGs.

Increasing loan provisions and loan loss charges is not synonymous with weakening the bank's capital ratio. The difference should be made up by retained earnings. Senior management is well advised never to

slacken its drive to strengthen the capital base in good times. This allows it to have reserves that it can use in adversity.

The examples given in the preceding paragraphs reflect, in brief, some of the most important lessons the reader can find in the wealth of case studies included in this book. Chapter 1 is a reminder of how the Western banking industry badly wounded itself through lending and trading follies, including the securitization of worthless loans—the subprimes—that were conveniently rated triple-A by independent rating agencies and found their way into the portfolios of formerly serious credit institutions.

An integral part of this discussion is the definition and objective of two new measures sponsored by governments: the *bail-in* and *living wills*. Both are still concepts rather than hard facts. Though bail-ins were applied in the most ill-conceived way in March 2013 during the Cyprus crisis and their wider application is considered beyond doubt, the first official document is Euroland's resolution and recovery directive (RRD)—and it shows that the opinions of 17 finance ministers do not converge.

Chapter 1 also refreshes the reader's memory on how and why big banks, the LCBGs, were christened "too big to fail" while in reality they were "too big to be saved." This has been a collective failure of good sense by sovereigns, central bankers, and regulators.

Chapter 2 concentrates on other recent regulatory measures like capital requirements under *Basel III*, the leverage ratio, and liquidity coverage ratio.

Regulators and, more recently, politicians are trying to suppress banks' risk appetite. Financial institutions are expected to hold more capital to confront their exposure and conform to international standards. Worried by the potential for banks to game the calculations that underpin risk-weighted assets, regulators have proposed a *leverage ratio* that is a simpler and more direct measure of capital reflecting the overall size of a bank's balance sheet as well as its riskiness. Another important part of Basel III is the *liquidity coverage ratio* whose numbers will require institutions to fund themselves with more liquid assets to avoid a crunch due to the absence of liquidity while their solvency is beyond reproach (sometimes illiquidity can morph into insolvency).

Chapter 3 concentrates on banking practices, such as shadow banking and the resurgence of risky securitizations, as well as on rules and processes intended to limit the amount of gambling that has found residence in the financial industry. The Volcker rule, central counterparties for OTC derivatives, and an increase in legal risk are examples. Rules and limits commensurate to the exposure assumed by the banking industry are urgently necessary to stem a new conflagration due to financial gambles that may well destroy the global economy.

The theme of Chapter 4 is Euroland's banking union that was supposed to give air, breadth, and scope to the European economy, but has turned into a subject of contention and a liability even before it saw the light. The reasons can be found in the most significant difference that so often exists between theory and practice, particularly in working out the details of a complex novel structure. The problem of evidence has been corrected by the cocktail of stress testing, which is an objective exercise, and of high stakes in politics, which is fully subjective.

Chapter 5 devotes itself to the big headline of an LCBG bankruptcy: Lehman Brothers. It explains what went wrong and how the scare it created in the minds of governments, central bankers, and regulators was instrumental in giving birth to the *Reign of Error*: the "too big to fail" saga. A second case study in the same chapter is that of Bear Stearns and its acquisition by JPMorgan Chase, with Treasury and Fed acting as midwives.

As a piece of bad news never comes alone, in September 2008, other LCBG failures accompanied that of Lehman Brothers. Around the time Lehman went bust the American International Group (AIG, chapter 6), Fannie Mae, and Freddie Mac fell on their sword (chapter 7). All three were nationalized to avoid outright bankruptcy. The socialist state has been on march in the United States, just like it has rolled over Europe, and the free market was asked to take the backseat.

Theoretically, but only theoretically, Citigroup was not nationalized. It was only fed with an unprecedented amount of public money. In practice, as chapter 8 explains, everybody knew that this was a fiction. Without the sovereign running to its rescue, Citi would have belonged to history. The same is true of the Royal Bank of Scotland, Lloyds HBOS, and Northern Rock, except that these three were in Britain and the government was run by Labor. So the sovereign had no difficulty in calling a spade a spade. As chapter 9 explains, it nationalized the fallen banks.

In continental Europe the LCBGs' financial conditions have been hardly better. Like their Anglo-Saxon peers they failed to watch over their liquidity and solvency. This is documented in chapter 10 with case studies from Germany, Italy, and France. Bankruptcy was hardly the nightmare of these banks because political complicity was in the air and they knew they could depend on a benevolent sovereign to use other people's money to "save them"—with all that this means in terms of plain moral risk.

What has happened to LCBGs and even smaller banks on both shores of North Atlantic in 2008 and thereafter could have as well been expected. Not many years before, in the early to mid-1990s, it had taken place with Japanese banks all the way from savings and loans to mammoth credit institutions. But no lessons were put black on white on *what not to do*.

Such lessons are the contribution made by chapters 11 and 12. It took more than a dozen years and many mergers till the income statement of at least three of the big five Japanese LCBGs—Mizuho, Mitsubishi-Tokyo, and Sumitomo-Mitsui—turned positive (as of March 2004). As a percent of all loans, the nonperforming fell from 5.3 percent to 2.9 percent at Mitsubishi Tokyo Financial Group (MTFG), from 6.3 percent to 4.4 percent at Mizuho Financial, and from 8.4 percent to 5.0 percent at Sumitomo Mitsui Financial Group.

But even after this dozen years and torrents of public money spent by the sovereign on private institutions, there was still bad news. A tide of red ink at Resona, Japan's fifth largest LCBG, resulting from bank mergers, led the government to repeatedly rescue it at great cost. Resona ended by posting nearly US$15 billion in net loss in the year ending March 31, 2004. This offset gains at the country's biggest LCBGs, in spite of wild use of money of the like-minded deferred tax assets (DTAs).

Combined with billions of net loss at UFJ (since merged into MTFG), the fourth largest Japanese lender that sharply increased its loan provisions under pressure from regulators, as a group the Japanese LCBGs (including two big trust banks) had a significant net loss in the year ending March 31, 2004. That was seen as an "improvement" of sorts since their combined losses were higher the previous year. In fact, in spite of the relative turnaround there were worries about the Japanese banks' future, because of the unknown health of their loans book and trading book. A great deal also depended on the Japanese economy, as a reversal of its relative recovery could easily make dud loans pile up again.

Many of the references that I make come from two sources: (1) private bank meetings where valid statistics are presented but the meetings themselves cannot be identified precisely because they are private, and (2) research "on background" where the participants who contribute their time specifically ask not to be identified—but their contribution has been most valuable and should not be skipped over just for the sake of referencing.

The wealth of case studies, briefly described in the preceding paragraphs, is intended to improve the *institutional memory* of bankers, analysts, and investors—who may have forgotten past mistakes, or are too young to have been exposed to them. Governments were ousted by popular vote for being unable to turn around the economic situation and several big bank heads fell. Unless we learn from the errors of the past, we will repeat them only to find out that it is never easy to repair the damages created by greed and mismanagement—two of our society's most dangerous pathologies.

* * *

I am indebted to a long list of knowledgeable people and organizations for their contribution to the research that made this book feasible. I am also beholden to several experts for constructive criticism during the preparation of the manuscript. Dr. Heinrich Steinmann, Dr. Nelson Mohler, and Eva Maria Binder have, as always, made a significant contribution.

Let me take this opportunity to thank Leila Campoli for suggesting this project, for seeing it all the way to publication, and for the editing work.

April 2014

Dimitris N. Chorafas
Valmer and Entlebuch

# 1

# Banks "Too Big to Fail"

## 1. Large and Complex Banking Groups

According to the Bank for International Settlements, "Institutions that are too big to fail—those that created intolerable systemic risk by themselves, because others are exposed to them —pose a significant challenge."[1] Moreover, "Mergers and acquisitions that have formed a part of the crisis response…may have increased the number of such institutions…[and officials realize that big size] creates an unsustainable structure."[2]

There are various ways of measuring a bank's size. One of the popular measures is market capitalization. This is an unstable metric. An alternative measure is monthly asset value—provided we are clear which are the "assets" and what they are worth. Still another measure is the institution's product channels and the number of markets to which they appeal. The premise is that each channel has to have a critical mass in order to increase its appeal, expand its services, and provide a profit.

With the economic and financial crisis that started in July–August 2007 with the subprimes and reached a first high-water mark with the bankruptcy of Lehman Brothers, AIG, Fannie Mae, and Freddie Mac[3] in September 2008, Large and Complex Banking Groups (LCBGs, the so-called *big banks*) have been in the frontline of both huge losses and a virtually unlimited amount of support by sovereigns to keep them out of failure and oblivion.

There is no universally convergent opinion about the wisdom of a financial supermarket, a trend that characterized the last 30 years but is now been questioned. In an interview he gave to CNBC on November 12, 2013, Ken Griffin, the CEO of Citadel, the hedge fund, said that the capital market should be pulled out of the banking system's realm. He also emphasized that big banks have become too difficult to manage. Smaller

banks, and a greater number of them, are easier to control and might help to lower interest rates.

Another point Griffin made in the course of the same interview is that there have been no important benefits from quantitative easing (QE) to outweigh its cost to the economy. In his opinion, it is necessary to change the perception that the Federal Reserve influences the long-term interest rates. Other financial experts have questioned the decision of having monetary policy and bank regulation under one roof. Still another domain of divided opinions is the role of rapid innovation in finance.

Those who relish rapid growth and exotic innovations in the banking industry say that to stay on top a financial institution must keep on breaking the sound barrier. Decisions must be fast and unequivocal. There is no time for committees or staff meetings in this business. The job must get done. Yet, but which job?

- Growth for growth's sake?[4]
- Leveraging for leveraging's sake?[5]
- Risk taking, by always assuming a greater exposure?

Marcel Ospel, the CEO of UBS, did all that and he failed, taking the global Swiss bank along with himself to the abyss and damaging his reputation. Companies of all sorts, not just financial, that adopt the policy of doing away with limits to exposure, and consider risk control to be a nuisance, are growing fast, blinded by their own success. Then, they fall even faster than they rose, or they become prey to takeover by competitors who know how to keep their financial staying power. True enough, times have changed:

- For centuries in the financial products market novelty was slow and growth was modest.
- Today, the innovation of financial instruments has moved to a higher gear, but the risks have also increased significantly and this is not properly reflected in their pricing.

The message is that while opportunities abound, so do hazards, and forgetting about them proves to be a costly mistake. As a financial entity makes its way from youth to maturity, discipline in estimating risks and rewards wanes. Traditional management techniques developed during banking's slow-moving decades have proved to be totally inadequate. The most successful financial institutions have been those whose management adjusted itself, its policies, and its tools to the fast-paced changes in the financial markets:

- From new product development that provides clients with a real service
- To the cultural change necessary to be truly in charge of risk.

This adaptation is necessary but it is not easy. Discipline has few friends, and it encounters many stumbling blocks. Therefore, it comes as no surprise that enormous challenges have been confronting LCBGs in exposing and in accessing long-term wholesale funding. The latter is generally reflected in a shift in the maturity profile of new debt issuance toward shorter maturities as investors try to control *their* risks.

After the July–August 2007 economic and financial crisis, the LCBGs' lucrative "new" product—the subprimes—lost its market, while at the same time a relatively large stock of bank debt was due to be rolled. This made several big banks vulnerable and they were increasingly faced with stressed market conditions.

In addition, the erosion of the LCBGs' profitability meant that these institutions were unable to be in control of their capital adequacy through the retention of earnings, and therefore to alleviate investors' concerns about their shock-absorbing capacities. Their management was forced to raise fresh equity capital under:

- An uncertain market response,
- Sharply rising required rates of return on bank equity, and
- A rapidly growing criticism that big banks were the problem rather than the solution.

This criticism grew to cover practically all financial conglomerates, which means any holdings whose exclusive or predominant activities consist of providing services in at least two of the three financial sectors: banking, securities, and insurance. The economic crisis, critics added, has been created by big banks, their greed and an ill-conceived innovation in financial instruments, followed by the drying up of credit in spite of lavish public money thrown to the financial industry.

The aftereffect has been that finance and banking got unstuck from the real economy, becoming unable or unwilling to serve the needs of industrial and commercial firms—which, after all, is what the banking industry is all about. Economists say that, in retrospect, above everything else, the 2007–2014 crisis has been the documentation of the financial industry's failure to perform its social duties. Banks and their bosses only worked for themselves and their bonuses, not for their community.

An interesting hindsight is that even if governments rushed to shower the banks and other financial institutions with taxpayers' money, in an

effort to avoid a new Great Depression, existing evidence suggests that the financial industry has passed its peak as *the* growth sector of the economy. The aftereffects of the 2007–2014 crisis also revealed benefits from what was believed to be the twenty-first century's wave of rapid financial innovation and its practical use.

This provided a flagrant contrast to the past: From letters of credit in medieval times to personal loans and mortgages in the 1920s, financial innovation benefited the real economy. But for the real economy nothing positive resulted from securitized subprimes, structured investment vehicles, and conduits. Their better-known aftermath has been the economic crisis followed by public indignation and a torrent of red ink.

Apart from major losses with derivative financial instruments and other trades, global large and complex banking groups as well as other credit institutions (the so-called nonbank banks) have been confronted with a significant increase in nonperforming loans and charge-off rates. Worse, estimates of potential loan and trading losses continued to increase as the macroeconomic climate deteriorated.

The losses affected households as well, particularly in terms of indebtedness[6] and rising unemployment, which had an evident impact on debt-servicing ability. Residential and commercial property became a source of worry while corporate default rates reached higher levels, with nonperforming loan rates of US banks hitting 4 percent in early 2009, and total net loan write-offs (charge-offs) going beyond 2.5 percent—an increase not seen since the Savings and Loan crisis of the late 1980s.

Following the persistence of problems in the credit markets, several well-known financial guarantors also reported large losses. Together with the guarantors' reduced capital buffers, this resulted in limiting guarantees on bonds. (When available, such guarantees have been helpful in securing access to medium-term funding.)

The net result of these developments has been that LCBGs, as well as medium-sized and even smaller banks, confronted challenges in ensuring that their funding bases remained stable and diverse enough to cope with adverse disturbances. In the absence of this stability, in October 2008, governments implemented measures designed to alleviate strains on the banking industry in their jurisdiction. Theoretically, but only theoretically, the main objectives of lavish public support schemes were to:

- Restore the provision of credit to the economy,
- Promote a timely return to "normal" market conditions,
- Assure the long-term viability of banks,
- Preserve a level playing field in the market, and
- Contain the impact of salvage operations on the public finances.

These goals have been targeted but not necessarily achieved through different forms of assistance ranging from direct handouts (read: bailouts, section 2) to the guaranteeing of bank debt liabilities and measures designed to relieve banks from risks embedded in troubled assets. The better-managed banks appreciated the need for deleveraging but the majority did so by scaling back on their lending rather than by way of recapitalization in conjunction with a sharp reduction in their liabilities.

## 2. Big Bank Bailouts and Bail-ins

With the economic and financial crisis that started in mid-2007 and the credit crisis that added itself to an already precarious situation in September 2008, the Large and Complex Banking Groups grew even bigger. By doing so they sowed the seeds of the next crisis unless, of course, sovereigns bend over to pull them out of the abyss using an unlimited amount of taxpayer money—the *bailouts*. Or, the law of the land obliges all financial institutions to create capital buffers well beyond their shareholders' money including bondholders and other parties—the *bail-ins*.

In a *bailout* a third party takes on someone else's debt obligations. This is typically, though not exclusively, arranged by the government when there is an economic or financial crisis but the white knight may also be another private enterprise. In the case of Bear Stearns it was JPMorgan Chase (chapter 5). Bailouts have been favored when the anticipated damage is systemically important, but there exists a distinction between:

- Private-sector bailouts involving two banks,
- The government (public sector) and bank(s),
- The government and other private companies,[7] and
- One or more governments coming to a defaulting country's rescue.

By contrast, *bail-ins* force creditors to foot the bill for a bank's failure instead of using taxpayer money. (In Western banking bail-ins will come into force from late 2017 to early 2018). A bail-in for bank resolution is a recent option that confronts the risk of failure, giving officials the authority to force banks to recapitalize from within, employing private capital rather than public money—but its success is not yet tested, and, most likely, it is not going to be an all-weather solution (more on bail-ins in section 3).

Aside from the term "bail-in," there are no generally accepted rules defining its dynamics and mechanics. The G-20 have given bail-ins a green light, but every group tends to have its own definition of systems

and procedures. An example is the resolution and recovery directive (RRD) proposed by Euroland's finance ministers (to be applied from late 2017). It stipulates a strict write-down hierarchy:

- Equity capital would be wiped out first.
- This will be followed by subordinated debt and, if needed, by senior unsecured debt and deposits from large corporations.[8]

One way to think creatively about the effect of bail-ins is to examine *if*, in September 2008, they could have changed the outcome for Lehman Brothers. According to market estimates, at the time Lehman's balance sheet was under pressure from roughly $25 billion of unrealized losses on illiquid assets. The increasing probability of bankruptcy expanded that shortfall to a guesstimated $150 billion of shareholder and creditor losses[9] since the investment bank's failure acted as a loss amplifier, multiplying the scale of the problem and escalating its impact.

It is highly doubtful if Lehman would have had available $150 billion in bail-in money. This is not an argument against bail-ins. What it means is that when it comes to LCBGs they are *no* miracle solutions. Nor is what happened in September 2008 and thereafter, both in the US and in Europe, salvaging many of these amalgams of huge credit-and-gambling institutions with public money and by way of mergers between teetering big banks arranged by the sovereign a longer-term solution. The result was to have the survivor emerge from the turmoil with a strengthened market position, which meant:

- Greater control over consumer deposits and lending,
- More "assets" with toxic waste, and
- (Theoretically at least) greater potential for paper profits and bonuses.

Megabanks might have looked as an ingenious idea but not everything went the way wishful thinking wanted it to go. Bank of America (the former Nation's Bank from North Carolina) suffered greatly for years from its acquisition of Countrywide. It paid dearly for the tricks invented by Countryside to feed the subprimes engine, creating for itself a Mickey Mouse sort of business expansion.

Bank of America's headaches from the acquisition of Merrill Lynch were less intense but still unsettling, as the third largest investment bank of the United States had accumulated lots of liabilities with subprimes and other trades that turned sour, but not all of them were evident at acquisition time. This led to a management shake-up and eventually the sale of

the Merrill Lynch branch network outside the US to Julius Baer, the Swiss bank. (The broker's acquisition increased Julius Baer's business by 16 percent but deprived Bank of America of its global reach in securities.)

JPMorgan Chase, the LCBG that resulted from the acquisition by Chemical Banking of Chase Manhattan, Bank One, Manufacturers Hanover Bank, and JP Morgan, got even bigger through more acquisitions—like Bear Stearns (chapter 5)—at crisis time to the point that it now holds more than $1 of every $10 on deposit in the United States. So did Wells Fargo with its acquisition of Wachovia. Another example is the government-rescued Citigroup (chapter 8). Among themselves, the aforementioned big institutions issue:

- One of every two mortgages, and
- Two of every three credit cards in the US.

With the government's heavy hand creating financial monopolies[10] US consumers are confronted with fewer choices for financial services while LCBGs run the show (and the government). In addition, beefed up with taxpayer money big banks have returned to the risky trades that led to the economic crisis, while regulators are afraid to clean up the mess for fear they uncover many more unpleasant surprises.

One of the negatives of very large size is that it is not humanly possible for the person at the top of the organization to reach every corner to find out what is going on. Of course the CEO has assistants and there are divisional managers as well helped by computers and models. But:

- What are all these people worth?
- To what extent are they mixing professional business and personal interests, such as bonuses?
- How well is the information system, its software, and its security working; how dependable are its deliverables?

Necessary as it may be for large organizations, divisionalization has limits derived from risks that are rarely, if ever, accounted for. Quite often, its set-up resembles the last decades of the Roman Empire when there were four Caesars and one Augustus above them. That structure proved to be highly unstable and it crumbled, heralding the end of the centuries-old Roman dominance over a big chunk of the then known world.

Another reason for the malfunctioning of the LCBGs is the *Detroitization* of large financial institutions, a term derived from the formerly great city that went bankrupt. Problems are hidden from view till they become king size, and then hit the bad news. For instance,

JPMorgan Chase's loss of $5 billion in its London operations because the chief investment officer (CIO), supposed to control risk, let exposure run wild,giving practically carte blanche to the so-called London whale.

The Detroitization of LCBGs has, as well, other negatives that are not readily apparent. Other things equal, the larger and more complex an organization is, the longer is its reaction time. This happens not only with credit institutions but also with other industries. For instance, IBM's managerial and product line troubles in the late 1980s–early 1990s nearly wiped out the company.

Detroitization also carries a lot of deadwood. In a May 10, 2009, interview on *Bloomberg News*, analyst Richard Bernstein made the point that the US government was on the wrong track because it was trying to keep the excess capacity of the financial system alive. Bernstein was right. This is the policy that brought down in flames the former "big three" automakers of Detroit, two of which went bust but came back to life, albeit more humble, thanks to taxpayer money.

Detroitization leads to overcapacity and subutilization of resources. There are simply too many banks in the global economy and the fire of overcapacity has engulfed Wall Street: three of the top five investment banks in New York have disappeared. In a way resembling the glut of global manufacturing capacity of motor vehicles that, along with aloofness and mismanagement, brought some of the automakers at the edge of a precipice, there are too many banks around at both levels:

- International investment banking, trading, and wealth management
- National, regional, and local credit institutions, from commercial to savings and popular banks

According to IMF statistics published some months after Lehman's bankruptcy, relative to their population the United States and Germany have more than twice as many banks as Britain, Canada, and Japan, with France and Italy falling in between.[11] The intense competition for customers means that they are less careful (and less profitable) than they should have been. Moreover LCBGs are:

- Taking inordinate amounts of risk, particularly with derivatives, and
- Weakening their financial staying power by warehousing worthless paper, partly in a vain effort to hide it from market view and partly because they don't find any buyers.

Timely action by regulators is very important in overall risk control, but politics sees to it that supervisory authorities move too little, too late. Regulators turn a blind eye, or push failing institutions—such as mortgage lenders and Wall Street firms—into the arms of even bigger banks. Then, they hand out billions to ensure that the deal will go through. This wrong-way policy has two unwanted consequences:

- It compounds the risks, which get concentrated in some megabanks, and
- The financial landscape is increasingly characterized by oligopolistic institutions and small banks that fill in the cracks.

Once the big banks have conquered the cream of the market and tightened their grip on the financial system, they will not allow other banks to grow and take away part of their turf. Highly paid lobbyists, many of them former government employees in top positions, take on the task of convincing decision-makers (through words and presents) that the oligopoly in financial services, and other industries, is the best possible solution, and that those who created the risks, the huge losses, and the scams should not be punished because all they did was to try to increase the wealth of the nation.

Immunity has a perverse effect. The fact that nobody has been brought to justice for having pushed the American and global economies at the edge of chaos, saw to it that the abuse of power continues unabated. Nothing has been learned from the debacle of the 2007–2014 severe economic and banking crisis, particularly in Europe. Having escaped the court of justice, the people running the big banks returned undeterred to their bad habits of under-rating risks.

As for the argument by Jamie Dimon, the CEO of JPMorgan Chase, that "big global companies like GE and Pfizer need money, and they can only obtain it from a big bank, not from a community bank,"[12] this is the crust of the cake hiding beneath it the real facts.

- Syndicated loans can take care of what Dimon is talking about, and
- Anyway loans to big companies belong to the past.

Big industrial companies don't need the banks; they tap the capital market at lower cost by issuing bonds. As for the LCBGs themselves, they make the bulk of their money and their losses through trading. Loans are at the bottom of their management's preoccupations—proof being that after having been recapitalized by governments through taxpayer money,

this money never found its way into the credit market and banks are still not lending to the small and medium enterprises (SMEs) and other willing borrowers.

### 3. Small Is Beautiful

Richard W. Fisher is president of the Federal Reserve Bank of Dallas. In a lecture that he gave on March 16, 2013, to the Conservative Political Action Conference at National Harbor, Maryland, Fisher argued that big banks represent a threat not only to financial stability but also to fair and open competition. They are practitioners of crony capitalism and not agents of democratic capitalism that has classically been the strength of the United States. In addition their privileged status places them above the rule of law. In Fisher's words:

> A dozen megabanks today control almost 70 percent of the assets in the U.S. banking industry. The concentration of assets has been ongoing, but it intensified during the 2008–09 financial crisis, when several failing giants were absorbed by larger, presumably healthier ones. The result is a lopsided financial system.[13]

As the president of the Dallas Fed has pointed out, US LCBGs represent a mere 0.2 percent of banks and by being considered "too big to fail" are treated differently from the other 99.8 percent of American credit institutions. As Eric Holder, the Obama administration attorney general, admitted to the Senate Judiciary Committee in early March 2013, "When banks are too big to fail, it is difficult for us to prosecute them."[14] In Holder's opinion a criminal charge has a negative impact on the national economy. It is curious that the attorney general was not thinking of *moral risk*.

Holder's thoughts, nevertheless, mediate against the big banks, not for them. What the attorney general did not say in his US Senate testimony is that there exists a tightly kept financial secret and LCBGs' top brass is most evidently aware of it and of its vast impact: The ownership of financial assets is very highly concentrated among the top 10 percent of wealth holders. If you are in the top 10 percent and manage to stay there you don't need to mix with the lower 90 percent of banks or, for that matter, people.

To the contrary, at least theoretically, credit institutions are an industry dedicated to keeping the community's wheels lubricated and running smoothly. When banking loans dry up the small and medium enterprises find themselves deprived of liquidity. SMEs are not interested in megadeals. They have enough challenges in trying to survive and no time to join the casino society.

To serve their community in an able way, bankers should return to their origins: understanding the problems of their clients. For their part, governments should appreciate that employment is created by the SMEs, not by mammoth industrial and commercial enterprises that can hire the skills they need anywhere around the globe. Hence Richard Fisher's proposal to break up the biggest US banks[15] is the best way to:

- Bring the bankers down to earth, and
- Avoid highly expensive (to the taxpayer) government bailouts of LCBGs.

Aside from other advantages, dividing big financial firms into smaller legal pieces permits that each is easily disposed of in case of bankruptcy, without requiring massive government handouts. (With smaller credit institutions it may be that the new bail-in policy will even work.) Fisher also said that the sovereign and his regulators should make clear that only plain-vanilla commercial banking operations would be protected by backstops such as deposit insurance.

- *If* the government backs big banks over small,
- *Then* regulators stop worrying about reckless behavior, and this skews the market in favor of those awarded preferential treatment.

"Small is beautiful" does not mean there will be no bank failures. Bankruptcies are not only unavoidable but they are also necessary to prune the financial system from the zombies. But the resolution of such bankruptcies will be easier and less costly to the taxpayer —and we should keep in mind that the use of bail-ins will not eliminate the bailouts.

As far as resolution of bank failures is concerned, via its finance ministers[16] Euroland at least sketched out what will happen with the bail-ins. Deposits that are guaranteed by law would be protected and losses imposed on creditors in order of seniority (see section 2). But from then on Euroland's resolution is a compromise that leaves plenty of uncertainty for both shareholders and creditors.

Part of the downside, at least as far as Euroland's Resolution and Recovery Directive is concerned, lies in the fact that the bail-in loss will be shared among a relatively small number of creditors with a consequently lower recovery rate. This means higher risks for investors, in particular for hybrid debt,[17] contingent convertible and senior unsecured bondholders, as it increases their loss-absorption exposure.

A research paper by Credit Suisse[18] viewed Lower Tier-2—the so-called contingent convertibles, or CoCos—as the most penalized asset class

following a trigger event: It becomes *bail-inable* and ranks junior to senior unsecured debt and upper Tier-2 bonds. The same research, however, also finds the risk-reward in this asset class "attractive," betting on the likelihood that the market will price-in that risk by way of a higher coupon.

Always according to Euroland's RRD view of bail-ins, losses equivalent to 8 percent of total liabilities would have to be covered by shareholders and the lowest level of creditors. *Then*, it is left to each government to decide whether to bail in more creditors, or use the resolution fund to be established by the sovereign—at least partly with taxpayer money, though the banks will contribute in a way similar to that of deposit insurance. This will cover further losses to the tune of 5 percent of total liabilities (that is, peanuts). In addition governments have the discretion to exclude certain liabilities from bail-in if they see fit, which leaves creditors in a limbo.

- Will they be bailed in?
- How big are the losses they face?
- How long will they have to wait for a "yes or no" final decision?

It is evident that the investors' response to such uncertainty is to demand a higher risk premium for lending to the bank, and that would increase funding costs for credit institutions. The requirement to put money into the national resolution fund would also have its cost, which mediates for "small is beautiful." Other things equal, the smaller the bank the less will be the fallout from its bankruptcy and the lesser the cost.

One might be inclined to say that when in 2008–2009 the LCBGs' losses were tremendous, governments should not have been so deeply embedded in the banking industry. Yes, but this did happen in real life and it will happen again if the same situation develops. Politics see to it that the sovereign–big banks deadly embrace has not been broken, and the bail-in's contribution has its limits. Following Lehman's bankruptcy not only did the sovereigns refill the treasuries of zombie financial institutions but they also:

- Guaranteed far more deposits than before the crisis,
- Stood behind the issuance of new debt, and
- Owned preferred shares in many banks, common equity in others.

Post-September 2008 many big banks existed at the largesse of governments while those of their executives responsible for their distraction opened their golden parachutes and, unharmed, moved somewhere

else to continue their good deeds. The behavior of many CEOs, boards of directors, regulators, and sovereigns violated a long-standing principle that commercial banks should not be allowed to take risks. They are public service companies like utilities, and they should be steadily supervised along this guideline. Hedge funds can take risks, that's their business, but they, too, should be under prudential supervision as high risk takers.

Instead, many of the world's large and complex banking groups, including American and European outfits, ran wild until they registered huge losses, as the following chapters document. In 2008, the Royal Bank of Scotland, Citigroup, and Wells Fargo suffered a combined loss of $150 billion. Here is the red ink of the top nine in a nutshell:

- Citigroup, $53 billion
- Royal Bank of Scotland, $50 billion
- Wells Fargo, $48 billion
- Fortis, $29 billion
- UBS, $20 billion
- HBOS, $16 billion
- Crédit Suisse, $14 billion
- Deutsche Bank, $8 billion
- HypoBank, $7.5 billion

Merrill Lynch, the third largest US investment bank, also lost nearly $7 billion by gambling on subprimes and other garbage. In the aftermath, it has been sold for a piece of bread to Bank of America. The same is true of Dresdner Bank, a German commercial institution that ventured into investment banking with disastrous results. Dresdner was bought by Commerzbank, which itself was limping, after being hit by an inordinate amount of losses.

Patchy credit histories of subprime "clients" and the incomplete documentation of borrowers made it hard to estimate default rates. Marking to model (or myth) accounting meant that banks were valuing illiquid assets at prices that reflected not only absence of buyers but also violations of credit principles.

As a result, unpredictable shocks continued and bad surprises became relatively common. To sustain an unprecedented situation, profits had to be steady. They were not. Though many LCBGs managed to survive with money they got from the sovereign, these handouts damaged the public finances. The IMF reckons that average government debt for the richer G20 countries will exceed 100 percent of GDP in 2014, up from 70 percent in 2000 and just 40 percent in 1980.

Critics have pointed out that the banking industry also failed its owners. The scale of wealth destruction for shareholders resembled that of the South Sea bubble. The total market capitalization of the financial industry fell by more than half in 2008, erasing the gains it had made since the early years of this century. Employees and their pension funds have scarcely done better as job losses were savage and Western central banks adopted the policy of near-zero interest rates. From September 2008 to the end of April 2013 there have been altogether 511 interest rate cuts in the West.[19]

In March 2013 in Cyprus the IMF, European Union, European Central Bank, and the island's government used strong-arm tactics and put their hand into the pocket of depositors.[20] The Cyprus banking crisis was a seismic event, just below the threshold of the bankruptcy of Lehman Brothers in September 2008.[21] If, after having become the *State Supermarket* of health services, pensions, and other goodies,[22] the sovereign becomes the *Megabanker* who serves himself with depositors' money, then the foundation of a communist regime in Western societies will be firmly in place.

### 4. The Case of "Stickier" Deposits and of Living Wills

Analysts who examined the reasons underpinning the collapse of credit institutions in September 2008 and thereafter, have come to the conclusion that there was a common ingredient in a significant number of failures: overreliance on wholesale borrowing. Over the past two decades the Western banking system had expanded with the result that its assets grew to about 250 percent of its deposits. This forced management to seek other types of finance, typically short-term borrowing. For example, prior to the 2008 crisis, the total funding maturing of Britain's Lloyds Banking Group was in under a year.

The downside has been that big and medium-size banks reliant on short-term borrowing, faced the bigger version of a "run" when their counterparties got cold feet and refused to roll over debts. Eventually, financial entities that, for whatever reason, suffered loss of confidence, turned to funding from the government, hence the need to establish more secure sources of funding as well as increase the level and quality of capital to make the system safer. The satisfaction of the need to provide the bank's capital with greater resilience requires:

- Reducing dependence on wholesale funding, and
- Increasing their reliance on more permanent, or "stickier" deposits.

For reasons of public confidence, banks on the brink are wrongly positioned for doing so. Hence, they are all interested in downsizing the amount of risk they take,[23] avoiding gambles in proprietary trading, and concentrating more on clients and activities that consume less capital. Banks that decided to follow this course are shrinking their balance sheets, something almost unheard of prior to the crisis that destroyed so much value among the LCBGs.

Because contagion is a significant part of the overall risk, if one big bank falls, others would come under pressure, making it harder for them to avoid default, the new rules of Basel III[24] (chapter 2) significantly increased the level of required core capital. In fact, some regulators, for instance, the Swiss, set even higher standards than those of the Basel Committee. The overriding policy is that of improving the funding profile, but not all deposits are sticky. The Bank of England reckons that $100 billion of Russian deposits were shipped out of Britain in the last quarter of 2008.

When this happens, the outlook for the bank suffering a capital drain becomes uncertain. A prospective increase in loan losses and additional write-downs from portfolio positions further affects credit institutions, particularly those with elevated funding costs. In the first quarter of 2009, Euroland's LCBGs had to take major steps to convince financial markets and authorities that they would be in a position to withstand the risks that lay ahead, but they still had to do with shorter maturities of loaned funds that required:

- More elaborate pricing of loans,
- Better hedging of securities,
- Further cost cutting, and
- Rethinking of business models.

Banking strategies were revised in an effort to restore stable earnings and to benefit from organic capital growth. Still several LCBGs remained in the sick list, reduced to depending on the government's support, which continued, even if such handouts were originally projected to be withdrawn as the panic subsided.

The fact that on both sides of the North Atlantic the macroeconomic environment remained so much uncertain and fragile saw to it that LCBGs' performance deteriorated significantly during the first quarter of 2009, much more than analysts and market participants had expected. In parallel to this questions were raised about the transparency of quarterly earnings reports and the pattern of reported profit erosion. Those

who had assumed that the worst of the crisis would be over by end of the year were deceived.[25]

In the interim, however, there were some bright spots. By the end of the first quarter of 2009, the performance of Euroland's LCBGs improved somewhat in comparison with that of 2008 as a whole. But at the same time there were significant underperformers that pulled down the average ratios in terms of financial results. Under these conditions investors were afraid that sovereigns would change their policy of leaving bondholders of nearly bankrupt banks unscathed, thereby weakening or closing the second channel of rebuilding the big bank's capital with private funds.[26]

In addition, further strains on profits were foreseeable as pressures on income remained high and write-downs did not abate, putting additional pressure on banks' capital buffers. Underlying the declines of return on equity (ROE) was a significant drop in intrinsic profitability, while attempts by banks to deleverage also placed downward pressure on the ROE. In the aftermath:

- The equity of LCBGs tanked, depriving them of refinancing by issuing new stock, and
- By not ignoring the fundamental weakness of the Western and of the global economy, investors became extra prudent and the price of risky assets fell.

Because of the prevailing uncertainties investors no more believed that momentum (and herd mentality) could drive the market higher over the next year or two. Analysts were not convinced about the fundamentals—even if some markets rose prior to coming down. An example is the Russian capital market that, over the first half of 2009, soared with stock indices up 85 percent for the year, making the Moscow stock market the best performing stock market in the world. But the underlying economic damage was dire, a reason why the International Monetary Fund predicted economic output to fall 6.5 percent in 2009.

New ideas were needed. One of them, advanced by regulators in mid-2009, was *living wills*. In its background lies the concept that making banks safer through bigger capital buffers and more rigorous supervision is necessary but not enough. It is also advisable to make credible the threat that next time banks will be allowed to fail.

Living wills are supposed to be drawn up when the LCBG or any other institution is still a going concern. At least theoretically, that would force banks to organize themselves so that it is easier to dismember them in a crisis. According to the pros, proposed laws will make it possible to kill

any financial firm in a way that imposes losses on its stakeholders (bail-ins and so on). But for living wills to be effective they must move beyond simple contingency planning and toward a partial break-up of banks' balance sheets. In September 2009 G20 leaders endorsed the idea but it is far from clear what they meant.

In principle, living wills could help address the challenges posed in surrounding the dying bank with prudential measures to avoid contagion. But who is going to enforce them? Lehman Brothers had 2,985 entities,[27] but nobody really understood their counterparty relationships with the rest of Wall Street. Clients and creditors were locked up in the failed institution. Next time around they may have to wait forever till all of the clauses of a living will are implemented. Neither is it evident if living wills can do away with conflicts of interest and moral hazard.

Of course there is no such thing as an "orderly failure" of an LCBG. Investors and counterparties as well as regulators and sovereigns should be prepared for this. With or without a living will, the logical solution is ring-fencing those operations that serve the business community and the common citizen. Then it might be relatively easier to separate, even save, vital parts while allowing other parts to die.

Let me repeat that statement. Orderly failure is not in the nature of financial markets. Particularly in a big bankruptcy, but also in many smaller ones, the prevailing mood among counterparties and creditors is panic. Then comes squabbling for what remains in the carcass.

Neither is it rational, in a globalized economy, to implement living wills only "here" or "there." Even if some of the chiefs of state, ministers of finance, or regulatory authorities want to see the living wills solution applied, this has to be "all or none" (provided technical hurdles are overcome and the mechanics are properly explained). With bailouts blacklisted and bail-ins taking the spotlight:

- *If* the LCBGs are unable to locate and attract stickier deposits, and
- *If* no agreement can be reached on how a failing bank's legal entities can be precommitted to creditors,
- *Then* the answer should be to split up the banking behemoths before they fall off the cliff.

Regulatory authorities should no more bend over, changing the marking to market accounting rules, thereby providing the LCBGs with the opportunity of marking their portfolio to myth. These unwarranted gifts to risk management mythology have ensured, in 2013, that almost every risky asset has rallied—that contrasts greatly to the prudence of late

2008–early 2009. While there are plenty of signs of distress in the global economy these are being ignored in favor of a return to gambling habits.

In the aftermath bad debts are again accumulating in the financial industry. Reserves for bad loans, too, are being underestimated. One example is provided by the Quarterly Banking Profile (of the second quarter of 2013) from the Federal Deposit Insurance Corporation (FDIC). It indicates that loans where payments have fallen behind schedule[28] have been rising at a much faster rate than loan loss reserves.

Proprietary trading, too, continues unabated as the Volcker rule's implementation is delayed. In mid-November 2013 it was learned that, acting as regulator of the US banking industry, the Federal Reserve considered a delay on the compliance date for the Volcker rule.[29] Theoretically, the reason is to give banks additional time to conform with its provisions banning proprietary trading that puts a bank's own capital at risk.

The pros say that this is not a major delay, particularly as its authorization will include conditions. Critics answer that there has been plenty of time to prepare for the applications of one of the most far-reaching (and feared) rules to come out of the Dodd-Frank financial reform legislation.

Advocates of the Volcker rule add that it is needed to prevent banks from making risky trades that led to incidents like the $6.2 billion derivatives trading loss suffered by JPMorgan in 2012. Banks are opposed to the Volcker rule on the ground that it will curb legitimate activities like market making and hedging. But in reality what they care most about is its effect on their bottomline since gambling with depositors' money has contributed quite significantly to their profits and bonuses—and, let's not forget, to their losses.

## 5. *If* Risk Control Is Ineffective, *Then* Hopeless Cases Should Go Bankrupt

Bank bosses want to be in charge, but are they really properly informed and up-to-date? In the course of the economic and financial crisis that struck in July-August 2007, Citigroup's CEO reportedly learned of its $43 billion toxic assets only in September of that year. Till then he was told that losses were unlikely. Merrill Lynch signaled a $5 billion write-down in October 2008, which increased to $8 billion 19 days later. A postmortem by UBS found that *at no stage* did managers have a decent assessment of its subprime exposure.[30]

Something similar can be said of regulators. In an interview published by the *Financial Times*, Andreas Enria, the CEO of the European Banking Authority (EBA), said that his mission is to ensure the creation of a true

single market for finance in the European Union and to reverse a worrying trend in which governments and supervisory authorities increasingly treat cross-border lenders as purely national outfits.

Enria added that the functioning of the single market has been deeply damaged by the Euroland sovereign debt crisis that led to a lot of repatriation of assets. Cross-border banking is now at its minimum since the introduction of the euro in 1999. Trust between national supervisors has also been lacking due to an outbreak of financial nationalism,[31] a trend that worries EBA's boss more than any other factor. There is no lack of examples.

RBS was saved at the eleventh hour thanks to the generosity of the Labor government (chapter 9), which (in a first time) let the LCBGs CEO retire in riches. This policy of hear no evil see no evil is wrong, but it has been the policy emulated by the American, French, German, and other sovereigns. The only thing the CEOs who gambled with shareholder and taxpayer money did not get was a medal of honor. But in what concerns golden parachutes they had a ball.

Dexia was a Franco-Belgian bank that had no business in high stakes gambling. Back in the fall of 2008 the cost of salvaging Dexia with taxpayer money hit € 13.2 billion ($17.9 billion). But Dexia's accumulation of toxic waste continued and, some years later (in 2011–2012), when it drove itself nearly bankrupt again, it was dismantled.

Less well known is the fact that the nearly $18 billion already spent is only a small part of the money French and Belgian taxpayers may have to come up with. Dexia's management had contracted 40-year-long derivatives deals; these were in the red at the time of the bank's dismantling and they are guaranteed by the sovereign. To provide for losses associated with derivative contracts, the French government had to buy guarantees for €80 billion ($104 billion), as Gaël Giraud, the French economist, reminded Hollande's (socialist) administration on March 18, 2013.[32] Think of that. A mismanaged bank alone created such a hole in the taxpayer's pocket and the risk goes on for some 40 years—or nearly two generations.

Dexia is not really an LCBG but it gambled with money *as if* it were one, using the funds of depositors in small, local, popular banks for faraway ventures, including loans to the city of Detroit that itself went bankrupt in July 2013. The next example, Meinl, is also not an LCBG. Its case has been included to show how difficult it is to untangle cross-border done deals even for smaller conglomerates.

The Austrian Meinl Bank saw the light in 1862 as a coffee and food store chain. In recent times, it expanded into real estate. Its Meinl European Land (MEL), a Jersey-listed fund, prospered till interest rates started to rise in 2006. The Meinl Bank also had another Jersey-based

subsidiary, the MERE, which acted as MEL's market maker, broker, and manager. Still other subsidiaries were Meinl International Power (MIP), which invested in power projects, and Meinl Airports International (MAI), which invested in airports and airport facilities, particularly in Central and Eastern Europe.

Superficially, Meinl looked as being a rather prosperous, medium-sized conglomerate. But in 2008 an audit established that the whole enterprise was worth well below what seemed to be the value of its parts. Austrian regulators came into the act, but they found it difficult to establish:

- Where the money had gone, and
- Which country's law applied to Meinl's assets and liabilities?

To make matters more complex, in July 2008, MEL was sold to Gazit Globe. Reportedly, this deal severed the fund's ties with its parent, the Meinl Bank. In the Jersey Islands, the Financial Services Commission investigated allegations that MEL had provided financial assistance to itself to buy its own shares. Then MAI said it wanted to extricate itself from its Meinl relationship.

For Austria's Financial Markets Authority (FMA) and its Central Bank (OeNB) the Meinl case came on the heels of the conclusion of a trial over improper usage of funds at BAWAG, a banking outfit that proved to be a major scandal. Evidence points to trading between different Meinl Bank subsidiaries that pushed up the value of the group without providing much material evidence. Austrian regulators estimated that in 2006 Meinl Bank made some 60 percent of its income from business it did with MEL; in 2007 this grew to over 80 percent if the internal trading with MIP and MAI were added to it.[33]

If the relatively lower complexity problems of Dexia and Meinl are difficult to untangle, think about adding poorly studied but supposedly "more sophisticated" instruments and a richer range of options. Before going under in 2009, the Bank of Wachovia, an LCBG, developed and marketed a range of "Pick-A-Pay" retail loans that permitted borrowers to defer principal as well as interest payments. Of those that were still current at the time Wachovia's remnants were bought by Wells Fargo, 3.2 percent were seriously delinquent.[34]

The default rate on Wachovia's $38 billion property development loans was several times the national average. Wells Fargo argued that the official numbers did not reflect merger-related adjustments. As if this was not enough, a big part of the self-wounded bank's $127 billion commercial property portfolio consisted of hard-to-refinance, interest-only loans

with a balloon payment at the end (a sort of a wholesale equivalent of Pick-A-Pays).

Still another exposure was the large amount of credit protection Wachovia had sold on risky tranches of mortgage-backed securities. A filing shows that $105 billion of protection was sold and a similar amount bought, with the extent to which the latter offset the former being quite unclear. All this was upped by inadequate Tier-1 common equity, well below the 6 percent level that, at the time (2009), was regarded as a sort of minimum required to see through the crisis without having to deposit one's balance sheet. In 2009 Wachovia also confronted the challenge to repay the $25 billion of government capital it got a year earlier.

It mattered little that after months of indiscriminate fear, widespread losses, and huge capital injections by sovereigns it looked *as if* the banking industry was gradually stabilizing. By mid-2009 money markets looked "calm" as American LCBGs got a clean bill of health in stress tests by the Fed of New York, but not everybody believed that announcement, characterized by some experts as equivalent to cooking the books.

Neither side was really comfortable with the results. The Fed criticized banks for faulty models used in stress testing,[35] and the bankers expressed uncertainty as well as confusion with the way the Fed's stress tests were conducted.[36]

Still, as analysts pointed out, a small group of LCBGs—including Goldman Sachs and JPMorgan Chase—were emerging from the crisis with franchises strengthened, which permitted them to raise funds, win clients, buy assets, and attract knowledgeable employees. But many other LCBGs, both American and European, were still hanging between life and death, surviving mainly because of government handouts.

While suggesting that further action was needed to restore confidence, on May 12, 2009, the International Monetary Fund said that the European Union should follow the US in conducting stress tests on individual banks. But European policy makers were afraid of a disastrous outcome, therefore they preferred a test that summed up the state of all EU banks (whose outcome was singularly useless) to one that would have taken a careful look at each of them individually.

Criticized as nothing more than a kangaroo test, this test was to be coordinated by the London-based Committee of European Banking Supervisors (CEBS). Sensing the ridicule, the CEBS preferred to limit its intervention to setting common parameters for national regulators in Europe—to help avoid the risk of regional and national distortions.

In conclusion, whether we talk of banking, manufacturing, merchandizing, or any other industry it is natural to be rattled when giants fall but catharsis is a physical process prerequisite to renewal. This catharsis

may indeed be large size. The liabilities restructured by General Motors amounted to $172 billion. It is more difficult to obtain similar figures for LCBGs because:

- Inventoried trading contracts are marked to myth,
- Retained tranches of securitized loans with complex covenants are difficult to untangle, and
- When some dependable numbers exist but are negative, banks keep them close to their chest.

Far from being an aberration, bankruptcy offers a new chance, provided the favored response is to keep fighting. Economic dynamism owes much to a forgiving attitude to risk-taking, the prerequisite being to have a direction and to avoid accumulating delays by choosing a debt overhang rather than writing off the losses.

# 2

# Banks and Regulators

## 1. Basel III

Since the late 1980s the Basel Committee on Banking Supervision (*Basel*) has been seeking to improve the capital adequacy (section 2) and liquidity[1] (section 3) of banks as well as to promote regulatory understanding of financial problem areas and the worldwide quality of banking supervision. This work is accomplished by:

- Setting rules to be followed by the banking industry,
- Supporting supervisors by providing a forum for exchanging information on national regulations, and
- Trying to improve the effectiveness of methods and techniques associated with supervisory activities.

Based on a quarter century of experience in this role, the Basel Committee appreciates the need to organize and focus regulatory chores affecting the soundness and survivability of individual banks. It also elaborates the requirements for broader financial stability objectives and the avoidance of systemic risk. Within the realm of these policies, the microprudential foundation of supervision is supplemented with a macroprudential approach.

Known as Basel I, the first set of global capital rules for the banking industry was released in 1988, and it was followed in 1996 by the Market Risk Amendment.[2] A couple of years later came Basel II. Its more sophisticated model-based approach was gamed by the banks whose inordinate exposure was supposed to be put under lock and key. No wonder this led to the severe economic and banking crisis of 2007 and, a year later, to the massive bankruptcy of the LCBGs. With the exception of Lehman Brothers (chapter 5) among the big banks, the self-wounded big financial institutions were salvaged by the sovereigns with taxpayer money.

In July 2009, the Basel Committee approved a package of measures[3] to improve upon the 1996 rules governing market risk (essentially trading book capital) and enhance the three pillars of the Basel II framework.[4] Five months later, in December 2009, it published for consultation a comprehensive reform document aimed at substantially reducing the probability and severity of economic and financial stress by strengthening global:

- Capital adequacy, and
- Liquidity regulations.

An impact assessment of those proposals was conducted during the first half of 2010 with the goal of delivering a well-calibrated group of standards, with a two-year phase-in to ensure a smooth transition. Two forces rose against the new standards: the first was governments, afraid that they will again have to recapitalize their zombie LCBGs, as the new capital standards were (correctly) higher than those that preceded them. Governments demanded (and to large measure obtained) a delay in the implementation of the Basel III rules[5]—while a rational solution would have been to accelerate their application.

The other opponents of the new standards were the big banks. They rose against not only Basel III's higher capital adequacy standards but also the new (and absolutely necessary) liquidity requirements, coming up with the silly argument that improved bank liquidity hinders lending and thus economic growth—*as if* they were really dying to lend. The truth is that inadequate liquidity standards, and even more so their absence, makes available more money to be used for gambling while the unholy sovereign–big bank alliance provides:

- The safety net of taxpayer-funded bailouts and implicit bank subsidies, and
- The new saga of bail-ins (chapter 1) whereby investors and depositors are asked to pay for other peoples' greed and mistakes.

Carefully hidden from these irrational reactions against Basel III has been the fact that, far from increasing the gross domestic product (GDP), bailouts either reduce the pool of funds available for economic activities and growth, or, even worse, beef up the public debt. Hence, regulatory standards should be so strict that there is a near-zero possibility for bailouts. The way a letter to *The Economist* put it: "Shrinking the banking industry will not cause the sky to fall in. This industry is 10 times as large relative to GDP as it was 50 years ago."[6]

Through lobbying and political leverage, those opposed to new regulations always found a way to make a muddle out of what should have been an urgent implementation of stricter rules. Plenty of conflicting interests contributed to this muddle with the result that the full Basel III application has been delayed till January 1, 2019.

Worse yet, regulatory experts believe the Basel Committee is bowing to pressure for a softening in its rules for bank supervision. In the background of this reaction is a September 29, 2013, statement by Stefan Ingves, the Swedish central banker who heads the Basel Committee, that capital rules on securitizations, introduced as part of Basel II BIS reforms of 2009, could be softened.

"Securitizations need not in any sense be bad," Ingves said. "Risk weights are not forever. We need to review them. We need to look at the appropriateness of various structures and pass judgment on them. This should happen next year."[7] The bad news is that the securitization of subprimes hit in 2007 the same time bomb of superleverage by the financial industry, and brought the economy to the abyss. A questionable mortgage securitization is again around the corner.

The good news has been that Ingves's compromise over the regulatory capital treatment of securitization does not extend to the broader capital rule requirements. He also underlined the Basel Committee's unhappiness with the degree of inconsistency between different countries in the way risk models calculate capital needs. There is too much variety in internally modeled risk weightings, and:

- *If* the regulator softens his stand
- *Then* this discrepancy is bound to increase, which is, indeed, now happening.

With the softened-up standards, banks will be required to have a core Tier-1 capital ratio of 7 percent, composed of a minimum common equity ratio of 4.5 percent plus a capital conservation buffer of 2.5 percent. The overall Tier-1 capital requirement, which includes common equity and other qualifying (or only semi-qualifying) conservation buffers, must amount to at least 8.5 percent. The minimum total capital requirement comprising Tier-1 capital and Tier-2 capital should be 10.5 percent. Figure 2.1 shows how this will work out.

The capital structure in Figure 2.1 has been promoted by the fact that during the economic and financial crises of 2007, 2008, and beyond, it turned out that much of banks' losses from trading, particularly in derivatives, were not caused by counterparty default but rather by marking-to-market losses resulting from deterioration in the

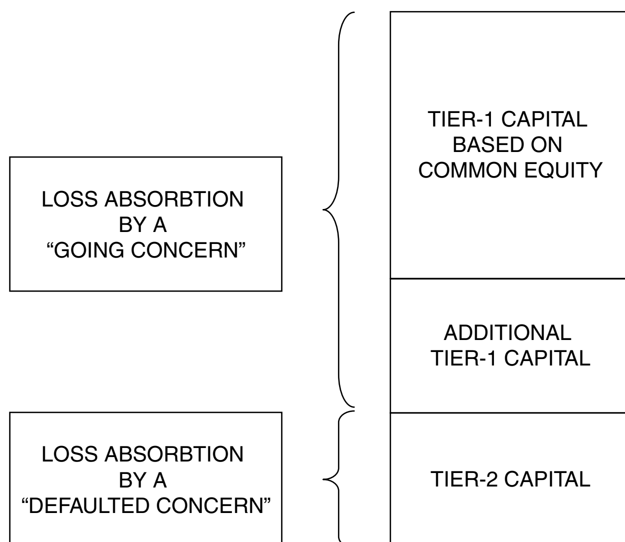



**Figure 2.1** The definition of regulatory capital by Basel III.

counterparty's creditworthiness. Therefore Basel III introduced new capital requirement to cover such losses, known as *credit valuation* adjustments, required by all derivatives trades that are not settled via a central counterparty (CCP). It has also imposed a mandatory capital charge on derivatives contracts settled through a CCP.

For reasons of greater dependability, some supervisory authorities, for instance, the Swiss, demand from the LCBGs in their jurisdiction a higher minimum total capital than 10.5 percent. They also implemented Basel III's stricter eligibility criteria for capital instruments and more stringent rules for regulatory adjustments,[8] but many experts doubt that regulators in every jurisdiction would stick to this policy when confronted by big banks that have reached the edge of the abyss.

Two significant improvements have been the *leverage ratio* (section 2) and *liquidity coverage ratio* (section 3) introduced with the December 2009 Basel Committee upgrading of the regulatory framework. The latter was based on appropriate capital review and liquidity calibration. It is expected that the leverage ratio would:

- Contain the build-up of excessive gearing in the banking system,
- Introduce additional safeguards against attempts to game the risk-weighted assets (RWAs, section 2),

- Help in addressing model risk, which is widespread in the banking industry, and
- Ensure comparability that is lacking today, as each bank computes its RWA the way it serves it best.

Sheila Bair, the former boss of Federal Deposit Insurance Corporation (FDIC), a major regulator in the United States, suggested that the leverage of American banks should be reduced by half.[9] She is right. Though Bair did not mention the European banks, her words apply to the leverage of the EU's LCBGs as well as to those of emerging markets.

It is nobody's secret that many Western LCBGs have been, are, and remain highly leveraged. There exists no publicly available proof to document their statements that they have pruned their balance sheets and that the recapitalization by governments,which is very costly for the taxpayer, will not again become necessary if their capital buffers prove to be inadequate or illiquid.

The Basel Committee also found that one of the most destabilizing elements of the economic and banking crisis of 2007 was *procyclicality*.[10] This term stands for amplification of financial shocks through the financial system, for instance, by way of convergence of cyclical reasons (and, sometimes by marking-to-market assets and loans held-to-maturity). The procyclical capital buffers are intended to serve as shock absorbers, stopping procyclicality from becoming a transmitter of risk; they should be created in good times so that they can be drawn upon in times of stress.

Another improvement upon earlier capital standards is the introduction of an interest rate risk coefficient to provide supervisors with a normalized indicator for interest rate mismatches and other exposures in the banking book. Critics say that associated with this coefficient are certain disadvantages that must not be overlooked. Starting on the positive side, we can see that this coefficient helps in making interest rate exposure (in the banking book) comparable by:

- Applying standard scenarios, and
- Using regulatory funds as a reference variable.

This enables supervisory authorities to track a bank's interest rate risk over time. In addition, through standardization, the interest rate risk coefficient can be used to draw comparisons between institutions. The downside is that banks are not necessarily including, as they should be, all material types of interest rate risk and don't always make suitable assumptions about positions where capital or interest rates are locked in for an indefinite period.

Interest rate exposure in the banking book should also reflect mismatches between deposits and commitments, to be computed on the basis of all material positions that carry interest rate risk. This calls for mapping all on-balance sheet and off-balance sheet transactions, including margin income. Only positions that make no material contribution to interest rate risk may be omitted, though such omission (often made for the sake of simplicity) could become a widely used loophole.

## 2. The Leverage Ratio

Section 1 made reference to the fact that the *leverage* of banks, particularly of the LCBGs, is way too high. In good times, this increases the institution's profits. But in bad times, high gearing as well as thin capital and low liquidity positions have the power to turn a credit institution, investment bank, or other financial entity belly up.

The solutions Basel II promoted to identify exposure associated with risky assets and oblige creation of corresponding capital buffers were based on risk-weighted assets . The caveat has been that each bank was permitted to use its own homemade models to compute it. Practical experience documented that this leaves much to be wanted. A growing number of regulators, investors, and analysts have been concerned by the fact that:

- The different RWA models don't tell the truth about the risk weights, and
- The complexity and opacity of risk-weighting has become legendary, leading to a justified loss of confidence in disclosures.

The observed high level of inconsistencies and incompatibilities of risk weights applied by banks goes beyond true differences in the underlying risk factors, with the result that risk profiles across institutions are incompatible with one another. This is due to a number of reasons ranging from the way individual business models have been built to macroeconomic hypotheses and other choices made by banks including management's wish to downplay assumed exposure.

In turn, such practices lead to an unjustified divergence between the capital positions of LCBGs with loan portfolios of similar levels of risk. A research conducted by the EU's banking authority has shown that *half* the variation in banks' risk-weighted assets cannot be explained by reasons such as portfolio contents and regulatory differences (significant variations mainly appear in corporate and retail loans).

To provide a remedy to this situation, regulators have introduced the *leverage ratio* as an additional risk metric alongwith risk-based capital

requirements. It is simply expressed as a bank's Tier-1 capital, not just common stock, over total exposure. To make the leverage ratio globally comparable, arrangements have been made with regard to:

- Derivatives,
- Off-balance sheet transactions, and
- Netting securities repurchase agreements.

From 2015 banks will be required to disclose their leverage ratio and its components using a standardized template. While following the new rules, supervisors will initially not set a binding minimum ratio requirement. The observation period will last till January 2017 and supervisory authorities will track the new ratio in order to analyze its impact more closely.

This might lead to changes in the methodology for calculating the leverage ratio. In fact some details regarding the design are still being discussed by the Basel Committee. But the prevailing opinion is that the strengthened leverage ratio will be manageable without major disruptions. Full compliance is mandated in 2018. This is a new experience and chief executives who wants to be in charge of it are well advised to involve their:

- Chief financial officer (CFO),
- Chief risk controller, and
- Chief investment officer (CIO)

in testing their bank's leverage ratio against big financial events since the late 1980s. A good start will be with "Black Monday," October 19, 1987, when stock markets around the world crashed, losing plenty of value in a short period. The Dow Jones Industrial Average (DJIA) dropped by 508 points to 1739 points, or -22.6 percent, severely affecting the banks' leverage ratios (if they were used at that time).

A geopolitical milestone with important economic and financial aftermath has been the Gulf War. A preferred testing period is August 1, 1990–April 30, 1991. As it will be recalled, in 1990, Iraq invaded Kuwait, provoking strong international solidarity with the emirate. In January 1991 the anti–Saddam Hussein coalition launched attacks against Iraqi troops and liberated Kuwait from occupation. This caused a strong relief-rally in the global financial markets, and it is interesting to know how the leverage ratio of each systemically important bank might have behaved.

Another economic milestone is the tandem of the Fed's interest rate hikes, from February 1, 1994, to January 31, 1995. In early 1994, the Federal

Reserve made a series of preemptive strikes against the risk of future inflation, raising short-term interest rates by 300 basis points (3 percent) over 12 months. The bottom fell out of the bond market. At the same time, central banks in Europe moved to a restrictive monetary policy.

July 1, 1997–May 31, 1998, is the time frame for testing the leverage ratio (as well as the liquidity ratio) against the background of the Asian crisis. Having exhausted its foreign reserves, Thailand conceded that it could not maintain an exchange rate pegged to the US dollar. On July 2, 1997, it allowed the baht to float but fearful that the Thai currency would depreciate, many investors responded by pulling their assets rapidly out of Thailand, with the result that both the baht and the stock market crashed.

The same scenario was replayed throughout East Asia in the following months. The Philippines spent $2 billion of their reserves before the peso was floated on July 11, 1997. The following month Indonesia's rupiah followed; on October 17, 1997, the new Taiwan dollar was cast off; and in December it was the turn of the South Korean won, which was floated while overleveraged South Korea had to be bailed out with a loan of $80 billion.

A year later came the time for Russian bankruptcy—another excellent opportunity to test the bank's leverage ratio. The ruble crisis hit Russia on August 17, 1998. The Yeltsin government's decision to devalue the currency and default on tens of billions of dollars of debt created economic and political turmoil. Countries heavily dependent on the export of energy and other raw materials were among those most severely hit. In September–October 1998 the Long-Term Capital Management (LTCM) hedge fund collapsed and the New York Fed forced its creditors and depositors to bring funds to stabilize the banking system.

From March 2000 to October 2002 was the time of the dot-com bubble, which started in 1995 and blew on March 10, 2000, when the NASDAQ peaked at 5132. During that bubble Western stock markets saw their value increase rapidly on the back of brisk growth in the new Internet-based companies; many among them were nearly empty shells. The bubble was a combination of:

- Individual speculation,
- Surging stock prices, and
- Widely available cheap capital.

The fall of the dot-coms hit banks, insurance companies, pension funds, and individual investors hard. A year later, a major terrorist event—the September 11 attacks on New York's twin towers and the Pentagon—upset

the financial markets. They had a significant economic impact on the American and world markets. The New York stock exchanges remained closed till September 17. When the markets reopened the Dow Jones index fell 684 points (or –7.1 percent), its biggest-ever one-day decline in absolute terms. By the end of the week, the DJIA had fallen 1369.7 points (–14.3 percent).

In July–August 2007 started the subprimes crisis that proved to be an ongoing economic problem manifesting itself through liquidity challenges and capital shortfalls for big banks and triggering a near-collapse of the banking system in September 2008 with the Lehman Brothers bankruptcy (chapter 5). The nationalization of AIG (chapter 6), Fannie Mae and Freddie Mac (chapter 7) did not improve investor confidence.

Without any doubt, the leverage ratio should also be tested with the 2010–2013 Euroland's debt crisis with the euro's tribulations in the background.[11] Each and every one of these events provides an excellent example to study the behavior of each energy bank's leverage ratio (as well as the liquidity ratio, section 3) and reach conclusions about the credit institution's ability to confront polyvalent market challenges.

Instead of capitalizing on the opportunity, banks, and their lobbyists, particularly the LCBGs, are complaining that the leverage ratio will make it more expensive for them to secure repo financing (repurchase agreements) and extend it to others. They say that the new rule will force them to hold additional capital against all their securities, regardless of the perceived riskiness of the assets. That is simply ridiculous:

1. Senior management at LCBGs knows very well that it is underestimating that "riskiness." The crises show that it needs to hold more capital; much more.
2. Complaining without testing is evidence of second-class management. By "forecasting the past first," bankers will have a serious, unbiased documentation.

This does not mean that the leverage ratio will not present some weaknesses, but these could be flushed out by the tests I am suggesting. This is particularly important as several regulatory authorities plan to address "too big to fail" concerns by increasing the leverage ratio requirements. For instance, American regulators issued a notice of proposed rulemaking (NPR) for a revised, supplementary leverage ratio that will cover only eight LCBGs: JPMorgan Chase, Citigroup, Wells Fargo, Bank of America, Goldman Sachs, Morgan Stanley, Bank of New York Mellon, and State Street. According to some opinions all but two of them would currently have capital shortfalls under the ratio.

Through NPR, US regulators seek to enhance the big banks' capital structure, so that capital can serve as a more meaningful constraint on bank activities. Supervisory authorities did not forget that in 2006, at the crisis threshold, half of the LCBGs would have met the 3 percent standard with the other half quite close. Hence, their conclusion that a uniform capital structure is a necessary but not a sufficient constraint.

For their part, some US banks have stated they will be able to meet a new regulatory requirement on debt levels by shuffling assets between subsidiaries, shortening the duration of derivatives, reducing credit commitments, and using other optimization strategies to cut down the amount of leverage they report. This means they are going to pull a lot of levers. We shall see who will have the last word.

American and Swiss watchdogs, as well as the Bank of England, are watching out. But the EU, which hosts some of the most leveraged lenders in the world, is regrettably still dragging its feet, with governments continuing to complain that capital demands on the LCBGs are too high. Brussels conveniently forgets that most global banks did not have enough capital going into the crisis, and they should strengthen their buffers now if they have not done so already.

### 3. Liquidity Coverage Ratio

Over the years the banking industry has inflicted serious liquidity problems upon itself. There have also been cases when it is indeed difficult to have a firm opinion on whether the underlying cause behind a troubled big bank is illiquidity or insolvency. This is particularly true when many illiquid positions in an LCBG's portfolio consist of novel and complex derivatives.

Because by majority the ongoing stream of new financial instruments is not normalized, the problems of their analysis, pricing, and risk evaluation are on the increase. Neither does it escape the regulators' attention that after a brief reduction in its volume, which was largely crisis-induced, trading again became:

- A large source of income for big banks,
- An even more major source of exposure that can once again turn national economies on their head, and
- A bottomless pit of systemic risk, created by the capsizing of illiquid LCBGs.

*Liquidity risk* is one of the critical issues that attracted the Basel Committee's attention and found its way into Basel III. Particularly

scary has been the liquidity risk and its mismanagement by the banking industry. The absence of adequate liquidity was central to the economic and financial crisis that started in July–August 2007. Therefore, in 2008, Basel issued the *Principles for Sound Liquidity Risk Management and Supervision* and, more recently, it focused on:

- Enhancing the resilience of internationally active banks to liquidity stresses, and
- Increasing international harmonization of liquidity risk supervision by way of the *liquidity coverage ratio* (LCR).

For LCBGs, a consultative document was introduced in December 2009 on global minimum liquidity requirements, including a 30-day coverage ratio underpinned by a longer-term structural ratio and a set of tools aimed at identifying and analyzing trends in liquidity risk. Both identification and analysis of liquidity risk have been addressed at individual bank and system-wide levels. In the background of this effort is the search for better bank-wide governance and the avoidance of systemic risk.

Like with the leverage ratio, big banks consider the liquidity coverage ratio to be their enemy because it constrains their profits, and they try to find a friendly soul to express a similar opinion. Two studies made in late 2012, one by the European Banking Authority (EBA),[12] and the other by Clearing House, a banking association in New York, warned that sudden implementation of Basel III rules would expose a liquidity shortfall of €1.15 trillion ($1.55 trillion) for European banks and $840 billion for American banks.

This was the overstatement of the year. On the contrary, estimates by Crédit Suisse suggested that most European LCBGs already met the original and tougher-than- the-present liquidity requirements, six years before the 2009 deadline. Britain and Switzerland introduced liquidity rules for banks in 2010. Sweden did so in January 2013, along the lines of the original Basel proposals, which, unwisely, were softened under pressure from irrational governments—particularly the French, Spanish, and Italian.

Still under sovereign pressure, on January 7, 2013, the Basel Committee announced greatly softened rules on its *liquidity coverage ratio*. Some analysts say that this was unwise, particularly because it was done through a wholesome reduction of 30 percent from the original LCR. The amount of cash and liquid assets regulators want banks to hold as a buffer to ensure obligations can be met *if* there is another freeze in funding markets has been reduced—and so has the banks' ability to confront times of liquidity stress.

The revised LCR rules allow banks to hold a wider range of assets in the liquidity buffer, including equities and mortgage-backed securities as well as lower-rated sovereign and corporate bonds. Another softening has been the assumption of a less dramatic withdrawal of bank deposits and a slower loss of income over a hypothetical 30-day crisis period. This means the liquidity buffer will be much smaller. Banks will also be allowed to run that buffer down in times of stress.

The liquidity coverage ratio is due to take effect in 2015; in its original version it was a groundbreaking attempt to prevent runs like the one that brought down Lehman in 2008. Softened rules will only do part of the job, but at least—despite excessive lobbying—there was opposition to a proposal from the Bank of France and the European Central Bank to revamp the rules to include anything a central bank would accept as collateral, which means accepting liquid plain garbage.

It has indeed been hard for any policy maker to endorse asset-backed securities (ABSs) as being liquid instruments after the mess of the "AAA subprimes" and other worthless mortgaged-backed securities turned out to be a scam. Let's look at this issue in a different way. Basel III was supposed to bring into perspective the weaknesses of the banking system and bring a sense of responsibility to the banking industry by obliging credit institutions to hold capital commensurate to the risks they were taking. The softening of rules will let banks "increase" their liquidity with illiquid assets.

There must be a reason for these changes that look irrational. Anecdotal evidence suggests that in the majority of Western nations the big banks' management of capital adequacy and liquidity is in such a derelict state that the highly indebted governments were haunted by their own disorderly mountains of debt when they exercised inordinate pressure on the Basel Committee on Banking Supervision to both soften and delay the implementation of the new prudential norms.

An editorial article in *Progress* reported that the reason for "the slow pace" of Basel III's implementation is the fact that only 8 out of the 27 member jurisdictions of the Basel Committee are ready to immediately start the transitional phase. This could mean that only 6 out of the 28 global systemically important banks might be subject to Basel III regulations at this date, and "(there is as well) a weak preparation of the supervisory systems to ensure their effectiveness."[13]

Delays and uncertainties are precisely the opposite of what is necessary for building up the confidence of the markets, investors, and consumers. Instead of helping the LCBGs in their procrastination policies, sovereigns should be eager to dispel doubts over their willingness to face-down special interests. Taming the banking industry in terms of capital and liquidity is just as important as setting the government on a fiscally responsible course.

Indeed, one of Basel III's strengths, developed because of, and documented by, the experience of the banking industry's descent to the abyss in 2007 and subsequent years has been the development of the first global liquidity standards ever to be applied to banks. But as the preceding paragraphs have shown these standards were diluted in January 2013.

Critics say regulators have let their arms be twisted by politicians and the power of the banking lobby. The changes in implementation deadline and in liquidity requirements are rendering the Basel III rules ineffective as safeguards for future financial stability. Under "normal" conditions this may not make a great difference because after the debacle of 2008, most large banks meet the liquidity requirements. Prudential rules, however, have been made to guard against excesses, of which there have been a great deal in the past.

It is necessary to provide for the day when central banks will wind down their own balance sheets and return to their monetary policy duties. As Mervyn King, the former governor of the Bank of England, has pointed out, central banks should act as lender of last resort—not first resort. Moreover, with globalization and deregulation, the old concept of liquidity risk has taken a new and much wider dimension because:

- A major liquidity crisis in a big bank risks snowballing through the financial industry, and
- A liquidity crisis in one market is exported the world over, as the 2008 banking crisis documented so well.

True enough, prior to the crisis most policymakers had ignored the central problem of a decade-long global misallocation of liquidity, while they allowed LCBGs to take on additional leverage with dangerous effects. But when one is repeating his past mistakes he is either 100 percent stupid or of very bad faith. The problem with lowering the rating of bonds admitted for liquidity purposes is that bonds from the private sector are inherently risky. Cash is the best example of liquid assets followed by central bank reserves and debt of highly rated governments.

- *If* the rules are loosened so banks can use lower-quality assets as collateral, and eventually as liquidity buffers,
- *Then* the financial industry is again in peril of illiquidity and, bail-in or no bail-in (chapter 1), the taxpayer may be repeatedly called to pay for the fault of bankers and politicians.

A serious liquidity and funding structure must be designed to ensure that funding is available to meet all obligations in times of stress, whether caused by market events, moral hazard, or issues specific to banks. This

can be achieved through a conservative asset/liability management strategy aimed at maintaining long-term funding, including stable deposits (chapter 1), well in excess of illiquid assets.

Banks should manage a strong liquidity profile in full observance of a *net stable funding ratio* (NSFR) intended to ensure that they maintain a structurally sound long-term funding structure beyond one year, even if this requirement is not expected to be introduced until 2018 and is still subject to adjustment. Regulators are structuring the NSFR such that illiquid assets are funded with an appropriate amount of stable long-term funds.

Like capital adequacy, a liquidity ratio is critically important to a bank's survival in case of a severe crisis. Not only regulators but also shareholders should care about it as must debtholders who have now joined the hierarchy of unsecured creditors if a bank is liquidated. Hence the importance of a bigger equity cushion and of a sound liquidity ratio has increased significantly.

### 4. Should the Glass-Steagall Act Be Reintroduced?

Gordon Brown, the British prime minister during the critical years of the economic and banking crisis that started in 2007, is allegedly proud of having led the world, in 2008, in understanding that the survival of the global financial system required the provision of an abundant amount of capital, and that the sovereign was the only secure source of that capital. In the opinion of his critics, however, this was no brilliant idea but a wrong-way initiative that subsequently led to other missteps.

The prize for insight on what to do with failing big banks, by reviving a nineteenth- century strategy, goes back to the years of the Roosevelt administration, to Senator Carter Glass (a former secretary of the US Treasury) and Representative Henry B. Steagall. Their Congressional Act (generally known as the *Banking Act of 1933*) separated retail and investment banking and protected specialist small business lenders. It did not embolden the conglomerates the way Brown did:

- Filling the treasury of the LCBGs with taxpayer money, and
- Allowing them to continue gambling with derivatives and other instruments, while the economy remains dangerously weak.

Looking back to economic history, the concept of splitting the banks along the line dividing deposits and community loans from investments, trades and generally merchant operations was first put into practice at the end of nineteenth century in France. Right after the first decade of the

Third Republic[14] the growth of the French economy slowed down, and after 1880 it stood below the average for that century, with a tendency to stagnate.

Against this economic background stood out recurring crises like that of 1882, with events like the crash of the Union Générale characterized as the most serious one of its time.[15] Union Générale was a merchant bank that extended its operations toward central and southeastern Europe in a risky way. For all practical purposes the Union Générale was the forerunner of today's investment banks and of those commercial banks bent on gambling with derivatives.

But Union Générale's good luck did not last forever. In January 1882 it had to suspend payments creating a depression in the French economy. Following this, the country's banking system was reorganized with a clear division between deposit banks and merchant banks. The so-called high finance no longer had absolute power in the French state, though its influence remained considerable if for no other reason than its role in public loans—hence in politics.

Behind the merchant banks were the Rothschilds, Neuflizes, and Hottinguers, while the deposit banks specialized in short-term credit leading to economic development.[16] Correctly, the French government did not intervene, like the British government and the Bush Jr. administration did (as well as so many other Western sovereigns) to fill the coffers of the merchant banks. Instead, it brought the Union Générale's CEO, Bontoux, to justice.

This separation of banking duties, as well as of risks and profits inherent to each market, has been the cornerstone of the Glass-Steagall Act, making it harder for banks to take risks with depositors' funds. In the years of the Roosevelt administration, it was complemented by deposit insurance, which was an innovation, and bylaws to stop banks from offering services in more than one state, which kept them smaller and easier to supervise and also helped to avoid bank runs.

Bank runs with long lines of depositors queuing up in front of branch offices in the hope of getting back their money became infamous in the early years of the 1930s. Postmortem, economists like Milton Friedman argued that the government should have provided the banks with all the money they needed to return to depositors since the latter were most likely to bring that fiat money[17] back to the banks after their confidence returned.

Bank runs have taken place in Russia in the late 1990s in the wake of its bankruptcy and more recently in Britain when in the 2008 crisis it saw the famous run on Northern Rock as well as on money market funds. The latter were seen by many as a direct alternative to bank deposits. Guarding

against bank runs that create a very negative public response and market psychology is one of the several sound reasons for separation of:

- Taking depositors' funds,
- From trading and risky investment activities.

Another benefit of this separation is to inhibit the spread of capital markets to areas best served by the banks' lending. This focused view of risks and benefits suggests that the split between deposit banks and investment banks should be seen from a wider perspective that accounts for today's bewildering range of financial instruments.

Let the investment banks take the risks and profits from dealing with CDOs, CLOs, CDSs, and other credit trading derivatives on the risky side of the old Glass-Steagall Act split. The mounting level of exposure is a reason why America's liberals, who have long demanded that LCBGs are forcibly broken, are now joined by influential conservatives. On Capitol Hill Republicans have introduced legislation and written letters, urging government officials to study the negative effects posed by LCBGs on financial instability and on stalled economic growth:

- Demanding the restructuring of big banks, and
- Making mainstream the smaller bank until recently dismissed as a fringe idea.

Gradually the conservative-liberal British government is also recognizing the need for a structural change. The Vickers Commission, which reported in 2011, put forward the separation of retail and investment banking (albeit in a subdued tone because of pressure from big banks). In a subsequent report on banking standards, the Parliamentary Commission proposed criminal sanctions for those who recklessly pursue their own interests over those of the bank they are in charge of.

Among other issues, LCBGs have against them the fact that being big makes it hard to avoid attention, whether from regulators or from the market. The massive, $100 billion-plus credit-derivatives position attributed to Bruno Iksil, known as the London Whale—a London-based JPMorgan Chase trader (section 5)—sparked a debate about whether the bank was violating principles restricting proprietary trading.

In Washington, on April 3, 2012, regulators finalized a rule enabling them to expand the designation of *systematically important* institutions to nonbanks. In 2013 this was extended to a group of big insurance companies like MetLife. The Financial Stability Oversight Council (FSOC), which groups senior regulators, has established a process of identifying

nonbank financial firms that will get special supervisory attention from the Federal Reserve. The consequences could change the financial system with asset managers, like money-market funds, coming under the new identification.

A mid-2009 research on private wealth found that the money private individuals have in banks as assets under management were down by almost a fifth in 2008 to $33 trillion[18] with the largest wealth decline in North America, Europe, and Asia, while the rich of the Middle East and Latin America rich were less affected. These statistics also revealed that North America and Europe are not the only areas where wealth management is burgeoning. Asia is not far behind while Latin America is catching up.

A more serious challenge for wealth management banks was that, fed up with poor investment advice, clients rushed into low-cost exchange-traded funds. Not long after 2008, however, funds under wealth management have surpassed previous high-water marks. Worldwide assets under management were:

- $102 trillion in 2008, and
- Nearly $122 trillion in 2010, a 20 percent increase.[19]

Of this $122 trillion 61 percent was in accounts of over $1 million and the balance in accounts of less than $1 million (usually accounts of more than $500,000). This widespread increase in the size of individual accounts presumably led the US Treasury to propose that banks and brokers assume a fiduciary duty to put client interests first in the form of a "trusted advisor," with more transparent pricing based on assets under management rather than transactions. That's what clients want.

The markets could force further change, not only in the direction of greater personal care for the truly wealthy but also by bringing the new class of financial outfits under banking supervision, beyond deposit taking and investment banking. Wealth management somehow sits between these two classes: The wealth banks manage on behalf of their clients is essentially deposit, while investing these funds unavoidably involves some of the merchant banking's risk.

### 5. The Role of the CIO Must Be Rethought

A vital issue for any bank, big or small, that Basel III does not pay enough attention to is the need to restructure, upgrade, and empower risk control. In most financial institutions the management of risk is a paper tiger,

easily overrun by the different trading desks and loans officers. Neither is it so easy to control an LCBG's sprawling exposure.

The pros say that this is one of the duties of the *chief investment officer* (CIO). This is untrue. Paraphrasing Georges Clemenceau, the French prime minister of World War I fame, "Risk management is far too important to be left to the CIO."[20] In the majority of cases, though not in all, the chief investment officer is essentially a *chief risk-taking officer*, hence unfit to exercise risk control.

Take the case of JPMorgan Chase, Ina R. Drew, and the London Whale as an example. The LCBG's multibillion-dollar trading loss with derivatives instruments was brought to light by a report from the US Senate Permanent Subcommittee on Investigations, which documented that:

- Bankers are not acting cautiously, and
- Risk managers are not loved by Wall Street.

The losses of the big bank's London office were going on unchecked because JPMorgan traders fiddled with risk measure valuations and company policies to the point that risk managers defended rather than controlled the traders and paid no attention to risk signals. As if this was not enough, the bank gave incorrect information to its regulator, with senior executives making misleading statements to shareholders and the public. This led Senator Reid, the majority leader of the US Senate, to say: "I suggest moving JPMorgan to Las Vegas because it is a gambler."[21]

The way it has been reported in the press following the Congressional hearings, referring to how the positions were calculated, Ina R. Drew, the big bank's chief investment officer, asked an underling if he could "start getting a little bit of that mark back." She then asked if he could "tweak at whatever it is I'm trying to show."[22]

In JPMorgan Chase, Drew survived in her position for several years. In the end she was ousted. But her CIO policies and actions show that what financial executives do postcrisis when faced with trouble is no different from what they did prior to the crisis. In her Congressional testimony she deflected blame to Jamie Dimon, the bank's president, and her traders, claiming that:

- She was deceived by them, and
- She has been kept in the dark.

Indirectly Ina Drew admitted she was a mismanager. A good manager investigates and follows up. He does not accept being "kept in the dark." It is not enough to give an order, Napoleon said, you must also personally ensure that it is executed.

Testimony before Senator Carl Levin, who heads the Senate subcommittee, revealed that the LCBG stopped giving important information to its regulator, the Office of the Comptroller of the Currency, and told the agency that it was reducing the size of its positions when it was actually increasing those positions (according to the Senate report). The regulator, too, was to blame. By April 30, 2012, a few weeks after the trading debacle came to light and before any serious investigation began, the Office of the Comptroller of the Currency declared the matter closed, according to internal minutes from a meeting.[23]

Without a steady and focused watch on the wealth under management and on the risks being taken, an institution's treasury can be emptied in no time and its equity price may dive. At the end of October 2008 the share price of CITIC Pacific, part of China's largest state-owned investment group, plunged by 55 percent after it became known that it was about to lose up to $2 billion because of betting that the Australian dollar would strengthen while the currency fell by 15 percent against the American dollar in the month of October 2008.

The bonus of the CIO should be linked to both the share price of the firm and to its credit rating, not just to the ill-documented "profits" produced by its gambles, trades, and loans. An analysis by Standard & Poor's that concentrated on bonds found a clear link between ratings and default risk, with 7.5 percent of bonds rated BBB defaulting within ten years; 15.1 percent of those rated BB; 32.1 percent of those rated B; and an impressive 94.4 percent probability of failure for debt instruments rated CC or CCC.[24]

Sometimes the risks assumed by the CIO have in their background conflicts of interest that go way up to the top of the organizational pyramid. In other cases it is not conflicts of interest (because of hoped-for big bonuses in the aftermath of assumed oversize risks), but structural failures that lead to an ineffective control of exposure(s). For instance, the risk manager stands low in the organization, reports to the CIO, the finance director, or the auditor. All three are poor structural solutions.[25]

In addition, the compartmentalization of risk information creates a perilous combination of circumstances and exposures. Though this is well known, few institutions provide for the necessary integration of information on newly assumed and inventoried exposure—to allow for risk profiles that pinpoint the trouble spots as well as trades or investments likely to turn sour, or even become *la crème de la junk*.

Banks, particularly big banks, must reexamine their assumptions about how effective their defenses are against simultaneous multiple risks in their widespread operations by geography and product line. All markets can become illiquid and most risks are correlated, removing many of

the benefits of diversification. Financial innovation has made the system more fragile. It has also demonstrated the inadequacy of many hedges.

Risk control has to work in real time and it must be in tip-top condition if for no other reason than because deregulation, globalization, and financial innovation have led to the creation of many complex and often misunderstood banking activities. The system should be able to track and measure what is happening with financial exposure, including ongoing transactions with complex futures and options like those leading to Kweku Adoboli's fraud at UBS.

The absence of Basel III requirements regarding the breadth and depth of risk control in LCBGs has been deceiving. A sound solution should include methods, tools, and organizational prerequisites that are not commonplace today. Even Goldman Sachs, widely regarded as one of the best managers of risk in the banking industry, did not foresee quite how bad things could get.

Goldman's most demanding pre-crisis stress test, known as *wow*, or worst of the worst, took the most negative events to have happened in each market since 1998 and assumed that they got 30 percent worse and they all happened at the same time. That sounded as a good basis for exposure management but 2007 and 2008 events have shown it was not pessimistic enough.[26]

Both financial innovation and the magnitude of recent crises have made the available risk management tools obsolete and inadequate if not plainly misleading. An example is *value at risk* (VAR) developed in the early 1990s by JPMorgan for a far more limited usage than its present-day one. In a Congressional testimony James Dimon said that he does not even look at it. Equally misleading is the so-called conditional VAR (CVAR) supposed to provide the average tail loss beyond the 95 percent fractile.[27]

Let's face it. Big banks (as well as medium-sized ones) are giving batons to chance to beat them up. Ineffectual risk-control methods and obsolete models fail to account for the fact that in the banking industry the push has been *from hedging to betting*. As a result, and also due to moral hazard and conflicts of interest, risk control has waned. This should have been sanctioned by bank supervisors, but it is not.

# 3

# Banking Practices and the Evolution of Trading Rules

## 1. Shadow Banking

In the course of the last few decades the economy has experienced a rise in the so-called *nonbank banks*[1] that engage in *shadow-banking* practices. Their activities are similar to those of classical banks. They may take deposits (under different schemes) and give loans. But they do so outside the regulated banking system, in the *shadow* of traditional banking.

The shadow banking system is generally defined as one of credit intermediation, which involves entities engaging in extracurricular banking activities. Under this definition fall, among others, hedge funds, money market funds, exchange-traded funds (EFTs), and special-purpose vehicles (SPVs). The latter have been widely used for securitization and speculations, which led to the subprimes disaster.

Most of the nonbank banks are part of the intermediation chain, investing in debt securities and various other forms of credit. Aside from the fact that they are not regulated by supervisory authorities, the problem with them is that frequent, and often sudden, changes in their investment behavior can affect funding conditions and maturity transformations throughout the financial industry. Shadow banking increases system risk because of interlocking credits, shareholdings, and exposures.

From interest rate commitments to maturity matches and liquidity transformation, there is no financial transaction that it, or can be, risk free. To ensure that no major exposures in the financial system are overlooked, and in order to cover new forms of intermediation, the interconnections of the shadow banking system have to be established and updated as the nature of financial products and services evolves.

A number of years ago the New York Federal Reserve helped to visualize how carefully policy makers must look at an increasingly complex

financial world by creating a large wall map of shadow banking. This was the first time that a central bank mapped financial flows in a detailed graphic form, demonstrating why policy makers need to rethink how the financial ecosystem works under its new mantra of banks and nonbank banks.

Just prior to the 2007 economic and banking crisis regulators did not really bother about shadow banking. That was anyway the time of deregulation. Postcrisis reregulation initially focused on banks' solvency. Banks that could not raise equity had to deleverage fast to meet the new capital ratios. Subsequently the Financial Stability Board (FSB) worked on ways and means to clamp down on shadow banking, with the aim of reducing the risk from:

- Lightly regulated and little monitored nonbank activities that can destabilize financial systems, and
- Lending schemes that do not rely on deposit taking but instead use customer money to fund loans.

Nonfinancial corporations are large money market investors, with plenty of liquidity to deploy in short-term investments. Securities lenders, too, are major shadow banking participants. Most securities lending is done against cash collateral, which means that securities lenders usually have large pools of cash that they seek to reinvest on behalf of their clients, and their investment strategies often resemble the investment strategies of money market funds.

The Financial Stability Board is right to be concerned about the possible aftermath of shadow banking practices. Nonbank banks' assets have been growing and were an estimated total of $70 trillion (by the end of 2012), which is roughly a quarter of the total financial assets of the 20 countries covered in a survey by Euroland in November 2012.

The FSB's concerns have included banks, fund managers, insurers, and other entities. The aim has been to understand and then control the complex chains of deals that begin with stock lending (repo) transactions and end in other investments vulnerable to investor runs if the underlying asset values fall sharply. In September 2008 AIG, the global insurer, had to be rescued after it invested part of the cash collateral proceeds from its $75 billion of stock lending in long-term mortgage-backed securities on which the underlying loans went bad.

The interlinkages between insurance companies and mutual funds, on the one hand, and other market agents, on the other hand, are manifold. By providing capital to banks, enterprises, and government budgets, insurance firms and mutual funds perform a key funding function.

But the weight of interconnections between banks and nonbanks varies among different countries. In the United States the role of nonbanks has historically been much larger than in Euroland.

Unsecured short-term wholesale funding for banks and broker-dealers might contribute to a systemic risk in case such loans are not rolled over. Hence the argument by regulators that to promptly identify the build-up of systemic risk, and take appropriate countermeasures, all major segments of the financial system have to be supervised, and this is also true of all alternative types of credit intermediation.

A major regulatory worry with shadow banking is *contagion*, which could also be generated if massive losses in value put a strain on institutional investors, especially with regard to specialized funds. This is true the world over because with globalization the economies of different countries are interconnected.

There are direct links forged by assets and liabilities stemming from ties such as repo operations or securitizations and, less visibly, by implicit guarantees and liquidity lines. For example, the German financial system has strong ties with the global shadow banking system, which means that major problems in a part of the global shadow banking system can also affect financial stability in Germany.[2]

The contraction of lending by nonbank banks can be much more rapid and damaging than a return to greater prudence by the banking industry. Following the 2008 descent to the abyss of big banks, the really precipitous contraction in credit has come from nonbank lenders: money-market funds, hedge funds, exchange-traded funds, and so on. These capital market lenders are especially important in America.

Moreover, nonbank lenders have been buyers of securitized products (section 2). When, in September 2008, the banking industry descended to the abyss, an estimated $8.7 trillion of assets worldwide were funded by securitization.[3] Such a large figure gives an idea of what happens when the shadow banking system contracts, while banks might act as lenders of second-to-last resort.

- Borrowers who can no longer get money from capital markets can call instead on contingent funding commitments made by the banks, and
- Banks can fund their expanded asset base because at the same time deposits are attracted into the banks by the guaranty of deposit insurance.

It is necessary to bring to the reader's attention two more increasingly popular banking practices prior to closing this section. One of them

is *dark pools*, a term used in conjunction with trading in off-exchange venues. These, too, have been unregulated but could be reined in after proposals from both America and Europe to crack down on dark pool practices. US exchanges and banks could require brokers to offer public markets their best available price to buy or sell a stock before they trade that price at off-exchange venues.

In late November 2013 European regulators reached an agreement in principle to cap dark pool trading,[4] as part of a toughening up of the Markets in Financial Instruments Directive (MFID) by Brussels. In principle, the agreement is to cap dark pool trading at 8 percent of each EU stock. American regulators have not yet reached a clear decision on that point as the concept behind it has yet to gain broad support among exchanges, banks, and the Securities and Exchange Commission (SEC). The SEC would have to approve any such rule before it becomes effective in the US market.

A solution that provides fair ground for all players has nevertheless to be worked out as trading outside public markets has crept up to record levels, putting further strains on the once-dominant share trading by established exchanges as the New York Stock Exchange, NASDAQ, and the European stock exchanges. According to some estimates, in the US today more than 37 percent of all US stock trades are executed at off-exchange venues run by brokers.

A different critique is made of *high frequency trading* (HFT). Theoretically, it results in greater market efficiency. Practically, a study by the Federal Reserve of Chicago found that HFT practices have many weaknesses.[5] One of the most important, pointed out by the Fed, is that there are more out-of-control algorithms than had been originally anticipated.

Losses can follow swiftly. A high-profile example was when, on August 1, 2012, Knight Capital lost $440 million in 45 minutes because of a rogue HFT algorithm. The Chicago Fed's study also exposed a lack of controls, while critics also call into question the claimed efficiency advantages.

In addition, while computer-based direct market access has significantly reduced spreads compared with the days of purely phone-based dealing, current evidence suggests that while high frequency trading is on the rise, spreads are no longer tightening. HFT also tends to correlate positively with stock price volatility like stock prices overreacting to fundamental news when high frequency trading is at a high volume.

## 2. Risky Securitizations Get a New Life

"Banks must serve broader areas of the economy and be accountable for what they are doing," said Sheila Bair, the former head of Federal

Deposit Insurance Corporation (FDIC).[6] Bair is right; her statement came at a time when risky securitizations got a new lease of life—just as dangerous as the one that led to the 2007 economic and banking crisis, if not more so.

Securitizations are an important financial tool, but not at any level of risk. Besides that, it is silly to repeat the same mistakes that a mere seven years ago led to the severe crisis, nearly ruining the global financial system. One might even understand the madness of crowds when it comes to supposedly win-win investments, because they are uninformed about (or fail to understand) embedded risks. But sovereigns and bankers who pride themselves at being knowledgeable and rational should not repeat the same mistakes.

In mid-December 2013 it was revealed that Citigroup and Santander have sold $1 billion of trade finance assets in a securitization designed to pave the way for more obscure assets. Projected to be sold to institutional investors like pension funds and insurance companies, that garbage in bank balance sheets can be hardly called "assets." Pension funds and other institutional entities have a fiduciary duty, but they are attracted by unsafe "investments" because of their thirst for yield in a prolonged low interest rate environment.

All sorts of banks have spent years trying to get toxic securities out of their balance sheet, particularly "assets" that are fairly obscure and afflicted by all sorts of risks. Potential investors do not know much about them and this can be disastrous when a downgrade starts suddenly. For instance, in August 2013, BNP Paribas launched a commodity trade finance securitization known as *Lighthouse*. This was backed by the short-term loan advances that the French bank had offered to companies shipping oil and metals.

With the new form of securitization both the liquidity that it provides to the institution's treasury and the opportunity to prune the bank's balance sheet matter a great deal. The same factors of motivation have prevailed with the subprimes and Alt-As.[7] Instead of replacing the old policies that led to disaster, plenty of banks in Euroland and in the US succumb to them time and again.

Investors who buy all sorts of toxic waste should take notice of a new credit risk that did not exist in the early years of this century dominated by the euro and Euroland's euphoria. On December 20, 2013, the credit rating of the European Union was downgraded to AA+ from AAA. This changes nothing, said the French president François Hollande.[8] But:

- For Standard & Poor's, the rating agency, the cohesion of the European Union has melted, particularly during the long negotiations for the 2014 budget, and

- For investors the downgrading is significant because there is a synergy between a country's (or region's) credit and that of banks domiciled in it.

The puzzle is to find out when the cataclysm will hit. The way a recent commentary had it, today's EU is like Emmental cheese where the holes take up more place than solid matter. During the last two decades all sorts of headwinds have hit the European Union converting it from a great stimulus to a great obstacle in economic, financial, and banking terms.

American banks, too, are pruning their balance sheets and securitizing real estate "assets." Sliced and diced these inventoried commercial and residential loans are considered a true sale and this helps with the reduction of Basel III's risk-weighted assets (RWA) ratio. Bank of America and Citi in the US, as well as Santander in Spain sold a lot of them, rated from AAA to single B, while retaining an unrated equity tranche.

But though the housing market in the US has improved, some toxic risks remain. Commercial mortgage-backed securities (CMBSs) are a case in point. Some loans to shopping malls have gone sour, as the malls became victims of a shift to online shopping and were also hit by the wider US recession. Other malls, however, prospered and this underlines the divergence in the performance of malls reflected in bonds backed by their mortgages.

In spite of their opaqueness and wide-ranging level of exposure, sales of commercial mortgage-backed securities in 2013 surged to the highest levels since 2007. In parallel to this, however, many of the investors are increasingly wary of deals that contain loans to the most troubled US malls, particularly as the gap between the strongest and weakest malls continues to widen.[9]

According to research released on December 17, 2013, larger losses from the worst performing shopping malls are increasing in frequency. The rating agency's commercial real estate analysts estimate that in 2013 losses from CMBS deals backed by the most troubled malls averaged about 90 percent. That's way above the 60 percent recorded for other types of retail properties, which itself is too high.

Rentals from real estate properties bought on the cheap in the early years of the crisis are also subject to slicing and dicing. Blackstone is one of a number of investors with deep pockets who purchased such properties in fire sales. The private property outfit spent the five years since the worst of the banking crisis:

- Buying tens of thousands of residential assets on the cheap, and
- Converting them into rental homes, providing a source of income.

Blackstone now packages the rental proceeds from those homes into securitizations. In the first week of November 2013 it sold the first of these bonds in this class. In a huge $480 million deal it bundled the cash flows from more than 3,000 single family rental properties across three states.

The market success of this asset class is closely linked to the future of the American housing market as well as to a recovery in credit sectors that more or less died during the recent financial crisis. Such securitized instruments are known as "single family reos." "Reo" is an industry term for foreclosed houses that have been repossessed by banks.

A fairly specialist market is that of mortgage real estate investment trusts (M-Reits). They invest in packages of mortgage bonds but analysts say that the rapidly expanding world of M-Reits could potentially deliver some bad surprises when interest rates rise. For instance, even a modest increase in rates might spark fire sales of certain mortgage-backed securities, because it would raise mortgage interest rates sharply:

- Producing a tsunami of RMBS and CMBS sales, and
- Bringing instability in other areas of finance, due to its spillover implications.

Not all investors appreciate the outstanding risks. One of the more lethal risks is liability mismatches and associated vulnerabilities. Special investment trusts (M-Reits) hold long-term mortgage assets, but rely too much on short-term funding from repurchase markets.

The fact that they lack a comfortable capital cushion, as required by law, to return profits to investors leaves them vulnerable to the same risks that confronted shadow banking securitizations prior to 2007. In case of a shock, they will be forced into fire sales of assets to meet investor demands, with contagion risk spreading all over the market.

The growing size of this market is in itself a reason for concern. Until some years ago, these were relatively small firms involved in M-Reits and since they mainly operated in shadow banking (section 1) they received no regulatory scrutiny. By contrast, since 2009–2010, bigger nonbank banks joined this business, partly because they have rushed to fill gaps created by banks reducing their lending activities. Today it is estimated that in the US M-Reits hold more mortgage bonds than government-sponsored mortgage agencies like Fannie Mae and Freddie Mac.

## 3. The Volcker Rule

Named after Paul Volcker, the former Federal Reserve chairman who proposed it, the Volcker rule calls for deposit-taking institutions to be

banned from proprietary trading in capital markets and from investing in hedge funds and in private equity. Since the moment it was proposed, it was welcomed by the Financial Stability Board, which stressed that such a move would need to be combined with:

- Tougher capital and liquidity standards, and
- Other regulatory measures aimed at increasing its effectiveness in controlling the banks' exposure.

It is important to note that the Volcker rule does not seek a full separation of commercial banking and investment banking like the Glass-Steagall Act. Nor is it targeting only the big banks. Its goal is to limit further growth of non-deposit liabilities by restoring some elements of the Depression-era regulatory regime meant to ensure that commercial banks are not engaging depositors' money in proprietary trading of securities.[10]

Britain, formerly an enthusiastic champion of financial deregulation, is going further still pondering whether banks' retail arms should be so tightly regulated that they become public utilities. Here again the underlying concept is that banks should not use deposits to gamble in markets, and because this might happen even if it is outlawed, regulators are also working on resolution regimes and living wills (chapter 1).

Banks, assets managers, and several foreign governments are generally opposed to the Volcker rule, which, in the US, has been voted by Congress as part of FINREG, the Dodd-Frank Act. Their argument is that the ban on proprietary trading could exacerbate a liquidity crunch or even harm markets by preventing or deterring US banks from trading. That's baloney. The real reason for opposition is its effect on banking profits and fat bonuses that are at stake.

This opposition is misplaced, first, for reasons of ethics. Using depositors' money for gambling is a severe violation of fiduciary duties. Second, because, after all, proprietary trading is not so much of a profitable business as it might sound. Only Goldman Sachs derives 10 percent or more of its revenues from proprietary trading. Morgan Stanley and Citigroup derive half as much and other big institutions like JPMorgan Chase and Bank of America get a little more than 1 percent from proprietary trading. That's peanuts compared to the risks they are taking.

Additionally, a great deal of the objection to banning proprietary trading from the activities of deposit-taking institutions has been based on the sacrosanct status of financial innovation. Yet, in his testimony to the US Congress on February 2, 2010, Paul Volcker is quoted as having deposed

that there is no evidence financial innovation has contributed anything to the wealth of the United States.

By contrast, some of the risks that have been assumed were high and widespread ending in disaster. Subsequent to this taxpayers, the common citizens, were obliged by the sovereign to put up the cash for all of the damages. And as we saw in section 2 nothing has much changed in attitude since the 2007 crash, when hell broke loose on Wall Street.

Still, big banks have not reduced their opposition to the Volcker rule. On November 7, 2013, the US Chamber of Commerce urged a "rethink" to avoid supposedly unintended consequences. This interference by a party confronted with conflicts of interest came at a time regulators have been putting the final touches to this sweeping US financial reform. The Chamber of Commerce wrote to the heads of the five regulatory agencies involved in writing the implementation details of the Volcker rule stating that:

- Regulators had not provided a public "cost and benefit analysis" of the rule, and
- The measure should be "re-examined" to allow regulators to address a range of issues since it was proposed in 2011.

This dilatory action has been followed by a judicial challenge mounted by a US "banking industry group" against the Volcker rule. At Christmas 2013 it became known that a case has been brought to court against Volcker rule's implementation, an act full of consequences.[11] In a democracy laws are decided by the parliament, not by the court. By contrast, the court examines and decides *if* actions taken follow the letter of the law. What the "banking industry group" has done is not only antidemocratic but also demonstrates a curious fanaticism in favor of financial gambling.

Over and above all that, regulators and legislators have been pestered by lobbyists and bombarded with 16,000 letters underscoring the gamblers' high stakes, all part of an ill-advised strategy against the American economy, as Wall Street sought to soften the rule.[12] It will be to the regulators' credit, nevertheless, that they stick to their guns.

Insiders say that it has taken regulators longer than expected to finalize the details of Volcker rule's implementation partly because of intensive lobbying against it by big banks and partly due to differences in opinion between agencies that oversee the banking industry and financial markets. This includes the Securities and Exchange Commission (in which there are different currents regarding the rule's details) and for bank regulators: Federal Reserve, Federal Deposit Insurance

Corporation, Comptroller of the Currency, and Commodity Futures Trading Commission.

Jack Lew, Treasury secretary of the Obama administration, has made it a priority to finalize the Volcker rule soon and has allegedly put pressure on regulators to complete it. Till that happens, all sorts of speculators, some masquerading as bankers, will be making wild bets, trading among themselves novel and risky derivatives while piling on debt.

With the Fed keeping interest rates at nearly zero for half a dozen years, big banks have cheap access to money, and bonuses are as generous as ever. At the other side of the equation millions have lost their jobs, homes, and savings—and nobody answers their question why giant banks are important to the economy and to the public. In fact, too-big-to-fail credit institutions may well be a hindrance rather than an advantage.

In his book *The Rise of Christian Europe*, Hugh Trevor-Roper, who taught modern history at Oxford University, makes the point that the structure Europe acquired during the fifteenth and sixteenth centuries, and strengthened through steady expansion, had more to do with small nation-states than with big ones. He takes Portugal as an example and presses the point that *if*, like, for instance, Spain's Andalusia, it was governed from Burgos or Toledo, much of its economic life would not have been drained away into the Spanish monarchy.

On the contrary, because of Portugal's independence and its smallness, "it was forced to live by its own economy; and that economy lay on the sea. Portugal in the fifteenth century was like Genoa or Venice in the twelfth century, or Holland in the seventeenth: a small state forced by geography to look outwards... (and) Lisbon retained its old character. It was still a capital of merchants and seamen"[13] and a booming one for that matter.

As chapter 1 brought to the reader's attention, small is beautiful. It would be better for the global economy not to have these "too big to fail" mammoths around, but at least the implementation of the Volcker rule can lead to a gradual reduction of uncertainty and this would be helpful in restoring market confidence. Moreover, in the medium to longer term, barriers to entering the more exposed parts of the banking industry should increase, with ethics, capital adequacy,[14] and liquidity becoming the basic criteria for entry and for sustenance in the gambling club.

By contrast in a more classical bank, which involves a great amount of intermediation, because of the Volcker rule (which they try by all means to bypass) credit institutions will be less likely to prejudice confidence in the financial system. Critics of the Volcker rule say that the ban on proprietary trading would have done nothing to prevent the last crisis, nor will it prevent the next one. That's not true. The exceptional gains risky trading generates can at any time be matched by exceptional losses.

Whether engaged in transactions that have to do with intermediation or with a proprietary epidemical folly, big banks don't seem to be fully aware of the fact that the regulatory mood has radically changed. Yet, over the past three years they have been confronted with a tandem of large fines related to unethical practices for the most part in trading.

- Betting against rigged subprime products,
- Manipulating electricity and other commodity prices to beat the market.

Only those bank managements that are able to understand the headwinds confronted by their widely spread practices of the last 20 years are closing down some of these activities. In that sense, by prohibiting proprietary trading, the Volcker rule helps them not to return to the old rotten path, which had become lax, comfortable, and very risky.

True enough, the better-managed credit institutions are asking regulators to clarify an aspect of the Volcker rule that relates to their ability to hold certain complex securities. This is a teething-trouble issue centering on the so-called trust preferred securities (TruPS) that were sold by small banks and insurance companies in the run-up to the financial crisis. Subsequently, they were repackaged into collateralized debt obligations known as "TruPS CDOs."

Several of the banks' remaining TruPS CDOs are classified as held-to-maturity, hence they do not have to be marked to market. Reclassifying them as available-for-sale, in preparation for divestment, could lead to paper losses and potentially impact regulatory capital ratios. The counterargument is that banks should not have invested in such poisonous "assets" in the first place.

### 4. Bank Consolidation: An Elephant in a Glass House?

In the 16 years from 1994 to 2010, the top five American banks beefed up their combined share for deposits from 7.9 percent to 34.3 percent. This is a nearly 434 percent increase in market share. It is also a concentration, the direct result of mergers and acquisitions that have largely taken place after the collapse of Lehman Brothers in September 2008, pulling down to the abyss mortgage banks like Countrywide, big savings and loans like Washington Mutual, and investment banks like Merrill Lynch and Bear Stearns.

Bank consolidation of that magnitude reduces competition and it would have been allowed in normal times. But the years that followed the

hecatomb of 2008 were no "normal" times and regulators were keen to save badly wounded financial institutions from bankruptcy by pushing them into the arms of those that looked like survivors. To a large measure, the latter were among the big, global banks. That's how Bank of America acquired Merrill Lynch and Countrywide (which subsequently created major legal problems for it).

In the aftermath of such wide consolidations, the wealth controlled by the big global banks, the scale of their operations, and their multiethnic organization made them the prime determinants of economic policy in the United States where they became homegrown banking leviathans. Enriched with political power leveraging, wealth and size created at the vertex of these banks a situation of nearly absolute financial power that did away with the bankers' fear that risks being assumed are not sustainable. Hence, the policy of high risk taking took off again (chapter 4).

Banks that were already large but were badly wounded by their exposure in the course of the 2008 crisis, saw their treasury refilled with taxpayer money, while in parallel to this they sold some of the diamonds of their crown to raise much-needed cash ahead of what was expected to be more dismal quarterly earnings. Citigroup sold its German retail banking business to France's Credit Mutuel for $7.7 billion. Merrill Lynch sold its 20 percent stake in Bloomberg for $4.8 billion, but this did not prevent its falling under the sway of Bank of America.

In the background of the forced mergers engineered by the US Treasury was the fact that would-be predators were in no position to make big ticket acquisitions. Deutsche Bank had been under pressure to bring down its leverage ratio, which measures gross assets to capital. In June 2008, Barclays raised $9 billion in an effort to rebuild its balance sheet (a capital increase interpreted by the market as a weakness) and HSBC was burned by the disastrous acquisition of Household Finance, an American mortgage lender.

Even banks that, for some time, were believed to have steered clear of trouble were sinking in red ink. Wachovia, America's fourth largest commercial bank, suffered from outsize exposure to California's imploding housing market and became a potential takeover target, eventually being acquired by Wells Fargo for a song.

Also in California, in early July 2008, IndyMac Bancorp was told by regulators that it had insufficient capital. As it found difficulties in refilling its treasury and cleaning its balance sheet, regulatory authorities took it over and guaranteed $100,000 to each depositor while trying to slash its loan book. These and similar problems faced by the bigger banks fed back into the credit markets in more ways than one:

- They made it very difficult for the banks to raise capital,
- Obliged them to sell assets, and
- Increased the spreads in credit default swaps.

Senior bankers who went through a similar turmoil in their careers were expecting an unending fire-sale of noncore assets over the next few years. A big question was whether regulators will keep bank finances shored up long enough for markets to stabilize, *if*:

- Losses continued to spiral,
- Capital dried up, and
- Disposable assets could find no purchasers.

In such events, banks had little choice but to cut back even harder on lending, and to take whatever price they could get by selling even core assets. The sales drive evidently included a considerable amount of leveraged loans that had to be offered at a big discount. Combined with a rise in the default of highly leveraged firms, this put downward pressure on the earnings and capital ratios of banks exposed to the leveraged loan market.

Economists said that in most Western countries banks not only overplayed their hand, with the result that they fell under a huge amount of exposure, but they also failed two tests. One was the test of being socially useful, in which the whole financial system got poor grades. The other was the test of the marketplace exemplified by the fact that many banks proved unable to command the confidence of their investors and counterparties.

Too much energy was put into the complexity of product offerings and into speculation. Hence, rather than being a source of stability, banks intensified the negative aspects of the economic cycle. Compared with these results, the banks of developing markets performed better, proving that big size was a negative (see also the Portuguese example in section 3). This banking system of developing markets continued to extend credit throughout the crisis, while Western institutions cut credit.

Weaknesses in funding laid bare the fact that overleveraging had taken its toll while some franchises were too focused on the wrong markets. This wrong-way orientation did not happen overnight. It built up over the months of May–September 2008, while well-known institutions like Lehman Brothers were desperately fighting to restore confidence in their prospects. Their efforts backfired, as they were hit by massive write-downs on mortgage-backed securities—the subprimes.

Some experts said that the credit crisis was reversing the role of *financial buyers* and *strategic buyers*. Typically the former might wait in line behind the latter, as financial buyers tend not to consolidate an industry or remove productive capacity. In fact, their role is the exact opposite. They hope to make companies more efficient and profitable, which either expands capacity or, at least, keeps it alive. Hence as credit tightens and the economy slows, the influence of financial buyers wanes.

By contrast, strategic buyers effectively focus on reducing capacity. They improve profitability by taking advantage of economies of scale. Because the focus of their efforts is different, strategic buyers rarely use the leverage that financial buyers employ when making acquisitions. They also avoid unhealthy consolidations that may not be meaningful over the next several years.

Contrary to this classification, the banks that came forward and bought those credit institutions falling down the precipice have been, by majority, strategic buyers using leverage. They primarily did so to strengthen their market position when normal times returned, which is a strategic move, but given that they were themselves under stress, their acquisitions had a good deal of leverage including the risk associated with it.

The irony of this situation is that such strategically motivated banks capitalized on government policies that encouraged the financial industry to proceed with consolidation. By contrast, when things returned to nearly normal, the government extracted big money from these banks because of the misdemeanor of the institutions they had been asked (even begged) by the sovereign to acquire at low rates but in a hurry without exercising due diligence. This reaction depended not on logic but on a complex chemistry of causes with sovereign income being the focal point.

## 5. OTC Derivatives and CCPs

A major part of the prevailing opaque ties between market players has been promoted and sustained throughout the global over-the-counter (OTC) derivatives markets. Therefore, it is not surprising that OTC derivatives have come under the regulator's scrutiny as a potential threat to financial stability. Reform now aims to:

- Increase transparency, and
- Mitigate systemic risk

by shifting default risk incurred in derivatives transactions to central counterparties (CCPs). This is a sound initiative. The headwind is that

regulatory differences in the national implementation of reform measures within each jurisdiction can trigger arbitrage strategies by different participants. Hence the need for homogeneity in systems and procedures.

In July 2013 a milestone was crossed when the United States and the European Union were at least able to reach a provisional agreement on a procedure to mutually recognize their derivatives market rules. However there is still no agreement between the United States and the European Union on how central counterparties should calculate initial margin requirements. Differences also exist with regard to who reports to the trade repositories and what should be reported. The absence of a mechanism—at least for the time being—to aggregate data gathered in individual jurisdictions for reasons of analysis is also a handicap.

The essence of what has been achieved by way of the CCP agreement is that a central entity assumes the counterparty risk arising from trades among market players. The systemic importance of a central clearing house (and procedure) is the guaranty obligation associated with over-the-counter derivatives markets. A simple example with a repurchase agreement (repo) transaction conducted through CCP is presented in Figure 3.1.

- The cash borrower enters into a repurchase agreement with the CCP, borrowing the required amount and providing collateral to the CCP as required.
- The cash lender enters into a reverse repurchase agreement with the CCP.
- The CCP administers both the transaction and the collateral, acting as a direct counterparty to borrower and lender.

In this manner, the CCP assumes the risk of the borrower defaulting. But with collateral management standardized in terms of profiling and margining, the transparency of the transaction is improved while

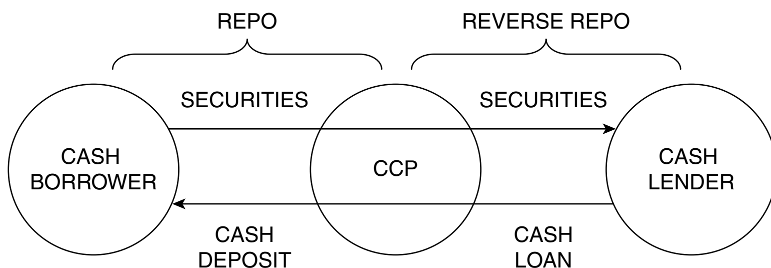



**Figure 3.1** Repurchase agreement through a central counterparty.

administrative burden and cost for both counterparties are (theoretically) reduced in comparison to a bilateral repurchase agreement.

The big goal, which will take some time to reach, is the taming of a $700 trillion global derivatives market. Already on October 2, 2013, swaps market participants began to trade standardized derivatives on new electronic platforms called Swap Execution Facilities (SEFs). Forcing over-the-counter derivatives trades contracts that are transacted away from prudential supervision on to a visible trading platform is the beginning of reforming a shadowy market that many blame for being behind the crisis in 2008.

Many (albeit not all) financial industry professionals approve the CCP solution and other measures. Derivatives trading has improved dramatically, becoming safer and more efficient through postcrisis reforms that have shifted power from bank dealers to investors, says Ken Griffin, founder and CEO of Citadel, a Chicago-based fund, one of the world's biggest.[15]

In Griffin's opinion, as trading volumes shifted to electronic platforms, the difference in prices quoted for buying and selling derivatives narrowed because of material reduction in counterparty credit risk and dramatic reduction in operational risk. According to some market players, the spread between bid and offer prices in relatively common instruments, like interest rate swaps, has narrowed, by as much as 60 percent.

Institutional investors also say that the economic organization has improved by dealing through one clearing house. This, however, is not a general opinion as, according to others, not all changes have been positive. Some see the ongoing restructuring as being more expensive, with more upfront fees to clearing houses that used to be absorbed by the trading bank.

Critics also point out that from a financial stability perspective, there is a danger that the default of one or more clearing participants could place a CCP in distress. This argument tends to forget that the clearing counterparty can adopt a range of measures to close out its open positions if a clearing participant defaults. It can also:

- Conclude offsetting transactions on the exchange,
- Conduct auctions with the clearing participants, or
- Transfer the open positions to those clearing participants who remain.

To confront clearing risks, consideration is currently being given to the design of a future-dedicated recovery and resolution regime for such financial market infrastructures—making it more resilient in safeguarding

financial stability. Given the cross-border nature of many of the financial markets serviced by CCPs, this is a fairly complex understanding.

In August 2013 the Committee on Payment and Settlement System (CPSS) and the International Organization of Securities Commissions (IOSCO) published a joint consultative report elaborating on tools and measures that could be useful in the recovery of CCPs and other financial market infrastructures. In parallel to this, other proposals for the resolution of financial market infrastructures (including CCPs) have been drawn up by the Financial Stability Board (in conjunction with the CPSS and IOSCO).

Indeed, an important element of a CCP system solution is the existence of a competent resolution authority able to curtail the CCP's liabilities or convert them into bail-in capital. In the resolution phase the Financial Stability Board's proposals foresee the possibility of partially retaining the variation margins and—if permitted by law—using the collateral provided by all clearing participants for safeguarding liquidity or loss sharing. It also endows the resolution authority with the ability to enforce restructuring measures of the CCP.

As the new rules are being elaborated in more detail, regulators are paying attention to the interaction between national and regional provisions. There is a danger that various jurisdictions will require market participants to meet different sets of standards. It needs no explaining that contradictory rules would pose a serious challenge to the operation of the global clearing system.

Not only are uniform rules a "must" but it is also necessary to maintain transparency of the statistics and consistency with international reporting standards. Particularly important is the internal consistency of monetary statistics and their breakdowns in a way that is meaningful to all users. Solutions must also be consistent with the economic concept of money and credit. Monetary analysis should ensure that the framework can be used effectively for policy applications by examining the aftermath of financial innovations that impact, or might impact, the empirical delineation of the economic concept of money.

It is unavoidable that some technical problems are going to show up with the CCPs as more and more financial transactions are channeled into that system. They even happen with already established networks. On August 20, 2013, a large number of erroneous trades flooded the US options markets after problems stemming from NYSE Euronext spilled on to rival exchanges disrupting trading activities.

The New York Stock Exchange said it was reviewing transactions in symbols beginning with "H" through "L" that occurred in the opening 17 minutes of trading on its AMEX venue. CBOE and NASDAQ, which

run other leading options exchanges, temporarily stopped accepting quotes from AMEX, after problems emerged highlighting the systemic challenges for the fragmented US stock market, where securities swap transit across a dozen venues.

A fairly persistent problem is that the different US exchanges are not necessarily compliant with securities laws. That will surely show up in a global setting with the CCPs as they try to become transparent with transactions backed by collateral or insurance. For this purpose, regulatory authorities want to create a composite record of derivatives deals conducted both on and off-exchange to better spot potential threats to banks and clearing houses.

Records will be stored in trade repositories. The European Securities Markets Authority (ESMA) wanted to delay reporting of exchange-traded derivatives to January 2015, to give itself and the industry more time to prepare for the changes. The European Commission answered that it did not consider ESMA's concerns as justifying the proposed delay in the implementation of the reporting of exchange-traded derivatives to trade repositories.[16]

Another divergence of opinion, this time between regulators and bankers, concerns the collateral to be used in connection with CCPs. In the bankers' opinion, the regulators did not really think about where the collateral is going to be coming from. A big chunk of it will be coming from the banking system, particularly from shadow banking, and estimates have varied wildly over how much collateral is needed. The Basel Committee has suggested the financial system may need to find an extra $4 trillion, which amounts to more than a third of the high-quality collateral in active circulation.

Bankers warn that from January 2015 Basel III regulatory capital rules will get in the way of using the repo market for collateral management, though sales and repurchase agreements could be employed to transform low-quality collateral into assets acceptable to a clearing house. Still another uncertainty regarding regulations emerged in November 2013 when the Commodity Futures Trading Commission, the main US derivatives regulator, announced it would require cash to backstop US Treasuries posted as collateral in clearing houses.

All this is part of the teething troubles that characterize any new complex instrument or process. The message to retain is that CCPs are here to stay, with current problems taking their time to be resolved. This will not happen overnight, but if regulators resolve the differences characterizing their approaches and keep on the implementation pressure, the different parts will start working together as a system.

### 6. The Increase in Legal Risk

Changes in supervisory rules and regulatory environments have more important implications than those apparent at first sight, including changes in accounting and reporting conventions as well as the need for increased cooperation between supervisors in the different sectors of the economy as well as cross-border. An integral part of these changes are important developments in capital adequacy regulations, leveraging limits, and liquidity requirements (chapters 1 and 2).

Seen in unison with regard to their merits, and in comparison to the previous regime, these changes provide evidence on benefits and costs. So do efforts seeking to achieve risk sensitivity through less reliance on the banks' internal estimates of risk, increasing the dependence on an industry-wide standardized approach. As the reader should be aware, however, even after a new regime has been established, many challenges remain to be confronted in the years ahead. Some of the most important are the effects on:

- Litigation,
- Competition,
- Cost/effectiveness, and
- Cross-border opportunities as well as headwinds.

In a globalized economy, alongside the further development of the regulatory framework—particularly those pertaining to implementation details—one of the key tasks of regulatory attention is the promotion of internationally consistent application of standards and rules so that the risk of litigation due to juridical differences in different independent states is minimized. This is particularly true with regard to the unbiased and unaltered application of important standards for the maintenance of a sound financial system.

Sovereigns, their legislators, their judges, and their regulators should assess each other's willingness and ability to apply internationally agreed standards, as well as policies, through a program of peer reviews:

- Examining whether the new rules are being applied consistently,
- Identifying typical difficulties and weaknesses in the implementation of each one of them,
- Assessing how well each individual country follows agreed-upon guidelines in connection with the new regulatory environment, and

- Engaging in calls for action to ensure the wider possible adoption of international standards,[17] after these have been established in the most critical jurisdictions.

Particular attention should be paid to possible violations of the new standard and associated rules and regulations. Among the violations are persistent negative feedback loops among banks and sovereign borrowers that had become a major cause of financial stress in some countries since 2008 (see also section 5 in chapter 4). Also, cases where, while progress continues to be made, it is slow and at an uneven pace, making a mockery of the new rules and putting under stress those banks and sovereigns who apply them.

Legal challenges may as well result from a half-baked banking supervision, due to obstacles put in the way of regulatory authorities in terms of hiding or altering statistics identifying a defective macro-prudential dimension. This is also true of bias (or outright false elements) introduced into analyses and the altering of perspectives that can be used to study the *cross-sectional* (across banks) dimensions of systemic risk.

All these issues matter greatly because no failure of a regulatory system has a single cause. Banks that ended up having a predominance of toxic waste in their vaults because of greed or imprudence, have created a negative financial force that proved to be more terrible than they had imagined. They also made the fortune of law firms, which has been one of their most wasteful achievements.

On an average, litigation departments of international law firms are thought to account for around 45 percent of law firms' revenues in America and 25 percent in Britain. Much of this comes from foreign expansion of financial conglomerates that international law firms faithfully follow in new jurisdictions as the financial industry expands.

The "too big to jail" wrong-way principle still prevails. Aside from differences in the letter of the law, which contribute to the volume of litigation, there are untrustworthy bankers who must be weeded out of the system, but are protected by swarms of lawyers. Only a few countries are keen on prosecuting wrongdoers; Ireland is an example. Others tend to let those who misbehave enjoy their loot. Sorry to say, the US is one of them.

In mid-December 2013, three senior Irish bankers were arrested and charged with offences related to an alleged fraud of €7.2 billion ($11.5 billion)[18] involving the Anglo Irish Bank, the defunct lender at the center of Ireland's banking crash. Such charges follow a four-year investigation into the collapse of Anglo Irish in 2009, which cost Irish taxpayers €30 billion ($40.5 billion) and played a role in forcing Dublin to apply for an international bailout.

Commenting on the prevailing absence of prosecution of wrongdoers in the US, an American judge said that it is deceipt if the people responsible for financial scams and for running down the economy are not being brought to justice. For this he gave three reasons:

- Too big to fail,
- Too big to jail, and
- Lack of prosecutors able to understand the complexities of modern finance on the government's side.[19]

A properly studied financial manipulation can shine a light on key aspects of the economic and banking crisis, including the role played by not only the wrongdoers but also the financial regulators and government officials in attempting to stave off a banking crash. No banker has yet faced trial in the US on charges related to the 2007 and 2008 crises. The market, however, is full of references to alleged fraud with complex and opaque novel financial instruments.

There are some exceptions to the statement that wrongdoers escape prosecution. This is the case of the aforementioned prosecution of misbehaving bankers in Ireland (and in Iceland). Another case to bring to the reader's attention has been the jail sentences for senior Yamaichi executives though it dates back to 2000 (see also chapter 12).

In late March 2000, two senior executives of the failed Japanese brokerage Yamaichi Securities were sentenced to prison for hiding losses of more than ¥200 billion (then $1.9 billion), which was big money at that time. They were also prosecuted for paying illegal dividends. Atsuo Miki, former president of Yamaichi, and Tsugio Yukihira, former chairman of Yamaichi, were sentenced by the Tokyo District Court to 30 months in prison. Miki was also convicted for paying off a *sokaiya* corporate racketeer.

This sentencing closed a chapter in Japan's biggest financial company failure, in November 1997, which took many people by surprise. Yamaichi's collapse damaged the image of the country's banks and brokers, sending shockwaves across corporate Japan. Two years later, in 1999, the Yamaichi case was followed by other large failures by the Long-Term Credit Bank and Nippon Credit Bank (chapter 12).

In passing sentence, Judge Kaoru Kanayama dismissed arguments that the two top executives had hidden the losses to keep the company alive, a frequent excuse used not only in Japan but also worldwide. Their claims of being unaware that their actions were illegal were "excuses beyond the realm of understanding," the judge said, adding that "both defendants had taken part in the off-balance sheet measures over the losses from

the beginning and were clearly aware due to having received reports of account rigging."[20]

It would be good to hear European and American judges making such sharp statements in similar cases. Unfortunately there is no evidence of it, because too many deals are arranged in plain secrecy due to the "too big to fail" principle as well as political plots where top bananas manage to save friends from prosecution. With such ingenuity, the economy, finance, and society at large have been pushed on a new policy of perpetual "presidential pardon"—a very unhealthy basis.

A perpetual presidential pardon and unstoppable bank acquisitions correlate. The pros say that a cross-border consolidation of the banking industry (section 4) might carry certain risks but these are difficult to quantify because of incompatibilities in national company laws, wanting supervisory cooperation and absence of widely accepted convergence of supervisory practices. That may be true, but it does not change the need for bringing wrongdoers to a court of justice—save the silly principle of "too big to fail"-"too big to jail."

Another reason why politicians and supervisory authorities turn a blind eye to legal risk is nationalistic cultures and drives (see, in chapter 4, the problem confronted by Euroland's banking union). Nationalism and protectionism add both depth and complexity to legal problems. The need to comply with different sets of rules and to interact with several authorities gives rise to substantial compliance costs and it also complicates prosecution. We forget that when we talk of global markets. There is insufficient legal harmonization of what is permitted and what is a fraud.

# 4

# Euroland's Banking Union and Its Stress Tests

## 1. The Rush for a Banking Union

The rush for the creation of Euroland's *banking union* started in mid-2012 when the markets signaled their fear that Spain was a bailout risk. Then the rush slowed;while many of its original main elements have been watered down or delayed, the concept of the banking union has survived promoted by the profligate member states.

Critiques said that this so-called banking union is essentially a *transfer union* from the better-off countries to those with a deeply wounded banking industry—a statement that is 90 percent true. To halt the criticism, the authority to oversee Euroland's financial institutions was assigned to the European Central Bank (ECB). That deal included many compromises. The European Commission wanted all of Euroland's banks to fall under a single supervisor's authority. That would have been an impossible task given the:

- Magnitude of the job,
- Absence of experience and skill in transborder supervision, and
- Protectionism, indeed nationalism, characterizing the different sovereigns, their central banks, and their banking industry.

Yet, the demand posed by Brussels was not totally out of place as proven by some of the collapsed banks that wreaked havoc: Ireland's Anglo Irish, Spain's Bankia, and Britain's Northern Rock. These were not mammoth institutions. They were small to medium-size institutions yet they created a financial earthquake because of the uncertainty they brought to the market.

Germany and other EU member countries resisted giving such wide-ranging powers to a central supervisory authority, in part because of pressure from the majority of institutions that dominate their financial system, and partly because they did not want that the ECB becomes a czar. In the end it has been agreed that the ECB will directly supervise only the 130 largest banks out of over 6,200—particularly those posing a systemic risk.

That was a compromise and, like all compromises, it did not please everybody. The European Commission and the European Central Bank proposed the banking union as a way of safeguarding financial stability in the old continent, breaking linkages between national governments and their domestic banking sectors, and enabling monetary policy to pursue its task of price stability—even strengthening efforts to overcome the financial crisis. That in itself has been a vast program whose fulfillment supposedly lies in the creation of:

- A single European system of banking supervision,
- A single system of deposit protection, and
- A single recovery and resolution framework.

The argument made by critics of the small (but loaded toward the big institutions) sample of 130 banks out of 6,200 is that the largest Euroland banks are much less of a problem than the many undercapitalized local and regional banks run by people with little or no understanding of the risks they are taking. There has been a deeper reason why public banks, savings banks and mutual banks have been lobbying hard not to fall under the ECB's centralized system.

- Their business models rely on a friendly neighborhood regulator looking the other way, and
- With stringent controls exercised by a remote center that cozy relationship between lenders and borrowers would disappear.

Critics pointed out that with the sample of 130 largest banks the very concept of a banking union has irrevocably failed. The EU may congratulate itself, but that small sample will be largely irrelevant to the workings of Euroland's financial setting, which will remain a predominantly monetary union, nationally supervised and crisis prone.

Indeed, there are several sticking points with the chosen solution. One of the major points is how much flexibility national resolution authorities should have over bailing in bank investors (chapter 1), creditors and, in extreme cases (like that of Cyprus), deposit holders,

before taxpayer money is spent on the bailout of a self-wounded credit institution.

Led by the French, one group of Euroland's member states wanted national authorities to have freedom to decide when, and on whom, losses are forced. Another group, led by Germany and backed by the European Commission, wanted to see standard rules implemented for all. It would not accept *feudal* solutions in Euroland's banking with hierarchical subsystems.

In a loose sense, the word *feudalism* does not necessarily describe a system based on land. Regional feudalism can be just as disturbing and the European Commission, which had put its weight behind the creation of a single supervisory authority responsible for restructuring and bailing out failing banks, saw feudalism as undermining all of its authority over the EU.

In the commission's opinion, Brussels should be the boss and arbiter but the thesis of Wolfgang Schäuble, the German finance minister, has been that EU treaties do not allow the transfer of powers to shut down and restructure banks to Brussels. Instead Schäuble suggested a network of national resolution authorities until EU treaties are changed. Nothing should be done outside the powers defined by the Lisbon treaty. This thesis between feudalism and an end-to-end authority prevailed, with the result that the European banking union would consist of four pillars:

- A single EU deposit guarantee scheme covering all EU banks,
- A uniform, single rulebook for the prudential supervision of all banks,
- A single EU supervisor with ultimate decision-making powers, in relation to the 130 systemic and cross-border banks, and
- A common resolution authority and a common resolution fund for at least systemic and cross-border banks.

Endowed with €500 billion ($675 billion), the European Stability Mechanism (ESM), which predated the banking union discussions, has the cash (albeit limited) and power to pump financial support directly into shaky Euroland banks. Up to a point, but only up to a point, this helps in relieving the burden on national treasuries. Euroland's finance ministers agreed on a so-called *operation framework* for ESM direct recaps. Critics however argue that this only partially delivers an answer to the vow to break the vicious cycle that led bank bailouts to destroy the balance sheets of otherwise healthy governments, such as Ireland's.

As it has happened with the €41 billion ($55.3 billion) of Euroland's cash for recapitalizing badly wounded Spanish credit institutions, the

chosen road is that the loan is made to the sovereign (in this case the Spanish government) who then proceeds with pruning out the balance sheets of banks in his jurisdiction. A direct recap requires the bank's home country to invest alongside the ESM, which is only normal. There are limits to everything.

There is, however, a catch. Too much paying of a profligate country's public debt and too much refilling of its wounded banks' treasuries with money belonging to other member countries' taxpayers, leads to the *Cobra Effect*. Concerned about the number of cobras, the British colonial government in India offered lots of cash for every dead cobra. Initially this was successful, but people eventually got smart and began breeding cobras on a large scale. The colonial authorities learned of the breeding and scrapped the reward program. Breeders promptly freed the worthless reptiles and the adventure ended by increasing the world cobra population.

The next step will most likely be from clearing up overleveraged underwater balance sheets to legal separation (ring-fencing) of bank retail operations, and from there to a new version of the Glass-Steagall Act, dividing retail banking from other more risky operations like investment banking. The discussion on ring-fencing (which is set to continue) will unavoidably entail a bondholder's preference for the more stable retail operations.

The emphasis on the effect of a banking union and of legal separation on the way bondholders open their purse is justified by the switch taking place in financial markets. Traditionally, European companies have relied much more heavily than their American rivals on borrowing from banks, not from markets. But when the toxic combination of higher funding costs and poor lending practices hit, the priorities shifted.

- Banks have deleveraged, and
- Investment grade corporate bond issuance surged though Europe's reborn capital market, even if the latter is still one-third that of America's.

The problem is that EU or no EU, banking union or no banking union, national interests take priority over the wider common good. Nationalism and protectionism play dirty games. In the US the Federal Deposit Insurance Corporation has been closing down an average of 90 banks per year. In Europe the Spanish government continues to insist that there should not be a single bank closure, which makes the banking union a matter of symbolism but unable to take decisive action and prune the banking system.

## 2. The Difference between Theory and Practice

Theoretically, but only theoretically, a banking union involving the credit institutions of Euroland's 18 different economies can boost confidence in the banking sector and, at the same time, loosen the link between the creditworthiness of sovereigns and banks. If you believe this overoptimistic pronouncement, you will believe anything.

Practically, to be successful a banking union requires a well-studied short-, medium- and long-term plan. For example, one of its requirements is a medium-term strategy for the ongoing development of the European financial architecture, as contrasted to "quick fix" policies usually followed in banking crises. As for unified supervision it must account for the highly integrated European banking industry. Only then does it stand a chance to develop into a tool for creating a sense of confidence in Euroland's credit institutions.

The practical problem is that the necessary preconditions to achieving such objectives, do not necessarily exist. "Agreements" in the EU at large, and specifically in Euroland, are reached through interminable economic summits, all the way from examining a new initiative to disagreeing on how to confront the unending financial crises. After each of such "summits" there is a brief respite, followed by a hangover as well as a kind of a consensus that the measures being taken:

- Were not big enough,
- They came too late, or
- They failed to rally all interested parties.

Postmortem, practically every chief of state has tried to put the blame for "no results" on his peers, also stating that failure to eventually reach concrete results would result in a total meltdown. This has all the characteristics of a dangerous poker game. The aftermath of such a failure has by now become a self-fulfilling prophecy.

Bank recapitalization is an example. If it were to start tomorrow it would do so without clear rules and conditions, which means that the ESM funds will be over in no time. How long will it take to have 18 countries *and* Brussels *and* the ECB agree on the details of needed rules? Every country is in a different situation and most countries have both well-managed banks as well as some banks in big trouble that they want to "save" at any cost, particularly if the money belongs to someone else.

To just recapitalize those banks that have taken too much risk would be a big distortion of free economic activity and provide a terrible

example to others who have refrained from gaming the system (which also means that their managers and traders collected lesser bonuses). The most hilarious part of all this is that nobody has a clear idea on how deep is the black hole into which the capital of Euroland's banking industry has disappeared.

The best-available guesstimate is that Euroland's banks' debts are nearly 300 percent higher than Euroland's governments' debts. That gives a measure of the bottomless pit taxpayers, savers, retirees in the so far better-off European countries would be made liable for backing defunct institutions that are not worth being "saved." This comes over and above the rivers of red ink springing from the treasuries of Euroland's southern countries.

Another practical problem is elaborating the requirement for special measures designed to avoid conflicts of interest between ECB's monetary policy duties and banking supervision. The essential part is that of preventing any encroachment on central bank independence, particularly in its duty of safeguarding price stability. For this purpose the idea of creating a separate supervisory body, with the ECB ultimately responsible for price stability, has been advanced. However, it is doubtful whether such a new body, expected to work alongside the ECB Governing Council, is consistent with European primary law.

On the other hand, running after two rabbits at the same time is characteristic of a dysfunctional system, adding its weight to the current paradox of the euro having moved the economies of member states further apart, not closer together. An increase in economic dysfunctionality carries a number of unintended consequences. This is the destiny of any system:

- Strictly based on a political decision,
- But lacking what is necessary to obtain general acceptance, hence sustainability.

As a political over-endowed approach without firm bases, it also comes at a time when the outlook for the European and world economy is still dark. A long recession has been undermining normal policies, creating conditions for markets to take fright rather than to prove their resolve over and over again. As for the politicians, they are not known to stick to their word when things turn sour.

Absolute certainty is never possible to attain. Everything is a matter of degree. The market, however, has no patience for half-baked practices. It will reject any measure that is just a Band-Aid, because it consists of people who put their money on the table. To leave it there they want

confidence, which will only come when policies, measures, and accounts are sustainable, not when words come and go with the wind.

*If* past experience is worth anything, *then* the argument that the coming stress tests will tell a great deal about the big banks' financial staying power is for the birds. As we will see in sections 4 and 5 the tests that took place in 2010 and 2011 were not stress tests; they were normal tests rebaptized and they led to an unprecedented fiasco by the European Banking Authority (EBA). The virtue of tests and of experiments can be found in what one can learn from them. When they become ridiculous they are counterproductive.

While there are many things wanting in a banking union, one of the greatest practical dangers associated with it lies in the fact that a comprehensive approach that could be the better alternative harbors the risk of communitizing the consequences of economic and fiscal policy failings in one of the 18 sovereigns. For instance, the frequently practiced budgetary deficits state financing by profligate governments.

Regulatory measures are needed to reduce risk concentration vis-à-vis individual countries, through an adequate sovereign risk weighting. This is, however, sure to raise plenty of negative reactions by the profligates who would interpret it as "austerity forever." There is as well the need to watch over breaches of the rules, a duty requiring powers to monitor and intervene in the economic and fiscal policies of a member state. No wonder that some sovereigns have fundamental concerns over the:

- High degree of centralization,
- Wider scope of bank recapitalization,
- Quick pace and sequence of implementation, and
- Risk of creating expectations that cannot be fulfilled.

Still another issue, whichdid not attract the attention it deserves, at least so far, is the not-so-evident but important link existing between the banking union, sovereign intermediation and Target 2[1] balances. Yet there are dangers associated with large non-covered balance sheet positions of Euroland's national central banks known as *target balances*.

Rising imbalances in Target 2 have been criticized as reflecting unwarranted external financing for stressed Euroland member states as well as hidden risks for other member countries. Such imbalances typically emerge when commercial banks in profligate countries find it increasingly difficult to finance themselves in the market.

- To cover net capital outflows commercial banks turn to their national central banks for liquidity, on a substantial scale.

- The result is that Target 2 imbalances reflect accumulated liabilities as a country sees capital outflows, or claims in case of capital inflows.

The size of these positions and their somewhat misleading classification as "other items" on national central bank balance sheets have given rise to questions about their potential risk. A fair amount of clarification is needed on how to deal with legacy problems in the balance sheets of banks that obtain access to ESM funds but at the same time maintain important Target 2 liabilities.

A decision to communitize legacy burdens would lead to a transfer union, which some member states may try to conceal through the banking union. In contrast, as it has been nearly decided that such covert transfers are incompatible with sound governance, grandfather cases would have to be borne by the member states in which the bank in question finds its origin.

Last but not least another practical challenging problem is that of reconciling the nascent banking union of Euroland with the EU's 11 non-euro members. Britain, which has Europe's biggest financial industry, says it wants Euroland's banking to integrate, but fears other EU member states will object to this. Alternatively, the voting methods in the European Banking Authority and the EU agencies will have to be adjusted so that the 18 members of Euroland do not have an automatic majority against the other 10 whose main fear is exclusion.

The banking union can be used as a protectionist tool, said Alastair Darling, chancellor of the exchequer in the Labor government of Gordon Brown. "There has been no agreement on bank supervision in the EU, because this has to be done on equal terms not in an uneven way," stated Anders Borg, the Swedish finance minister.[2]

## 3. ECB's Single Supervisory Mechanism

Provided everything goes well with the banking union and no major disagreement or strong headwinds flare up, which is far from being a certainty, the European Central Bank is scheduled to assume responsibility for directly supervising 130 most significant banks in Euroland in November 2014. This will be done through a *single supervisory mechanism* (SSM).

The stated goal of the single supervisory mechanism is to reduce the threat of problems facing banks spilling over into public finances. This, however, is a misleading objective because the recapitalization of banks

will be done by the sovereign after loans are directly obtained from ESM under ECB authorization. To fulfill its objectives, the SSM will need to tackle, early on, inappropriate concentration of risk at major individual banks or in national banking sectors—which raises sovereignty and protectionist problems.

Short of a timely and forceful action it will not be possible to prevent the worst from continuing to worsen, placing substantial pressure on public finances. Theoretically, ECB's single supervisory authority will provide a timely and unbiased assessment of banking problems (including scams), identifying the need for resolution, while the single resolution authority will ensure a timely and efficient corrective action.

That's the scenario Herman Van Rompuy, the EU president, wrote in a December 2012 paper titled "Towards a Genuine Economic and Monetary Union." But this, too, is a theoretical projection. Practical details are still missing including Van Rompuy's exact authority on SSM issues. (In reality he is one of the three EU presidents. The other two are José Manuel Barroso, president of the EU Commission and one of the chief of member states whose *tour* of duty lasts six months.)

A negative aspect of the chosen SSM solution is that it strengthens the unholy alliance between sovereigns and big banks instead of breaking it. The risk of unsustainable public deficits impairing financial stability because banks use their recapitalization to buy nearly worthless government bonds has not been averted. Instead, this risk is amplified by the preferential regulatory treatment afforded to banks' sovereign exposures.

Nowhere in the SSM rules, and more generally in the agreed-upon banking union directives, is it clearly stated that claims on governments need to be subject to limits on concentration risk. Moreover, as section 2 already brought to the reader's attention, to close the loopholes and compromises associated with the banking union the Treaty of Lisbon has to be renegotiated to authorize all stops and whistles needed to control the exposure of Euroland's banks, particularly in connection with cross-border supervision. This is important because bank supervision structured along national lines,

- Lacks the required robustness,
- Does not lead to coherent supervisory practices, and
- Fails to support the high degree of financial integration that is necessary.

Provided that it is successful in its mission, and no Euroland sovereign raises walls of protectionism for its banks by covering supervision and enabling resolution, SSM is an important step toward a banking union

providing a certain dimension to the main pillars of the structure needed for safeguarding the stability of the banking industry.

Success will depend a great deal on how close the ECB and the national regulatory authorities of Euroland can work, not only among themselves but also with the regulatory authorities of non-euro EU member states. While the SSM will concentrate on the 130 big, systemically important banks of Euroland, at least theoretically its concept might be extended to all of Europe's credit institutions. The likely differentiation basically concerns two populations:

- Banks falling under direct ECB supervision, and
- Other institutions that will primarily be subject to supervision by national regulatory authorities.

Under the current state of affairs, direct supervisory responsibility of the ECB is projected to be exercised in connection with credit institutions whose total value of assets exceeds €30 billion ($40.5 billion), *or* where the ratio of the bank's total assets over the GDP of the participating member state exceeds 20 percent (unless the total value of its assets is below €5 billion [$6.75 billion]), *or* banks already receiving government support, *or* where the ECB takes a decision confirming such significance.

To protect the SSM from adverse forces regulators will have to actively pursue banks that try to game capital rules for their trading activities. In October 2013 the Basel Committee on Banking Supervision published a consultation paper that could have important repercussions on the way banks run their trading operations. This came after regulators uncovered wide divergences between banks: Some are using complex internal models to minimize the amount of capital they have to set aside.

Basel aims to provide a level playing field that is easier to control. Therefore the new system will require banks to calculate risks according to a standardized approach, in addition to their own in-house modeling. At the core of the regulators' concerns is also the ability of banks to put illiquid assets in their trading book. A uniform weighting and evaluating system could have knock-on effects on the liquidity of some markets *if* the trading inventory of market makers ends up being reduced because creative accounting gimmicks would no more pass.

As these references document the single supervisory mechanism might hold surprises, but it also has the potential of developing into a major element of European banking. It is, however, too early to form an opinion on whether the SSM could or would provide a convincing answer to the question on how to wind up a failing bank swiftly without falling back on taxpayers to bail out the bankers. The seeds of the system's failure might

have been already planted by involving the central banks of sovereign Euroland member states.

It is not possible to create a single European bank resolution mechanism and still maintain national vetoes over decisions. There would always be a temptation for a member state to bail out a national institution without involving the ECB and the ESM. Infighting on jurisdictional authority will render the whole system unworkable. Reaching an agreement on a sizeable financial backstop is no small matter.

Critics also say that other factors, too, would play a role as making a more effective Euroland is not limited to the banking union. Over the past decades some promising projects have become victims of political fudges and compromises. Both nationalizations and resistance to change are responsible for negative outcomes.

Past history is highly relevant because the ECB is already enmeshed in squabbles with national banking supervisors over the extent of its powers and the rigor with which it will undertake its first big task. This is the evaluation of the balance sheets of the banks it will take charge. Known as *asset-quality review* (AQR) it will aim to ensure that the European Central Bank is not embarrassed by postmortem revelations of gaping holes in commercial banks' balance sheets.

The case of the European Banking Authority that lost much of its credibility after the collapse of banks that had passed its "stress tests" only months prior to going against the wall (section 4) is still a joke. The ECB emphasized that the AQR is not a stress test, but still national regulators are worried about what the investigators may find. This has led some regulators to try to limit the scope of the ECB's inquiries and balance sheet analyses.

Then there is the case of different scandals popping up, which is, to say the least, not helpful. On January 29, 2013, in the aftermath of the scams that shook Monte dei Paschi di Siena, the third largest bank in Italy and the oldest bank in Europe, the *Frankfurter Allgemeine Zeitung* published an article with the headline "Monte dei Paschi Affair Reaches ECB President Draghi." A day later, *Die Welt*'s feature article was "Bank Scandal Puts Draghi Under Pressure."

In the eye of the storm has been Mario Draghi, president of the European Central Bank, top boss of the SSM pan-Euroland bank inspection authority and former governor of the Bank of Italy. He had held the Italian central bank's governorship—with full responsibility for regulation and inspection of Italian credit institutions—from December 2005 till late 2011 when he took over the top job at the ECB. The deceits at Monte dei Paschi were, so to speak, perpetual but *Santorini* (the most damaging of them) happened in 2010 under Draghi's watch.

It took two years before Italian prosecutors were notified. The Italian financial police was informed in 2012 by Draghi's successor at the Bank of Italy. As is to be expected, this had wide repercussions. Critics also talk of the possibility of, because of loss of trust, the single supervisory mechanism becoming a train wreck even before it starts to have an impact.

According to some opinions, if the Bank of Italy under Draghi turned a blind eye to the Monte dei Paschi scandal it is difficult to imagine a different result if the big Italian bank was supervised by the ECB. It is only normal that mismanaged banks fail. It is abnormal that governments refill the bank's depleted treasury with an abundant amount of taxpayer money. That's the dolce far niente habit and it will be interesting to observe if, with the SSM, there will be a significant change.

### 4. The Cocktail of Stress Testing and Politics

Under certain conditions a big bank's systemic importance can cause negative externalities. One of them derives from hypotheses made on the base of past practices and their outcomes. For instance, *if* the market assumes that a bank "too big to fail" enjoys an implicit government guarantee, *then* the market assumes that its bankruptcy is not an option.

A sound approach in dealing with such institutions is to test them through a two- portfolio method: a trading portfolio and a loan portfolio. Expected losses are the result of write-downs on market risk and credit risk under adverse economic conditions. By testing under rare but plausible systemic events, losses in excess of a given statistical threshold can be quantified, and the results are often fascinating.

This is the sense of *stress testing*, a generic term that does not necessarily mean the same thing to different people. In general, it describes various techniques and conditions used to gauge potential vulnerability to exceptional or unexpected but realistic events. The stress tests of a portfolio are made by simulating the ramifications of large market or credit swings, and it can be accomplished by way of:

- Scenario writing,
- Sensitivity analysis,
- Statistical inference under extreme conditions, or
- Drills in case of a meltdown.

In the background of stress testing is the fact that markets are very good at reading the writing on the wall, especially when the message is written in their language. The misalignment between currencies and interest rates is

an example. The stress test capitalizes on the fact that crises cannot be made to run on a timetable, but we may experiment and study the aftermath under test conditions with respect to a given timetable. Testing under stress is the best type of prognostication made possible through experimentation.[3]

Macro stress tests for credit institutions are designed to identify weaknesses, inordinate exposures, and vulnerabilities when faced with unfavorable developments in the economy. A stress test will typically be comprehensively severe, played within a plausible economic scenario and target unexêcted losses. Figure 4.1 makes this distinction:

- Expected losses are the domain of normal tests.
- Depending on their severity, stress tests will look for the so-called known unknowns and unknown unknowns.

*Known unknowns* are events that have happened in the past, albeit at a low or very low frequency. Stock market crashes and economic crises are examples. *Unknown unknowns* are theoretically plausible events that have not yet materialized, as well as those we don't even think about. The subprimes was such a case till it broke into the open in 2007. Our particular interest is in finding the spikes associated with such happenings.

Let me explain this reference in a different way. While simpler models help in *risk identification*, a stress test must be designed to provide more rigorous responses, particularly in regard to complex or unusual

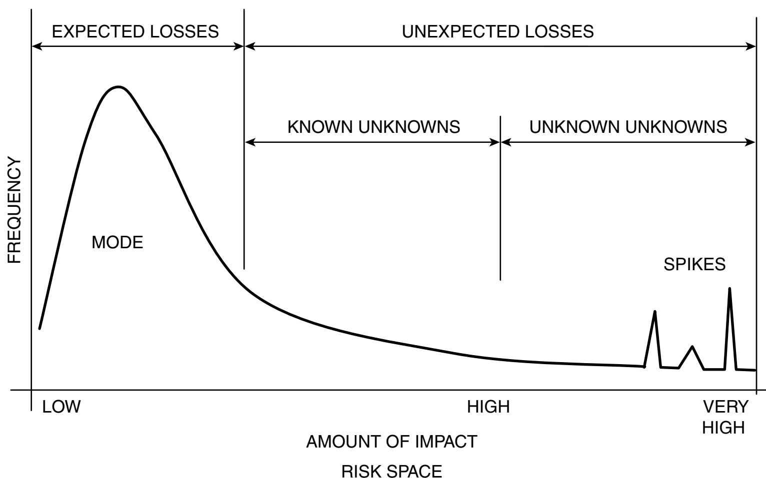



**Figure 4.1** Risk exposure with extreme events and the long leg of an unexpected losses distribution.

transactions and the reliability of financial data. In addition, contrary to the steady risk control that requires continuous monitoring of the banks' portfolios and associated evaluation of assumed exposure, the stress test in a periodic experimentation should cover all risk categories, market changes, and loans conditions.

To be credible, the comprehensive assessment by a stress test should be stringent. Supervisory authorities and sovereign governments must be prepared for surprises as stress assessments may well uncover hidden or outright unexpected weaknesses leading to the need for a highly expensive recapitalization of some banks. Against a damaging but not an outright disaster, the institutions themselves should continue to review all options for:

- Reducing a lot of risk assets, and
- Increasing capital levels, including retained profits.

The better approach is to make stress testing practices part of a bank's risk management process that analyzes all the long and short global positions, and simulates exposures at 5, 10, and 15 standard deviations negative change in those positions. Subsequently, a risk control model can express the output in profits and losses per share for senior management to be thoroughly reviewed, leading to corrective action.[4]

Not all stress testing experiments are successful but failures have more to do with politics—from protectionism to nationalism—and with absence of knowhow. One of the most glaring shortcomings of the stress test by EBA, the results of which were announced in London on July 15, 2011, was that the large majority of the 91 banks that have undergone this test held a lot of sovereign debt—a factor that was not considered by the stress tests (see section 5).

There is a sort of wrong-way policy among central bankers and bank supervisors that facts and figures regarding bank exposure to sovereign debt should be kept under lock and key. The ECB view is that government bonds on bank balance sheets should not be overly penalized in bank stress tests to avoid undue volatility.[5] That's most definitely not a stress test. It's a cover-up.

With bigger economies than the Greek, Irish, and Portuguese still on the sick list, the big banks' exposure to sovereign debt can turn several credit institutions belly up. It is therefore proper not only to include sovereign exposure in stress testing but also to consider the aftereffect of an Italian, Spanish, or French bankruptcy. Even better, a US bankruptcy.

The absurdity of not doing so, and the resulting unreliability of final results, has been demonstrated by the EBA stress test fiascos of 2010 and

2011. In 2010 only 7 banks failed the long-running stress test carried out on 91 European banks. Ironically, the capital shortfall "was found" to be a mere €3.5 billion ($4.7 billion)—peanuts.

In 2011 9 out of 91 European banks failed the EBA stress tests, and the capital shortfall even shrank to €2.5 billion ($3.4 billion). Practically everybody knew that these numbers were invented, a fact that undermines claims made by the EBA and other authorities that the exercise was tough enough to restore investors' faith in Euroland's financial system.

As was to be expected in the lightweight 2011 stress tests Spain was the worst performing country with five of its banks—CAM, Pastor, Caja3, Unnim, and Catalunyacaixa—failing the test. Bankia and Banca Civica, two savings banks, known to be on the sick list, raised €5 billion in separate stock market listings and passed the EBA test. Bankia, the result of a merger of several Spanish savings banks that were basket cases, went bust some time after the tests.

Two of the 2011 test failures were Austria's Volksbanken and Germany's Helaba; the latter withheld its result after a row with the European Banking Authority, the testing body, over the quality of its capital. Two more of the nine banks that failed the tests were Greek: Eurobank EFG and ATEbank (the latter was owned by the government).

Analysts stated that the credibility of these stress tests remained in question, not only because they were lightweight but also because they avoided the inclusion of the potential impact of a Greek default, which (at the time) had the appearance of being increasingly likely. Spain and Italy, too, whose banks survived the stress tests, were bracing themselves for a renewed onslaught in bond markets.

Three Irish financial institutions were tested: Bank of Ireland, Allied Irish Banks, and Irish Life & Permanent. They all passed, thanks to government bailouts, but there was a hiccup. When somebody in the EBA expressed doubts concerning the financial staying power of one of these banks, the Irish government got tough and the record was "corrected."

French banks, among the most heavily exposed to Greek sovereign debt in 2011, passed comfortably. Italy's bigger five banks also passed the tests. In Rome, government officials said that the results indicated Italian banks had the resilience to withstand market and macroeconomic volatility even greater than that experienced during the Greek contagion fears.

All British banks passed the EBA test but were hit by the impact of the findings, with an average 10.1 percent core Tier 1 ratio estimated ahead of the tests cut to 7.6 percent in the modeled 2012 scenario. This was the steepest reduction affecting the banks of any country bar Greece.[6]

The 2011 tests also revealed that the aggregate exposure to Greek sovereign debt among the 91 banks tested was €98 billion ($132 billion) at

the end of 2010—down about €10 billion from the aggregate exposure recorded in the 2011 tests. That was nearly twice the banks' €52.7 billion ($71 billion) exposure to Ireland, and much higher than the €43 billion ($58 billion) aggregate exposure to Portugal.[7]

Analysts had predicted that at least 25 of the 91 banks would fail the EBA stress tests. Political manipulation of the results became evident when twelve so-called *near-fail* banks, with stressed Tier-1 ratios between 5 and 6 percent, which also had substantial exposure to risky sovereign nations, were given grace and time to strengthen their balance sheets.

If the number of banks that failed the tests and the near-fail are added together that makes 21 banks in all, not so far from the analysts' prediction. It fact Andrea Enria, the EBA chairman who defended the tests, commented that without a swathe of capital-raising 20 banks would have failed with a combined shortfall of €26.8 billion (36 billion).[8] This, too, is an understatement. In 2012 the recapitalization of the Spanish banks alone absorbed €41 billion ($55.3 billion) advanced by Euroland—and nobody dared to ascertain if such big money was enough.

### 5. A Vicious Cycle of Sovereign–Big Banks Alliance

The financial banking crisis that started in 2007, reached a high-water mark in September 2008 with Lehman Brothers, AIG, Fanny Mae, Freddie Mac, and other institutions, but its long leg continues to weighon the global economy. This fact has illustrated the tight negative feedback loop between banks and their domestic governments. The theoretical financial health of credit institutions and sovereigns' assessments of their solvency and liquidity are correlated. All but forgotten is the lurking strong risk of contagion, as demonstrated by:

- The bank and sovereign risk premiums moving together in the same direction, and
- The effect of rating downgrades; after a sovereign's issues rating has been lowered, the big banks in that country are also usually downgraded.

Yet, in spite of political pronouncements that governments want to sever their link with big banks, nothing of that kind has taken place so far. If anything the opposite has happened. Liquidity provided via the Eurosystem's three-year tenders prompted credit institutions domiciled in Spain and Italy to make substantial net purchases of domestic government bonds. This has shown the limitations of central bank measures,

due to the fact that three-year tenders had only a short-lived impact on the capital markets.

"The business of the bank is above all to anticipate and calculate the risks," said Jacques Attali, a former president of the European Bank of Reconstruction and Development (EBRD). "But the French and (other) European banks have underestimated their risks."[9] In mid-August 2011, when this statement was made, there were widespread rumors about the precarious situation of France's Société Générale whose equity had crashed.

When in mid-2011 Attali spoke of the banks' responsibility to be in charge of their exposure, loans by French banks to Greece, Ireland, Portugal, Spain, and Italy stood at $645 billion, or $100 billion more than that of German banks. The irony is that these big banks have continued taking sovereign risks even after the 2008 cataclysm in the financial industry. They had even reimbursed to the French state the $15 billion they received as loans in the crises year 2008, in order to be able to pay bonuses without limits.

Many economists considered this to be irresponsible because over some years debt levels rose exceptionally fast. In Spain and Ireland, for example, the construction industry ran up heavy debts during the real estate boom, while the bursting of this bubble and the impact of the recession caused a significant loss of business that adversely affected credit quality.

The risks persisted. In the second quarter of 2012, debt levels in Ireland were almost twice Euroland's average of around 104 percent of GDP. The banking industry in Portugal and Spain too, faced a dramatic situation with above-average debt levels hampering loan activity. A year later, in 2013, nonperforming loans were still climbing in Greece, Portugal, Ireland, and Cyprus, while in some cases like Spain and Italy they reached historical highs[10] with evident impact on the quality of bank assets.

It therefore needs no explaining that while using the same model and the same stress testing variables in connection with all of Euroland's 18 member states and their banks has the advantage of homogeneity, the significant differences prevailing country by country can produce misleading results. The economic problems confronting Germany are not the same as those facing the Greek, Spanish, and French governments, nor is it that the last three Euroland countries can be put in the same envelope of economic conditions.

There exist of course common problems that confront all of Euroland's 18 sovereigns and practically every government outside the common currency. An example of a common problem (and a major worry) is the freezing of funding markets, as happened in mid- to late 2011, with investors

pondering the potential impact of losses that banks would take on their holdings of Euroland's government bonds.

Along with the heralded balance sheet adjustments and a (dubious) effort made at deleveraging, many Euroland member states have adopted the bad policy of loading the local banks with their government bonds. This is an unfavorable situation for the banking industry, one that also deprives local companies of bank loans. Money taken out of the banks by way of (nearly) forced sales of debt instruments takes precedence over what they can get from the ECB (inter alia through Target 2 balances) to close the gaps created by their budget deficits.

Evidence is provided by the fact that while loans to the nonfinancial private sector have shrunk, the bigger banks' holding of domestic government bonds continue to expand. A large part of additional purchases of government debt securities coincided with the European Central Bank's three-year long term refinancing operations (LTROs) that started at the end of 2011, while Italian and Spanish banks continued buying (high risk) sovereign bonds thereafter.

- On November 30, 2011, Italian banks held €240 billion ($324 billion) of Rome's debt instruments. This rose to €330 billion on June 30, 2012, and €415 billion ($560 billion) on September 30, 2013—a 73 percent increase in less than two years.
- Comparable numbers for Spain are €165 billion, €245 billion, and €300 billion.[11] That looks like being less than Italy's, but it is still a hefty 82 percent increase in less than two years and it is also a greater debt load on a per capita basis.[12]

Such rapidly expanding holdings of government bonds by the local banking industry, at the level of about 40 percent per year, is a total negation (and reversal) of heralded balance sheet adjustments. It is a shame and it could make the libretto of a soap opera where governments borrow from banks to pay for their huge deficits and then need to recapitalize the same banks to save them from going bankrupt. This Italo-Spanish scenario resembles that of a dog turning around a pole trying to catch its tail.

Over the earlier part of the period under consideration, American money market funds almost completely withdrew dollar funding from European banks, forcing them to sell dollar assets as well as curtail not only loans but also other traditional banking activities denominated in dollars such as trade finance. An even bigger worry was the freeze in euro funding, with pension funds and insurers refusing to buy unsecured European bank debt in any meaningful quantities till the end of 2011.

The risk of funding markets freezing was not properly reflected in the test done by the EBA in 2011 (section 4), which is another reason why these cannot be called "stress tests." Neither were the idiosyncratic characteristics of southern European member states accounted for, which adds up to a failure to properly reflect the economic environment in the experimentation taking place.

Moreover, a well-done stress test will involve not only a quantitative analysis but also a qualitative analysis,for instance, an evaluation of the quality, timeliness, and action of a bank's internal control (IC), which has become, by law, the auditors' remit. Among other criteria, the quality of internal control is judged by its ability to keep a close watch on limits with the aim of protecting the company from runaway trading and lending operations, upholding its reputation and ongoing viability.

Another reference to qualitative analysis is that of a correct, comprehensive, transparent, and objective financial reporting and disclosure system. In the US, the responsibility for correct financial reporting has been legislated by the Sarbanes-Oxley Act of 2002 and it falls on the CEO and the chief financial officer. This is a commitment to provide consistent, high quality reporting for all stakeholders.

### 6. Risk Premiums and the Rescue Fund

Putting the existing exposure in the trading book and banking book under stress conditions ensures that transactions and inventoried positions have been booked in a way that permits appropriate ongoing risk evaluation with concomitant identification of sore spots. Of the four stress methodologies identified in section 4, default stress testing is the most important because the shock that it provides can

- Energize senior management, and
- Prompt it to taking corrective action.

An integral (and important) part of this corrective action is refinancing and the clearing up of the bank's balance sheet. Who will advance the funds necessary for doing so? In 2007, 2008, and afterward the answer was the taxpayer. In 2014 the conditional response is the ESM—as long as its endowment lasts. Nobody would venture to predict for how long it can last given the totally improper usage of bank capital identified in section 5.

At the same time, the European Central Bank says that it is engaging in the Herculean task of conducting a comprehensive assessment of the Euroland

banks' balance sheets. Its objective is to sanitize the banking industry. *If* this is indeed the objective, *then* the EU cannot and should not allow the Italian and Spanish governments to game the system by siphoning funds out of the banks by selling them the sovereign's highly risky debt instruments. *If* sanitizing is to be successful, *then* Brussels (and the ECB) should close all the loopholes governments (and banks) find to do something unethical. Otherwise:

- The banking industry will never get back in a position to supply much-needed credit, and
- The whole exercise would end up lowering confidence in the future rather than improving it.

Under these conditions of depleted bank treasuries credit will remain expensive and scarce in large parts of Euroland. This will continue to impede investment recovery, and it will feed on the ongoing uncertainty surrounding urgently needed fiscal adjustment. A direct result will be that Euroland's GDP growth will continue lacking momentum amid a never-ending negative output gap and high unemployment.

Profligate state finances also lead many economists to project a depreciation of the euro on the back of an easing in fiscal austerity and a likely divergence in monetary policy between the US and the EU. In addition, downside risks stem from the ECB's bank review exercise coupled with unstable politics in some of Euroland member states as well as the absence of fiscal room for maneuver.

Furthermore, problems are also expected to emerge from continuing arguments about who will get how much of the €500 billion ($675 billion) of the European Stability Mechanism, whose original aim was to lend money to stricken sovereigns willing to accept strict conditions—even if everybody knows that strict conditions are not applicable. This primary ESM objective has now taken a backseat while at the driver's wheel is the practice of pumping money into banks under terms that have not yet been agreed upon. Neither will it be easy to find a common ground, given the prevailing divergence of opinions.

The pros say that this is simply not true, and they provide as evidence the three mid-December 2013 meetings of Euroland's finance ministers that defined a system for policing how the member states' banks live and die. Critics answer that this was an important but imperfect outcome, pointing out:

- The maze of national safeguards,
- The number of committees being involved, and
- The fact that these hinder swift decisions.

After appointing the ECB as the central supervisor of Euroland's 130 big, systemically important banks, the challenge has been to agree on a way to shut down badly wounded institutions and share costs. This should not be confused with a single deposit guarantee, which was ditched at an early stage. Underwriting deposits in Greece, Cyprus, Portugal, Spain, or Italy is not something Germany is willing to consider.

The most significant change is that a lender could be wound up without the permission of its Euroland home state. While the precise details are still unclear, a labyrinth of committees are involved in this task. If the ECB identifies a bank in deep trouble, it will ask a single resolution board to propose a rescue plan, but will also allow national regulatory authorities a say. A decision would then need approval from the European Commission. If the commission objects, EU finance ministers would have a vote.[13]

Legacy costs will not be shared. The fallout from the review and analysis of a bank's financial health will be mainly handled at the national level under existing rules. Taking into account the time necessary to implement the new system, it is a safe prediction that the banking union would not be ready for the results of the ECB check-up even in November 2014. In all likelihood the resolution system will only be up and running from 2016 or thereafter.

On December 18, 2013, the evolving solution to risk premiums and the workings of the rescue fund suffered a blow after Vitor Constâcio, vice president of the European Central Bank, warned it would fail the test of market credibility without better funding and streamlining of decision-making. These remarks came only some hours after Euroland's finance ministers emerged with a compromise that they thought would clear the path for a deal on a single system for winding up badly wounded banks.

Constâcio, a former governor of the Portuguese central bank, probably knew well what he was talking about. Euroland's banks are so thirsty for capital ratios—and in such a close proximity to their governments that siphon out funds—that the ECM's €500 billion could be eaten up for breakfast. His words cast a doubt over whether the proposed system would be capable of:

- Swiftly shuttering a failing bank,
- Or, covering the costs of its windup.

Neither is there an agreement over what should be done if the ESM resources are overwhelmed. The drama of Euroland, of its overleveraged banks and of its profligate governments is that both Vitor Constâcio of the ECB and the member countries' finance ministers are right.

The €500 billion of ESM will be open to the four winds just by trying to recapitalize the banks at the capital ratio level required by Basel III. Even that may not be accomplished with available funds, which, it should be remembered, come from member states and go to member states through a *transfer union*, both prior to reaching the banks and right after.

This is a great financial and political scam and an intellectual convulsion, too. Recapitalization means that banks, particularly the big self-wounded banks, will absorb a huge amount of money in one great bite, not in several nibbles interrupted by slow digestion. No amount of money will be enough to satisfy all the desires. The finance ministers are right when they say that their countries, Euroland's 17 member states, don't have more funds to put on the table. No matter how one looks at it, this is taxpayers' money; it did not grow on trees.

Solution to such a complex problem where the different theses are diametrically opposed to one another and still everybody is right cannot clearly be simple. It is unavoidable that there will be tensions, a direct result of the fact that the so-called banking union was given only a superficial view prior to hitting the public eye. Nobody bothered to study in advance whether it was affordable and doable. Successful projects are not constructed like that. When inner uncertainties dominate, the unavoidable result is bankruptcies of the sort described by the case studies in the next eight chapters of this book.

# 5

# Lehman Brothers and Bear Stearns

## 1. Case Studies Are the Best Way to Examine "How" and "Why" the Bankruptcies Took Place

The aftermath of major economic and banking crises can be devastating. The one that started with the subprimes in 2007 and gained momentum with the Lehman bankruptcy, brought the American economy to its knees. Millions of people lost their houses, many more millions have been laid off as factories and offices closed, and there has been, generally, a lot of consternation as well as uncertainty about what tomorrow will bring. Companies found it difficult to defend their margins as production volumes dived.

What began as a US residential real estate crash in July–August 2007,[1] escalated into a prolonged global financial crisis. When the first signs of a deep impact on the real economy emerged in the second half of 2008, the first reaction was to officially declare some national economies, including the US, as being in recession. Pretty soon, however, economic expectations were subdued worldwide, with all Western nations paying for the mistakes made by the big banks and their CEOs, as well as by regulators and governments.

Following the fall of Lehman Brothers in mid-September 2008, the first case study in this book, the world has witnessed the intensification and broadening of financial turmoil, with tensions increasingly spilling over from the markets to all walks of life. The global economy felt the adverse effects of stress and tension, which were more pronounced in Western countries than in developing markets. Particularly perverse was the number of downside risks to economic activity, which were previously identified as "possibilities" but have materialized with both major and minor economies experiencing a contraction of gross domestic product.

- The year 2008 has joined 1931 as the worst year on record since 1825, and the International Monetary Fund (IMF) estimated that 2008 has seen the worst crisis in modern times.
- The LBCGs that had the greatest leverage also faced the more acute problems, particularly in the developed counties rather than in the emerging countries.[2]

In the second half of 2008, Britain found it necessary to nationalize two of its three biggest banks. The US Treasury did so for Fannie Mae, Freddie Mac, and AIG while it let Lehman Brothers sink. In an interview he gave to Bloomberg right after the Davos 2009 World Economic Forum, Nouriel Roubini said that three of the four biggestbanks in the US were virtually bankrupt and the prudent way to proceed would be to:

- Nationalize them,
- Clean them up, and
- Then sell them to investors.

Roubini however cautioned that this must be done very carefully, heeding lessons learned during the previous couple of decades. *If* these banks were kept alive artificially, like the Japanese did with their bankrupt big banks in the 1990s (chapters 11 and 12), *then* it would take much more than ten years to get them back on their feet.

While the notion of a banking crisis was by no means unprecedented, 2008 saw the greatest bubble in history when measured by the scale of investments wiped out as a proportion of national income. The predecessor was Britain's railway boom and bust in the 1840s. At that time the railways were the really great technological innovation. During a four-year period its promoters presented literally hundreds of schemes to Parliament to build new railway routes. Investors rushed to put money into the railways by:

- Paying a small deposit for the initial legal and surveying work, and
- Committing themselves to further payments as the building work proceeded.

Between the start of the railway mania in 1844 and its end in 1847, the British Parliament approved 9,500 miles (15,000 km) of new railway lines.[3] As share prices shot up, peaking in 1845, smart investors and speculators sold their shares, usually to smaller investors. The amounts of capital being committed to the industry made competition ever fiercer, and led to ever more optimistic business plans till the 1847 crash.[4] Sounds familiar?

The events of the first decade of the twenty-first century were not so different from those of the mid-nineteenth, except that peoples' houses, not railroads, were the raw material of the boom and bust. The residential real estate bubble of 2007 was followed in 2008 by sharp declines in equities, credit assets, and (in the second half of that year) commodities. Credit became scarce and the rush to quality saw to it that government bonds were the sole major asset to rally substantially over the year.

Some banks found it difficult to raise the funds needed for their day-to-day operations. Behind these trends was the intensifying credit crunch, as half a decade of rising leverage unwound. By mid-March 2008, before the financial bad news spread like a shockwave, optimistic analysts and investors (particularly those who were caught in the credit crunch) thought that the credit crisis was easing and argued that market participants should be overweighting financial instruments. This was stated at a time when the lagged effects of the credit crisis on the overall global economy were just beginning to appear. Actually two issues faced the financials:

- A recession, and
- The credit crisis.[5]

Critics of the optimistic position promoted by some quarters suggested that economists and investors considered only credit conditions and largely ignored the coming slowdown in global growth. They also pointed out that the FDIC had begun to accelerate its hiring of bank investigators, as the agency prepared for an increasing number of potential bank failures—a very negative signal indeed.

Those who questioned the resilience of the Western economies to the subprime shocks and their aftereffects proved to be right. The squeeze spread from its epicenter in subprime mortgages across the global financial system to other areas with a gridlock in inter-bank loans, and by 2009 the greatest victim of the upheaval was *trust*.

On February 26, 2009, the FDIC announced that there were 252 problem banks in the US with assets of $159 billion. This was a six-fold increase over 2008 when there were 25 bank failures. Some experts said that there could be 1,000 bank failures in the US over the next five years. This proved to be too pessimistic, as governments became the "no questions asked" financiers of self-wounded banks.

Market participants had good reasons to worry: their instincts for spotting the suspect and what it may do to the economy. A rather pessimistic view was promoted by the fact that the solvency and liquidity troubles confronted by the LCBGs were spreading to the 8,500 community banks

in the US, which were till then healthy. Moreover, according to the FDIC, in early 2009 American banks had $38 billion of problem loans, and this hit both big and small credit institutions.

There are many lessons the crisis that started in 2007 can teach through case study analysis even if, like any economic, financial, and banking crisis it was idiosyncratic. The better way to learn from it is to identify and analyze *patterns of risk* not as a general trend but institution by institution, particularly those that suffered the most from their self-inflicted wounds. This helps in focusing attention on factors that should be carefully watched:

- From counterparty credit quality,
- To toxic exposures related to novel, little-known instruments, and
- Major portfolio losses because of wrongly estimated or downplayed risks.

When such patterns are established, careful study usually flashes out the wrong practices, as well as exposure, that were unwarranted. It is a misconception taught in schools that "averages" are meaningful. Instead, it is advisable to focus on individual, case-by-case *salient problems*, particularly those cases that involve an inordinate amount of risk, or a potential to assume it, on which senior management should bring first its undivided attention.

## 2. Lehman Brothers

"The real estate market was living on borrowed time and Lehman Brothers was headed directly for the biggest subprime iceberg ever seen, and with the wrong men on the bridge," says Lawrence G. McDonald. "[Big corporations have] got too many people on their staff who don't know their ass from their elbow."[6] In addition Lehman, like nearly all LCBGs, carried a debt load and you have the investment bank's electrocardiogram.

The week of September 8, 2008, was particularly rocky for Lehman Brothers as its management predicted another huge quarterly loss and unveiled more measures to boost its capital, including a sale of property assets. Earlier on, its share price had tanked when Korea Development Bank (KDB), a state-run lender, pulled out of talks about buying a stake. (It was said at the time that South Korean regulators had warned KDB on the risks in taking over Lehman.)

At Wall Street, critics had been calling, for some time, Lehman's highly leveraged position indefensible, wrong, excessive, unwarranted,

and unsustainable in the longer run. This also pointed to an interesting hindsight brought in perspective with the LCBG's failure: the absence of any value in the credit guarantees given by banks to investors for the purchase of structured products, derivative instruments, and other alternative investments.[7] When Lehman went bankrupt, the 100 percent protection New York's fourth biggest investment bank had provided to investors meant only pennies. Let's look at the facts.

On September 10, 2008, Lehman Brothers hurried to announce projected third quarter 2008 results. Their outstanding feature was a loss of $3.5 billion. This announcement was part of an ill-judged effort to end months of speculation over its future and halt a share price collapse. The result was that banking stocks tumbled and the Federal Reserve said that it had opened its discount window for loans to the investment bank (loans to which it had no right according to the Fed's status).

A few commentators celebrated the Fed's move as saving Lehman from falling off the cliff, noting that some months earlier Bear Stearns (sections 5 and 6) did not benefit from this facility when it hit the rocks. Other Wall Street analysts, however, were not so sure Lehman really passed the cap, noting that from August 2007 the cost of its funds had increased by 400 basis points. The cost of insuring $10 million of Lehman debt rose sharply to $745,000, an all-time high.

In addition, Lehman's equity had become volatile. In the financial turmoil of March 2008 its shares plunged 40 percent as the market worried about solvency. A month later, in April, the bank issued $3 billion in convertible bonds to rebuild its balance sheet. But in May its shares fell again (by 6 percent) as rumor had it that it could face losses on poor hedging conditions.

The bad news of March and April for the LCBG was followed by two June 2008 events. Lehman sought to raise $6 billion in new capital after second-quarter 2008 losses of $2.8 billion, but its shares fell 16 percent as investors feared it may be the next Bear Stearns. The month of August was not any kinder as the investment bank:

- Entered into talks to sell $40 billion from its wounded real estate portfolio, and
- Tried to sell Neuberger Berman its equity management unit.

The third-quarter 2008 loss was a turning point. It was the worst ever for Lehman, and came after the bank suffered $7.8 billion in credit-related write-downs, bringing its torrent of red ink, since the credit crunch began, to more than $15 billion. It might also have been the reason for the breakdown of the months-long talks with Korea Development Bank.

Following the September news of Lehman's huge loss, the New York stock market penalized the bank with its equity shedding a third of its value. A day later, on September 11, it fell another 41 percent to $4.27 and hit $3.89 on September 12.[8] This was not the first time in 2008 the investment bank had gone through the eye of the storm, but it had managed to come back to life—a feat that now looked as being increasingly unlikely.

As the bad news continued to worsen, Lehman's stock went into free fall. Year on year (from September 1, 2007, to September 12, 2008) it lost about 93 percent of its value. When during the weekend of September 14–15 the talks with Bank of America and Barclays, with participation from the Fed and Treasury, reached nowhere, Wall Street judged that Lehman was clinically dead.

Barclays's thesis was that the proposed transaction required a guarantee that was potentially compensating for the trading operations of Lehman. The British bank was not unwilling to provide that guarantee, and regulators had repeatedly stated there would be no government intervention along the lines of the $29 billion guarantee offered when JPMorgan Chase bought Bear Stearns.

A takeover of Lehman by Bank of America or another late suitor hinged on whether Wall Street banks could agree on a plan to ring-fence its bad assets. That is, did Lehman's rivals want to fund the purchase of some $80 billion of its troubled assets and of whatever else might be still hiding besides this large amount? Nobody came forward to accept that proposition.

Indeed, a measure of the uncertainty surrounding Lehman's financial health was the fact that the value of its assets that were deemed toxic had risen from $33 billion to over $80 billion within a few days, but it was impossible to be sure that this was the upper limit. The idea of spinning off of a "bad bank" with the aim to make the rest of Lehman a more attractive target for potential suitors did not fly either. Even the pros were not enthusiastic.

Trying to get Lehman back on its feet was attempted against the backdrop of a severe financial crisis, with no imminent prospects of a source of financing its huge capital black hole. At Wall Street some analysts suggested that the Fed of New York should get tough. Others said that it could be tough, sure, but what was the point of being tough when you know there is a big capital hole that can't be filled? What should the regulators do then?

The options were indeed limited. When in mid-September 2008 Lehman Brothers stood at the edge of the abyss, there was no talk—let alone agreement—on the bail-in rules for creditors. If anyone was suggesting such a solution it was evident that it would not carry legal weight.

Instead it would have been reinforcing exactly the problem it had been designed to fix (which more or less happens to be the current situation with the bail-ins; see chapter 1, sections 2 and 5).

In addition, putting up capital to buy Lehman's "bad bank" was not as easy as it sounded. The Fed and Treasury had called in representatives of some of the 30 largest banks in the world, only to learn that many of these institutions had themselves suffered big losses. Yet, ironically, this concept of setting up a "bad bank" with only toxic assets was precisely what the Treasury and Federal Reserve were going to do with AIG, Fannie Mae, Freddie Mac, Citigroup, and other entities, putting on the table a huge amount of taxpayer money.

Still, senior executives of the Big Board and government officials continued being engaged in increasingly desperate efforts to save Lehman Brothers. But when Barclays let it be known officially that it was walking away, US regulators began preparing the ground for a possible bankruptcy. Barclays's withdrawal was also a blow for the efforts by the US Treasury secretary Hank Paulson and New York Fed president Tim Geithner to organize a rescue takeover before markets opened on Monday, September 15, 2008.

When Bank of America, too, dropped out as a potential suitor, the fate of the 158-year old financial group was sealed. Many people said it was incorrect Hank Paulson was involved in the decision that let Lehman go to the dogs because when he was president of Goldman Sachs he was in conflict with Richard S. Fuld Jr., then Lehman's CEO. In a personal meeting, a former New York judge stated Paulson should have abstained from that decision because of possible conflict of interest.

Ten years after Wall Street came together to bail out the Long-Term Capital Management (LTCM) hedge fund, leaders of the American financial services industry found themselves huddled together once again to stave off the crisis resulting from Lehman Brothers on the ropes. This time around, however, there was no "happy ending" even if Lehman was the only Western LCBG to fall on its sword as government suddenly became scared of a torrent of big bank failures.

### 3. Who Could Provide Assurances on Counterparty Risk?

The shock from Lehman's bankruptcy was felt by market practitioners around the globe. As investors ran for cover, they were asking for reassurance that the top brass of the firms in which they were investing be ultra-careful and start without delay to prune their balance sheets. There were a lot of discussions between banks and their most important clients as the latter started to look for fiduciary diversification.

Concerns were rising about institutions that have been strong advocates, and practitioners, of liability-driven investments, an approach that relies heavily on derivatives to manage inflation and interest rate risk, as each derivatives transaction involves counterparty risk. A growing number of credit institutions confronted the operational challenge of looking at individual credit risk daily, on a business-wide level. This was a demanding job as it involved a large numbers of contracts with different counterparties, many potentially changing in creditworthiness every day.

Market risk, too, demanded a great deal of attention, breathing life into risk control processes that in the go-go years had faded in the background. Since asset managers use collateral to mitigate counterparty risk, it became necessary to make sure:

- The derivative instruments are valued regularly, and
- The amount of collateral is adjusted to suit the value.

Because the value of derivatives would very likely fall in the run-up to a default, collateral that was sufficient even a week earlier might turn out to be inadequate or even turn to ashes when a failure occurs. But because daily valuation imposed a considerable operational burden poorly managed banks only looked at collateral twice a month—which is plainly inadequate.

Even credit rating was no more a good indicator, first, because things moved so fast and, second, because of a lingering suspicion that credit rating agencies were lenient. The better-managed banks worried about what was coming next in more than one of their major counterparties, but they soon found that trying to set an optimal distribution among counterparties was a hopeless task.

In the weeks preceding Lehman's bankruptcy even countries found the going daunting. Japan was fretting that Lehman's potential default on almost $2 billion of yen-denominated bonds would send a chill through the *samurai* market. Russia suspended share-trading and propped up its three largest banks with $44 billion, as emerging markets lost their appeal.

A major weak spot was the $62 trillion[9] market for credit-default swaps (CDSs), which had given regulators nightmares since the loss of Bear Stearns earlier on in 2008 (sections 5 and 6). Fears that Lehman would be forced to file for bankruptcy within a matter of days spiked when the New York–based International Swaps and Derivatives Association (ISDA) opened an emergency trading session among Wall Street dealers with Lehman.

This particular trading session was designed to minimize the risk associated with the likelihood of a Lehman bankruptcy. The trades would be void if Lehman filed for bankruptcy. Left unattended, the exposure resulting from such an event would have wreaked havoc on the failed LCBG's counterparties and the global derivatives markets.

In spite of the deep economic and banking crisis that should have led to greater prudence, this global derivatives market was growing by leaps and bounds in the intervening years—as if *risk-on* became the dominant and permanent banking culture. From $62 trillion in notional value in August 2008 it skyrocketed to $639 trillion in August 2013.[10] This increase of 1030 percent in five years was promoted by the:

- Prevailing gambling spirit,
- Laxity of rules and of supervision,
- Absence of punishment for damaging the economy,
- Outspoken critics of regulating the derivatives market at high places, and
- A swarm of lobbyists who greased the political machine and kept talking to the anti-regulation big shots.

Almost forgotten is *why* and *how* Lehman Brothers descended to the abyss and why bankers, investors, and speculators looked at the likelihood of the LCBG's survival. This is best measured by the spread of the investment bank's credit default swaps, which widened 165 basis points (bp, 1.65 percent).

Credit-default swaps on Lehman's debt leapt to levels higher even than they were in March 2008, when the markets were in turmoil preceding the bailout of Bear Stearns. Such an increase suggested that Lehman was considered more likely to default. Its CDSs zoomed prior to the company's September 10 announcement of :

- Plans to split itself up, and
- Its largest ever quarterly loss.

Experts suggested that Lehman Brothers' risk capital was already wiped out and that its equity was fast absorbed by the debt that stood at 93 percent of the investment bank's balance sheet. After failing to secure capital from outside investors, in a last-minute effort to salvage what remained of the wreckage, senior management pinned its hopes of the bank surviving the financial crisis on selling a 55 percent stake in its "prized" asset management unit. (After the bankruptcy Nomura, the Japanese investment bank, offered to buy bits of its European, Middle

Eastern, and Asian divisions. Barclays, which had refused to buy the whole of Lehman, bought the doomed bank's main American unit for $250 million and several of its properties for $1.29 billion.)

Sure that the fourth largest American investment bank would not be able to avoid the day of truth, potential buyers held their cash. There was no interest in Lehman's offer of spinning-off $30 billion worth of troubled property assets into a "bad bank." This $30 billion had been in the investment bank's commercial real estate portfolio. Also planned were the sale of $4 billion in British property assets to Black Rock, and a slashing of dividends (more on this later).

The projected "bad bank" plan for the property assets would have seen Lehman injecting up to $7.5 billion in the new entity, which would hold the assets to maturity thereby sparing the rest of the institution the pain of quarterly write-downs. Three parties—KKR, Bain Capital, and Hellman & Friedman—were believed to be interested in buying a stake in the asset management unit, but according to analysts this could only fetch $3–$4 billion—peanuts compared with what Lehman needed to pull itself up by its bootstraps. Allegedly Lehman's top management had also hoped that some of the entities that had invested money in the LCBG would step forward to save their capital. In terms of top exposure, these included:

- The Republic of Italy to the tune of $3 billion,
- Germany's KfW, a state-owned bank, $2.5 billion,
- America's Freddie Mac (chapter 7), $750 million, and
- Reserve Primary, the money market fund, $180 million.

Yen-denominated bonds lost $2 billion. The Bank of New York Mellon had not invested in Lehman but its Institutional Fund sold for less than $1 billion as the market was hit by the Lehman losses that set off a spiral in money markets. In Germany the government started an investigation of conflicts of interest in the transfer of €319 million (US$425 million) to Lehman Brothers a day after the bank went bankrupt.

Lehman went bust with $613 billion of debt, of which $160 billion was unsecured bonds held by investors around the globe, including pension funds and individuals in Europe and in Asia hyped by Lehman's high credit rating. The price of these obligations quickly collapsed to 15 cents or less on the dollar. Not surprisingly, investors withdrew $400 billion from money market funds when one of them who had bought Lehman debt suffered major losses.

Central banks all over the globe had one aim: to limit the spillover effects of Lehman's demise, while Lehman insiders questioned whether the bankrupt company's board pushed Richard Fuld Jr., its chief executive,

hard enough to consider selling the bank or slashing its risky property portfolio earlier in 2008 when such a transaction was doable. "I think Dick was pathologically incapable of selling," said one banker. Even while Lehman shares were falling and uncertainty was starting to engulf the bank, Fuld refused to countenance any capital infusion.[11]

Even after more than five years have passed since September 15, 2008, the full costs of Lehman's bankruptcy have yet to be determined, both in terms of the damage to credit markets and the losses inflicted on its creditors and trading partners. Swap exposures are still being unwound. Recovery values fluctuate with the market. Hedge funds that used Lehman as a prime broker had to fight for the return of assets. Lehman's case and, subsequently, AIG's failure (chapter 6) document that Wall Street institutions had an inordinate amount of leverage and too much capital devoted to products of:

- Questionable economic utility, and
- Highly doubtful inherent value.

While the Treasury and the Fed decided against saving Lehman, central banks around the world attempted to limit the fallout from its collapse by providing billions of dollars of short-term funds to their banking systems, boosting liquidity. But as commercial banks found themselves short of cash, with exposures to Lehman Brothers tied up in bankruptcy proceedings, overnight bank borrowing costs soared around the world.

### 4. How Dependable Can a Broker's Investment Conclusions about an LCBG Be?

On May 12, 2008, just four months prior to Lehman's bankruptcy, one of the major New York brokers issued an investment conclusion stating plainly that Lehman Brothers had an A+ credit rating and there was no reason to worry about its future. It had only been affected by the market-wide dislocations, but in this broker's opinion financial results had shown that the LCBG's:

- Positioning,
- Risk management, and
- Cost discipline limited the damage.

This investment conclusion further emphasized that, if anything, Lehman Brothers was enhancing its diversification in recent years through

growth in non-fixed income areas including equities, mergers and acquisitions (M&A) advisory, asset management, and international operations. All was for the better, if you can believe such conclusions. The broker's investment "advice" emphasized the (teetering) bank's strengths:

- Strong franchise, as it maintained a solid presence through its operations in equities and fixed income capital markets, investment banking, and investment management.
- Successful leveraging. The LCBG was leveraging, "in an able manner," its key fixed income franchise, while diversifying its product offerings.
- Risk management. Its risk management capabilities were described as being "a credit positive," with operating performance favorable versus many peers.
- Good liquidity. Lehman's liquidity position was described as having improved through capital-raising transactions.
- Rating/outlook upgrade drivers: A (hypothetical) resumption of more normal conditions in the US market was described as contributing to strong and more consistent earnings over a number of quarters at Lehman.

Financial results and other considerations were also stated as being positive for the LCBG: Lehman was presented as having taken its lumps along with other financials in the (then) "current market," but as having still managed to do well on a relative basis. The broker expected the investment bank, which its conclusion promoted, to remain profitable even if it posted a sharp decline year-on-year. All that investors needed to do is to trust the phoenix being born out of the market's ashes.

Of course, the real situation was quite different and this could also be detected by the fact that, as it has been the case with so many other big banks, Lehman's management displayed ambiguity and confusion about how to address the credit crisis that had swept across Wall Street since July–August 2007. The only thing the friendly broker found as an excuse was to say that these days the financial markets' complexity is mind-boggling. This, however, was the bankers' own fault.

Moreover, always according to the broker's views, while in an environment of credit market fears, its bonds and preferreds were pushed sharply lower over concerns regarding its viability, *its* fund raising and the Fed's moves to backstop the industry were positives. After starting with these good words about Lehman, the broker's investment advice went on to outline three outstanding risks that contradict its positive conclusions:

- *Lending exposures*. The LCBG maintained exposures to funded and unfunded lending commitments.
- *Real estate exposures*. With its dominant positions in mortgage and fixed income markets, Lehman featured some of the highest exposures to real estate loans and securities.
- *Volatile and uncertain near-term earnings*. In addition to current asset risk, future revenues were constrained by cyclical pressures across areas of operations.

No mention was made of the fact that one constant in financial crises is *moral hazard*, whereby repeated bailouts encourage excessive risk taking. When this investment conclusion was published (on May 12, 2008) practically everybody knew of Bear Stearns's troubles and the fact that AIG, Citigroup, Bank of America, Wachovia, Fannie Mae, Freddie Mac, and other institutions were in poor to disastrous financial health. The Fed and US Treasury were faced with the high-risk decision of letting at least some of them go to the wall in an attempt to address this endemic Wall Street problem.

Merging together two or more financially weak LCBGs (which, in the end, proved to be the favored solution of the Bush Jr. administration) was not a wise course, because such a consolidation would lead to more concentration: a smaller number of much bigger institutions that are "too big too fail."

The argument that many LCBGs had a top-level finance and risk committee did not wash. Lehman had such a committee that might have reviewed the bank's financial policies and practices, but there were unanswered queries on how deep that review had gone and how well its opinions were documented. The LCBG was counterparty to hundreds of billions of dollars of over-the-counter (OTC) derivatives trades. Referencing everything from the default risk of individual companies or complex structured bonds to interest rates and commodity prices was a Herculean task.

Making things so much more difficult in terms of coming out of the high risk tunnel was the fact that the credit derivatives market, like other over-the-counter derivatives such as swaps, is traded privately between banks as well as between banks and investors. Without an exchange or clearing house backing the market,[12] the risks are taken on by the bigger dealers. A default by one of these dealers could well result in losses for all the LCBGs and other entities that act as counterparties. Therefore:

- Regulators have long feared that credit derivatives could be a source of major systemic risk,
- But the regulators' efforts to reduce systemic exposure met with fierce resistance from the LCBGs.

Systemic risk has been a real and present danger all along an economic and banking crisis, while the credit derivatives market scrambles to handle the unwinding of billions of contracts. In Lehman's case up to $500 billion in contracts were linked to Fannie Mae and Freddie Mac, triggered by the Fed's and Treasury's seizure of the government-sponsored huge mortgage companies (chapter 7).

Even if Lehman's own exposure was not that deadly, it still had $53 billion of mortgage assets and leveraged loans on its books, almost double its shareholders' funds. Moreover, a bankruptcy of that size was sure to have a major impact on the huge credit-default swaps market where investors think that they are buying insurance against corporate default, while paying little attention to counterparty risk. Indeed, as a *credit event* Lehman's bankruptcy triggered the settlement of contracts under rules drawn up by the ISDA:

- Deals where Lehman was a buyer or seller of a swaps contract unraveled, and
- Those who sold insurance against Lehman going bust lost a lot.

Take as example a bank that bought a CDS as insurance against an AIG default, with Lehman on the other side of the deal. That protection was worthless when Lehman failed to pay up. Until it went bankrupt, the investment bank would have posted collateral that the counterparty could claim. After bankruptcy day, the buyer was exposed to price movements before it could unwind the contract.

Another Lehman fallout that the broker's conclusion failed to bring to its readers' attention was on the collateralized debt obligation (CDO) market. This issue has generally caused and continues to cause so many problems. The sheer size of Lehman in the market, given its gross derivatives positions in hundreds of billions of dollars, made its default a severe test. Inevitably, there were legal disputes that lasted for years.

On the other hand, while Lehman Brothers was worth very little as a going entity because of its huge toxic waste, several of its bits and pieces had a residual value. As we have seen, Barclays paid big money to get the investment bank's headquarters at Times Square, NYC, two data centers in New Jersey, and Lehman's North American investment banking and capital markets operations. Because of lack of an alternative offer, the creditors committee did not oppose the latter sale, but did not support it either.

Standard Chartered, Barclays, and Nomura battled to acquire the flagship Asian operations of Lehman Brothers, trying to assess the value of its regional assets, including its investment banking, fixed income,

and equity divisions. There had also been preliminary inquiries from Samsung of South Korea and Citic of China.

There were, most evidently, some big losers in the Lehman bankruptcy. According to Arturo De Frias, of Dresdner Kleinwort, European banks had estimated losses of about $31 billion on short-term loans to Lehman.[13] This came over and above their losses because of subprimes and other causes. The problem of replenishing treasuries of wounded LCBGs was made more acute by the fact that some of Europe's biggest banks, like UBS, ING, and Fortis, were based in some of its smaller countries such as Switzerland, the Netherlands, and Belgium.

Other big European banks were negatively affected because of shortage of money for dollar-denominated loans, particularly because they did not have dollar deposits and relied largely on capital markets to fund their investment. These were Barclays, Royal Bank of Scotland, and Deutsche Bank that saw huge spikes in the price of insuring their debt against default.

AXA, the big French insurer, said its exposure to Lehman Brothers was about €300 million ($390 million), primarily to debt issued by the defunct investment bank. Additionally, its 7.25 percent stake in Lehman Brothers Holding (the listed entity of the investment bank in which it emerged as the single largest shareholder) was managed on behalf of third parties, principally in its fund management business.

The lesson from this double-edged sword of investing in equity and debt has been that investors should not merely look at the stability and health of the companies to which they entrust their money depending on the companies' creditworthiness. They should also keep a close eye on how well the counterparties stand and how much risk they are taking that can turn the counterparty on its head.

## 5. Bear Stearns

The Bear Stearns crisis started in February 2007 and intensified in mid-June of the same year, when it became known that two of the investment bank's hedge funds were in trouble. Both had borrowed heavily to enhance returns, and in doing so they posted collateral with prime brokers. As the market turned against the hedge fund's bets Merrill Lynch, one of the prime brokers, threatened to sell its collateral but then it transpired it was driving down prices sharply and it stopped.

To fill the gap, Bear Stearns pledged its own money, providing $3.1 billion to cover the obligations of one of its hedge funds, ironically known as "High-Grade Structured Credit Strategies Enhanced Leverage Fund."

Other creditors, like JPMorgan Chase and Deutsche Bank, worked with Bear Stearns to unwind their positions. There were, however, few buyers for the subprime-backed debt—even the higher-rated tranches—raising the possibility of:

- A wave of repricings, and
- Banks and hedge funds downgrading asset-backed holdings.

Many of these asset-backed holdings were illiquid, yet they were still booked at their original inflated rate. Heavily invested in collateralized debt obligations of subprime loans, the Bear Sterns funds had already had a warning about what might lie ahead when investor confidence was briefly shaken in February 2007.

To cut their losses, the Bear Stearns hedge fund managers sold CDOs short, betting on buying them again at a lower price. But in the lull of April 2007, Congress let it be known that it *might* come to the rescue of subprime lenders facing foreclosure and the market for CDOs turned around—making the fund managers losers twice over.

The "High-Grade" junk was the first to be salvaged by the parent company. Then, at the end of June 2007, Bear Stearns decided against rescuing the second of its hedge funds that came close to collapse. Though it pledged $1.6 billion, this was half the amount it had been prepared to offer the first hedge fund. (Eventually both hedge funds had their debts covered by the parent firm, thereafter remaining with zero assets.)

This story about salvage by the parent institution, which was itself wounded, is full of ironies. For instance, in June 2007, a group of other hedge funds urged regulators to investigate banks, including Bear Stearns, for alleged manipulation of the market for mortgage bonds and the booming derivatives transactions linked to them, such as collateralized debt obligations. The hedge funds accused the banks of:

- Protecting their own positions in derivatives trades, on which hedge funds are often counterparties, and
- Propping up the prices of dodgy mortgages bought under the pretext of helping struggling borrowers(!).[14]

Another irony with more dire consequences for the financial industry as a whole was that, as many experts were suggesting, by helping its hedge funds Bear Stearns changed the rules of the debt trading game, not necessarily for the better. At least theoretically, banks treat their hedge funds as:

- Arm's-length entities, and
- Independent of the parent company.

The arm's-length solution was originally established in the 1990s when LCBGs and brokers lost their AAA and AA+ credit rating, typically demanded by counterparties. Therefore, they endowed independent subsidies to get high ratings, which also enabled them to keep hedge funds, and their liabilities, off balance sheet, avoiding the need for provisioning and other regulatory requirements.

On the one hand, counterparties required higher interest rates to lend to entities like arm's-length funds because, at the end of the day, their "independent" status made them riskier than if they were formally a part of a big financial group. On the other hand, Bear Stearns, or any other investment bank, had no obligation to rescue these funds in times of trouble. Precisely for this reason the aforementioned bailout created:

- A dangerous precedent,
- A pricing problem and
- An important business confidence issue.

The bad news for Bear Stearns did not end there. On December 20, 2007, the smaller of the top-tier independent American investment houses announced a new loss of $1.9 billion with subprimes. This has been a totally misguided, flat-footed approach to investment banking, said one of the critics, adding that it was bad for financial institutions to try to satisfy their CEOs' big egos. Instead, they should pay more attention to their shareholders.

Other critics foresaw Bear Stearns heading toward a massive run on its liquidity, as clients and trading partners would flee fearing it would be unable to meet its obligations. One expert even predicted that it would take the investment bank 24 hours to go from solvent to dead, saying that Bear Stearns had put many of its eggs in one basket,mortgage-backed securities, which:

- Were fast turning rotten, and
- Became impossible to sell, as house prices tumbled.

In failing to diversify, its CEO had become a Sophoclean tragic hero, ruined by his own terrible choices. It was Walter Bagehot's dictum that if you have to prove you are worthy of credit, your credit is already gone. Jimmy Cayne, the investment bank's long- standing CEO had overseen:

- The ballooning of Bear's balance-sheet to as much as 50 times its equity, and
- The aggressive push into complex credit products that the majority of experts find difficult to understand, let alone price.

Before being brushed aside in a high-level mutiny, Cayne had reportedly mingled awkwardly with the traders, trying to get a grip on the bank's assets. This, critics said, was symptomatic of an industry that had lost sight of how inherently unstable its business really was and tried to come to its senses only at the eleventh hour.

Bear Stearns was by no means the only Wall Street investment bank losing money like Rome's Fontana di Trevi spouts water. On December 19, 2007, just one day prior to the aforementioned announcement, Morgan Stanley, the second largest investment house in the US, said that it had suffered a new loss of $5.7 billion. Together with an earlier loss of $3.7 billion, this brought its 2007 write-downs for mortgage-related red ink near to the $10 billion mark.

To find urgently needed capital, Morgan Stanley sold 9.9 percent of its equity to the Chinese government's investment fund for just $5 billion. The Chinese promised, at least for some time, to be passive investors and not to ask for board membership. It is, however, interesting to notice that the $5 billion paid for slightly less than 10 percent of Morgan Stanley's equity, value the investment bank at roughly $50 billion. This was below its capitalization and contrasted sharply to Abu Dhabi's valuation of a wounded Citigroup at about $150 billion.

Bear Stearns was not far behind in getting an injection of Chinese money. The investor was Citic Bank, an institution that had raised $5.4 billion in an IPO in Shanghai in early 2007. (Listed in Hong Kong and Shanghai, this bank was at the time China's seventh largest lender by assets. Since 1979, when it was established, Citic Bank had grown into an international conglomerate with 44 subsidiaries whose businesses ranged from banking to petrochemicals. Rumor had it that the Chinese government was actively encouraging the country's banks to buy stakes in international institutions.)

Even prior to Citic's interest in 2007, Bear Stearns had held talks with China Construction Bank (CCB) about a potential tie-up, but negotiations fell apart. Reportedly, these negotiations involved the Chinese bank buying convertible bonds that could be translated into an equity stake of up to 20 percent in Bear Stearns. But the American government was uneasy because Bear Stearns was one of the five top-tier investment banks in the US.

At Wall Street, analysts stated two reasons for why it should come as no surprise that a cash-rich Chinese investor was considering a deal with an American investment bank. First, contrary to the policy of the Japanese government that brought up all sorts of obstacles to sovereign acquisitions of Japanese financial institutions, the Chinese followed a liberal policy—if for no other reason than to bring foreign banking skills to Chinese credit institutions.

- Goldman Sachs had acquired a stake in China's Industrial and Commercial Bank.
- Merrill Lynch had invested in Bank of China.
- Bank of America had bought shares in China Construction Bank, and
- Citigroup had taken a big stake in Guandong Bank.

US banks have made money from stakes in Chinese banks. Can the US really now turn round and say to the likes of Citic that it can't acquire a stake in a US bank? asked one investment expert. Another person's reaction was: "There are many in the US who will not like it, but I don't see how it can be stopped on national security grounds. Citic would not be opening branches on Fifth Avenue. This is a doable deal."[15]

Neither was this the first time Chinese banks would have been buying a share of Western institutions. In August 2006, China Construction Bank made a $1.2 billion investment in Bank of America's Asian business; in July 2007, China Development Bank had bought equity valued at $3 billion in Barclays. While a couple of other deals were (by the end of 2007) pending, the one involving capital injection in Bear Stearns by a Chinese entity did not go through. This had a catastrophic aftermath for New York's fifth largest investment house.

## 6. The End of Bear Stearns

Bear Stearns's end came in mid-March 2008 as the inevitable consequence of lack of capital, overleverage, high exposure to subprimes, absence of rigorous risk control and absence of proper supervision by the SEC—that allowed financial services companies to do whatever they pleased almost unchecked. This situation had created a complex and interdependent tandem of events leading to shocking financial failures.

Early in the week of March 10, 2008, Bear Stearns said it did not have a problem raising funds to finance its operations, and issued a press release three times, taking to the airwaves to assure investors it faced no liquidity crisis. On March 12, 2008, on CNBC, Alan Schwartz, who replaced Cayne as Bear's CEO, stated: "We don't see any pressure on our liquidity, let alone a liquidity crisis." But according to rumors the bank was having trouble raising cash.[16]

The rumors were right. Negotiated in the evening of March 14, 2008, and officially announced on March 17 morning, Bear Stearns fetched $2 per share in a fire sale to JPMorgan Chase (reportedly with the Fed acting as midwife). Each share was worth $30 prior to the fire sale, while in early

2007 it had topped $170. The $2 per share was tough on people who had invested their savings in their own company, as 30 percent of Bear Stearns was owned by its 14,000 employees. (The fire sale price was eventually raised to $10 per share, after shareholders revolted.)

At Wall Street, investors, bankers, and other financial experts were asking themselves how things had reached that point. Many wondered at the reasons Hank Paulson, the Treasury secretary and a former boss of Goldman Sachs, insisted on Bear being sold for a mere $2 per share. Many investors, including the employees of the firm itself, felt they had been let down by this Paulson-engineered "shotgun wedding."

The federals pointed out the systemic risk associated with an outright Bear Stearns bankruptcy. Though this investment bank was not that big, compared to Goldman Sachs or Morgan Stanley, its positions in credit-default and interest rate swaps were worth a notional $10 trillion. Therefore, the idea of its sudden collapse was chilling, and nobody wanted to put that to the test. The Fed's rescue was no bailout of Bear, because in March 2008 the central bank was adverse to bailouts—though by September 2008, the Bush Jr. administration had radically changed its opinion on this issue.

Then there was liquidity risk. In mid-March 2008 depositors had withdrawn $17 billion in two days, after rumors spreadthat other banks, too, faced tough times. The Fed had moved in with emergency funding, using JPMorgan Chase, Bear's clearing bank, as a conduit. But it was clear that no one would want to do business with an investment bank reliant on only the government's money—an opinion that, in a few months, was completely reversed.

Bear Stearns's liquidity risk was a real and present danger because, as section 5 brought to the reader's attention, its mix of businesses was less diverse than that of other investment houses. It also relied more heavily on overnight funding in repurchase (repo) markets, in which dealers sell securities to investors then buy them back the next day for slightly more, with the difference being the interest. Merrill, which had to confront enormous mortgage-related write-downs, was also seen by some as vulnerable and so was Lehman, but Bear, big in mortgage-backed securities, topped many worry lists.

According to expert opinions, a third good reason for salvaging Bear Stearns was that the Wall Street firm was particularly active in credit default swaps, and deeply embedded in huge risks associated with them. Still several financial experts disagreed with the Fed's interference, because it reflected a bias for free market operations, and regarded its midwife role in rescuing then selling Bear Stearns as a black day for America's free enterprise system.

JPMorgan's motives for taking over a wounded investment bank were by no means those of a good Samaritan of the financial industry. As the biggest dealer in credit derivatives, it was greatly exposed to Bear Stearns in case it went bust—with huge losses looming on the horizon. Besides, the Fed pledged $30 billion of taxpayer money to cover losses in Bear's portfolio from securitized commercial real estate, including prime house mortgages, Alt-As, subprimes, and other toxic waste.

Slowly, it dawned on the gurus that the price of reckless banking was an unstoppable descent to the abyss, and that rescuing mismanaged banks was being done at somebody else's expenses. This was not the Federal Reserve's opinion when, on March 16, 2008, it rewrote its rulebook by rescuing Bear Stearns from its own folly and greed:

- For years Wall Street minted billions through high leverage and the assumption of inordinate risks, and
- As the size of exposure shot sky-high, Bear was counterparty to some $10 trillion of over the counter swaps.

In an interview he gave to *Bloomberg News*, John Gutfreund, of Salomon Brothers fame, said that the Fed had to act because of systemic risk; but the SEC had performed its supervisory duties. Those experts who justified the eleventh-hour Fed move pointed out that had Bear Stearns collapsed huge derivative contracts would have been no longer honored, infecting the world's financial markets. Bear Stearns was entangled in a game of its own making from which it could not extricate itself—and it was by no means the only one in that position.

Critics also pointed out that Bear Stearns was no rare bird in high-stakes investment banking. It was using a steady stream of innovative financial instruments, generally poorly studied in terms of risk, to write in their books a golden horde of phantom profits. Managers and traders rewarded themselves lavishly for what they had not earned, while they well knew that profits were still a pie in the sky.

- With real money pulled out and fake money put in, the investment bank had become an empty shell.
- While this continued, the day was coming when the speed of demise would shock the market.

Clients and others were waking up and withdrawing the remaining billions. Who played which role in the Bear Stearns drama is not exactly known, and probably it will never be. The depositions by the key players to a Congress Committee have been contradictory, at best. Was it the Fed

that found JPMorgan Chase as a white knight? Or did JPMorgan offer to pay a total price of $236 million if the Fed took the then unprecedented—if not outright disturbing—step of financing up to $30 billion of Bear's weakest assets?

JPMorgan Chase said it would take three years to turn around Bear Stearns rather than six months as originally planned. At Wall Street experts expressed the opinion that Bear was probably in much deeper troubles than JPMorgan thought. Such news had a very negative effect on financial stocks, particularly as they came in tandem with the announcement by S&P that it had downgraded three of the other four largest American investment banks.

The JPMorgan deal also carried risks. The LCBG had pledged to honor all of Bear's commitments, despite having had no time to exercise due diligence. Analysts stated that Bear's gross mortgage exposure and other hidden toxic waste was likely to be well beyond the Fed-guaranteed $30 billion. There were also costs associated with the merger, including those that had to do with firing about half the Bear Stearns 14,000- strong staff.

For their part, Bear Stearns executives claimed to have lost billions from their own piggy banks. According to *The Economist*, the 5 percent stake of former CEO and chairman Jimmy Cayne was worth $1.2 billion at peak price in early 2007. At the fire sale price of $2 it was valued at $11 million.[17] But the hardest hit of all have been the employees prompted to buy Bear shares after the company went public in 1985. With the bank's virtual bankruptcy they lost their savings and their pensions. Many also lost their jobs—and with it their faith in high-stakes investment banking.

# 6

# American International Group

### 1. Corporate Bankruptcies Are a Part of Business Life

In mid-September 2008, when Lehman Brothers became America's biggest corporate bankruptcy (chapter 5), the financial markets were in turmoil. There is nothing really unique about defaults and bankruptcies; they are a way of pruning the capitalist system and 2008 saw nine of the dozen biggest bankruptcies and near bankruptcies in the history of American business. General Motors (GM), Chrysler, Washington Mutual, and Thornburg Mortgage as well as American International Group (AIG), Fannie Mae, Freddie Mac, and Citigroup, salvaged through federal money, joined Lehman on the blacklist.

These have been the high visibility cases. According to JPMorgan, there were also 15 defaults a month in the first four months of 2009,[1] but the rate fell in May and June. Particularly companies specializing in the so-called high-yield debt—a euphemism for junk bonds—failed globally, though the roster was dominated by American issuers.

It does not require a genius to appreciate that ten names in the list in this chapter's opening paragraphs were financial institutions, and with one exception (Lehman) the federal government acted as a deep-pockets financier after having tried its hand as a midwife. The leading role Washington played in the bankruptcies of GM and Chrysler—as well as AIG, Citigroup, and the two government-sponsored mortgage giants—has prompted fierce debate about the future of the Chapter 11 bankruptcy process.

The Bush Jr. administration's action in the cases of GM and Chrysler gave much less to some classes of creditors than the usually strict rules of Chapter 11 dictate. The politicization of General Motors and Chrysler

prompted fury and lawsuits and many questions were raised about ineffective top management policies and sloppy practices in connection with negotiations with counterparties.

A few years prior to going bankrupt, GM had reported an annual loss of $24.5 billion. The loss of $1 billion came from operations and the $23.5 billion from unfunded health insurance for its employees. In negotiations with labor unions GM management was most generous with health insurance because commitments did not showing up in the P&L (the income statement). But when the US financial reporting law changed what was hidden under the carpet came out into the open.

Other skeletons were hidden in other closets. In the case of the American International Group, in 2007, its chief auditor warned top management that derivatives valuation may be flawed.[2] But the top brass did not pay due attention and business continued as usual, including AIG's mounting exposure (section 2). Then in September 2008 came the moment of truth.

Indeed, already in March 2008 Wall Street spoke of two names known to have struggled over that month—Citigroup and AIG—with the latter treated especially harshly by the market as the scale of the task of selling its assets becomes apparent. By the end of March 2008 it had become necessary for the Bush Jr. administration to add another round of aid (the third one) to prop it up.

At the time, analysts said that, to some extent, the continued inclusion of AIG in high-grade aggregates was something of an anomaly because despite its rating being nominally investment grade very few market participants still seriously considered it as such. AIG was the archetype of a large and complex financial entity, an LCBG whose deteriorating condition was amply illustrated by the pricing on the majority of its outstanding paper.

Critics of government intervention and bailouts lamented that financial firms were getting preferential treatment because they form the plumbing of the economy, yet were careless enough to need sovereign help. American firms were not alone in that need. In Germany, Commerzbank received €8 billion ($10.4 billion) of capital, or nearly double its market value. No wonder then that politicians have been jawboning banks into risk control action.

In the US, the chairman of the Senate banking committee said that if progress was not forthcoming, they were prepared to legislate. France's finance minister told a conference she hoped that threats would be enough. But they were not enough. Bankers and other financial industry executives understood that sovereigns were undecided on whether their reaction should be hard or soft.

Pouring public money into private enterprises was not a problem that could be taken lightly. Long-term state ownership of the banking system was, is, and will remain an unattractive prospect. There exists plenty of evidence that state-controlled banks can become politicized and misallocate capital, For instance, directing cheap credit to companies in regions that voted for "this" or "that" political patron.

Having seen that a decade after Japan's financial crash, up to a third of the firms were zombies kept alive through unwise lending by banks under government pressure, the more clear-eyed Western politicians tried to structure their bailouts and other assistance as short term. Over time, they were largely deceived to find out that it does not work that way.

"Banks must concentrate on clients instead of on Ferraries," said Mark Carney, the new governor of Bank of England (and former boss of the central bank of Canada) in February 2013.[3] In mid-August 2013, as these lines were being written, George Osborne, the British chancellor of the exchequer, was still talking on and off of selling the government's stake in Lloyds Bank and Royal Bank of Scotland (chapter 9). In America, there was no mention about privatizing Fannie Mae and Freddie Mac (chapter 7) while the government still owns a large chunk of AIG.

There is nothing morally wrong about sovereigns hoping to encourage banks to repay taxpayers as quickly as possible, but it is not realistic. Once they get the money banks run their own schedule and this involves major risks. While there are hints that France is often tempted to micromanage its banks, most governments do not to do so.

With the Western economies finding it difficult to become upbeat again, banks and insurers still confront problems and risks due to past mistakes, which have continued to materialize since the beginning of the economic crisis; for some of them, these have been the largest losses ever recorded in their financial statements. Write-downs by insurers and financial guarantors over the July 2007–May 2009 timeframe dramatize this point. For:

- AIG (alone) write-downs stood at $89.8 billion
- US financial guarantors, $22.6 billion
- Other North American insurers, $95.5 billion
- European insurers, $34.7 billion
- Asian insurers (surprise, surprise), $1.5 billion[4]

Though this data is not fully comparable across Europe, the US, and Asia, due to differences in accounting rules and practices, the differences are overwhelming. By September 2012 80 percent of AIG was still owned by the American government and trying to dispose of assets to repay a

$182.3 billion taxpayer infusion during the crisis. Since early on in 2010 AIG tried to sell its Asian business to Prudential, a British insurer, for $35.5 billion but the deal fell through and so did other deals-to-be. The Fed and other central banks were printing money like crazy and the market had lots of liquidity, but badly wounded companies had no investment appeal.

What has been offered, nearly with no questions asked, was taxpayer money and this was the stuff to be used. In the case of the American International Group the government bailout started with $123 billion, but as it has also happened for instance with Greece, the terms were renegotiated, resulting in an expanded package worth $153 billion that was again upped. Even with that money, the company was in trouble. It reported billions in net losses and booked more write-downs under government ownership.

As was to be expected the Bush Jr. administration was ready to oblige. In sum the American International Group got a $182 billion bailout in 2008 as a runaway subsidiary built up huge exposures to American subprime mortgages, while regulators and counterparties worried about annuities, pensions, and most particularly derivatives as well as global systemic fallout.

By the end of 2012, four years and a quarter down the line, the former US flagship was in the sixth position in the roster of Western top eight insurers. This list included three American firms, two British, and one each from France, Germany, and Italy:

- French AXA with $1 trillion total assets
- German Allianz, $910 billion
- US MetLife, $800 billion
- US Prudential Financial, $720 billion
- Italian Generali, nearly $600 billion
- US AIG, $550 billion
- British Aviva, $510 billion
- British Prudential, $500 billion

With its creditworthiness still in question, AIG featured the least assets under management: just $300 billion, compared to the $2.4 trillion of Allianz, $1.5 trillion of AXA, and $800 billion of Prudential Financial. All eight, however, or more precisely nine with China's Ping An ($470 billion in assets), were named *systemically important* by the Financial Stability Board (FSB). As such they are facing the prospect of closer regulatory scrutiny and tougher capital standards, which should have been the case from Day 1.

## 2. The American International Group Was More Than an Insurer

The American International Group was generally thought to be primarily an insurance company. In reality as Figure 6.1 shows it was a highly diversified conglomerate, a huge derivatives outfit with an insurance business on the side—fully qualified to be regarded as the structure LCBGs hope to reach as they expand their operations worldwide.

The insurance side was itself huge. AIG's global life insurance business was not only a major provider of life insurance policies but also operated many US pension plans. According to experts, this was a reason why the US government could not let AIG go bankrupt, since the pension funds would go down the drain.

The sovereign had to account for the fact that AIG was one of the country's biggest retirement plan suppliers to the education and healthcare industries, as well as its general insurance operations were one of America's biggest providers of home, automobile, life, and aviation insurance. But it was AIG's Financial Products operations that caused the most concern as they had:

- Accumulated most of the problem investments,
- Posed the biggest challenges, and
- Led to the company's downfall and takeover by the government.

The risks posed by AIG Financial Products, if the company failed, are generally considered the second biggest reason for its nationalization, though I personally consider them to be the no 1 reason, given the most likely snowball effects. According to some estimates, an AIG failure could result in well over $200 billion of losses to *other* financial institutions—wiping out about half the capital banks had raised to cope with the worldwide credit crunch.

The insurer had $441 billion in exposure to credit derivatives and because a lot of this was provided to banks, the Federal Reserve felt that it had to intervene. A debacle would have hit the market of the so-called synthetic CDOs, which comprise a bunch of credit-default swaps, while an even bigger exposure was thought to be in the interest rate swaps market, which is many times larger than the market for credit derivatives. This would have raised serious questions about the health of the world's big banks and investment funds.

Another horror story was the $310 billion of contracts written on instruments owned by banks in America and Europe, designed to guarantee their "asset quality," which is a way of describing occult help for their regulatory capital levels. (Ironically, a research paper presented at

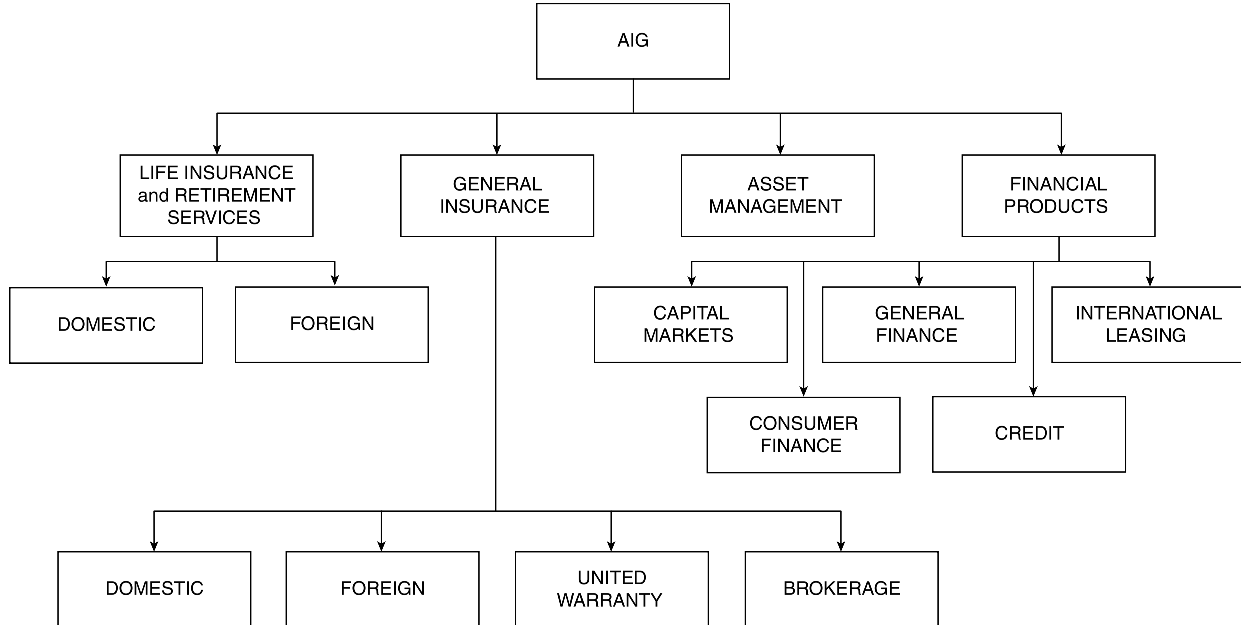



**Figure 6.1** The AIG empire of diversified subsidiaries.

the summer meeting of the world's economists, politicians, and bankers at Jackson Hole, Wyoming—organized by the Fed of Kansas City—suggested that banks hold little equity capital while their capital adequacy is being guaranteed by an insurance company's policy.)

Some experts also advanced the opinion that while the CDS market probably figured in the Treasury's calculations of whether to save AIG (given that its collapse would have forced banks to write down the value of their contracts with the insurer, further straining their capital ratios), the government also had an eye on Main Street. A significant number of consumers and small businesses depended on AIG honoring its contracts. Its failure would have shaken their:

- Confidence, and
- Financial staying power.

The domino theory was at work. Apart from the huge write-downs with its warehoused subprimes, AIG had equity of over $600 million in Fannie Mae and Freddie Mac. That was another source of red ink as the stock of the two giant mortgage firms sold for 6 cents to the dollar. In other terms, there was a pyramid of guarantees that risked crashing down. As if the aforementioned huge exposures were not enough, on September 16, 2008, it was revealed that Pimco, the large bond asset manager, had guaranteed $780 million of AIG's CDSs.

All told, AIG Financial Products had written billions of dollars of derivatives that were at the heart of the firm's woes as well as a long way from the mainstream insurance business. With its AAA credit rating, AIG was an attractive counterparty for long-term swap transactions, which ensured that its Financial Products division continued to expand. Derivatives contracts and the insurance business had merged:

- In the process of insuring investors against defaults on collateralized debt obligations, and
- These accounted for the bulk of the $41 billion of write-downs that AIG suffered in mid-2008.

Miscalculations were the order of the day. The talk on Wall Street was that, in the opinion of AIG executives, insurance against defaults on CDOs would be extremely unlikely to generate any losses because most related to the so-called super-senior tranches deemed so safe by the rating agencies that gave them a triple A. (AIG first started becoming exposed to these "super-senior" tranches of otherwise garbage securities about a decade prior to the crash when its appetite for risk increased.)

It needs no further explaining that AIG's involvement in the high-risk business, as well as in hedging and investment products, meant it operated almost as an overgeared investment bank that eventually crashed. This did not discourage Maurice "Hank" Greenberg, AIG's former CEO and major shareholder, from suing the government. (He filed his suit at the end of 2011 but a decision is still pending.) Greenberg claims that when the US Treasury and Fed took 80 percent of the firm's equity as counterparty to the rescue they violated the Constitution, which says the government cannot take private property without "just compensation."

This argument conveniently forgets that at the time of AIG's crash "just compensation" might well have been zero-point-zero dollars. In the week of September 8, 2008, AIG sought to raise $20 billion in equity from buy-out investors Kohlberg Kravis Roberts, Texas Pacific Group, and JC Flowers. This was part of an emergency plan to shore up its balance sheet. It also aimed to restructure its debt. But there were no takers while the worst continued to worsen.

The erosion of AIG's balance sheet and the growing concern among its investors showed that problems associated with mortgage securities backed by subprime debt were not confined to the conglomerates and to investment banks that manufactured and sold these products. Several American and European LCBGs had entered the high stakes, to their eventual sorrow, and AIG was deprived of outlets to unload its toxic waste.

In addition, following the Lehman Brothers bankruptcy the equity markets fell and spreads in the credit market surged, accentuating AIG's problems. Investors were awakening to the fact that as of December 2007 AIG had sold protection on $527 billion of debt and even if it still retained its AAA credit rating, 12 percent of the portfolio had subprime exposure while plenty of issues surrounded its CDS portfolio and securities lending program. With the amount of its exposure thought to be high but uncertain, a falling domino effect was coming into play.

The regulator (if you can believe it), the Office of Thrift Supervision (more on this in section 3) and AIG's own staff, did not have the skills to appreciate the zooming risks, let alone be in charge of them. As more of the US regulatory authorities took a look at AIG's CDSs, they first thought of requiring that, for transparency purposes, these are traded through a clearing exchange, but:

- They were not standardized,
- It was not clear what could be carved out of them, and
- The whole process (let alone culture) of exchange-traded CDSs was absent at the time of these events.

The reasons that made AIG insolvent, later on frustrated the American government's long-term plan to raise cash by spinning off or selling the traditional insurance businesses. Soon, however, the examiners discovered that there was no truly "traditional" insurance business and what there was would most likely crystallize losses. Several AIG "assets" eventually ended up fetching less than book value—that much about Greenberg's request for "just compensation."

### 3. Regulatory Authorities Had Not Performed Their Duties

As mentioned in section 2 AIG's bailout started with $123 billion in public money, but this sum was subsequently upped as it proved inadequate. What has not been said so far is that AIG's executives continued their big spending practices, this time around at the taxpayer's expense. An outcry in the US put a temporary stop to posh resort retreats in Las Vegas and California, but a lavish shooting party at a British country manor went on.

An article by Maureen Dowd[5] reported that London's *News of the World* sent undercover reporters to hunt down AIG's financiers on their $86,000 partridge hunt as they feasted on pigeon breast and halibut; stayed at Plumber Manor, a seventeenth-century country house in Dorset; and spent $17,500 for food and rooms. The cost of a private jet to get them there was another $17,500, and the limos added up to $8,000 more.

Sebastian Preil, an AIG big shot, held court at the bar and told an undercover reporter: "The recession will go on until about 2011, but the shooting was great today and we are relaxing fine."[6] In the US, New York's attorney general, Andrew Cuomo, got AIG to reverse itself and cancel 160 conferences and other events that would have cost more than $8 million, as well as disclose information on compensation, bonuses, and other payments to determine whether they were deserved. But in Britain, AIG's after near-bankruptcy party went on.

"We stopped a $10 million severance payment to Stephen Bensinger, the chief financial officer," Cuomo also said in a statement. "Just look at the words chief financial officer. There's a phenomenon when senior management sees the corporation deteriorating and they concoct a version of looting the company to take care of themselves." New York's attorney general also stopped a $19 million payment to AIG fired CEO Sullivan,[7] using a state "claw back" law that allows recovering contracts and rescinding payments if there was unjust compensation.[8]

Many blamed AIG's demise and continuing escapades after the eleventh hour salvage through public money to very weak supervision. Its supervisory

authority was the rather constrained New York Insurance Department, yet this was a highly diversified conglomerate that owned 71 US-based insurance companies and 176 other financial services entities including non-US insurers. Moreover, AIG's holding company was regulated by the Office of Thrift Supervision (OTS),[9] by its own choice and without other regulators objecting. As a supervisory agency, OTS is charged with overseeing savings and loan associations, not complex conglomerates.

The skill of the examiners working for a regulator is of capital importance. A savings and loans (S&L) and an LCBG are diametrically opposed entities. Not only were AIG deals complex and highly risky, but they also operated in some 130 countries, and it had more than 100,000 employees. This requires as skilled examiners as they can ever be.

Highly relevant to the required amount of regulation and supervision was also the fact that it provided credit protection to tens of thousands of financial institutions and other firms around the world by steadily opening markets all over the globe. For more than three decades, AIG stood for liberalization of the world's trade in services. In addition:

- Its stock was owned directly or indirectly by millions of Americans, and
- It had contributed to US gross domestic product and balance of payments over the four decades of its existence.

That's not the sort of stuff the Office of Thrift Supervision was tooled to handle, and even Washington Mutual (the big S&L that went bankrupt on September 25, 2008) proved to be too much for it. The bending of regulatory chores was endemic. As chapter 5 brought to the reader's attention the Securities and Exchange Commission (SEC) had not done a better job as supervisor of investment banks than OTS with AIG.

The evidence has been that in a world where LCBGs turn themselves into big financial "supermarkets" and they become the norm, and financial institutions are exposed on more fronts than before, regulators must be given wide authority and (most definitely) keep on upgrading their skills to obtain the knowledge they need to oversee sprawling behemoths.

- AIG was too large and too interconnected to be transparent, this being one of the many and dire regulatory failings, and
- According to several expert opinions no state insurance regulator could possibly have identified AIG's problems in time.

When AIG's financial staying power had melted away and the company could hardly survive through its own devices, came the September

16, 2008, intervention by the US government. In exchange for cash and guarantees for AIG financial products (including the subprimes). This was dubbed a bailout though it was really a managed bankruptcy. The US Treasury became 79.9 percent owner of the hedge fund with an insurance business on the side.

Right after the Treasury's announcement, experts suggested that the saving of AIG was not the same as the program put in place for Fannie Mae and Freddie Mac. The Treasury injected capital and took the most senior place in the capital structure, but the remaining AIG capital was not guaranteed by the government. Still with this salvage the Bush Jr. administration did a huge U-turn. From then on Treasury and Fed officials made it their duty to intervene.

The solution chosen by the US Treasury to save AIG from default looked like a copy of what the French government did to save Alstom from filing for bankruptcy. As for the $700 billion projected to buy the toxic waste of US banks, it is no different from the strategy employed by François Mitterrand, when he was president of France, to save, also at the eleventh hour, Crédit Lyonnais from descending to the abyss. (This was a bad decision as Crédit Lyonnais has become a steady source of financial troubles.)

Keeping in mind that the day before AIG's salvage the Fed had allowed Lehman Brothers to go bust, some financial analysts expressed surprise at the bailout because AIG was (theoretically at least) an insurer, not a bank. As such, it had neither statutory federal backing nor much federal oversight. Other experts tried to guess what makes the Treasury secretary tick in terms of interventions.

According to learned opinions the salvage of AIG formed, some time down the line, a template for other US bailouts, including those for bond insurers, highlighting the broadening scope of TARP's Capital Purchase Program (CPP). The Treasury purchased from AIG $40 billion in new preferred stock, with 10 percent coupon. But the existing $85 billion credit facility with the Fed was restructured:

- Extending the maturity to five years, and
- Dramatically reducing the interest rate[10] and commitments fees.

The Fed was also committing loan financing to two limited liability companies (LLC), called Maiden Lane II and Maiden Lane III, designed to purchase troubled assets from AIG. One $23.5 billion LLC was destined to purchase RMBS from the company's US securities lending program, while the other $35 billion program was set to acquire ABS CDOs on which AIG Financial Products had written CDS protection. The package

did not address AIG's $237 billion exposure to corporate CDOs, where performance is sensitive to the developing default cycle.

In retrospect, the Treasury's decision to reverse gears and change its policies related to bailouts, seems to have been highly influenced by the fact that the LCBG was so large and complex that its failure could be catastrophic. Little was however done by way of truly unifying and strengthening the LCBG's supervision, which left the door open for the next bubble and bust.

At the news of AIG's managed bankruptcy the market felt relief. Part of it was due to the fact that, with government banking cast in stone, the Chicago Mercantile Exchange (CME) allowed the ailing insurer, which also sponsored a major commodities index, to conduct limited block trades in livestock and grains contracts. Also, to offload some of the positions it built up by selling investment based on its so-called Dow Jones-AIG Commodities Index, the second largest of its type.

The CME also permitted AIG to conduct block trades—that were held outside the public auction market—of soybeans, soybean oil, corn, wheat, live cattle, and lean hogs futures. The move helped ensure prices were not roiled by sudden big buy or sell orders coming onto the exchange, whose (then) relatively small turnover (when compared to big financial markets) made it susceptible to volatility.

The DJ-AIG index of 19 major contracts had attracted investment of about $55 billion by the end of the second quarter 2008, just before commodities markets tumbled by a third. AIG had not only sponsored and helped manage the index but also sold it directly to investors, making the insurer a counterparty as well as an index provider—a plain conflict of interest.

On the other hand, the unwinding of positions at Lehman and the sale of assets at AIG continued to disrupt markets for some time. The risk aversion of investors was running high, and there was concern that other financial institutions and leveraged investments could fail. All these economic downsides, and the managed bankruptcies engineered by the government, happened in the land of free enterprise, leading to the conclusion that whether under socialism or liberalism it always ends the same way: the taxpayer foots the bill.

### 4. Lessons Taught by AIG's Debacle

In its unprecedented role propping up one of the world's largest insurers, the US government appointed trustees to oversee its stake in AIG. Critics said that this extended the breadth of government in private industry and

it sketched a blueprint for managing a sovereign's ownership in financial companies. The bailout put the taxpayer in the unusual position of being AIG's:

- Owner,
- Lender, and
- Client.

These three roles could collide, involving conflicts. As a lender, the Fed is responsible for ensuring that AIG pays the interest on its loan and repays the money it got. Therefore the lender's interest would be best served by AIG operating conservatively, with a primary focus on replenishing its treasury.

By contrast, as AIG's controlling shareholder, the government should want to maximize value in the short, medium, and long term. That would ensure taxpayers, who became shareholders without being asked for their opinion on the matter, have a better chance of being rewarded. But the taxpayers themselves, as AIG clients, would like to see that its products and services are reasonably priced—thus curtailing profits.

As if this conflict of interest was not enough, the bailout also positions the US government to compete with private firms in the insurance business without a dependable plan on how to insulate its heavy hand from political influence. This promiscuity can well end up in decisions contrary to the nationalized company's economic interest.

Indeed, since the first bailout there has been a contradiction in the fact of targeting sound recovery while AIG was given two years to repay the loan, a period judged to be quite short. The government's intention was to let the company proceed deliberately and avoid a fire sale. Such concern was real since credit markets had seized up and the stocks of several insurers (potential asset buyers) were hammered.

There was also the challenge of restructuring the financial mammoth's supervision. Many experts found it surprising that regulators had done nothing to stop the superleveraging with highly toxic instruments when there was still time to exercise prudential control. Charging with all eight cylinders meant that there were no capital reserves left to use in case of a crisis.

Not only in the case of AIG, but also in the case of many other companies, management's ability to service debts and cover losses incurred by its business units (particularly the one that provided financial guarantees) depended heavily on the soundness of risk control, the questioning attitude of top management, and the ability of some of the product lines

to continue being profitable. In AIG's case this role was supposedly taken over by its insurance operations that were themselves overgeared .

Only postmortem the hopeless exposure of each AIG division became evident, and such finding created great concern among supervisory authorities about the ramifications of an AIG bankruptcy—particularly as no one knew how many *in-credit* default swaps had been written on AIG itself. This is a stark example of how activities occurring at the vertex of an LCBG could detrimentally affect:

- The entire conglomerate, and
- The global financial system.

Another lesson taught by AIG's debacle is that first estimates made by the Treasury and Fed for an LCBG's salvage were accurate. As a rule bailout estimates made by government are always too optimistic. This is particularly true when a big financial entity is brought to its knees by its escapades in the derivatives market, while the sovereign tries to be a firefighter by throwing at the problem both capital and loans.

Then there is the case of moral hazard, always present when public policies are part of the picture. Even on September 16, 2008, when the Bush Jr. administration first intervened, AIG was a controversial candidate for assistance. As the careful reader will recall, the bankruptcy was avoided only because of the size of the holding company's book of toxic credit derivatives, which the government barely understood.

Complex and obscure deals had left the LCBG so intertwined with other financial firms that its failure was judged by the Federal Reserve and Treasury to endanger the financial system. But neither of them was sure about the house of which it was taking control. Postmortem, it became clear that the government's original plan was flawed. It was too little too late. The plan came at a time when:

- AIG faced crippling collateral calls, and
- Lehman Brothers had just folded.

Moreover, in mid-September 2008, the authorities lacked the wide powers granted by the Troubled Asset Relief Program (TARP) and approved by Congress in October 2008. It comes therefore as no surprise that the original salvage plan looked a lot like the traditional remedy for a liquidity crisis at a solvent bank. In the month that followed the cash injection, to the dismay of federals, the chances of AIG being able to repay the loan shrank (though it recovered later).

AIG had a trillion-dollar balance sheet but unraveling complex financial products saw to it that there was only a thin buffer of core equity between the taxpayer's preference shares and any further losses. Exposure to written CDSs had much to do with it, and according to a former securities regulator, the CDSs are a "Ponzi game" that no self-respecting firm should touch.

- Alan Greenspan, the Fed chairman, who used to be a CDS cheerleader, disowned them in "shocked disbelief," and
- Eric Dinallo, the insurance superintendent of New York State, called them a "catastrophic enabler" of the dark forces that have swept through financial markets.

Theoretically there is nothing wrong with CDSs, originally conceived as a means for banks to reduce their credit exposures to large corporate clients. Practically, there has been overkill as highly rated companies were allowed to write reckless volumes of them. CDSs quickly became instruments of speculation for insurers, big banks, and hedge funds, while bets were almost limitless.

Banks paid insurers such as AIG to take on the risk that their assets would default, which in itself was a loophole because it saved them from having to put regulatory capital aside. To make matters worse, in a collusion with rating agencies they converted lower-rated securities into AAA ones through covert action in securitization—except that AIG went bust, their grand plan capsized, and the taxpayer had to put up trillions of dollars to keep the zombies alive (and continues doing so because of the unholy alliance between LCBGs and sovereigns which developed out of the most recent crisis).

Some experts said that the real reason underpinning the bulk of AIG's troubles was its low-grade mortgage lending, not derivatives. Swaps on subprime mortgages grew unstable because the loans themselves were dodgy. Those who subscribed to that hypothesis urged regulators to look into methods and tools that increase transparency, as well as into the reasons why major counterparties fail to properly manage *their* risks.

Postmortem, several experts admitted that they could not have thought that such a massive company like AIG with total assets of about $1 trillion would run into such severe problems and would have to be practically nationalized. These experts pointed out that one of the key things one learns from AIG's failure comes by looking at the origins of its problems which did not stem from the regulated parts of its insurance business but from the largely unregulated Financial Products unit.

- AIG engaged in trading of credit risks and in securities lending, and
- The holding company was too much of a geared structure, with many different supervisory authorities expected to look into deals whose risk they could not appreciate.

As section 3 brought to the reader's attention, no supervisory authority was responsible for the monitoring of AIG's steadily growing exposure. The overall view of the company was simply missing and therefore it was extremely difficult to see where problems arose, how severe they were, whether top management was aware of them, and what interrelationships existed between the company's different domains of exposure. Within this sea of darkness and absence of attention, superleveraging continued its course unattended.

The catastrophe had taught valuable lessons, but for how long would they be remembered? Problems resulting from leverage with derivatives are hardly uncommon, which means that they are repeated time and again. Another puzzle was said to be the rickety state of AIG's back-office plumbing, neglected as the market boomed. Technology was blamed for that, which was a dirty excuse. The same technology was available to all financial institutions—some used it rightly, and others used it wrongly.

### 5. Bonuses, Counterparties, and Public Money

Six and a half years after the bankruptcies and near bankruptcies that shook the American economy then spread abroad, the problems of the financial industry continue to weigh heavily on the markets. This justified the dictum when leveraged deals go right the result can be spectacular. But when they go wrong, they may wipe out capitalism's capital.

The early March 2009 announcement that AIG needed billions more public money and the further bailout of Lloyds in Britain were only two examples of the stress that remained in the system. Financial stocks continued to spiral down, while the banking and industrial sectors tried to deleverage. (Since the start of 2009 there was a net $120 billion fall in corporate paper outstanding in the financial industry. By contrast, in manufacturing, commercial paper outstanding fell only $11 billion.)

Part of the gloom was due to the fact that on March 6, 2009, the American International Group reported a net loss of $61.7 billion for the final quarter of 2008, the largest in American history. Some economists suggested that the AIG mess could force Congress to reconsider any future largesse. As the problems spiraled Treasury secretary Timothy

F. Geithner's star fell. His inability to get ahead with a viable solution for AIG followed his botched unveiling of a bank-rescue plan. Pundits said that regaining his credibility would depend on the success of two new schemes:

- To boost consumer lending by reviving securitization, and
- To remove toxic assets from banks—a Herculean task.

Like the stories that created a public outcry about oversized bonuses and other frills, the row was fanned by the media, delighted to have a simple story to tell about the financial crisis and its social consequences. In mid-March 2009 Barack Obama ordered his Treasury secretary to find a legal way to claw back the bonuses while the Democratic leadership in Congress suggested a special tax, set as high as 90 percent, to practically wipe out the bonuses if the claw back failed.

The negative public opinion did not change when the LCBGs tried to beat newly established government guidelines and restrictions, particularly those placed on companies that received public money. They responded to new executive-bonus limits by increasing salaries, which flew in the face of making pay more performance related as should be the case. Besides, these higher salaries (and in some cases shareholder dividends) were paid by money the big banks got from government assistance. (In 2013 Spanish banks did exactly the same with the billions of euros Madrid got from Euroland to recapitalize its banking industry.)

"Resign or go commit suicide." According to Charles Grassley, these were the only honorable choices open to the executives of American International Group who had taken $220 million in bonuses since the giant LCBG was bailed out with billions of taxpayers' money.[11] Those who got the fat bonuses during an economic crisis, looked at their CEO as being a brave person—but in reality he was not because he disregarded both the common citizen and the institution under his watch.

AIG with its huge bailout was casting a long shadow, provoking not only the public but also lawmakers into removing the ability for institutions to "charter ship." This was supposed to happen by merging the supervisory powers of four regulators into one and stopping the ongoing regulatory arbitrage. (It did not happen that way.) There was also the feeling that AIG owed much more money than it could pay, as Barney Frank, the former chairman of the House of Representatives Banking Committee, said in an interview by Charlie Rose on March 22, 2011, on *Bloomberg News*.

Many at Wall Street were lamenting that the government got so deep into micromanaging free enterprises. With AIG, Fannie Mae, and Freddie

Mac, the US sovereign had in a first time invested over $160 billion of equity in the toxic trio, and that number was rising. Investment experts estimated that including other kinds of help, such as loans, would see the total pumped into the three firms eventually reach $800 billion (or 6 percent of GDP). Some economists commented that the least one could have expected is that that the self-wounded financial institutions don't use such lavish funds to "reward" their executives for their failures.

The office of Andrew Cuomo, New York's attorney-general, revealed that 73 AIG employees had received over $1 million and that $57 million of its retention payments were earmarked for staff it planned to lay off. Edward Liddy, the big insurer's CEO, said he had asked all those who received more than $100,000 to give back at least half.[12] At the same time he worried that they would leave AIG, making it harder to manage its unprecedented toxic waste.

In late November 2009 Neil M. Barofsky, special inspector general for the Troubled Asset Relief Program, published his report on the US government bailout of the American International Group. Analysts suggested that this must be required reading for any taxpayer hoping to understand why the multibillion rescue of what was once the world's largest insurer ranked as the most troubling episode of the financial disaster that began in 2007.

Of special note in the report was the statement that the Federal Reserve had failed to develop a workable rescue plan when AIG began to sink. The Barofsky report also criticized the Fed as having refused to use its power and prestige to wrestle concessions from the failed LCBG's big, sophisticated, and well-heeled trading partners, with the aim of reducing the government's obligations in paying off full contracts. Instead it gave AIG's counterparties 100 cents on the dollar for positions that would have been worth far less if the LCBG had defaulted.

# 7

# Federal National Mortgage Association and Federal Loan Mortgage Association

## 1. Mortgages, Uncle Sam, and the Hedge Funds

Some people think that the *Federal National Mortgage Association* (FNMA, *Fannie Mae*) and *Federal Loan Mortgage Association* (FHMA, *Freddie Mac*)[1] now belong to history and therefore their case should be kept in the time closet. That's not true. First because their massive failure has taught many lessons on the unwanted consequences of runaway finance that will be lost if they just fade from the public eye. Second, because some Western governments, the British being one of them, contemplate resurrecting their defunct model through organizations aimed at recycling mortgages and (at least theoretically) promoting real estate sales.

It is serious error to repeat past mistakes but, when it happens, it justifies the statement by Ronald Reagan, the late US president, that the most terrible sentence in the English language is: "I come from the government and I am here to help you." Those who govern will be well advised to heed this. According to Seneca, the Roman philosopher, the repetition of errors of the past is diabolical. The wealth thrown down the drain through Fannie Mae, Freddie Mac, and their likes has been public money. It did not grow on trees.

In November 2013, when these lines were being written, neither the White House nor Congress had come to a conclusion on what to do with Fannie and Freddie. In December 2000, in their heyday, their combined market capitalization was $123 billion. But after they both hit the wall with the 2007 mortgage crisis, followed by the 2008 deep banking crisis, the US government poured $185 billion into them—a cool 150 percent their top market cap—to keep them alive.

The big handouts started in July 2008 when the Bush administration granted the two mortgage agencies, which at the time were government sponsored but not government guaranteed, an unlimited credit line. In September 2008 this was followed by government control of Fannie and Freddie, injecting up to $100 billion of taxpayer money into their treasuries.

Fourteen months later, at the end of December 2009, the Obama administration pledged to back the nationalized mortgage agencies and their mortgage exposure for the next three years, no matter how large their losses. Good luck followed. Nearly a year and a half down the line, in May 2011, Freddie Mac announced a first quarter profit of $676 million (peanuts compared to the funds being invested), stating that it did not need to seek any further government funds.

Not everything, however, was going according to plan. As the two mortgage agencies continued being under stress, in August 2011, Fannie Mae and Freddie Mac were downgraded by Standard & Poor's. In all likelihood, this was also influenced by the fact that the US government had lost its AAA status. S&P was right, as in November 2011, Fannie Mae, in the aftermath of derivatives bets causing a record $5.1 billion quarterly loss, asked the US government for $7.8 billion.

Nor was this the last time the mortgage agencies went hat in hand after taxpayer money. In February 2012 Fannie Mae sought another $4.62 billion from the government. By November of the same year, however, the mortgage agency told investors it expected its first annual profit since 2006—precisely the year when American home prices hit their peak. This, however, does not mean that Fannie and Freddie are out of the long, dark tunnel.

In the first days of January 2014 in the US senate Bob Corker, a Republican, and Mark Warner, a Democrat, made another effort to get through their legislation aimed at winding down Fannie Mae and Freddie Mac. In their opinion, a chance to resolve the ownership of the mortgage finance government-guaranteed enterprises (bailed out during the 2008 financial crisis) should not be abandoned.

The Senate Banking Committee, as of April 2014, put together a compromise bill that used some of the aspects of the Corker-Warner proposal. In November 2013 Fairholme Funds suggested taking over the bulk of the two mortgage companies' operations, proving that there was an appetite for risk from the private sector. But many other entities, particularly hedge funds, called for Fannie and Freddie to be left as they are, given that they are now performing relatively well amid rising home prices and a better loan quality. The big question has been how long this will last.

The way an old proverb has it, one swallow does not make a summer. Nobody ever thought that, with all the liabilities they have amassed over

the years, the two mortgage agencies will be forever profitable. The bigger Washington's exposure to the housing market the more difficult it will be to wind down Fannie and Freddie. Among the solutions being discussed is a bill to replace the two mortgage giants with a smaller entity that would guarantee mortgage lenders against *catastrophic loss* (improperly) defined as 10 percent of principal.

There are also some policy conflicts to resolve. The Obama administration wants to continue with the 30-year mortgage loans, as well as maintain support for mortgages to low-income borrowers. This comes at a cost and many experts believe there is no reason the American taxpayer should be on the hook for the next housing bubble. Nor should the US government shield borrowers from the effects of monetary policy.

The irony is that at the same time as the two government-sponsored and government-guaranteed mortgage entities abused the taxpayer money, they were themselves being abused by major US commercial banks who sold them subprimes, alternative As (AltAs), and other worthless mortgages. More woes transpired from a lawsuit filed in March 2013 by Freddie Mac against commercial banks, in which it alleged that it had suffered substantial losses as a result of manipulation of the Libor benchmark in lending.

Fannie Mae was not left behind. What followed was a July 2013 announcement by Citigroup of a deal to pay Fannie $968 million for recycled loans of a questionable value. In January 2013 the Bank of America had already agreed to pay $11.6 billion to settle claims relating to toxic waste in residential home loans.[2] These postmortem settlements came about as both US government-sponsored mortgage agencies claimed that banks sold them toxic debts and, as a result, should be responsible for the losses on them.

September 26, 2013, saw another agreement by Citigroup to pay $395 million to Freddie Mac to settle claims of "potential flaws" in mortgages it sold to the public mortgage firm. This settlement covered nearly 3.7 million loans Citigroup had sold to Freddie Mac between 2000 and 2012, and it was the latest (up to the time of this writing) in a series of settlements US banks made with Freddie Mac and Fannie Mae to avoid legal action.

In Washington, both the lawmakers and the executive branch were uncertain about what to do with Fannie Mae and Freddie Mac. The Banking Committee of the US Senate reportedly spent as many hours trying to map a course of action with the two government-guaranteed mortgage agencies as it had on the landmark Dodd-Frank Act of 2010. Still, because of the prevailing conflicting viewpoints, it did not reach a final decision.

It would also be proper to mention the Federal Reserve's helping hand along with this reference to Uncle Sam's uncertainty. While the Fed's oversized $45 billion in Treasury purchases per month roughly equaled some 75 percent of the debt that the Treasury has issued, the Fed's $40 billion in monthly mortgage-backed securities purchases actually exceeded MBS issuance.

According to a growing number of economists, the continuing purchases of MBSs and Treasuries by the Federal Reserve can disrupt the proper functioning of the free market. In addition if and when the central bank decides to sell its bond holdings by exiting QE, it would quite likely incur massive losses on its balance sheet by selling into a market of rising rates. which will further jeopardize its independence, while the possible harm to the two big government mortgages is far from being clear.

Part of the perplexity confronting Congress and the Obama administration has to do with the fact that since their 2008 nationalization the two mortgage agencies managed to become more indispensable than they were prior to their downfall. In 2007, shortly before the mortgage crisis, they guaranteed less than 50 percent of all US mortgages. At the end of 2013, however, they accounted for 85 percent acting like Atlas holding up the US mortgage market on his shoulders.

One more interesting development in the Fannie and Freddie saga is that by mid-2013 they had become profitable, after being allowed to more than double their fees while the quality of the mortgages they underwrote rose. They also profited by suing banks that provided them with toxic mortgages, collecting fairly substantial penalties. But the federal government was watching. As far back as 2012, as Freddie Mac reported a rising net income, the US Treasury changed in terms of its preferred shareholdings to take all the profits the two agencies produced rather than just a 10 percent dividend.

Other observers of the changing fortunes of the two government mortgage agencies have been the hedge funds. On November 13, 2013, hedge funds and private equity outfits came forward with a $50 billion proposal to take over large parts of Fannie Mae and Freddie Mac, presenting it as a way for Washington to wind down the risks associated with the government's nationalized mortgage agencies.

The investors' new risk appetite was formulated in a plan to create two private sector companies with the objective of ensuring trillions of dollars of US mortgages. This was advanced as the way to restoring value to Fannie and Freddie's preferred shares that were zeroed after the bailout of 2008. The added argument has been that mishandling their future could threaten:

- The US housing recovery, and
- The nation's economy as a whole.

The hedge funds offer encountered skepticism in US government circles, but (at least till mid-November 2013) there was no flat rejection of the offer. Hedge funds and other investors already held more than half of the two agencies' $34.6 billion preferred stock, and they also solicited financial backing from other outfits. Another argument has been that banks were reducing their involvement in the mortgage market, while:

- The private label mortgage-backed securities market remained in doldrums, and
- Private insurers had no available capital in amounts needed to promote such investments.

In conclusion, while the future for Fannie and Freddie remained unclear, and the US Congress debated their sort, Wall Street, which for a long time regarded the two government-owned mortgage entities as unfair competitors to its business, suddenly saw a wealth of dollars in the horizon. Investors started to believe that with estimated profits of $25–30 billion per year, recoveries from legal action against the banks worth another (may be) $20–30 billion, and reserves amounting to some $50 billion, the two mortgage agencies could be worth $200 billion or more. It looks as if all of a sudden Fannie and Freddie became lucrative investments.

## 2. Can Mutual Agreements Cope with Risk?

Financial historians say that mutual agreements have been the first instrument developed and used to cope with risk. Their use started with benevolent societies in ancient Greece, followed by guilds in the Middle Ages. The object of mutual agreements is to offer reciprocal assistance to ensure against various exposures, for instance, fire, flood, or robbery.

Compared to mutual agreements, insurance companies came much later, appearing in Britain in the seventeenth century with fire insurance. In financial terms the difference is significant. Mutual agreements can only rely on internal capital—that of policy holders. By contrast, private insurers can resort to external capital. Mutual insurers bear aggregate risk among the membership. With insurance companies the aggregate risk spreads to investors (and eventually to taxpayers).

A government-sponsored insurance company can be conceptually examined as a hybrid of these two classes, being closer to mutuals though it is endowed with and exploits government guarantees. America has five government-sponsored enterprises (GSE) set up to subsidize loans to

homeowners or farmers.[3] The two organizations that interest us in this text are the *Federal National Mortgage Association*, organized during the Roosevelt years and guaranteed by the Federal Housing Administration (FHA), Veterans Administration (VA), and Farmers Home Administration, and the *Federal Loan Mortgage Corporation*,[4] which is much more recent having seen the light during the Nixon years.[5]

Both Fannie Mae and Freddie Mac were supposed to help American families buy their own homes by making the mortgage market work better. The two of them came to dominate the GSE system, accounting for about 80 percent of its total credit portfolio. Fannie Mae was created as a government corporation in 1938; its shares were quoted in the exchange in 1968 when the Johnson administration chose this approach to reduce budgetary pressures created by the Vietnam War. Freddie was listed in 1989.

Based on the 1934 housing legislation, sponsored by the Roosevelt administration, the Federal National Mortgage Association was established four years later (in 1938) with the purpose of giving the market confidence about mortgage loans. The mid- to late 1930s were a time when housing was depressed and many home mortgage–lending institutions were still nervous about financing new house loans. Fannie Mae's market integration was simple:

- A mortgage lender that had just issued a new mortgage to a homeowner, could sell that mortgage to Fannie Mae for cash,
- The lender would then use that cash to make another new mortgage, and sell that to Fannie Mae—almost an interminable motion machine.

The creation of Fannie Mae was, so to speak, a necessity as in 1936, the Office of the Comptroller of the Currency (OCC) had issued a rule prohibiting banks from buying bonds that were "distinctly or predominantly speculative." It is interesting to compare this prohibition to the current situation where over 60 percent of US banks with less than $100 million in assets have invested more than 50 percent of their capital in MBSs of Fannie and Freddie. For banks with assets over $1 billion, this stands at about 20 percent. Thanks to an implicit, but not explicit, government guaranty these securities mastered an AAA rating. But:

- Scandals and huge derivatives exposure have rocked the agencies' reputation, and
- Scant attention paid to the fact that a drop in the value of MBS could cause difficulties to banks and trigger a credit crunch including the GSEs, sent the latter against the wall.

The risk assumed by Fannie Mae and Freddie Mac was linked to the fact that they were designed to perform their functions by supporting the secondary mortgage market. Historically, a secondary market for securitized mortgages started back in the 1930s when the first packages were sold, but it really took off in the 1980s.

Fannie Mae entered that market, to its misfortune, in 1982 and Freddie Mac in 1983. Some experts say that these government-sponsored entities have been victims of their own success as between them they ended up guaranteeing about half of all US mortgages, till they went bust in September 2008.

According to critics, Fannie and Freddie should never have grown as large as they did. When they rushed into the secondary market, especially the subprime mortgages, they should have been stopped by the Bush administration and by Congress, or, more precisely, by their regulator: the Office of Federal Housing Enterprise Oversight (OFHEO). This outfit, however, has been a very weak regulator and politicians have got into the habit of using Fannie and Freddie as dumping grounds for all rotten mortgages.

A milestone in overcharging the already bloated structure of Fannie Mae and Freddie Mac was the launch, in 1995, by the Clinton administration, of a national homeownership strategy designed to increase greatly mortgage lending to minorities and those on low income. Along with it came legislation requiring lenders to lend to people with poor credit ratings or indeed without any credit rating at all—while the default risk was carried by Fannie and Freddie.

The two government-sponsored entities were happy to comply since their CEOs and the executives immediately below them had awarded themselves handsome remuneration packages based on the volume of business done. When George W. Bush succeeded Bill Clinton in 2000, he did nothing to stand in the way of the GSEs' race to the abyss. Bush Jr. was buying into the prevailing so-called affordable housing ideology with both hands.

This has been a typical case of two forms: A political environment and an organizational structure with perverse bonus goals led themselves to abuse and whatever their claimed "merits," they were abused, at great cost to the American economy as a whole. In addition, in 2003, the Federal Home Mortgage Corporation came under fire for using, among other things, falsely valued derivatives. In the aftermath:

- Freddie's share price plunged,
- Two CEOs were fired in three months,
- The SEC initiated investigations, and
- Freddie said it would restate its 2000–2002 financial statements (more on this in section 2).

As the regulator, the administration, and Congress looked the other way, the two GSEs overleveraged themselves and their balance sheet. This started in the late 1990s when they moved heavily into buying mortgage-backed securities (MBSs) issued by others. In 1998 Freddie Mac owned $25 billion of MBSs with "other originators"; ten years later, at the end of 2007, this had grown to $267 billion. Correspondingly, Fannie's so-called outside portfolio grew from $18.5 billion in 1998 to $128 billion by the end of 2007.

In between, accounting scandals (in 2003–2004) exacerbated the risks associated with these positions: The two GSEs restated earnings by a total of $11.3 billion. As with the AIG and so many other poorly managed companies, there has also been lust and greed among their top brass. Between 1998 and 2003 Fannie Mae's five highest-ranking executives received among themselves $199 million.[6] There was also another scam—Freddie and Fannie have been also attempting to support prices of securitized mortgages by:

- Extending guarantees, and
- Buying large volumes of MBSs.

Still another weakness of the two mortgage GSEs, and of their supervisory structure, was that they were allowed to operate with too small amounts of capital. As defined by their regulator, Fannie Mae and Freddie Mac, at the end of 2007, had a core capital of $83 billion, expected to support $5.2 trillion of debt and guarantees. The gearing has been 65:1, comparable to the Long-Term Capital Management (LTCM) hedge fund that blew up in 1998.

The authorities were aware that the two government-sponsored GSEs for mortgages were building up a bubble, but did nothing to stop them. In a speech to Congress in 2004, then Fed chairman Alan Greenspan had said that without the expectation of government support in a crisis, such leverage would not be possible. But the higher and higher gearing and associated debt still carried the day.

It is precisely the size of the government support that became the key issue in mid-July 2008 when the US Treasury secretary, president of Federal Reserve, and chairman of the Securities and Exchange Commission addressed a crucial note to the House Banking Committee. This common note practically demanded an unlimited amount of funds to buy Fannie's and Freddie's loans and, if need be, their equity.

The salvage plan worked out by Hank Paulson, then Treasury secretary, has been sort of midway between what some experts asked for in the past about privatizing Fannie and Freddie completely and other requests

that advanced diametrically opposing conditions. The latter pressed the need for nationalizing them, breaking them up, and selling them out.

As in that fateful month of July 2008 the share value of the two GSEs fell precipitously because of short-selling; to prevent their collapse, and that of other financial institutions, the SEC intervened, slapping a ban for up to one month on "naked shorting"[7] of the shares of the two mortgage giants as well as of 17 investment banks. The SEC also reportedly issued over 50 subpoenas to banks and hedge funds as part of its investigation into abusive trading of shares of Bear Stearns and Lehman Brothers.

All this has been an ironic turn of events, but it was not unforeseeable. Already, in January and February 2008, as the US housing market descended to the abyss, politicians were counting on Fannie Mae and Freddie Mac to bolster residential real estate by buying more mortgages. But by July of that same year the rescuers themselves needed rescuing to the tune of several hundred billion, if not a trillion, of dollars.

### 3. Eventually Comes the Day of Reckoning

It was *as if* till the day of reckoning few people truly realized that mortgage debts have to be repaid. Many mortgages, because they were well securitized, and often rolled over, had become poisoned loans and, as such, contributed to the exposure of the two government-sponsored institutions. Beyond that the mortgage market's strains created by the banking system's subprimes, Alt-As, and other garbage landed squarely at Freddie Mac's and Fannie Mae's doorstep where they got recycled. Then, they headed back for the market through:

- Corporate bonds issued by Freddie Mac and Fannie Mae, and
- Mortgage-backed securities, in which Freddie and Fannie put a guarantee after repackaging them for sale.

When the storm created by the inherent garbage of these operations met with the storm in the housing market, the two collided and led to a systemic risk. The buyers of the securitized residential house debt have typically been institutional investors: insurance companies, pension funds, and so on. MBSs were derivative instruments and aside from Fannie and Freddie, other institutions that performed similar functions, like the Federal Home Loan Bank Board, possessed additional billions in exposure, with the grand sum being well above the US gross national product (GNP).

Macro forces were at work shaping up a more general pattern of financial instability. At the root of this gigantic exposure to mortgage financing

has been the fact that the US real estate market is more heavily supported by the government than any other country in the West. Part of the occult support comes by way of big tax breaks:

- From deductions for mortgage interest,
- To exemptions from capital gains

The crisis of what has been the jewel in the crown of American housing policy, arose because rather than being enablers Fannie Mae and Freddie Mac were corruption infested and hybrids, something between government-sponsored mutual and profit-bearing outfits that carry an implicit guarantee of government support. (Or, more precisely, they did so until their bailout in September 2008, which made the sovereign's guarantee perfectly explicit.)

The critics said that since the start Fannie Mae and Freddie Mac were a distortion of the banking system aimed at achieving political ends. Rivals in the mortgage market wanted government-sponsored institutions to meet the same capital standards as banks, to level the playing field and cut risk. By law, Fannie and Freddie should have held in reserve at least 2.5 percent of their on-balance-sheet assets versus the 4 percent banks with national-only operations had to hold against their home loans (Basel I).

Freddie and Fannie answered that banks needed more capital because they were engaged in a broad array of loans, some of which were riskier than mortgages. The two mortgage GSEs also tried to deflect efforts to limit their investment portfolios, even if their trillions of investments made them more like hedge funds with an implicit government safety net. Fannie and Freddie, which had reached the point of getting the majority of their profits from such investments, insisted that risk is well managed by hedging. Indeed, it was so well managed that Freddie Mac had to restate three years' worth of its earnings (section 3).

The financial reporting situation at Fannie Mae was not really better. In the fall of 2004 regulators uncovered a plethora of accounting maneuvers, allegedly aimed at dressing up Fannie Mae's earnings. Subsequently, its financial statements underwent wholesale restatements. Such unreliability was particularly damaging as it came on the heels of similar misbehavior by Freddie Mac.

Fannie Mae's own regulator, OFHEO, said that the government-sponsored mortgages agency used its huge political influence to thwart efforts to regulate it more tightly, knowing quite well that its internal controls and accounting systems were shoddy. The company's board and managers, OFHEO stated, had created an "arrogant and unethical corporate

culture" in which "the ends justified the means."[8] Fannie Mae's reputation as a well-run and low-risk company was just a "façade."[9]

That was by no means the first time Fannie Mae had come under severe criticism. On December 15, 2004, the Securities and Exchange Commission had ruled that the company's accounting did not comply with GAAP, but no disciplinary action was taken as it should have been. The SEC simply advised Fannie to:

- Restate its financials, and
- Eliminate hedge accounting.

The mortgage company disclosed that historical earnings and capital could be subject to a negative adjustment of about $9 billion. According to experts, after the SEC's mild ruling Fannie needed to raise more than $12 billion in capital by mid-2005 as OFHEO finally required that the GSE must have a 30 percent excess over the minimum capital requirements. In reality, money was not the only problem. Fannie absolutely needed balance sheet shrinkage, but this was left for later on or never.

In spite of a tandem of mishappenings the pros have been arguing that, quite contrary to what some experts said, the concepts underpinning Fannie and Freddie were avant-garde because they created a deep secondary market in mortgages, making possible the 30-year mortgage at a low fixed rate. This greatly helped the US middle class to become home owners.

Critics answered that the argument of helping middle class families become homeowners, as Bill Clinton and George W. Bush wanted, was overblown because many households were overleveraged and risked losing their house (which has happened with the crisis). An estimated 20 million US households, mostly in the lower quartile by income, were paying between 35 percent and 60 percent of their wages for debt service payment of home mortgage, car debt, credit card debt, and other personal debt items. Once such debt crosses the threshold to being unbearable, it can be serviced only by greater issuance of credit thereby growing the bubble.

Events proved that the critics were right. One of the major exposures of the first part of the twenty-first century is that the unemployment crisis triggered a simultaneously large number of bankruptcies and this detonated the highly leveraged multitrillion market in household debt, including its mortgage portion. In turn, this greatly worsened the total US domestic debt bubble, documenting that no care was exercised in financing the housing boom.

Conservative economists pointed out that there were also other overblown sectors of the economy. Car purchases were growing fast because Ford Motor's Ford Credit Division, General Motors' GMAC, and comparable entities of

other car makers had been making car instalment loans at zero percent. The leveraging of families through credit cards was also a major worry.

When a household can no longer meet its debt obligations, it files for personal bankruptcy. Statistics suggest that since 1990 some 10 percent of households in America had filed for bankruptcy, including mortgage bankruptcy, not merely defaulting on credit card and instalment debt. A historic high of 1.57 million US households filed for bankruptcy in 2002 alone. The net effect of such personal and household defaults is that they make interest payments so much higher for those paying on time, since banks have to recover their losses from somewhere.

This model of living on debt is based on the ability of consumers to see through illusions the nirvana that boosts their willingness to believe in the permanent recycling of liabilities. Investors, too, have had an illusion; the most important "evidence" they saw through was that in spite of the official line that debt issued by Fannie and Freddie was not backed by the government, the sovereign would not let its two GSEs fail (and they have been proved right at least in that assumption).

Dysfunctional government policies and the push for home ownership at any cost had reached the point where 23 percent of home owners were confronted by negative equity, with loans worth more than their homes being in the billions. This mass of money was unlikely to shrink very rapidly, given the pressure on prices from a large inventory of housing that was yet to hit the market and the pace of foreclosures. This worked against the Treasury's broader goals of:

- Reducing the chances of foreclosures,
- Luring banks to start lending again, and
- Cleaning the financial system of bad debts and negative equity.

In conclusion, poor management at Fannie and Freddie greatly contributed to the critics' viewpoint. Using political means, the two mortgage GSEs acquired guarantees on millions of loans that, in retrospect, were far too risky. This accumulation of bad house loans drove them to the brink of collapse, forcing the sovereign (through their regulator) to take them over. Over the first three-year timeframe (September 2008–September 2011) the Treasury had to inject them with some $140 billion to keep them solvent.[10]

### 4. The Piercing of Government-Sanctioned Secrecy in 2003 was a Precursor to Bad News

The veil of secrecy sanctioned by the sovereign behind which government-sponsored organizations like Fannie Mae and Freddie Mac conduct

much of their operations, was pierced on June 9, 2003, when America's second largest mortgage finance provider abruptly dismissed three of its top executives. The stated reason was apparent—account irregularities. Experts at Wall Street were of the opinion that such "irregularities" were no exception; they had deeper roots.

- On June 9, 2003, the Securities and Exchange Commission made it known that it had opened up an investigation of Freddie Mac.
- On June 11, 2003, the US Attorney of the Eastern District of Virginia, in Alexandria, announced a criminal investigation involving the company had been initiated.

The lesson derived from this tougher stance by regulatory and judicial authorities goes well beyond managerial ineptitude characterized by the exit of Leland Brendsel, Freddie's chairman and chief executive; David Glenn, president and chief operating office; and Vaughn Clarke, chief financial officer. Covered by the aforementioned significant amount of secrecy in its operations, Freddie Mac was supposed to be doing well. But if it were doing well, why did three executives have to go?

Some experts were of the opinion that the mortgage finance company had become unable to value its increasingly complex portfolio of securities that was growing by leaps and bounds. But others disagreed saying that besides mortgages, which were in Freddie Mac's charter, its portfolio included:

- More than $1 trillion in different derivatives, and
- A very significant amount of specially structured complex notes.

Exposure was worsened by the fact that these instruments were highly leveraged, as the GSE had taken the road of wrong-way risk. The 2003 sharp drop in interest rates had brought a wave of mortgage refinancing, and geared instruments strained the mortgage finance company's overstretched resources so much more. By all evidence,

- This was greater than Freddie Mac had prepared for, and
- Over and above that, the maturity structures of its assets and liabilities were misaligned.

As if to confirm these worries of the financial experts, on June 25, 2003, following an investigation into its accounts Freddie Mac admitted that it will restate three years of earnings, 2000–2002, by as much as $4.5 billion. This information reflected poorly on Freddie Mac's past accounting, control and disclosure practices.

Events were suggesting that, with lots of delay, the supervisory authorities became aware of brewing financial troubles. On June 7, 2003, Armando Falcon, a director of the Office of Federal Housing Enterprise Oversight, released a statement saying that "I have become increasingly concerned about evidence that has come to light of weakness in controls and personnel expertise in accounting areas and the disclosure of misconduct on the part of Freddie Mac employees. The removal of members of the management team only goes a part of the way toward correcting serious problems—concerns surrounding management practices and control remain."[11]

"Management is aggressively addressing these issues," said Gregory Parseghian, the mortgage firm's new president and chief executive.[12] Analysts however noted that Freddie Mac was still under investigation by the Securities and Exchange Commission, and therefore the new disclosures of *creative accounting* practices could not be excluded.

The developing Freddie Mac crisis raised concerns about the stability of the no 2 US mortgage lender. Its derivatives holdings were somewhat improperly stated, the institution said, but practically nobody accepted the huge mortgage finance company's official diminutive version of the troubles. Surely not the market. The problems of a huge exposure were not going away just by denying them. Analysts pointed out that:

- Freddie Mac's stock plunged 20 percent, wiping out almost $8 billion of its market capitalization, and
- The company also took the extraordinary step of buying back $10 billion of its financial paper in the open market, in the false hope of conveying a message of financial staying power.

In New York, knowledgeable observers have been looking at far more serious problems at Freddie Mac. On June 12, 2003, an unnamed bank chairman told the *New York Post* that the Freddie Mac crisis "sounds like the derivatives disaster that nearly wiped out everyone back in 1998." That was the time when the Long-Term Capital Management hedge fund collapsed. It frightens a lot of us that it could happen again, but worse, said another senior banker.

One can better appreciate the escalation of the troubles that led to Freddie Mac's public disclosure about irregularities by taking a look at what had happened at the beginning of 2003. At the behest of PricewaterhouseCoopers, its new auditor, which had replaced Arthur Andersen, a review of Freddie's financial statements dating back to 2000 was launched. At issue was the manner in which the GSE stated its derivatives portfolio, reportedly:

- Understating derivatives profits during good years, and
- Overstating derivatives profits during bad years.

According to unofficial reports, David Glenn, the president and COO, kept a diary/journal. The audit committee had asked to see it, but Glenn allegedly ripped out some pages and altered others, before handing over the diary to an independent counsel hired by the Freddie Mac audit committee.[13] An opinion heard at Wall Street about the reason for mutilation of the COO's notebook was that, over the last few years, Freddie Mac had aggressively used derivatives first to beef-up and then to prevent the US housing bubble from blowing out.

OFHEO deployed a special team to investigate all aspects of the issues surrounding the reaudit that revealed deficiencies in accounting practices and internal controls. Reportedly one of the findings was that Freddie Mac was, in all likelihood, one of the most indebted companies in the world. This was a long way from its original objectives, particularly those that characterized its predecessor and sister company Fannie Mae, which, by 2003, had its own troubles.

The lesson to be learnt from Freddie Mac's travails is that government-sanctioned secrecy is the harbinger of all sorts of ills and scams. In the case of the mortgage GSE this lasted way too long, till 2003, and we saw what happened under that veil. A lesson associated with it is that, by omission or commission, as an auditor Arthur Andersen had done a very poor job. This emboldened the mortgage agency's executives in their mismanagement and conflicts of interest, perpetuating the deceits.

Auditing laxity also violated Regulation §240.17 Ad-13, which focuses on internal accounting responsibilities stating that every registered transfer agent shall file annually with the Securities and Exchange Commission, and its own appropriate regulatory agency, a report prepared by an independent accountant. This must include the auditor's evaluation of the entity's system of internal control and related procedures for safeguarding securities and funds. The auditor's report shall:

- State whether the audit was made in accordance with regulatory standards,
- Describe any material inadequacies found to exist as of the date of the evaluation,
- Outline any corrective action taken, and
- Comment on the current status of any material inadequacy described in the auditing report immediately preceding the current investigation.

The regulation also instructs that the study and evaluation of the transfer agent's system of internal control shall cover a well-defined set of requirements. All material inadequacies must be identified and reported by the auditors, a "material inadequacy" being defined as a condition for which the certified public accountant (CPA) believes that the prescribed procedures, or degree of compliance with them, do not reduce to a relatively low level the risk that errors or irregularities would have a significant adverse effect on the ability to exercise due diligence.

Occurrence of errors or irregularities more frequently than in rare isolated instances is evidence that the internal control system has a material inadequacy, or is confronted with conflicts of interest. This has a significant adverse effect on the firm's ability to safeguard securities and funds it is entrusted with, accurately and in a timely manner.

Existing evidence suggests that at Freddie Mac irregularities were not confined to the rather remote past. After being bailed out in 2008 with taxpayers' money the mortgage finance agency propped up its market share relative to Fannie Mae and spent hundreds of millions of dollars a year that would otherwise go to taxpayers. The scale of compensation payments to loan originators was estimated by Deutsche Bank at more than $2 billion since the company was put into state conservatorship in 2008, and this has spurred the US Treasury to demand changes to how Freddie sells loans to investors.[14]

Since the GSE's mortgage-backed securities trade at a lower price, in an attempt to maintain its market share, Freddie Mac compensated lenders with fee rebates. On the contrary Fannie Mae was gaining share. In the end, however, both GSEs' profits go to the Treasury under the terms of their $190 billion bailout. Hence the self-promotion money Freddie spent diminished by so much the taxpayer's return on its huge loan. To prevent happenings like the $2 billion draining of funds, auditors must ask themselves:

- How dependable are the entity's accounting records?
- How accurate is the estimation of market reaction?
- How authoritative are management's information sources?
- Are the professionals being employed competent enough to provide reliable references?
- Can the audit be based on data made available by the firm, or does this data need thorough screening and verification?
- Are internal controls rigorous enough to withstand attempts to bend them?

Other critical queries are also calling for dependable answers: How well can the auditors themselves challenge the obvious and dig deeper? Can they live up to their findings regarding internal control dimensions? Is senior management receptive to a better methodology such as risk-based auditing? If not, who is mounting the resistance? For what reasons? How far does one have to go up the organizational pyramid to take care of the bottleneck?

### 5. The Markets Did Not Know What to Think of Fannie and Freddie

Theoretically by mid-2008 Fannie Mae was weathering what its CEO termed "the toughest housing and mortgage markets in a generation,"[15] but everybody knew that by purchasing, issuing, and guaranteeing mortgage-related securities, his company was highly exposed to the weak trends permeating housing and debt markets.

- Its mortgage credit book was not just concentrated in prime.
- Imprudently, it had assumed exposure to the high-risk areas of subprimes and Alt-As.

Mitigating its weak operating results, the government-sponsored enterprise had raised capital, but analysts saw the likelihood of higher-than-expected losses and further capital erosion, which added volatility to securities pricing. With a $2.8 trillion mortgage credit book, Fannie was exposed to material credit risk, as declining home prices, delinquencies, and defaults eroded its earnings. Earnings and cash flows were as well impacted by factors such as interest rates, credit spreads, access to capital markets, and more. In addition, Fannie relied on counterparties in many ways:

- Mortgage servicing,
- Deposit taking,
- Credit enhancement, and
- A range of derivatives contracts.

Default or insolvency of counterparties poses business, earnings, and liquidity risk. The pros were saying that such exposures were taken care of by the mega-agency's strengths. In their view default risk on the debt was remote, based on US government support via its operating charter as well as and most evidently the agency's political and economic importance.

Still it should not have been forgotten that Fannie benefited from its status as a GSE. Of the nearly $12 trillion residential mortgage debt outstanding, its holdings accounted for 23 percent.

As the critics of the two agencies' wheeling and dealing had predicted, with the economic and housing crisis gaining momentum the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation found themselves in the eye of the housing storm. After posting substantial losses in 2007, uncertainty continued to surround their mortgage credit book and market risk markdowns given their (unwise) exposure to subprime and Alt-A house loans.

With a $2.1 trillion mortgage credit book, Freddie confronted real material credit risk. As in the case of Fannie Mae, declining home prices and rising delinquencies had eroded earnings while credit losses were rapidly rising. Furthermore, it relied on counterparties for mortgage servicing, deposit taking, credit enhancement, and lots of other deals.

Seen in unison, at almost $5 trillion, the portfolio of Fannie and Freddie exceeded the total stock of American government debt in private hands. Since 2006, the two GSEs' shares of monthly issuance of mortgage securities had doubled to 84 percent, and they had lost a combined $11.1 billion in the three quarters from July 2007 to end of March 2008—an amount difficult if not impossible to recover in a depressed market.

It comes, therefore, as no surprise that by May 2008 confidence in them had evaporated, sending the spread over Treasuries on GSE-backed securities above the levels where even junk bonds were trading before the crisis. And though this spread subsequently fell back, it still remained high, posing many questions about their future.

There was talk of a new regulator of the GSEs, and the people who wanted the two mammoths to survive said that he had to have powers akin to those of a first-class bank supervisor. But others suggested that, judging from the position taken by bank regulators before and during the severe crisis in the banking industry, this would not amount to much. Nevertheless, a strong regulator could:

- Insist on asset disposals,
- Enforce standards for pruning the firms' portfolios, and
- Check their rate of growth at an affordable level.

There were also suggestions that a new regulator should coax Fannie Mae and Freddie Mac into operating countercyclically, and lowering requirements in failing markets. All this was, however, questionable

because strong regulation did not serve the politicians' interest while, at the same time, Congress voted for an expansion of the depression-era Federal Housing Administration, the government agency that supports low-cost housing.

In a move brushing aside Fannie's and Freddie's woes, FHA was supposed to guarantee up to $300 million of refinancing of underwater mortgages as long as lenders agreed to cut the principal owed to below the home's current value. The cost was supposed to rise to $500 million ironically covered by Fannie Mae and Freddie Mac, which themselves were approaching the cliff of bankruptcy. Sometimes (for not to say all too frequently) politicians lose contact with reality.

Not long thereafter Wall Street voted with its dollars. On July 6, 2008, Fannie Mae and Freddie Mac shares plunged to their lowest in nearly 16 years while costs to insure their debt against default rose upon concern that the two largest US mortgage funders may need to raise vastly more capital amid larger-than-expected losses.

Corporate "federal agency" debt obligations and mortgage-backed securities guaranteed by the companies also plummeted relative to government debt, as investors reduced positions in response to ongoing worries. With this carnage each entity lost more than three-quarters of its stock market value since August 2007 when the crisis, initially believed to be contained to the subprime mortgage market, erupted at a global scale.

The equity falloff was triggered by a Lehman Brothers report saying a pending accounting change could force Freddie Mac and Fannie Mae to raise an enormous amount of capital at a difficult time. This ill-timed rule aimed at forcing companies to account for securitized assets on their balance sheets, but it could mandate Freddie and Fannie to boost capital respectively by $29 billion and $45 billion, the Lehman analysts wrote.

On July 13, 2008, Hank Paulson, the Treasury secretary, felt obliged to make an emergency announcement: He would seek approval from Congress for extending the Treasury's credit lines to the pair of Fannie and Freddie, even buying their shares if necessary. Separately, the Federal Reserve stated the two mortgage agencies could get financing at its discount window, a privilege previously available only to banks. Serious commentators spoke of the absurdity of this situation, highlighted by the way the discount window works.

- The Fed does not just accept any old assets as collateral.
- It wants to get assets that are "safe," and the two GSEs had little to offer in this class.

Theoretically, the government-sponsored enterprises could issue their own debt and exchange it for loans from the sovereign. This had not been done, let alone tested, till then. If it were attempted, it would have been the equivalent of giving the two GSEs access to the printing press—a privilege associated with fiat money typically reserved for the central bank.

Still Paulson's words gave the market some confidence and a day later Freddie Mac was able to raise $3 billion in short-term finance. But the deal did little to help the GSE in a significant way or the share price of either company or of banks. Market sentiment was low due to the collapse of IndyMac, a mortgage lender. For its part, Moody's, the rating agency, downgraded both the financial strength and the preferred stock of Fannie and Freddie.

To make matters even worse, when Freddie Mac's assets were marked-to-market the agency had a negative net worth of $5 trillion. This was not surprising, because the portfolio of both Freddie and Fannie included mortgage loans at 100 percent the houses' value—an act totally detached from reality. Hence, when house prices dropped by 10 percent the value of the mortgages, too, dived—indeed much more than 10 percent if the product was structured.

- A massive recapitalization was needed to save either and both of them from bankruptcy.
- Owing to this high-water mark in red ink, the money could not be found in the capital market.

The fact that American investors kept away might not have been terrible news because a large part of the two government-sponsored enterprises' $5 trillion debt and mortgage-backed securities were owned by central banks and investors outside the United States. Still Hank Paulson found himself in an impossible situation, which the director of the Congressional Budget Office (CBO), an advisory agency, stated that Fannie and Freddie would be counted as part of the public sector in future analyses of the federal budget.

Troubles also arose from the two mortgages agencies' traditional guarantee business. The pair had underwritten trillions of mortgages between them and as delinquency rates were rising these came back to haunt them. Wall Street gurus said that even if impairments were likely to be "only" 4 –5 percent of the total, it would be more than enough to sink the two agencies. A massive insolvency would have made it hard to restructure them though they might find a new life under *conservatorship*, a form of direct state control.

### 6. Fannie and Freddie Fall off the Cliff

Apart from the agencies' equity that they held, US commercial and investment banks, as well as many foreign institutions, were exposed to paper issued by Freddie and Fannie that accounted for roughly half of their total securities portfolio—a totally irresponsible act. They also owned much of the preferred stock issued by the two government-sponsored agencies, attracted by the preference shares' combination of supposedly low-risk weighting and not-so-bad yield. This would be wiped out if the government took over the two mortgage agencies.

Compounding the risks was exposure associated with the CDSs and the fact that contagion can spread widely through the market for credit-default swaps. Unwisely, banks had written an unprecedented amount of credit protection contracts on Fannie's and Freddie's $20 billion subordinated debt, knowing very well that it sat below senior debt in their capital structures. If the debt's holders suffered losses in a bailout, triggering a credit event, banks that had sold the swaps would face huge payouts that they could hardly afford.

It comes, therefore, as no surprise that by then a growing number of experts were suggesting that nationalization was the best way forward, and the only fair one in a depressed market. Some Wall Street observers added that it was as well fair to the taxpayer because it would (or, rather, could) lower the two agencies' funding costs (therefore, mortgage rates) and show commitment to the stability of the mortgage industry at large. At the same time, however, it was sure to add in one shot a huge liability to the government's balance sheet.

At the end of July 2008 the drama continued with the Housing Bill passed by the US Congress that included measures to shore up Fannie Mae and Freddie Mac. With politicians never being away from the pork barrel that bill also allowed some 400,000 homeowners to refinance their bank mortgages with loans backed by the government.

- Supporters of the legislation said it would help stem foreclosures and provide a boost to a moribund housing market.
- Opponents argued that the legislation was a taxpayer-funded bailout of reckless borrowers.

Providing some welcome thinking about a rotten situation, an article in *The Economist* elaborated the hypothesis that Fannie and Freddie had turned for financial support to Hank Paulson not as Treasury secretary but, in his old job, as head of Goldman Sachs. *If* that was the

case, *then* Goldman would have insisted that the two GSEs paid a high price:

- Shareholders would probably have been wiped out.
- By contrast, the federal government's negotiating skills looked soft and ineffectual.

*The Economist*'s article went on to say that one of the main weaknesses of the housing bill is that it imposes no changes in management and does nothing to change Fannie's and Freddie's culture as big spenders and poor deliverers of efficient mortgage services.

As if to disprove the point made by that article, on August 8, 2008, Fannie Mae announced that it would stop buying Alt-A mortgages. A week later, it successfully sold $3.5 billion of debt to investors. Still America's biggest mortgage company remained in crisis as Standard & Poor's downgraded its preferred stock and subordinated debt, reflecting the risk that it might be taken into receivership. By contrast, the GSE's senior debt, with its near-explicit government guarantee, remains triple-A rated.

Another ten days down the line, as the end of August 2008 was approaching, new doubts swirled around Fannie Mae and Freddie Mac, causing their share prices to plunge by almost half between August 18 and 20, 2008. Freddie Mac auctioned $3 billion of its debt, but only after offering very favorable terms to investors.

Then, most curiously, in the last days of August 2008, Fannie and Freddie enjoyed a respite, with the share prices of both government-backed mortgage finance agencies making gains after a couple of brokers pointed out that they had enough capital to avoid a government bailout for some months. Fannie shook up its management team, including its chief financial officer and chief risk officer.

This was not, by any means, the last act. In a manner reminiscent of wheeling and dealing in socialist states, on September 7, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac under *Conservatorship* to avoid insolvency. This state was defined to mean that the FHFA establishes control and oversight of the GSEs to put them in a sound and solvent condition. In the market's opinion this closely resembled bankruptcy.

Simultaneously, the Treasury announced steps to complement the FHFA action: It would purchase senior preferred stock as needed to maintain positive net worth at Fannie and Freddie, up to $100 billion each, expanded to $200 billion each under the Financial Stability Plan. In addition the Treasury's Government Sponsored Enterprise Credit Facility (GSECF) was directed to provide secured funding to Fannie Mae, Freddie

Mac, and the Federal Home Loan Banks. Another step by the Treasury involved direct purchase of agency MBSs until December 31, 2009.

These measures turned the government-sponsored enterprises into explicitly government-supported enterprises. As credit from private asset-backed securities (ABSs) issuers dried up, Fannie and Freddie became the source of net positive mortgage financing using taxpayer money. By 2010 they accounted for 53 percent of the total stock of home mortgages, compared with about 40 percent in 2006. Moreover, the US Treasury and Federal Reserve purchased more than $1.4 trillion of mortgage-backed securities issued by the two GSEs, contributing to historically low mortgage rates.

Such a torrent of taxpayer money found its justification (if one could be admitted) in the fact that Fannie Mae and Freddie Mac faced significant losses on their portfolios, especially on mortgages that originated in 2006 and 2007. It did not need a genius to appreciate that the American taxpayer was drafted to be paying for a long time for the effects of Treasury's nationalization of Fannie Mae, Freddie Mac, and AIG in September 2008. Between them the two government-supported agencies featured:

- $4 trillion of outstanding MBSs, and
- $17 billion of their own accumulated debt.

On September 30, 2008, Freddie had featured a negative shareholders' equity of $14 billion. As 2008 came to a close, the two government mortgage-financing agencies in *conservatorship*, stated in filings that they could need $51 billion of government aid, over and above what they had already got.

Fears have also been growing over the health of their corporate cousins, the 12 Federal Home Loan Banks (FHLBs), which had played a subdued role in good times but lent heavily when markets dried up. Advances to thousands of their member banks rose by almost 60 percent to roughly $1 trillion in 2008, with wounded institutions as main recipients, including Countrywide, Washington Mutual, and Citigroup. The greater exposure seemed to lie in $77 billion holdings of so-called *private label* mortgage-backed securities that were not guaranteed by Fannie or Freddie.

- The market value of these assets had fallen, and
- Losses could grow as a result of *cramdowns*, which allow bankruptcy judges to cut the principal owed on mortgages.

In the second week of March 2009 it was stated that in the fourth quarter of 2008 Freddie Mac made a loss of $23.9 billion and it would need an

extra $31 billion from the government. Fannie Mae reported a quarterly loss of $25.2 billion for the same period. But the benevolence of the government saw to it that big red ink numbers lost their meaning.

On December 26, 2009, came the announcement that the sovereign would give the Fannie Mae and Freddie Mac unlimited financing till 2012.[16] The same month an article in the *International Herald Tribune* stated that "these companies—American International Group, Fannie Mae, Freddie Mac and GMAC—are not only unable to repay the US government, but they are also in need of continuing infusions that make them look increasingly like long-term wards of the state. And the total risk they pose to US taxpayers far exceeds that of the big banks.

In conclusion, the way things were going it looked like the Federal Reserve was gearing up to take over the roles of the mortgage agencies, while also finding creative ways to do the same for the corporate bond market. What the Bernanke Fed seemed to forget was that having expanded its balance sheet so much and so rapidly, it may not have the courage to shrink it fast enough once the crisis passed. It was a sure bet that the accumulated huge amounts of extra liquidity—with quantitative easing and salvage operations taking place left, right, and center—could fuel inflation, first in the American economy and then in the global.

One of the out-of-the-box ideas following the nationalization of big banks as well as of AIG, Fannie Mae, and Freddie Mac has been offered by Mike Gallagher in a letter to *The Economist*. The letter reads: "Given that some countries have already nationalized the world's second-oldest profession (banking), why not nationalize the oldest? The industry would become fully regulated; the prostitutes could then work decent hours under close supervision, have regular holidays and be free from abuse by pimps. Governments could use the huge revenues that prostitution generates to bail out even more banks."[17]

# 8

# Citigroup

### 1. A Bank That Found Its Dual Origin in Reputation and Conservatism

Trading is a source of profit and wealth for big banks that have the skills and technology to be global players. Right? Wrong! The year 2013 was not yet over but by the end of the third quarter it was already clear that the past months had been bad for traders and their institutions. By contrast, the equity of the banks that reinvented themselves as financial institutions, and are now serious players in investment advice and wealth management, prospered. This strategy is favored by investors. Here is the evidence.

After deciding to concentrate on wealth management, UBS and Morgan Stanley cut back their trading in fixed income, currencies, and commodities (FICC) significantly and they outperformed their rivals. From June 1 to September 23, 2013, FICC trading at UBS represented a mere 6 percent of total group income.[1] Over the same time period, the LCBG's share price increased by 25 percent. For Deutsche Bank, where 26 percent of total group income came from FICC trading, the increase in share price has been 10 percent. For JPMorgan, which derives 18 percent of its group income from FICC trading, the increase in share price was practically zero.

Other LCBGs still concentrating on a big share of total group income from FICC trading are Goldman Sachs (30 percent), Barclays (23 percent), Credit Suisse (23 percent), and Citigroup (20 percent). In their days the banks that eventually merged with the First National City Bank of New York (Citibank) and eventually Citigroup, were well-run, conservative institutions that served their community efficientlyand prospered as the following case study documents. They were not high gamblers with a policy of steady accumulation of toxic waste that brought Citigroup to virtual bankruptcy in September 2008, saved at the eleventh hour through taxpayer money.

* * *

After the American Civil War, the New York banks that merged into the financial institution known today as Citigroup extended rapidly under the impulse of ambitious but prudent financiers and industrialists. One of the pioneers was Moses Taylor, who helped to finance the first transatlantic telegraph. Another was James Stillman, who became a skilled banker and led the First National City Bank of New York to commercial banking prominence.

The National City Bank traced its origin to a year marked by financial panic. Having survived this economic and market downturn, the bank prospered at the expense of weaker institutions. Under Percy R. Pyne (Taylor's son-in-law), capital was purely equity and it was equivalent to 16 percent of assets that at the time included:

- Loans,
- Interest bearing securities, and
- A large reserve of gold and silver.

James Stillman assumed the presidency in 1881, a year in which more American banks failed than in any other year since the start of the national banking system in 1864. National City had reserves for all contingencies and Stillman was unrivaled in saying no to dubious or risky projects, aware of the fact that shareholders, bankers, and depositors had much to lose if exposure was not kept under lock and key.

Stillman remodeled the National City Bank to fit his image of how banking should work. The working day was lengthened, the lunch hour was cut to 30 minutes. Even the most trivial items of overheads such as pads and pencils were thoroughly scrutinized. The new technologies of that time, like stenography and typewriters, were introduced in order to increase personnel efficiency.

This emphasis on cost control and on efficiency was also the Bible of the second major New York financial institution that eventually merged with George F. Baker's First National Bank. First National was the earliest national credit institution to be chartered in New York under the National Currency Act of 1863—and it was also the first in:

- Reputation, and
- Conservatism.

George Baker's bank had no branch offices. Its president and chief executive disapproved of what he called chain-store banking. Neither were there separately listed departments. In its 92 years of existence, First

National Bank occupied quarters at the corner of Broadway and Wall Street.

Baker made his mark as the most imaginative yet prudent banker of his time. The financial institution itself was part bank and part broker, specializing in buying and selling bonds rather than lending. Its directors had resolved never to lend except against the collateral of US government bonds.

The genius of Baker was that in banking he struck an instinctive, lucrative balance between safety and risk. First National was irreproachably liquid and well capitalized. Because of its status, it was able to borrow cheaply but its president, like Stillman, was also known to carefully watch even the minutest costs.

At the same time, however, there were major differences characterizing the two banks, particularly in setting up branches at home and abroad. National City Bank quickly established its own offices, first in Buenos Aires, then in Rio de Janeiro, Sao Paulo, Havana, and Montevideo. During World War I, while the European banks were losing ground, New York's bank seized its opportunity and opened up for business in Europe. After the end of World War I:

- In the 1920s, it made the most of the expansion of trade, and
- It survived the economic crises, having reached a peak of one hundred overseas offices by 1930 in 23 countries and territories.

While the National City Bank expanded, the First National Bank remained put in its New York market. As it turned out, Baker's bank had been largely Baker himself—uniquely suited to an era preceding the Federal Reserve, the FDIC, and the split of the securities and commercial banking business. By the end of 1954, the two banks merged and First National City Bank became the name of the consolidated institution.

Following this merger, James Stillman Rockefeller became the president of the combined operations. His name combined in itself two dynasties—Rockefeller and Stillman. His grandfathers were William Rockefeller and James Stillman, who had expanded and structured the bank's operations earlier in the twentieth century.

Rockefeller perpetuated the bank's tradition of dynamism tempered by conservatism: He expanded through the New York suburbs and moved closer to the ordinary consumer with easier access and loans. When he moved up the organization from president to chairman he encouraged new generations of professional bankers to further develop the financial network and its channels at home and abroad.

To plan the bank's expansion overseas Rockefeller appointed George Moore, who later became president and who, it has been said, did more than anyone else to create the new First National City Bank. Moore's most successful protégé was a young vice president Walter B. Wriston, who became the head of European operations.

Moore taught Wriston that intelligent risk taking was part of the essence of banking. If we did not have troubles, Moore told Wriston, we would not have any high-price people around to solve them. But also, when he promoted Wriston to president Moore gave him another precious piece of advice: Be brave and scare Chase (a major competitor) but do not be so brave as to scare me.

The policies-to-be of the new man in charge of First National City Bank were subject to speculation among rivals. He was considered to be a courageous banker, but some of his peers thought he may go too far. By forcing free enterprise to its limits, would he force governments to intervene in salvaging a major credit institution? Up to and including 1970 governments had not acquired the habit of acting as saviors of wounded banks.

Walter Wriston soon made his mark as a hard-driving executive who saw the world as his battleground. He was the son of a historian who became president of Brown University. Young Walter had specialized in international law and diplomacy. Proud of his historical perspective, he upstaged his colleagues with sophisticated jokes and quotations but also, some people say, scared them by being an aggressive financier.

Wriston's strategy was to head for the no 1 position in US banking, which essentially meant overtaking Chase Manhattan. By 1968 Chase had deposits of $16.7 billion, against $16.6 in First National City Bank. A year later First National City overtook Chase for the first time. By 1970 Chase had taken the lead again, but in 1971 First National City leapt ahead with foreign deposits, and from then on it maintained its lead. In the mid-1970s Wriston changed the institution's name to *Citibank* as well as exploited the concept of a bank holding company to bypass restrictions imposed by banking laws.

Today nearly all American banking assets are controlled by bank holding companies. These are corporations that have under their wings one or more credit institutions at home and abroad. US bank holding companies own more than $15 trillion in total assets over a range of organizational and financial structures including deposit takers. Assets held in nonbank subsidiaries of bank holding companies account for a large share of such assets (some 30 percent or more).

While credit institutions are funded by both deposits and the capital market, and also have access to central bank liquidity through the Federal

Reserve's discount window, till the recent economic crisis nonbank brokers had to rely on capital markets for their funding. To bypass this constraint, the largest brokers in the United States, too, set up bank holding companies. Among other stated benefits of this move are:

- Theoretically it spreads risk.
- Practically it concentrates risk at holding company level.

An interesting hindsight in connection with bank holding is that borrowing costs may vary significantly among different subsidiaries of the same group, particularly its bank and nonbank subsidiaries. Optimization is possible but not absolute because regulation limits the flow of funds and capital across its subsidiaries.

Some of the banks and brokers are Federal Reserve–designated *primary dealers*, authorized to trade directly with the central bank, but also subject to requirements and obligations that imply a specific market structure.[2] Primary dealers have access to Fed operations, while other financial institutions rely on them for access to central bank liquidity.[3]

While according to the majority opinion changes connected to bank holding companies and to the concept of nonbanks have been part of modern banking—propelled by their appeal—it is undeniable that by pushing and pulling the US legislators, as well as by walking near the border of banking, Walter Wriston accelerated the timing of changes (including the repeal of the Glass-Steagall Act). The key, he allegedly said, is to look for a creative answer to the question: What's the business we are in?

After becoming chairman and chief executive officer, Walter Wriston transformed Citibank from a commercial lender into an innovative purveyor of everything from mortgage financing and insurance to electronic banking services. He battered down or deftly circumvented regulatory barriers that had kept Citicorp, the parent company, and other commercial banks from getting into investment banking and found ways to expand across state lines.

It looked increasingly odd that giant money center banks that had built up branches round the globe could not, as per the 1927 McFadden Act, take money in other states. The irony was particularly cutting in California where the majority of the bigger banks were foreign owned, including the Crocker Bank bought by the British Midland.

It becomes increasingly ridiculous, Walter Wriston stated in September 1980, to say that Midland Bank can buy Crocker but Citibank cannot. The US Congress first began opening the door to interstate competition in 1970, when it permitted banks in one state to set up consumer-finance and business-loan offices in another. Citicorp soon established 95

consumer-finance outlets in 28 states under the name Person-to-Person. In 1978 a new International Banking Act allowed these subsidiaries to be merged.

## 2. Expansion under the Citibank Banner

In 1982, Congress passed the Depository Institutions Act, which permitted healthy banks to acquire ailing institutions in other states. Major banks jumped at the chance to grab new accounts. Bank of America, for example, bought Seattle's ailing Seafirst Corp. Citibank's takeover of Savings & Loans (S&Ls, thrifts) in Florida, Illinois, and California were all made under the 1982 Act, which was indeed to unlock the door to full interstate banking.

More than acts of Congress, new technology made it possible to break down the barriers of national banking. At a time when financial institutions could send billions of dollars around the world in a few seconds via networks, the state-line limitations seemed like a vestige of a bygone era. Information technology (IT) was making the old legal barriers irrelevant and from the late 1970s to the late 1980s Wriston invested billions in IT—which was also used to change the corporate culture.

To capitalize on the lowering of state barriers and on advanced technology Citibank organized itself along three lines of business: the *institutional bank*, which included commercial banking operations; the *investment bank*; and the *individual bank*, which handled retail banking. The strategy of focusing on deposits worldwide was successful and by 1986 it accounted for 62 percent of Citibank's business.[4]

With the individual strategy, emphasis was placed on continuing to grow fast in retail banking, making profitable all acquired savings and loans banks, and pushing the international consumer business further forward by aggressively expanding—internationally. With globalization on the move this was a logical extension of classical banking business that however required a significant level of legislative push and pull country by country.

While restructuring the operations at home Citicorp expanded retail banking abroad, positioning itself to deal with consumers in Canada, Britain, Germany, France, Norway, Italy, Spain, Argentina, Chile, Brazil, Hong Kong—even Japan. Growth overseas to conquer the world market focused not only on deposits but also on loans. Walter Wriston worked on the principle that countries don't go bankrupt. Surprise, surprise! Countries do go bankrupt and then negotiate on outstanding loans. It was bound to happen and it did.

In Germany, Italy, and Spain, Citibank bought local retail banking institutions. The Argentinean and Brazilian markets were approached with local knowhow as John Reed, the boss of retail banking,[5] grew up in the two countries where his father was an executive for Armour, the meat-packing firm. In Japan, market penetration was accomplished through local agreements with the rich in deposit and politically mighty postal services.

Citibank looked as if it was on its way to conquer the global retail market, its approach being judged as innovative and fairly successful. This was not necessarily the case with the strategy of being "all things financial to all people," using leading-edge technology where applicable to become the premier global financial services provider. One of the goals under this umbrella of banking services was to improve consumer profitability while expanding state by state. Wider geographic distribution of operations gave it clout to gradually break down interstate barriers. Job-creation promises helped to open several state markets.

But there was also a downside. The so-called financial supermarket included contradictions in itself. Slowly but surely it translated into four points: trimming work force, pulling back from middle market overseas, pushing investment banking products more aggressively, and cleaning up portfolio by reducing write-offs.

Conflicting goals aside, international expansion has its risks. Wriston's theory that sovereigns don't go bankrupt was based on the wrong assumptions. LCBGs that had aggressively expanded to less developed countries—particularly the Central and South American ones—got awfully exposed with the tandem of debt crisis. Some big banks lost a multiple of their capital.

With this, complacency about obtained results and unstoppable expansion were replaced by fear, and fear intensified with the failure of Continental Illinois. Nowhere did the need for reevaluation of and change in banking philosophy have a more dramatic effect than at Citicorp. Till then its management had come to believe that Wriston's style of being was right:

- Innovative,
- Aggressive,
- Entrepreneurial, and
- Market driven.

Other bankers had rushed to emulate it, in order to survive in an unregulated market. What they failed to appreciate was that Walter Wriston had taken some important risks. Over and above that it was not sure the

US government would never let Citicorp fail. America still believed in free enterprise. The sovereign was not yet in the mood of spending billions of taxpayer money to "save" the big banks.

No doubt the regulators followed closely what was happening at Citigroup and the other American banks and what they saw led to worries. The numbers indicated faltering performance not in one but in several channels. The beneficial effects of diversification have the nasty habit of fading in the background when red ink becomes the driving force and formerly prosperous channels like mergers and acquisitions are under stress.

When Citibank and Chase Manhattan failed to assemble $3 billion for a buyout of UAL (parent of United Airlines) its shares caved in but Citicorp's equity also dropped, triggering a 190-point dive in the Dow Jones Index. Campeau's Federated and Allied Department stores, with their junk bond payments, were also in deep trouble. Citibank was involved in the Campeau deals and there were also real and present dangers with investments in real estate, leveraged buyout (LBO), and highly leveraged transactions in Australia and Brazil.

In early 1990, Citicorp debt was downgraded by the major rating agencies. It was a time when the market was skittish. Citicorp's earnings report showed strains. In the third quarter of 1990, despite a $780 million increase in nonperforming loans, the credit institution increased its bad loan reserves by only $82 million. As a result, it had enough reserves on hand to cover only 39 percent of its bad loans, compared with at least 70 percent at other big banks.

By 1991 Citibank had made more than $13 billion in commercial real estate loans, and more than a third of that amount was concentrated in western United States. A cool 40 percent of them were non-performing. By lowering prudential lending standards Citibank had lent up to 80 percent of the value of the properties. When these values plunged, they put its investments underwater.

Year on year, in the third quarter of 1991, Citicorp disclosed a loss of $885 million. Of all its market channels and product lines, only its global consumer bank was making good, solid profits. Its carefully constructed networks capitalized on the international consumer business and could generate local currency deposits—which Citibank lent to local customers instead of dollars.

Citibank had to be recapitalized and, in the opinion of the Fed of New York, the recapitalization should come from private capital, not from the reserve bank or the federal government. This issue came up at the right moment. There was a young prince in Saudi Arabia to whom his father, the king, had made a present of a few billion dollars Prince al-Waleed bin

Talal was interested in testing his hand and Citibank its ability to come up from under.

The deal would give al-Waleed bin Talal an 11 percent dividend on convertible preferred stock and the right to convert Citicorp's special preferred shares to common equity once the price per share hit $16. That would represent a 4.9 percent stake in the US credit institution making the 35-year-old prince Citicorp's single largest shareholder.

But could there be a political problem with the new equity owner meddling with decision making at the vertex of America's largest bank? Gerald Corrigan, the president of the New York Fed, flew to Riyadh to explain to the newly discovered royal investor that while he could make another "small fortune" by trusting Citibank with some billions, he had to desist from running the bank. So it was, and in the end everybody profited from this investment.

The deal worked and riches followed. In 1992, Citicorp allowed its preferred shareholders to exchange their shares for common stock at a higher price. Later on, it presented common stockholders with the opportunity to acquire more equity at a 2.5 percent discount from the market price, and so on, and so forth.

Another strategy that helped Citicorp to come out of the tunnel was asset securitization—a process in which it has been an early pioneer. Lots of credit institutions were packaging assets like auto loans, mortgages, and credit-card receivables, and selling them to investors as securities. Then they used the receipts to clean up their books, give new loans and for trading.

The new money came in at the right moment for Citicorp, offering John S. Reed, the bank's president, an opportunity to reestablish his bank's market position. This was the time to get rid of problem loans to less developed nations as well as all other troubled loans and dubious investments at home. In addition, he had to persuade government officials and investors that he could manage the risks in his bank's traditional business even if he pushed into unfamiliar areas such as financing leveraged buyouts and the nascent business of derivatives.

To cut costs, Reed began to peel layers off Citicorp's hierarchy. In the commercial banking division, for example, he put country and region heads to report directly to group heads. The idea was to get rid of everything that was unwieldy, top-heavy, and exclusively formal. The relatively new CEO also scrapped many titles, a refreshing change in an industry where title inflation had led to a proliferation of vice presidents.

Given his industrial engineering experience few analysts doubted Reed's cost-cutting resolve. As in practically every LCBG, there were too many people engaged in too much unnecessary bureaucratic activity, too many management information systems, too many staff functions,

too many unprofitable relationships. The new spirit was: We must become one of the world models of cost management. We have to become flatter and leaner. No one here will get paid to have it the easy way.[6]

During the following quarters, expense growth slowed but the high overhead persisted. In nearly each quarter Citicorp tried to knock expense growth down a notch and push the return on assets (ROA) up. This did a lot to close the apparent efficiency gap between it and its peers but the overhead ratio shot up again as management's attention waned. Business nevertheless prospered and slowly Citibank found again the path of growth. As profits improved different suitors started circling around.

## 3. Citigroup: Merger with Travelers and Struggle in Boardroom

Announced on April 7, 1998, and consummated in October of that year, the merger of Citicorp with Travelers, a large conglomerate led by Sanford Weill, was supposed to be one of equals. At least superficially, early on, it appeared to be so but past the first impression it did not take long till fictions showed up in the boardroom.

Valued at $83 billion this was the largest corporate merger ever (at least till that time). It created a unique financial-services powerhouse with two bosses, both with giant egos. Informed insiders had enough reasons when they said this Byzantine eagle solution for top management could not last, and that things would not run smoothly behind the scenes.

The market paid no attention to the likelihood of a personality clash when the Citicorp-Travelers merger announcement was made. The late 1990s was the time when it got overexcited at the prospects of financial news, even if this was achieved at the cost of lesser safety for one's investments. "Breaking news" ranged from announcements on novel small dotcoms to big banks' mergers and acquisitions as well as LBOs and takeovers. A tiny America Online took over Time Warner and the equity of AOL Time Warner skyrocketed. So did Citigroup's stock—the entity that resulted from Citicorp and Travelers joining their fortunes.

From Citicorp, Citigroup inherited the world's largest financial services network, spanning 140 countries with approximately 16,000 offices worldwide. The company reportedly held 200 million customer accounts, till then a high-water mark. Just prior to its 2008 downfall Citigroup used to be the largest bank in the world counting in total assets, with over 350,000 employees versus 260,000 in 2013.[7]

Shortly after the merger news sparked a sharp rise in Citicorp's equity price the market's enthusiasm turned toward new pastures, while cracks

started appearing in its toll-rising edifice. The symbiosis of Weill and Reed as cochairmen of Citigroup did not even last a year and a half. In late February 2000 John S. Reed announced his retirement as he found himself at the losing end of a struggle with Sanford Weill, a well-known and capable corporate infighter.

It is an unwritten rule in management that power-sharing agreements between heavyweights collapse. The case of Citigroup was not going to be an exception. Eventually frictions accumulate and the next thing is a confrontation of egos and personalities fed by even small differences of opinion, style, and strategy.

The differences reportedly came to a head at a special board meeting in late February 2000, with Reed saying that he and Weill should leave the company together after finding a successor. Weill wanted to stay, and Robert Rubin, the former Treasury secretary and chairman of Citigroup's executive committee, agreed with him.[8] As for Prince al-Waleed bin Talal, one of Citigroup's largest shareholders, he allegedly stated that he didn't see anyone but Sandy (Weill) running the show in the foreseeable future.

For their part, company insiders and several outsiders commented that knowing Sanford Weill they were sure he had no intentions of relinquishing control anytime soon, even if the board appointed a search committee in the wake of Reed's retirement. As expected it did not take Weill long to consolidate his power in areas formerly under Reed's authority.

There was, as well, folklore. In March 2000, Weill was the guest of honor at a party to celebrate his sixty-seventh birthday. That party had a biblical theme with Citigroup's CEO playing the role of Moses. According to an article in the *Wall Street Journal*, general counsel Charles Prince, who acted as master of ceremonies, said: "We have been lost for two years now wandering in the desert…Now Moses saves us and brings us to the Promised Land." Later, he observed: "You know, Sandy, that Moses was never allowed to enter the Promised Land."[9]

Eventually Charles Prince[10] would succeed Sanford Weill at the top of Citigroup, but his reign would come at the worst possible moment as sometime thereafter the years of the fat cows in the financial industry ended and the deep economic and banking crisis, which started in July–August 2007, radically changed the rules of the game. (It is difficult to say if Prince was unlucky or simply unfit to lead a large and complex banking group.) Nor was Citigroup alone in the coming debacle.

The big banks' exposure to subprimes and CDOs was anything but mild. Market rumors had it that Citigroup urgently needed $20–30 billion in cash. On November 27, 2007, the largest American credit institution sold a bunch of preferred stock to the Abu Dhabi Investment Authority (ADIA). The conditions were draconian. Citi would pay till 2010 an

interest of 11 percent, while Abu Dhabi retained the right to convert the stock to common entity below its average market price of years.

This loan provided Citigroup with just $7.5 billion, and it was immediately stated that to survive the LCBG urgently needed another $20 billion. Short of that it could not face its commitments. Neither was this the only emergency case among LCBGs. On November 27, 2007, it was revealed by *Bloomberg News* that since July 27, 2007, Barclays Bank had sold 29 percent of its equity to institutions in China and Singapore.

The price of gambling with poorly conceived, wrongly rated, and badly controlled derivative instruments had become astronomically high. Exposure to securitized subprimes and risky undertakings with derivatives had much to do with it. On December 14, 2007, Citigroup announced that it had absorbed seven of its special investment vehicles (SIVs) and assumed their most substantial losses.

The first announcement on that fateful day assumed losses at the $40 billion level; this was revised to $49 billion and became $56 billion by the end of the day. A new catastrophe, worse than that of the early 1990s, was in the making. Some commentators said that this transparency was a show of goodwill by Citi toward its clients who had suffered heavily. Others suggested that the bank had the money to pay since it collected (the aforementioned) $7.5 billion by selling 4.9 percent of its equity to Abu Dhabi's Sovereign Wealth Fund.

The mathematics, of course, don't add up. Analysts summed up Citigroup's risks, starting with its sizeable consumer–real estate exposures, as well as material risks on- and off-balance sheet the giant LCBG maintained in some of the troubling segments of finance. These included prime and subprime mortgages, credit cards, loans, and CDOs.

There were also problems associated with funding and other commitments, such as credit risk from leveraged loan obligations along with conduit facilities—and uncertainties in future funding. To these weaknesses were added volatile near-term earnings as well as constraints associated with the future due to cyclical pressures across many areas of Citigroup's operations.

A management hazard was summed up by the assertion in 2007 by Charles Prince, then Citigroup's boss, that as long as the music is playing, you have to get up and dance. Citigroup's performance was judged as being "rather good" relative to that of its rivals or to an industry benchmark, encouraging the bank's managers to mimic competitors in risk taking even if in the long run mountains of toxic waste and of the high exposure assumed with them benefit no one.

In mortgages, bad lenders had been driving out good ones, keeping up with aggressive policies for fear of losing market share. A few

better-managed banks held back, but it was not easy: When JPMorgan sacrificed five percentage points of return on equity in the short run, it was lambasted by shareholders who wanted it to catch up with go-go rival institutions. That sort of go-go spirit had taken hold of Citigroup and, no doubt, Baker and Stillman were turning in their graves.

Citigroup, of course, still had strengths. Scale was one of them. The LCBG benefited by being one of the world's largest financial companies, possessing presence and market capitalization of nearly $125 billion. Another strength was its business positions and diversification, which, however, were waning. But were these strengths enough to compensate for the weaknesses in the short- to medium term when so many gambles are decided "win" or "lose"? and would they influence the rating agencies' outlook drivers? Rating agencies are primarily watching out for:

- Restoration of core profitability on the one hand, and
- For exposure associated with CDOs and leveraged loans on the other.

Improved capital ratios was something that neither Citigroup nor the other self-wounded LCBGs could deliver at the moment market conditions had taken a dive. Prevailing financial conditions were expected to be weak near term, accompanied by severe earnings volatility and unexpected declines in other business line performance. This could have contributed to downward ratings pressure—not to upgrades.

In addition, driven by a 48 percent decline in net revenues, Citigroup had posted a net loss of $5.1 billion in the first quarter of 2008. Results were impacted by $16 billion of write-downs and higher reserve accruals for mortgage-related securities and other consumer and commercial credit assets. Analysts doubted that, left to its own devices, Citigroup could turn itself around, and events proved them right.

## 4. Uncle Sam Comes to the Rescue

Citigroup suffered severe losses during the economic and financial crisis of 2008. In November 2008 it was rescued thanks to a massive package by the US government. Three months later, at the end of February 2009, Citigroup announced that the American government would take a 36 percent equity stake in the company by converting $25 billion in emergency aid into common shares with a US Treasury credit line. The sovereign would also guarantee losses on $306 billion troubled assets and inject billions immediately into the company.

For any practical purpose the bank of Moses Taylor, James Stillman, and George F. Baker had ceased to exist as an independent entity. It was now under government tutelage. The Bush administration had decided that Citigroup was too big to fail, and was taking it over. Uncle Sam gained control of half the seats in the board of directors, and the right of removal of senior management if there was poor performance. (By December 2009, the US government stake was reduced to 27 percent after Citigroup sold $21 billion of common shares in a large single equity sale.)

Under the sovereign's control, the salary of the CEO was supposed to be a symbolic $1 per year and the highest salary paid to any employee was limited to $500,000 in cash. Any amount above $500,000 had to be paid with restricted stock that could not be sold until the emergency government aid was repaid in full. But as with AIG the perks and other frills continued, at least for some time.

We can now add moral bankruptcy to the financial sort, said the CEO of a competitor bank. He was referring to the dubious bonuses that followed on the heels of Citigroup's new airplane purchase fiasco, which made many people wonder how could a bank that owed its survival to the taxpayer think it acceptable to procure a jet that boasted "uncompromising cabin comfort" and to hold on to several others as well as a helicopter.

Moral risk aside, both Lehman's and Citigroup's collapse have shown the dangers of leaving huge quantities of toxic assets inventoried on banks' balance sheets. Pumping in capital, as governments have been doing both in the US and in Europe, is not enough to put straight the wounded banks' balance sheets. The lesson from successfully handled banking crises, such as Sweden's in the early 1990s, is that government must ensure bad assets—the result of distorting excesses—are removed from the balance sheets of both banks and sovereigns.

Even formerly sound economies can succumb to the spend-and-spend fundamentalism. The Swedish currency was backed by gold and its paper currency could be exchanged for gold coins until 1931, when a law was written to free the central bank from this obligation. From 1991 to 1993, Sweden experienced the most severe recession since the 1930s. Then, in November 1992, the fixed exchange rate regime of the Swedish krona collapsed. Bengt Dennis, then president of Riksbank and the central bank's governing board, developed a new monetary policy regime based on a floating exchange rate and an inflation target.

Contrary to the policy of nearly zero interest rates followed by Ben Bernanke and the other governors of Western central banks in the aftermath of the 2008 crisis, Bengt Dennis brought the interest rate of the krona to 11 percent[11] while in parallel to this the Swedish government cut

its budget with a sharp knife. This led to a tumultuous week in the financial markets, an increase in unemployment and drop of the gross domestic product. But Riksbank correctly kept its policies and the Swedish economy came out of this experience in good shape. That's the policy that should have been followed in 2008 and thereafter.

As for the commercial banks, the better alternative to pumping up their balance sheets and recapitalizing them is ring-fencing those badly wounded and closing them down. Terminal illnesses are too costly and too hopeless cases to try to restore to health by using public money. Outright bankruptcy of a ring-fenced institution, to avoid contagion, is better than the slide into administration of a once-ubiquitous LCBGs. Like any individual, companies have a lifespan; their life does not go on forever.

*If* taxpayer's money is to spend, *then* cleaning up the mess will make the rescue transparent. This will help to better appreciate the risk confronting the taxpayer in these awfully complex and questionable salvages of mismanaged financial institutions. As stated at the beginning of this section, the handout to Citigroup came in two parts:

- Providing $40 billion in fresh capital and capital relief,[12] and
- Ring-fencing $306 billion of illiquid assets on Citi's $2 trillion balance sheet.

According to the conditions of the salvage, beyond the first $29 billion, the bulk of any losses in the above amounts were to be borne by the US government. This is a different deal than the one the Bush Jr. administration had offered to pull other institutions out of the abyss—where it satisfied itself by holding preferred stock, leaving common shareholders at the frontline of equity risk.[13]

Critics likened Citigroup's and the British banks' (chapter 9) rescues to moral hazard associated with *catastrophe insurance*, a strong sign that the government will do whatever it takes to maintain confidence in the big banks even if, in the longer term, this damages the economy.[14] Neither was it clear at first instance if the stated goal to reinstate Citi as a trusted trading partner would be met.

- Nobody really knew the total amount of toxic waste in Citigroup's books, and
- The market doubted that the committed taxpayer funds would be enough to save the LCBG.

In addition, several experts had expressed lack of confidence in the Treasury's and the Fed's patch-by-patch approach that preceded and

followed the $700 billion Troubled Asset Relief Program (TARP). This, the experts said, shows uncertainty regarding the immediate and longer-term aftereffects of one's decisions.Citigroup's rescue was an example because it targeted the billions tied in the bank's mortgages, commercial-property loans, and leveraged loans, but not in:

- Its huge off-balance sheet exposures, to the tune of over $12 trillion, and
- Its also large credit card and overseas loans portfolios, which remained outside the government's preoccupation and were fast degenerating.

There was, as well, an unacceptable amount of creative accounting in this deal, such as giving a most generous 20 percent risk weighting to partially insured assets that were previously booked at 100 percent but were probably worth no more than five cents to the dollar. Furthermore the Citi rescue did nothing to establish a clearing price for the impaired assets on the big bank's books—the original TARP aim by using auctions (but it was dropped midstream as an objective).

Another issue disturbing people who were critical of Citigroup's king-size rescue was that little was done by the Fed and the Treasury to change the bank's management and culture. This has been an institution that, since the 1970s, was nearly always in trouble, including some of the nastiest blow-ups, from the sovereign-debt defaults (of the 1980s) to the dot-com bust (of 2000). It was even temporarily banned from launching new takeovers in 2005, after a string of regulatory lapses.

Strategic issues, too, came up for criticism with some experts saying that with the exception of Travelers' takeover of Citicorp in 1998, when the stock peaked, the only clear signal its shareholders had seen was that of evidence that the financial supermarket model does not work. Therefore they suggested that a breakup might be the better option, as "too big" had become synonymous with:

- Mismanagement, and
- Risk-prone behavior.

At the end of the day there was no breakup (the sale of Smith Barney was voluntary) but there was a change in top management. Out of the top executive suite went Charles Prince's clan (along with Robert Rubin)[15]; in came Vikram Pandit who, till then, was the boss of Citigroup investment banking. Some people said that that was a curious choice because, as with the 1992 deep corporate crisis, Citigroup's strength was retail banking,

but Pandit stayed as the LCBG's CEO for a few years and, altogether, did a good job under a crisis regime.

Wall Street gave mixed marks to Vikram Pandit. Some commented that the clarity of thought the new CEO displayed in small gatherings often disappeared when confronted by large audiences of employees or clients. Others stated that he had a firm hand in steering the bank. Criticisms don't seem to have discouraged Pandit from performing his duties.

The new CEO launched a series of measures to put the sprawling financial services group back on course—a challenging feat. Four straight quarters of losses passed by and there was no sign of profits on the horizon. Trimming down, the LCBG cut staff numbers by 52,000[16]; still the stockmarket was not impressed. On November 19, 2008, $6.40 shares fell by a staggering 23 percent.

Still the LBCG was too big to fail, though the cost of insuring against its default had roughly doubled in a week. Citigroup not only faced a giant loss on mortgage securities and consumer credit, but also gave the impression of being a dysfunctional confederation of business lines that had become too big to manage. Shrinking the balance sheet by $308 billion, or 13 percent, was an achievement. Once again, and for good reason, costs were scrutinized across the whole range of operations; indeed there was plenty of cost-cutting scope in practically all Citigroup divisions.

### 5. A Year after the Sovereign Acted as Chief Savior

In mid-2007 Citigroup's assets had peaked at $2.4 trillion and they were down to a little over $2 trillion by the end of September 2008, shortly before the Lehman Brothers bankruptcy. This meant that during a period characterized by a growing economic and banking crisis, as well as by a credit crunch, the LCBG had unwisely continued its high leverage rather than drastically pruning its balance sheet (the way it was officially announced).

After the mid-November 2008 collapse of the big bank's share price, federal officials offered to back Citi's toxic assets with billions of public money. Timothy Geithner, the former president of New York Fed, was involved in the original rescue negotiations but the question still remains: Was he right as Treasury secretary of the Obama administration to come up with all that federal money or would it have been better to let Citi go bankrupt—like Hank Paulson, the previous Treasury secretary (and Geithner himself) had done with Lehman Brothers?

The alternative would have been to ring-fence Citigroup's deposits and retail banking activities, letting its investment banking business find its own solution. No doubt, the red ink would have been a torrent, but so it also was after the sovereign acted as chief savior of the LCBG—in violation of the free market principle.

When the worst continued to worsen, the government committed the US taxpayer to financing the rescue. With the Treasury's injection of equity in the week of November 22, 2008, to save the bank from outright failure, Citigroup's core capital reached almost 15 percent of total assets. This was once a very high ratio but nowadays, under Basel III, many banks will be expected to attain it in order to be considered viable.

By mid-January 2009, the market reflected doubts about Citigroup's ability to slim down without incurring further losses on $600 billion of subsidiaries, conduits, and assets deemed noncore. That was about a third of its then balance sheet. There was also present the danger of further deterioration in real estate assets of dubious value, which could force the sale of more desirable businesses.

Uncertainty was compounded by what Wall Street analysts nicknamed "strategic flip-flopping." Had pressure from the sovereign savior forced management's hand? Or was the prevailing uncertainty reflecting the fact that ever since Citigroup was created, bankers debated the merits of the so-called global financial supermarket—the notion that the future of banking services lay with large conglomerates that would be everything to everybody and benefit from economies of scale.[17]

Critics were saying that though backed by a host of executives, traders, and investment advisers, Reed's and Weill's creation had proved horribly flawed. Citigroup was built through and for deal making and this showed all over its human resources and organizational profile. By trying to do everything at the same time,

- Acquisitions were poorly put together to support one another,
- Cultures overlapped rather than melded,
- Risk control was dismal and getting worse.

When the financial results of the fourth quarter of 2008 were announced in mid-January 2009 the market was unforgiving. Citigroup reported a net loss of $8.3 billion for the fourth quarter and a net loss of $18.7 billion for 2008. Such results were primarily driven by write-downs and losses in securities banking, higher credit costs, as well as additions to loan loss reserves and restructuring costs. They were accompanied by an announcement that Citigroup would split into two entities:

- Citicorp, a "good bank," will hold the not-so-damaged assets in global banking, with emphasis on the core business, and
- City Holdings, a "bad bank," will include all noncore assets that the LCBG may divest, including all impaired assets, Citi's minority stake in Morgan Stanley Smith Barney, a brokerage jointventure with Morgan Stanley, Citi's consumer-finance businesses.

This split was a reversal of the group's strategy of the previous years aimed at building a universal bank. Rumor had it that the sovereign savior wanted to make "an aggregate bank" of toxic waste, which would be easier to supervise and to control the exposure Citi had assumed.

According to this plan, the "good bank" would have value, but investors and taxpayers would still remain exposed to the "bad bank." Valuing the company based on existing figures analysts thought the equity could be worth $110 billion, but deducting preferreds and assuming $24.5 billion had to be raised at depressed equity, they were coming up with a valuation of $2.30–4.00 per share, depending on whether the new shares:

- Were entirely dilutive, or
- Were produced via partial conversion of the government's stake to common.

The market had got it right in terms of remaining Citigroup value. CEO Vikram Pandit denied the breakup news and tried to reassure employees that he had no such plans. But the crisis was leading investors and regulators to consider ways in which the LCBG could be helped to come out of the tunnel, and the likelihood of a breakup was an unavoidable part of the picture.

Further fall in Citi's share price suggested investors were not satisfied by management's assertions that the bank had ample capital and liquidity. Because of the sovereign's intervention the salient problem was not capital but confidence, and for a financial institution the confidence its clients and stakeholders have for its future is just about everything.

The touted breakup did not materialize but by late January 2009 Citigroup undertook a big shake-up in its corporate structure. Speculation mounted regarding the probability of its success and regarding other issues, too. As part of management's restructuring Citi named Richard Parsons, Time Warner's former CEO, as its new chairman, replacing Winfried Bischoff.

In February 2009, while its equity value at the New York Stock Exchange was still falling, Citigroup was working with the US Treasury on a deal

that stopped short of outright nationalization but would give the federal government a stake of about 40 percent in the deeply wounded bank. That deal was in exchange for bolstering the LCBG's depleted capital base with more public funds.

Hammered out and announced on February 27, 2009, the agreement centered on the conversion of a part of the government's inventory of preferred shares into Citi's common stock. Other shareholders, which included sovereign wealth funds and pension funds, were also expected to convert some of their holding of Citigroup preferred stocks into common shares.

- This solution was primarily aimed at boosting Citi's capital base,
- But it also severely diluted the holdings of its existing shareholders.

The conversion price was set at $3.25 a share, much higher than the $1.20 or so that Citi's shared traded at that particular week. Those who exchanged to common shares were facing the choice of holding onto them or selling them. The downside for holding the common shares was that the exchange rate did not seem like a good choice for income-seeking investors, as the securities would still pay no dividends and would be further down in the capital structure than the preferreds.

On the other hand, those who planned to sell their common shares immediately after exchanging the perpetuals faced the prospect of a decline in their price between then and the exchange date, but they could hedge this risk. Unless, of course, there was a miracle, and the miracle did not take long to happen. On April 16, 2009, Citigroup announced a first quarter profit of $1.6 billion based on accounting (read: the legalized marking-to-mind myth) and trading (whose losses were paid by the American taxpayers).

Critics said the announced profit was smoke and mirrors. In spite of that Citigroup made great plans for the remaining part of 2009, particularly in regaining its independence from government tutelage by repaying the loans. But it did not work out that way. In mid-December 2009, two days after Citigroup's CEO trumpeted news that the company would start untangling itself from the sovereign's embrace, the bank stumbled on Wall Street.

Misreading the financial markets, the LCBG had struggled to raise the money it needed to repay its bailout funds. While it managed to raise $20.5 billion in the stock market and planned to forge ahead with the repayment, the sale generally went on poorly and US Treasury officials delayed their plans to immediately start unwinding the government's stake in the company. This:

- Represented a setback for Vikram Pandit and his efforts to free the bank from government control, and
- Underscored the lingering market worries over Citigroup's financial health, including concerns that US officials may have let the company leave the bailout program too soon for its own good (and theirs).

On the contrary, the LCBG's top brass maintained that it did a good job with the public offer, considering the tough market conditions, and should be praised for it. Analysts had their doubts, the majority of them admitting that any government stake would be a challenge to sell in a large stock offering—which meant that taxpayers were still on the hook.

A year later, by December 2010, Citigroup repaid the chief savior's aid in full and the US government received an additional $12 billion by selling its shares. Sovereign restrictions on pay and oversight of the senior management were removed after the government sold its remaining 27 percent stake, but in the meantime oversized executive bonuses and diamond-laced parachutes had become dirty words as public outcry intensified and the Group of 20 finally decided to take a stance against them. This public aversion, motivated by ethical reasons, was beneficial to Citigroup's financial health.

* * *

On October 16, 2012, Vikram Pandit resigned as chief executive at Citigroup after a clash with the board over a series of alleged missteps by the bank. Underlying issues were Citi's failure to pass the Federal Reserve stress test in 2012, a defeat on a "say on pay" vote, and the handling of the sale of the bank's stake in Smith Barney, the retail brokerage, to Morgan Stanley.

Citi portrayed Pandit's departure after five years at the helm as "amicable." Wall Street observers were not as sure that this was the right word. His successor, Michael Corbat, had been with the company since 1983. Citigroup's chairman also stepped down in 2012. At his resignation he told the *Financial Times*: "I was flying air cover as our ground troops got their act together. Now it's time for the ground war to start."[18] Mike O'Neill, who took over as Citi chairman, was already serving on a board. His promotion was not an obvious sign that Pandit would be replaced.

The musical chairs Citigroup went through in 2012 were the latest setback for a bank worth $1.9 trillion by total assets at its creation in 1998 through the merger of Citicorp and Travelers. At that time, the merger was hailed as a state-of-the-art financial supermarket, a model that is now regarded as being far from optimal. Moreover, since the credit bubble's peak Citigroup's share price fell more than 90 percent and it barely avoided nationalization.

This page intentionally left blank

# 9

# British Banks at the Edge

### 1. The British Socialists Bailouts

Aristophanes laughed at bankers and banking as the most pestilent of all trades, while others have called banking the second eldest profession (after prostitution) whose origins they have traced to ancient temples. Financial historians say that in all likelihood the first financiers were the Egibi family in Babylon that lived in the seventeenth century BC. Another hypothesis is that finance started with Pasion, an Athenian, in early fourth century BC.

There have been banking crises in ancient Rome, at the time of both Caesar and Tiberius. They intervened in the financial market in an effort to right the balance. Caesar cut personal and household debts in half and instituted an agricultural bank; Tiberius restructured the banking industry by using public money. Banking took on the form under which we currently know it in medieval Europe with the Medicis, de Bardi, and other families in fifteenth century AD in Florence. There is also a counterclaim that its origin dates to the twelfth century in Genoa spurred on by the revival of trade in the Mediterranean,[1] when it became important to transform one man's deposits to another man's credit.

One way sovereigns have found to manipulate this transformation to their advantage is nationalization of financial entities. During the last decade, in mid- to late 2007, when Gordon Brown's political star had not yet fallen into the pit, British financial experts said that he had shown his aversion to nationalization by hesitating for months before taking Northern Rock, the troubled mortgage lender, into state hands. Northern Rock was rescued in September 2007, more than a year before the much bigger Royal Bank of Scotland (RBS, sections 2 and 3), Lloyds TSB, and HBOS (section 4).

Northern Rock was bailed out by the Bank of England after reporting difficulties raising cash during the credit crisis. The British Treasury

extended its guarantee of customer deposits to include new accounts. For its part, the Financial Services Authority (FSA) admitted to a parliamentary committee that they had made mistakes leading up to Northern Rock's problems, which resulted in the first run on a British bank in generations.

It is an interesting hindsight that after being salvaged through a lavish outlay of public money and nationalization, Northern Rock continued with its bad past practices of highly risky loans that had brought it to bankruptcy. On March 21, 2009, the British auditor said that the wounded bank had again engaged in risky mortgages and other dubious "assets" to the tune of $2.6 billion. At the City of London, market operators and analysts regarded the Northern Rock bailout, and those that followed it, as a form of political capitulation. For the first time the Labor government:

- Intervened preemptively, and
- Shored up a lender who had committed financial suicide.

Northern Rock's salvage took place amid confusion with the government's moves, which were hastily finalized overnight after many contradictory statements that had shown indecision. (Indecision is a basic characteristic of most socialist governments.) Critics said that this the post–Tony Blair epoch in British politics should not be repeated.

On October 7, 2008, the British prime minister and his chancellor of the exchequer made up their minds to stick to the Northern Rock salvage template, following a torrid day when shares of the Royal Bank of Scotland overextended by an ambitious and overpaid acquisition of ABN Amro in 2007, and Halifax Bank of Scotland (HBOS), a big mortgage lender whose takeover by Lloyds TSB had come to look uncertain, tumbled by some 40 percent.

The first piece of news made public was that the British Treasury was prepared to inject up to £50 billion ($80 billion) into the country's banks to bring up the capital they needed to meet regulatory requirements and support their business activities. In return, the government asked for preference shares in the banks it rescued with taxpayer money.

It was then made known that the Bank of England's special liquidity scheme would double in size, making at least £200 billion ($360 billion) of Treasury bills available for banks to swap for their nonliquid assets. No questions were asked regarding the market value of that collateral. It was added that the Treasury would guarantee as much as £250 billion ($400 billion) of new wholesale funding obtained by banks.

Along with such measures, the government also lifted, from £35,000 to £50,000 ($80,000), the limit of retail deposits protected under the official

compensation scheme at any one banking group. That fell short of the pledge on October 5, 2008, by the German chancellor to guarantee all retail deposits and savings. The British government's offer was also much more restrained than an earlier commitment by the Irish government.[2] Two things must be retained:

- Confronted with a global banking crisis that devastated some British credit institutions, the Labor government decided to intervene using the Treasury to inject liquidity, and
- Some of the money on offer to British banks had been linked to purchase by the Treasury of interest-paying but nonvoting preferred shares, therefore, of equity stakes.

This was not too different from what the American government was prepared to do, except that (as we will see later on in this chapter) the equity stakes were big. One of the weaknesses of the British plan, as well as of the American and those of continental European countries, was that the sovereign did not say what level of capital it expects banks to hold against bad times. There had been little doubt that the Treasury's investment would increase their core Tier-1 capital ratios, but by how much? And what about the need to confront pressure on the banks' liquidity?

Moreover, who would be invited to join? And under which conditions? The first news was that Britain's biggest banks had all signed up for the new capital injection, while the government planned to help banks in facing the market's demand for short-term liquidity by lending for up to three months. Then it was revealed that:

- RBS, HBOS, and Lloyds TSB would participate in the plan and share among themselves £37 billion.
- Barclays chose not to participate, looking instead to raise £5.4 billion (later increased to £6.5 billion or $10.4 billion) from private investors through a shares offer.

Indeed Barclays issued a statement that its "proforma" Tier-1 capital was more than 11 percent. This left the market puzzled because proforma is a murky way to compute financials, totally at the discretion of the company doing the announcement. It has been used in the dotcom boom and bust to report on EBITDA (earnings before interest, taxes, depreciation, and amortization)[3] by upstarts of heavily indebted Internet companies.

The British government said that the share it took in the country's big banks would not be permanent.[4] But the sovereign was much less precise on how much of a share it would take in these banks. A first announcement

spoke of 50 percent in RBS and 60 percent or more in HBOS; then it ended with 40 percent in the merged Lloyds HBOS (a merger that also got the green light from regulators in spite of the mortgages monopoly it created in Britain) and 60 percent in RBS—a ratio that kept on increasing in tandem with capital injections.

Part of the Royal Bank of Scotland deal had been the head of Fred Goodwin, its CEO, who had taken inordinate risks in building up the bank in his eight years at the helm. RBS's downfall was a big comedown from a year earlier when it was racing to become the world's biggest-ever bank in competition with Barclays (Thales, one of the sages of antiquity, has said, "What one fool can do, another fool can do too").

The British government's socialist-style bank nationalization had so much of a market effect that regulators in London had weighted delaying stock trading to give investors time to digest the news. (The bailout plan was originally put in place during an all-night meeting between officials at the Treasury and their advisers at UBS and J.P. Morgan Cazenove. Some said it was in good shape but still needed refinement.)

The government had to be prudent because the capital injection in big banks came just days after the nationalization of Bradford & Bingley (B&B), the troubled mortgage lender, and there was always in the closet the skeleton of the wheeling and dealing with Northern Rock.[5] Accounting for Bradford & Bingley and Northern Rock market shares meant that, at the end of 2007, 11 percent of British mortgage loans outstanding were in state hands. And Lloyds TSB's takeover of stumbling HBOS created a group holding another 28 percent of all mortgages by value.

As it went ahead with the rescue packages, the Labor government, which already had nationalized two other lenders, poised to become one of the world's biggest bankers. The irony is that those Labor bailouts became sort of a model for the US in connection with the latter's emphasis on injecting capital into banks to boost their balance sheets as well as guaranteeing their loans.

From a moribund prime minister whose standing in the polls was as bad as the index in the stock exchange, which had dived, almost overnight Gordon Brown became a celebrity. As the market started to appreciate that the cost to the economy was real, the dividend in public appeal proved to be ephemeral. This did not last long. Politics is a funny game.

## 2. Royal Bank of Scotland

There was a time in the recent past when Scotland had two premier banks: The Bank of Scotland (BOS) and the Royal Bank of Scotland. Both were

mid-sized but well managed. After some financially hard times, the Bank of Scotland was the first to fall on its sword, being acquired by the Halifax Building Society to form HBOS. On the contrary, when Fred Goodwin, a young banker, was parachuted to its helm, RBS thought it had found the way to defy gravity and superleveraged itself and its assets through a policy of aggression and (not long thereafter) ill-fated acquisitions.

- From a regional Scottish bank, for a brief period, RBS soared high to become the world's largest bank.
- Then it collapsed into the arms of the Labor government in Britain's biggest bank failure on record.

Behind this spectacular rise and fall has been its young CEO, nicknamed by his peers and employees as "Fred the Shred." A book published in 2013 profiles him as a man who was compulsive, fixated about small irrelevant details, yet never fully able to grasp the risks his bank was running. He also misjudged how dangerously thin its cushion of capital was. "We would spend hours discussing the wrong things," a one-time colleague of Goodwin's told the book's author.[6]

RBS's first big acquisition was National Westminster Bank that, for several decades, was regarded as one of Britain's best-managed commercial banks—but this was not necessarily true when it came to securities. On February 23, 1988, NatWest made it known that in 1987 it had lost $204 million on investment banking. Even before the figures were out, two top investment bankers of NatWest Securities resigned.[7]

The losses reflected problems in all four of Britain's biggest banks rather than being RBS specific. When London's financial markets were deregulated in 1986, several British institutions rushed into investment banking. Later on Midland Bank and Lloyds Bank withdrew from much of the investment banking business—in appreciation of the fact that banks have a great deal of difficulty making money when they leave their traditional area without changing their culture consequently. But National Westminster stayed till NatWest Securities sank into a sea of red ink. RBS circled around the parent company and took it over (see also section 3).

By year 2000 mergers and acquisitions in the banking industry had increased. In 2000 Belgium's Fortis Bank took over BGL of Luxembourg; in 2001 Dexia acquired Kempen and Bavaria's HVB, Bank Austria; in 2005 ABN Amro bought Antonveneta and Unicredit acquired HVB (the larger of these mergers valued at €13.3 billion [$17.7 billion]); in 2006 BNP Paribas paid €10 billion ($13 billion) for Italy's Banca Nazionale del Lavoro and Credit Agricole purchased Emporiki, paying way above what the Greek bank was worth (chapter 10).

These were cross-border mergers. Whereas during the period 2000–2004, cross-border M&As accounted on average for only 14 percent of the total value of Euroland's mergers, this percentage rose to 38 percent for the period 2005–2006. The principal reason for such increase in the value of cross-border acquisitions was *ego* rather than a urgent business need.

Unicredit (section 8) wounded itself with the amount of money it spent to acquire HVB, and eventually Credit Agricole sold Emporiki for a symbolic €1 after having paid €3.3 billion to buy it and having injected another (nearly) €3 billion to restructure it. Other "big" M&A deals gave average results—but it was the 2007 takeover of ABN Amro, the premier Dutch bank, that saw only losers.

The big egos behind the ABN Amro acquisition were those of the Barclays and RBS chief executives who battled for it. Between March 2007 and July 2008 the share price of Barclays, which lost the battle for ABN Amro, fell by over 60 percent; that of Fortis and the Royal Bank of Scotland, which, to their misfortune, were ahead of the M&A game, performed even worse.

Three LCBGs, the Royal Bank of Scotland, Fortis (a Belgo-Dutch bank holding), and Santander of Spain, paid €72 billion ($101 billion at the time) to acquire ABN Amro in October 2007. Of the three Santander fared better, because it cushioned the financial impact of the deal by selling Antonveneta (ABN's Italian subsidiary) to Monte dei Paschi, while keeping ABN's Brazilian operations as a prize. Also, thanks in large part to Spanish banking regulation, Santander had steered more or less clear of the subprime mess. The Royal Bank of Scotland and Fortis, however, have been a totally different story. Both:

- Were exposed to the American subprimes,
- Overpaid for the parts of ABN Amro they absorbed, and
- Had CEOs who hoped to make a global reputation with that deal but lost their jobs.

Liquidity became for both of them a problem that grew in size in a short span of time. In July 2008, Fortis was raising €8.3 billion of capital by selling assets and scraping its interim dividend, after already having, in 2007, tapped shareholders for €13.4 billion (at the time $21.4 billion) to pay for its €24 billion portion of the ABN Amro takeover.

As for the Royal Bank of Scotland, it had to ask its shareholders to come up with the money after having denied that it would need more capital. The bank's £12 billion ($18 billion) rights issue closed in June 2008, but the pain felt by its equity holders continued. In July 2008, its shares were hammered in the stock market, as investors got nervous about its

exposure to the American mortgage meltdown through its Citizens subsidiary, growing problems in its insurance arm, and its silly ABN Amro acquisition.

Critics said that RBS and Fortis had not only picked the wrong time to act as ABN Amro predators, but also paid the wrong price for the chunks they got. According to some estimates, adjusting for goodwill and subsequent write-downs, the Royal Bank of Scotland paid 17.6 times tangible book value for ABN's wholesale business and Asian operations. As for Fortis it cashed out 14.2 times the book value for ABN's Dutch retail operations, asset management, and private banking. This speaks volumes about substandard management at RBS and Fortis as well as the cost of big egos.

Fortis was the first to turn from a "successful" predator in the battle to acquire ABN Amro, a big Dutch bank, to a financial carcass. The governments of Belgium, the Netherlands, and Luxembourg all injected capital to stabilize the bank. The Dutch then nationalized their bits of ABN Amro while the Belgians and Luxembourgeois agreed to sell to BNP Paribas the businesses that Fortis had in its jurisdiction.

That salvage did not go smoothly. Problems appeared when a Belgian appeals court ruling froze the BNP sale and ordered that shareholders be given a proper say in the breakup of the bank. Alleged attempts by officials to influence the court's ruling caused the Belgian government to fall.

For its part, in late November 2008, the Dutch government announced plans for a phoenix-like revival of ABN Amro. The finance minister came to the decision to press ahead with the merger of Fortis Bank Netherlands, the nationalized Dutch arm of the Belgo-Dutch financial group, and its share of the ABN Amro assets. The resulting credit institution was to remain in state ownership until at least 2011 before being sold off or floated on the stock exchange.

As section 1 brought to the reader's attention, the British government nationalized the Royal Bank of Scotland, but the first refilling of the wounded credit institution's treasury proved inadequate. It did not matter that the sovereign's money printing presses were working full time and that good money running after bad money increased the government's share in RBS from 60 percent to 70 percent through new injections. Analysts commented that eventually Labor would have to assume 100 percent control.[8]

At the end of February 2009 the British Treasury spelt out the details about its Asset Protection Scheme (APS), in which a fallen bank's riskiest assets are ring-fenced, and under which the government will cover up to 90 percent of future losses. The Royal Bank of Scotland was the first to join APS, placing £302 billion ($430 billion) of assets in the scheme and

taking a "first loss" of £19.5 billion (RBS had previously reported a net loss of £24 billion for 2008, the biggest in British corporate history).

At the same time, Stephen Hester, RBS's new boss, provided details on plans to break up the LCBG. There was a lot to break up. In 2008, aggressively acquisitive, RBS was the world's largest bank in terms of "assets." There were plenty of rotten assets around and the new CEO wanted to split the bank into two parts:

- The "good," and
- The "mediocre."

The plan was that into the good bank would go about 75 percent of the LCBG's existing activities, consisting mainly of its British and American banking operations, its insurance business, and the less-dangerous bits of its investment banking operations (scheduled to be halved in size).

By contrast, the so-called mediocre bank would contain many of the foreign retail assets that RBS wanted to try to auction, and most particularly, if not overwhelmingly, the most avant-garde of RBS's investment bank like leveraged loans. Led by Labor, the British taxpayer was investing billions in the teetering LCBG with no evidence that he stood a chance of getting his money back sometime in the future.

### 3. The RBS Way to Disaster

Three years later, after having replaced the ousted Goodwin, in an article in the *Financial Times* Patrick Jenkins wrote that (in his judgment) Stephen Hester did a pretty good job of clearing up the mess at the Royal Bank of Scotland. When he arrived as chief executive the bank's balance sheet was bigger than Britain's gross domestic product: "It was full of gilts with bad debts and underperforming businesses, and staff sentiment was at low ebb. Since then, [Hester] rid the bank of £600 billion [$960 billion] of unwanted assets and started to turn round its lossmaking parts."[9]

Keen observers of corporate misgovernance said that the foundation for the assault on ABN Amro were laid almost ten years earlier when two "Sirs" at RBS's helm—Fred Goodwin and George Mathewson (Goodwin's predecessor and protector) —waged their hostile takeover battle for NatWest, the British bank wounded by the excesses of NatWest Markets (section 2). This was the deal that:

- Launched RBS on a path of acquisitions-fuelled growth, and
- Persuaded Goodwin as well as other RBS executives that they could stretch the bank's capital reserves to absorb ever larger institutions.

Like Citigroup (chapter 8), which for the sake of unstoppable growth—the philosophy of the cancer cell—had denied Taylor's, Stillman's, and Baker's policy of reputation and conservatism, RBS had denied its past. Historically, the Royal Bank of Scotland had a proud heritage. It received a royal charter from King George I in 1727 even though it featured a rather modest balance sheet. NatWest's acquisition brought it into banking's top league. The deal was sort of a triumph, but meant running down capital to dangerously low levels.

Third-class management, however, persisted and prevailed in its wrong-way course. With this, fortunes changed. In October 2008 RBS was forced to ask for billions in capital from the Labor government. Critics add that even in good years the ambitions of RBS and its CEO made investors nervous. Shareholders were growing disillusioned; some did not quite believe in the released numbers indicating that profits continued to grow, as the bank's rating waned because of:

- Growing exposure to derivative instruments, and
- Top management's aggressive approach to acquisitions.

Among themselves these two bullets made an explosive mix. RBS could not maintain its growth rate without acquisitions. In addition, for growth's sake, investment banking was playing an increasingly important role. In the US, Greenwich, its subsidiary inherited from NatWest's acquisition, went full speed, bundling together securities into collaterlized debt obligations (CDOs). The bank also became a leader in:

- Financing private equity buyouts,
- Lending heavily for commercial property deals, and
- Canvassing the market for all sorts of "investments," rewarding senior staff and traders with high cash bonuses.

What should have been seen as an ominous sign, was taken as a proof of success. In the three years to July 2007, the bank's balance sheet doubled to more than £1 trillion ($1.6 trillion). Its original strong credit rating and large deposit bases in Britain and the US raised few concerns about financial staying power. But the severe economic crisis and credit crunch that started in July–August 2007 turned all these high spirits on their head.

As Figure 9.1 shows, the value of RBS stock went off the cliff in inverse proportion to the rise of its total "assets," which, as the market had begun to appreciate, were smoke and mirrors. The equity has been in free fall even if the bank kept its dividend at a lucrative 7.5 percent of equity value.

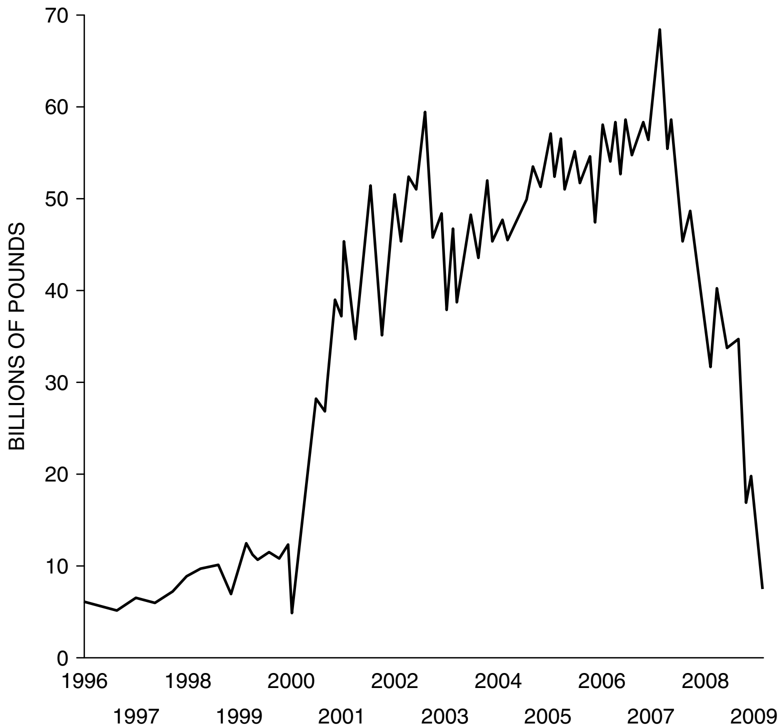



**Figure 9.1** Market capitalization of the Royal Bank of Scotland equity.

Investors finally understood that there was something unhealthy in the way the LCBG's total assets rose:

- From £100 billion in 1996
- To £400 billion in 2001
- £850 billion in 2007
- And beyond £1 trillion in 2008.

Classically, such a rise is unsustainable, and the market's perception was that RBS's top management was betting the bank without listening to warnings. RBS's chairman, who had overseen the merger of Astra and Zeneca, had warned that a cross-border deal is more complex than the NatWest takeover. Also, one of the Royal Bank of Scotland's partners to the ABN takeover, Spain's Santander, expressed concern about RBS's capital reserves. To raise cash, Goodwin sold the bank's insurance operations.

Other critics, aware of the dangers sophisticated financial instruments can hide, expressed a well-documented concern that RBS was yearning to take control of ABN Amro's large balance sheet, which was full of worthless derivatives. And this happened at a time when the financial markets were creaking. There was also a rather widespread suspicion that the top brass had done little due diligence, which meant that a major mistake, able to drive the LCBG against the wall, could not be excluded.

Clearing up the mess created by a giant LCBG takes both effort and time. In 2009 the bad news about RBS's ability to survive had continued to worsen. On February 26, 2009, the big bank revealed £27 billion ($43.2 billion) in 2008 losses. A large part of these losses could be traced directly to the decision Fred Goodwin, the bank's CEO in the go-go years, made in the spring of 2007 to launch the unprecedented hostile bid and breakup for ABN Amro—as well as to his determination to press ahead with that acquisition even after the markets cracked later that same year.

During the epic battle for takeover, ABN sold its American bank, LaSalle, for a stated $13 billion (£8 billion). In theory that money belonged to RBS. In practice it got stuck as, worried about the unfolding disaster, the Dutch regulator refused to let it be passed quickly to RBS. That significantly increased the capital the LCBG tied up in ABN.

A few days later, on March 3, 2009. it was publicly revealed that following a late night meeting the board of the Royal Bank of Scotland had awarded Fred Goodwin, the fired CEO whose policies and practices had brought the LCBG to bankruptcy, an annual pension of £700,000 ($1.2 million). Many judged this million dollars as an aberration, unbelievable for other CEOs who have or will ruin their institutions through gambles, laxity, and false incentives.

Much later Goodwin found himself obliged to disgorge it, but at the time of the board's decision "Sir Fred" insisted that he was entitled to his full pension of £700,000 a year, due at once although he was only 50. "Appeals to his sense of honor yielded about as much as an RBS share," said an article in *The Economist*, adding that "natural justice demands that Sir Fred be stripped of his dosh, for if the government had not stopped RBS from going bankrupt, his pension would have been paid out of the pension-protection fund, at the princely rate £28,000 a year, at the age of 65."[10]

The Royal Bank of Scotland was embroiled in more controversy over executive pay when, in late June 2009, it emerged that Stephen Hester, its new chief executive, would receive a compensation package worth up to £9 million ($14.4 million). That package was backed by the bank's institutional shareholders to incentivize Goodwin's successor.[11]

The costs of cleaning up the mess also continued to mount. In the last week of June 2009 the Royal Bank of Scotland announced that in the first half of that year it lost £1 billion ($1.6 billion) after tax as impairment charges on toxic loans soared. Such huge losses, however, did not discourage high salaries and bonuses. In the first days of December 2009 directors at the Royal Bank of Scotland threatened to resign if the British Treasury forbid them from paying £1.5 billion ($2.4 billion) in bonuses at its investment-banking unit.

Other British bankers, too, stepped up their criticism of what they said was overbearing government influence in matters of pay and compensation. But several institutional investors expressed the opinion that bonuses were not being paid because of "tradition" but for exceptional results and, as it turned out, several banks had business models that were totally unviable except during a credit bubble.

The LBCG had made a miscalculated bet. The deeper cause of RBS's failure, like that of many others, was its policy of aggressive balance sheet management. It entered the crisis with a core capital ratio of some 4 percent, totally inadequate given its policy of high leverage. Unavoidably its fall brought up a lot of existential questions in regard to its investment banking culture.

During Hester's four and a half years in charge, RBS's troubled noncore book of "legacy assets" was wound down from a peak of about £260 billion ($400 billion) to an estimated £60 billion ($95 billion). Still, to a large measure, the "new RBS" was the old RBS. It lacked a strategic plan different from the one that went on and failed. This is a weakness shared by nearly all LCBGs. It's a tunnel vision, which, rather than leading to a win-win situation, is a prescription for disaster.

## 4. Lloyds, HBOS

In mid-September 2008 HBOS, Britain's biggest mortgage lender, was taken over by Lloyds TSB, creating a king-size LCBG with almost a third of the country's retail and mortgage markets.[12] Competition regulators who normally balk at such a deal, looked the other way and the rescue was supported by the Labor government in an effort to avoid another Northern Rock.

Yet, until its balance sheet troubles became known, not so long before the takeover, HBOS was considered to be a profitable business. The senior management's forecast had been that the mortgage lender was on its way to make about £4 billion ($6.4 billion) underlying profit in the financial year 2008. It was also stated to have £4.5 billion ($7.2 billion) cash from its (then) relatively recent rights issue.

The pros said that they could see no other reason for HBOS going to the rocks other than speculators shorting the stock. This did not affect the day-to-day operations, but the bank's shrinking capitalization led to more shorting followed by a vicious cycle of undervaluing the business and making market sentiment more negative.

True enough, this was a time when hedge funds and traders were trying to guesstimate which were, most likely, the next banks to fall, with the aim to profit from their misery, but the pros were wrong as far as the reasons for a teetering HBOS were concerned. The mortgage lender was confronted by serious problems that, if left unattended, could bring it down.

Many of the deals in HBOS's £45 billion ($72 billion) commercial property portfolio had turned sour. There were also fears about hefty losses in HBOS's huge mortgage loan book, as house prices continue to fall. According to some opinions Lloyds did not notice these lurking dangers, blinded by the prospect of adding under its wings a huge market share by taking hold of HBOS.

Ready to act as savior, the Labor government brokered a rescue of Britain's biggest mortgage lender by a white knight: the relatively well–to-do Lloyds TSB. Ironically Lloyds and HBOS were Britain's fourth and fifth biggest banks by assets, and their merger would have produced a big oligopolistic retail banking outfit. Nobody bothered about its effect on retail banking competition, or about the money the government had to commit.

The £17 billion ($27.2 billion) the sovereign earmarked for HBOS and Lloyds TSB was said to be dependent on their merger. On October 31, 2008, the new business minister disregarded the recommendations of some HBOS shareholders, many Scottish politicians, and the Office of Fair Trading (OFT),[13] waving through the deal. But there was a major difference between:

- Rescuing a stand-alone HBOS, and
- Rescuing it as part of an LCBG, like Lloyds.

As the official competition watchdog, at no time did the Office of Fair Trading publish a sober analysis of a merged Lloyds and HBOS. The combined banks would have around 30 percent of British citizens' personal current accounts, 30 percent of mortgages, and some 45 percent of small-business services in Scotland.

It has been nobody's secret that major bank bailouts always involve balancing acts between moral hazard, oligopoly, and the search for systemic stability. The pros said that it did not really matter. The deal had

to go through and when this crisis was over, the financial system would work better if a healthy number of competitors were still standing.

How many competitors? This was the question many people asked. RBS and Northern Rock aside, HBOS was not the only British bank with a problem. FSA, the financial regulator, was said to have sounded out potential white knights for Bradford & Bingley (section 5) as part of its contingency planning in the event that the country's biggest buy-to-let lender got deeper into market turmoil. With Alliance & Leicester was taken over by Santander of Spain, Bradford was the only stand-alone mortgage lender left in Britain.

FSA said that it would not comment on any individual institution, but market rumor had it that it was looking around for someone to act as midwife. According to some market experts, if Bradford & Bingley were to run into difficulties and no buyers came forward, alternatives could include breaking the company up and selling its assets.[14]

Were the banks salvaged with taxpayer money behaving in a way commensurate with their dismal financial situation and with due respect to the taxpayer funds that helped them survive? As reported by the media, at the time that so many pensioners lost their savings as a result of banking share collapse:

- The Royal Bank of Scotland was spending £1 million on parties for its rank and file staff, and more than £300,000 entertaining senior employees and partners.
- Lloyds, which got billions from taxpayers to shore up its broken balance sheet, was spending £2.5 million on Christmas parties for its 100,000 employees.
- HBOS was hosting a luxury dinner and dance in Birmingham for 12,500 mortgage workers, with free hotel rooms thrown in.

By mid-January 2009 Lloyds's stock price had dropped by 34 percent, while HBOS reported that in 2008 its losses amounted to £10 billion ($16 billion). In mid-February 2009 Moody's downgraded its AAA credit rating for Lloyds Banking Group (LBG), while speculation mounted that the LCBG, 43 percent of which was by then owned by the British sovereign, may have to be fully nationalized.

Critics said that, promoted by Labor, the takeover of HBOS by Lloyds was supposed to provide a safe haven for the troubled bank. Instead it threatened to bring down the combined Lloyds Banking Group. The announcement of the aforementioned, higher-than-expected loss of £10 billion at HBOS in 2008 alarmed the City. The merged bank's Achilles heel was the corporate loans book of HBOS.

In March 2009 Lloyds joined the British Treasury's Asset Protection Scheme, placing toxic loans worth £260 billion ($416 billion) in it, most of them from HBOS. The LCBG was also converting preferred shares it issued to the Treasury in 2008 into common shares.

Several experts in the City feared that the government might tweak the details of how Lloyds injects £260 billion of dud loans into the Asset Protection Scheme, to the disadvantage of private shareholders. Eager to capitalize on a government waiver of competition rules, Lloyds jumped at the chance to secure a dominant position in British retail banking, without taking the precaution of securing the same kind of backstop for unexpected losses, which JPMorgan insisted on when buying Bear Stearns.

This and other bad news continued to accumulate. In early August 2009 the Lloyds Banking Group announced it had lost £4 billion in the first half of the year, as it grappled with toxic loans at HBOS. In a way resembling results at Northern Rock, it reported a first-half loss of £725 million and revealed that the proportion of its mortgages that were more than three months in arrears had risen to 3.9 percent.

With time, it was learned that way prior to the crash the bankers had not exercised due diligence. HBOS had probably the worst commercial property portfolio of any British bank. In early December 2009 Lloyds—with roughly £42 billion of British commercial property loans—took a £9.7 billion charge for property- and corporate-loan impairments in the first half of 2009, largely attributable to HBOS.

Analysts calculated that about £100 billion ($160 billion) of new money was needed to get commercial property loans back in conformity with their covenants, and another £30 billion ($48 billion) to reduce loan-to-value ratios to a more comfortable 65 percent. Added to the mix was around £44 billion of commercial mortgage-backed securities to be restructured, securitized, and sold. Some reckoned that *if* not the taxpayer *then* the most likely providers of this capital were foreign investors, including private equity firms, and sovereign wealth funds. With the exception of Barclays, there was no longer a major private bank in Britain free of government intervention.

## 5. Overextended British Banks

In December 2008 the balance sheet of the British banking system stood at a whopping 450 percent of the country's GDP. This might have turned into economic, social, and political dynamite. Moreover, with the pound in shatters, at the end of 2008 Britain did not have a global reserve currency to draw on, if it needed to act as lender of last resort.

In contrast to Iceland, which had cornered itself into a similar situation, Britain had access to currency swap lines from the world's biggest central banks. These might have helped it prevent a run on its banks; though experts said that should this happen it would badly shake London's position as a global financial center.

London's weakening position as a global financial center was, practically, what the French wanted to see when, four years later (in December 2012), they attacked Britain's dominance by saying that of all forex transactions done in the world, the greatest concentration was in London. Statistics are eye-openers. Of all foreign exchange transactions:

- 38 percent are done in London,
- 18 percent in New York,
- 3 percent in Paris, and
- 2 percent in Frankfurt

On December 4, 2012, Christian Noyer, governor of Banque de France, made a statement that no euro forex transaction should be done in London because Britain is not a part of Euroland (probably meaning that they should be done in Paris).

- But is the British, or for that matter the French, economy in good shape?
- How far had the banking crisis as well as the sovereign's co-involvement damaged each and both of them?

Apart from the Labor government's, hence Treasury's, handouts the Bank of England had "loaned" £60 billion to RBS and HBOS.[15] Britain's central bank had to intervene because of the wide securitization that mushroomed relative to market value (as the market caved in). In September 2007, for example, Northern Rock's securitization program was equal to 1.725 percent its market value.[16]

Numbers for French banks' securitizations and toxic waste have not really been released, but from the Banque de France's insistence that inventoried commercial banks' paper (a sort of financial garbage) should be used for liquidity purposes to meet Basel III requirements, one can guess the extent of the central bank's involvement in secret loans to French credit institutions taking useless securities as collateral. (Correctly, this proposal was rejected by the Basel Committee.)

What we know is that in just one day, on March 5, 2009, the Bank of England put on the table £150 billion ($240 billion) of newly printed money to buy commercial paper. It is a reasonable guess that given the

ongoing economic and banking crisis other European central banks had taken similar initiatives. (That same day of March 5, 2009, Britain's big insurance companies, Aviva and Prudential, had record losses on CDSs, as defaults were rising.)

With the investment the British government had made to self-wounded LCBGs in its effort to provide them with artificial respiration, Treasury officials had taken on the role of fund manager through Financial Investments, the agency managing the high stakes in RBS and Lloyds. This was seen by the market as a longer-term commitment because shock therapy had fallen out of fashion.

The Financial Investments exit strategy was believed to depend on a mixture of institutional placements, secondary offerings, and issuance of structured instruments such as exchangeable bonds. The state agency was also open to what it called "reactive options," such as strategic sales through mergers or acquisitions, private stake sales, and share repurchases by RBS and Lloyds, if they could ever afford them.

Nor were the two LCBGs and the small "good bank"/"bad bank" that came out of Northern Rock, the only institutions the Labor government had to worry about. After Northern Rock's nationalization at a cost of £100 billion ($200 billion, at the time) Alliance & Leicester went under and was ushered in a hurry into the Santander stable, which had bought Abbey National in 2004.

Then at the end of September 2008 Bradford & Bingley was declared by the Financial Services Authority as unlikely to meet its obligations. [17] Attempts to sell the wounded bank in its entirety to the usual suspects failed. The white knight for parts of it was again Banco Santander, which agreed to pay £612 billion ($1.1 billion) for £20 billion in retail deposits and 197 branches. This purchase:

- Would add 2.7 million customers to those of Abbey and Alliance & Leicester.
- The combined bank was projected to have about 10 percent of British retail deposits.

To forestall a run on other shaky banks, as in Northern Rock's case, all deposits were guaranteed, not just the £35,000 automatically covered by the Financial Services Compensation Scheme. The remains of Bradford & Bingley, which practically meant £65.5 billion (nearly $105 billion) of ashes, were nationalized at great cost to the British taxpayer.

For the first time, the risks hidden in B&B's deteriorating £40 billion ($64 billion) mortgage book were to be borne mainly by British banks, through future contributions to the compensation scheme. *If* that fund

ran dry *then* B&B's mortgage book was to be honored by the taxpayer. This meant that other banks and building societies had to share the consequences of FSA's allowing B&B to exploit the fast-growing but risky buy-to-let market portfolio. Its contents were supposed to be doubly secured by two income streams.

- The owner's, and
- The tenant's.

In real life, however, they had turned out to be vulnerable. Because of lax underwriting, the rental income alone failed to cover the mortgage payments. In addition, apart from a sideline in self-certified mortgages, buy-to-let mortgages were a license for borrowers to lie about their income just as it had happened in America with the subprime and Alt-A mortgages. Regulators had turned a blind eye and bankers would never learn.

## 6. Ireland's Nemesis: The Anglo Irish Bank

On January 15, 2009, the Irish government announced the full nationalization of the Anglo Irish Bank, the country's third largest bank. Four days later the British government increased its stake in the Royal Bank of Scotland and also unveiled measures to stimulate lending, including a guarantee scheme designed to protect banks against losses on bad assets.

On January 20, 2009, the French government agreed to provide another €10.5 billion ($13.6 billion) of capital to its biggest lenders. After the Bush administration was forced to pump more money into Bank of America on January 16, 2009, the Obama administration announced that it was working on fresh plans to immunize banks from the effects of the infected assets they had collected left, right, and center.

The Anglo Irish Bank was not the only institution Dublin had to look after. The Bank of Ireland also had problems and so did the Allied Irish Banks. Both benefited from state and state-backed recapitalizations. The government of the Republic of Ireland had already agreed to invest €3.5 billion of preference shares in the country's largest bank. But after reviewing its loan book as part of the due diligence ahead of that investment, the government told its management it would need to raise an extra €1.5 billion in core Tier-1 capital.

Still it was the Anglo Irish Bank, the smallest of Ireland's three major credit institutions, that turned out to be the worst case. On February 24,

2009, Irish anti-fraud officers raided its Dublin headquarters as part of an investigation into alleged breaches of company law. The investigation was being conducted by the Office of the Director of Corporate Enforcement (ODCE), which moved following disclosures that for eight years Sean Fitz-Patrick, the bank's CEO, had hidden from auditors personal loans from the institution under his watch by transferring them temporarily to another Irish institution just ahead of the bank's financial year-end. The loans outstanding at September 30, 2008, amounted to €83.3 million ($108 million).

The ODCE was also probing the arrangements whereby in July 2008 Anglo Irish lent €451 million to ten long-standing clients to acquire 10 percent of the bank's shares. In a letter to the Irish parliament's committee on finance, in early February 2009, Paul Appleby, the director of corporate enforcement, wrote that, in his opinion, circumstances suggesting:

- Prejudice,
- Misconduct, and/or
- Illegality were present in the company's affairs.

The year 2009 had only seen a prelude to what was revealed nearly four and a half years later in the form of shocking conversations between executives at Anglo Irish Bank, in which they laughed about abusing Ireland's bank guarantee to attract deposits. This came to the public eye at the time the Irish government was lobbying the EU to enable Euroland's €500 billion ($670 billion) bailout fund to retrospectively recapitalize its banks—which have already received a €64 billion bailout from the taxpayer since Ireland's financial crisis began in 2008.

The revelation of taped conversations between senior executives at Anglo by the *Irish Independent*, in the week of June 24, 2013, prompted concerns about Dublin's case for relief. A second batch of tapes provided evidence on how senior Anglo Irish Bank executives laughed off concerns expressed by EU governments and Irish regulators. "So f***in' what. Just take it anyway…stick the fingers up," David Drumm, Anglo chief executive, told his colleague John Bowe, head of capital markets, in a phone call recorded by the bank's internal system.[18]

Acting as if he were a young teenager, Drumm mimicked a senior Irish regulatory official who had contacted him to express concern that the actions of the country's no 3 bank were causing a rift between Ireland and Germany. Bowe then broke into verse singing "Deutschland, Deutschland, über alles."

The Anglo Irish Bank executives deny that they have misled the regulators, and it is for the courts to decide whether their behavior was a

criminal one. But the Irish government would have done better to let a rotten bank like that fail instead of pouring in taxpayers' money. This incident is one more piece of evidence that the European Union is best characterized by what Leo Tolstoy, the famous Russian writer, said about families: "A group of enemies under the same roof."

# 10

# Euroland's Banks

## 1. The Need to Banish the Threat from Zombie Banks

Following the bankruptcy of Lehman Brothers, as the financial shockwave spread around the globe, many Euroland banks became exposed to the risk of being hit by both capital inadequacy and a loss of confidence. The greater danger has been speculation about their liquidity and solvency positions, especially those that were reliant on wholesale funding.

In late September 2008 three LCBGs with large cross-border activities in France and the Benelux countries came under intense market pressure because of perceptions of weak asset quality and capital shortages: Fortis, ING, and Dexia. In Germany Hypo Real Estate, a major commercial property lender had to be saved from the brink of collapse after its Irish subsidiary ran into funding problems.

As in the United States and Britain, self-perpetuating market dynamics became important drivers of risk, while the highly leveraged banks were forced to unwind loss-making positions. This led to substantial declines in the stock prices of both global and Euroland LCBGs. Collectively, between the middle of September and late November 2008, the market capitalization of Euroland's big banks dropped by almost €200 billion bringing the cumulative decline since the turmoil erupted to around €450 billion ($585 billion), which was more than half of the aggregate market value of these banks immediately prior to July–August 2007.

As counterparty credit risk concerns rose, credit default swap spreads for these institutions surged. Conditions in Euroland's unsecured interbank money market had become very tense, and banks were increasingly dependent on European Central Bank liquidity operations as well as on overnight borrowing. Interbank lending at longer maturities had ceased almost completely.

In an emergency, Euroland's governments agreed on a framework to support the banks in their jurisdictions. Announced on October 12, 2008,

this plan involved extraordinary measures that included a strengthening of deposit insurance schemes, offering sovereign guarantees for bank debt issuance and providing additional capital resources to banks "too big to fail." In line with this action plan, €2 trillion ($2.6 trillion) was pledged by governments to:

- Guarantee banks' new debt issuance,
- Support their recapitalization, and
- Purchase their not-so-valuable paper assets.[1]

This, however, did not mean that the pledged money was even approximately enough for Euroland's LCBGs confronted by a crisis in their treasuries. As in the case of America and Britain, Euroland's sovereigns rushed to throw money at the problem, illustrating the tight negative feedback loop between banks and their domestic governments.

Assessments of solvency and liquidity situation were highly interdependent and there was a strong risk of contagion. Evidence has been provided by the correlation between bank and sovereign risk premiums, as well as by rating downgrades. Once a government's issue rating was lowered, the LCBGs in that jurisdiction were usually downgraded. The institutional investors' memory of past happenings led them to adjust their benchmarks and reduce or even discontinue their purchases of sovereign and (bank) bonds of crisis countries.

The continuing pressure on many European banks' credit ratings amplified this trend. While information on some of Euroland's LCBGs' shortfall was not readily available, analysts believed several big banks could struggle to come through tests of their capital buffers' robustness. The worst performers included a clutch of real estate–exposed institutions like the Spanish savings banks.

Analysts also believed that higher credit losses were to be found in much of southern Europe, combined with squeezed margins as local sovereign also faced capital challenges. Also in what is generally considered to be Euroland's core there were problems with LCBGs' liquidity and solvency leading to state intervention.

On October 17, 2008, Germany and France gave final approval to their costly bank rescue packages. While several beleaguered Euroland banks were in no hurry to sign up for the government bailouts, some of their major financial competitors already had the benefit of state backing. Keen market observers named ING of the Netherlands and Unicredit of Italy as the first to go for capital injections. In an effort to improve its balance sheet without Italian government support Unicredit got funds from Libyan state investments.

The savior of ING, the large banking and insurance LCBG, was the Dutch taxpayer. The financial conglomerate received an injection of €10 billion ($13 billion) from the Dutch government, against which the sovereign got an 8.5 percent stake (which practically meant that ING was valued at about €118 billion).

Curious, indeed, impertinent, was the big-headed attitude of some of the self-wounded LCBGs' CEOs and CFOs. Almost in one voice they said: "We are strong and now we are becoming stronger." This did not fool the market. Goldman Sachs, which rated ING a "conviction sell," warned in a note that:

- "The LCBG needed to raise more capital, and
- "It will confront difficulties in trying to do so in a turbulent market."[2]

What has followed in rescue operations provided evidence that in Euroland, too, many things changed in the wake of the 2008 economic and financial crisis, with governments and central banks interfering much more than earlier in the functioning of financial markets. By choosing where in the capital structure to intervene directly and what to influence, they altered the market's behavior. The "free market" was not that "free" anymore.

Peer Steinbrück, who was at the time Germany's finance minister, hinted strongly that he would focus first on the interbank lending guarantees, which took up 80 percent of the German package totaling €500 billion ($670 billion). The plan also provided money for the government to take direct stakes, and it limited the pay of top executives at banks that take cash from the sovereign to €500,000.

The French plan called for €320 billion in lending to banks, with a more limited €40 billion set aside to take stakes in French financial institutions. It was largely a political issue to make banks overcapitalized, so that there is no doubt they could survive a crisis, said an economist. But far from being a matter of overcapitalization, the funds different Euroland sovereigns initially put on the block aimed to give some confidence to the market by allowing the big banks to show that they have the capital needed to be active.

Euroland's economists and analysts with clearer thinking than the average state of mind of their colleagues, were worried by the aftereffects of the sovereigns' rush to rescue. They warned against wholesale dependence on government money, and did not welcome the news that Europe's banking industry was being kept afloat by implicit state guarantees of virtually all liabilities. They were right in giving such a warning.

Years later, in the first days of May 2013, an analysis by the Netherlands Bureau for Economic Policy stated that in the previous year (2012) the

aforementioned stake guarantees provided Euroland banks with an annual average funding advantage equivalent to 0.3 percent of total assets. Since the total banking assets of Euroland were €33 trillion ($43 trillion) the "advantage":

- Was an implicit guarantee of somewhat less than €1 trillion, and
- Behind it stood the sovereigns with the power of life and death over the banks.

It is difficult to know how the LCBGs have used that advantage to come out of the woods, effectively managing the unrecognized losses on their "assets" estimated by several analysts to be at least several hundreds of billions of euros. Some banks, particularly from southern Europe, have found it almost impossible to recapitalize themselves by issuing equity or debt convertible into shares.

Alert presidents appreciate that as long as they depend on state handouts their institutions will be nothing more than zombie banks, while their low credit rating constrains them from issuing equity on international capital markets. To get out of this vicious cycle, in late April 2012, Apostolos Tamvakakis, CEO of the National Bank of Greece (NBG), went on a roadshow in London to fend off the elimination of private shareholder control, considered inevitable across Greek banking as lenders struggled to absorb losses on their government bond holdings in the aftermath of the ill-conceived and very poorly executed *Private Sector Involvement* (PSI).[3]

Not only NBG, but also Alpha, Eurobank EFG, and Piraeus, the other Greek main banks, will likely end up with the state owning them up to 90 percent, via capital injections from the EU/ECB/IMF-funded Hellenic Financial Stability Facility. Tamvakakis's effort aimed at raising at least 10 percent of the requisite capital from private sector investors. But at €20 billion ($26 billion) the sum needed is large, and the Greek economy has not yet significantly improved.

This in no way means that the woes are concentrated only in southern Europe and are limited to recapitalization. Euroland's banks in core countries, too, are not in pristine capital condition. As of August 2013, analysts estimated that to comply with forthcoming regulations aimed at reducing the likelihood of another taxpayer-funded bailout, over the next five years Europe's biggest banks would have to cut €660 billion ($880 billion) of assets and generate €47 billion ($63 billion) of fresh capital.

Such figures were part of an analysis by the Royal Bank of Scotland, which also stated that by 2018, overall, Euroland's banks would need to shed €3.2 trillion ($4.2 trillion) in assets to comply with Basel III

regulations on capital and leverage ratio (chapter 2). Britain, too, is far from being immune to the big banks' core capital shortfall. On March 27, 2013, the Bank of England announced that according to its Financial Policy Committee big banks were overstating their capital by £52 billion ($82 billion) and that two of them—RBS and Lloyds—accounted for £20 billion of a £25 billion capital shortfall across the banking sector.

## 2. Commerzbank and Hypo Real Estate

Back in 2007 Angela Merkel, the German chancellor, said that there would be no "state orgy" of regulation of the hedge funds, whereas in her speech at the colloquium held in Paris on January 8–9, 2009, she vowed that in the future she would not allow the movers in the financial markets to prevent politicians from imposing rules. But the reference she made in the course of the same event to "the moment when everything's going to get better," showed that like all other leaders she had underestimated the economic and banking crisis.[4]

Not only in Germany but throughout Euroland, as well as in the US and Britain, plenty of evidence pointed to the urgency of a solution aiming at bank bankruptcy reorganization. A German example is the partial nationalization of Commerzbank, so that in turn it could take over Dresdner Bank, which was sitting on billions in toxic waste. In late 2008, the German regulator promised Commerzbank €8.2 billion of loans and €15 billion in credit guarantees with public money.

According to *Der Spiegel*, Allianz, the huge insurance company and Dresdner Bank owner,[5] was committed to beefing up the self-wounded bank's treasury with a silent € 750 million deposit, and paying €2 billion in exchange for nearly valueless securitized paper. This has been the widespread Western model of financial institutions forging a web of cross-shareholdings to:

- Increase economic power, and
- Bolster and protect selected companies from takeovers.

However, the deep economic crisis had turned that model on its head. In the case of Commerzbank, the German government took a 25 percent direct stake in the LCBG to assure that its merger with Dresdner would go ahead. Berlin also had other wounded institutions to look after. Its bigger challenge was to refill the treasury of some of the Landesbanken[6] and persuade them to finally accept the logic of consolidation (more on this in section 3).

During good times, there was little incentive for politicians to agree to such a consolidation. The Landesbanken were a convenient asset to hold and all sorts of vested interests argued against merging them. The crisis, however, turned the Landesbanken into liabilities and the federal government came to their rescue.

Indeed, the two big German restructurings were arguably Commerzbank and WestLB, a Landesbank that entered aggressively into derivatives and accumulated mountains of toxic waste. Both had to shrink their balance sheets by about half from their peak though it was not that simple to identify those bits of the banks that were sicker than the rest—for instance, property, derivatives, and international operations.

In early 2009 the collapse of the real estate market had brought to the foreground another badly wounded institution in need of nursing: Hypo Real Estate, a German mortgage lender. Hypo shocked investors by revealing a charge of €390 million ($507 million) on its holding of collateralized debt obligations—which was a large sum at the time, as well as an extracurriculur activity for a mortgage lender. Hypo's share price fell by a third in the Frankfurt stock exchange with this announcement.

Underlying the spreading credit risk was the deeper weakness that hit the German banks, like those in other Euroland countries. Trading losses as well as loan losses from a prolonged downturn could quickly deflate their capital cushion. The risk was real because the banks' hoard of toxic securities was estimated to be at the €750 billion ($1 trillion) level, or more.

Prior to the takeover of Dresdner Bank by Commerzbank, the staff at Dresdner Kleinwort, the investment banking arm of Dresdner, used to refer to Commerzbank as a "Comedy bank." This changed on August 31, 2008, when Allianz gave up the effort to make anything of its purchase of Dresdner and sold it to Commerzbank for €9.8 billion ($13 billion).[7] Commerzbank received a €8.2 billion ($10.7 billion) infusion from the German government, but analysts and investors fretted that:

- Commerzbank was paying too much for Dresdner,
- The deal increased its exposure to toxic assets, and
- Shrinking Dresdner's investment arm could be costly in a falling market.

But downsizing of Dresdner's not-so-successful investment banking operations was on the cards as the merged entity was supposed to concentrate on German retail and business customers. Investment banking had to shrink, with the axe expected to fall hardest in London.

These were the plans. Things, however, went wrong for Commerzbank as the financial crisis reached a new level, even if the government

became the guarantor of the merger with Dresdner Bank. Indeed the Commerzbank deal turned the sovereign into the most important shareholder in Germany's second-largest private sector bank, giving it two representatives on the supervisory board and a 25 percent stake with the power to block every major decision Commerzbank's management board was taking in the future.

In a way quite similar to what happened in Britain with the Royal Bank of Scotland and Lloyds HBOS, as well as in America with a score of "rescued" banks, the heavy hand of the sovereign was a rather sobering development. Commerzbank found that out the hard way as it had to be rescued twice in the space of just a few months.

Indeed, according to some analysts, the German LCBG's initial trajectory through the crisis resembled, to a surprising extent, that of Britain's Lloyds Banking Group. Like Lloyds Commerzbank was a big bank, but not the biggest in the country, and it undertook a disastrous domestic transaction at the worst possible time, buying Dresdner Bank in the summer of 2008 just weeks before Lloyds took over HBOS. And like the British bank, it had to tap taxpayer money just to survive.

At the Frankfurt stock exchange, the prevailing opinion was that the Commerzbank-Dresdner merger would have collapsed without fresh money. Berlin's role as a financier of wounded credit institutions brought back memories of the previous time the state had bought a stake in Commerzbank. That was some 73 years ago, in the summer of 1931, at the height of the depression. In the early 1930s, as in 2008, the government wanted to demonstrate that it remained capable of taking action.

As in the case of the American and British sovereigns, the German government wanted to prove that its rescue of the financial industry could easily master even the biggest challenge, but it did not take long to find out that the first injection would not suffice. Dresdner Bank in particular had on its books so many securities under water that government experts described the bank as *toxically charged*. Yet nobody was brought to justice for having destroyed the once-prosperous Dresdner Bank.

As for Commerzbank, to justify its plight, it pointed to several forces beyond its control. Historically low interest rates had depressed income, while competition from Germany's many small savings banks and cooperatives put pressure on its fees. In addition, the restructuring of the Greek government debt and the silly PSI business handed it a big loss.

Another excuse was that a downturn in shipbuilding hit Commerzbank's big portfolio of loans in that industry, while in retail banking online banks serviced clients at a fraction of the cost of brick and mortar. Interestingly, no mention was made of the biggest of all reasons. Both Commerzbank and Dresdner had thrown their money to the

dogs by "investing" in subprimes before the crisis. And like many of their continental peers, they were also big international lenders having lowered their standard in order to get into the act.

As far as lending by lowering prudential credit standards and "investing" in garbage subprime mortgage-backed securities was concerned, similar excuses were advanced by Hypo Real Estate (HRE) to justify its descent to the abyss and its demand for taxpayer money. As if the subprimes blunder was not enough, in the third quarter of 2007 Hypo took over the Dublin-based DEPFA, a teetering public sector financing bank. In searching for ways to enhance its low margins in government financing DEPFA was heavily involved in maturity transformation. Following the takeover, Hypo sought to reduce that risk but (excuses, excuses) the situation on the money market grew acute in the wake of the Lehman Brothers insolvency and bankruptcy and it was no longer able to secure the necessary refinancing by private capital.

In the aftermath, Hypo Real Estate faced imminent insolvency, and the Federal Financial Supervisory Authority (BaFin) as well as the Bundesbank engaged in negotiation with the mortgage lender at the end of September 2008. The result was the first rescue package of €35 billion against the provision of collateral by Hypo. The Bundesbank was to pay €20 billion and €15 billion was to be paid by a syndicate from the financial sector, secured by a German government guarantee.

Still, two quarters down the line, by April 2009, Hypo Real Estate was the most visible of Germany's ailing banks. The government had already propped it up with more than €100 billion ($130 billion) of loans and guarantees, but positive results were still to be seen. Its DEPFA subsidiary continued to sink in red ink, along with its loans to central governments and local governments.

One of DEPFA's big mistakes was to try to boost margins by raising a large sum of the money it loaned out in shorter-term money markets. That business became a disaster when credit markets froze. With credit tight, the only way to make a profit on DEPFA's outstanding loans was by refinancing them using the government's deep pockets and cheaper debt.

On April 9, 2009, the German government's bailout fund offered to buy all of Hypo Real Estate from shareholders. Two weeks later, on April 21, Berlin suggested a plan to establish several small "bad banks" that would use as much as €200 billion ($260 billion) provided by the government. In the meantime, Hypo's liquidity requirements kept on increasing as it had to provide counterparties with additional collateral. The German Financial Market Stabilization Fund:

- Granted it a guaranteed line totalling €52 billion in stages, and
- Eventually took over 100 percent of the Hypo Real Estate shares.

There were direct consequences for Hypo's creditors, as well as the risk that German banks' refinancing could have been severely impaired in case of a loss of confidence in the German banking system. The stock market, too, might also have been dragged down. But the takeover of HRE by the Stabilization Fund achieved a sufficient level of legal certainty and provided the basis on which the market's worries waned, all that with the compliments of the German taxpayer.

### 3. IKB, WestLB, and Sachsen LB

In early August 2007 Dusseldorf-based IKB Deutsche Industriebank, a medium-sized German lender active in derivatives and subprimes, required a messy bailout. In an apparent total absence of risk control, since 2002 IKB had built up a €12.7 billion ($16.9 billion) portfolio of asset-backed instruments, held offshore and off balance sheet by a different entity known as Rhineland Funding. The latter got its money by issuing short-term commercial paper.

The financial markets were surprised that IKB's parent, Kreditanstalt für Wiederaufbau (KfW), a state-owned German bank (originally set up to finance the post–World War II German reconstruction), had failed to exercise prudential supervision. KfW had a 38 percent interest in the stricken lender, and was known to be a rather well-managed bank. Its inaction in IKB's case proved one more time that the absence of rigorous supervision is a prescription for failure.

In the aftermath, German experts suggested that while IKB said that it acquired assets that theoretically met its rating criteria, these "assets" carried an inordinate amount of opaque credit risk and market risk that senior management failed (or simply did not care) to consider. Ironically, the poorly governed Dusseldorf outfit had paid investment banks and ratings agencies some $200 million to:

- Structure its financial products, and
- Help in valuing them through mathematical models.

In spite of this "help" on financial alchemy bought at high price—or because of it—at IKB, the collection of toxic waste and associated mismanagement continued,uninterrupted. It came therefore as no surprise

when on November 30, 2007, it was announced that the money of an August 2007 rescue had evaporated and IKB had failed a second time.

- The cost of the first recapitalization by KfW was €3.3 billion ($4.3 billion).
- After the second failure of IKB, the money thrown down the drain increased to € 6.15 billion ($8 billion).

Three months later came the need for a third IKB bailout. Even though the previous two salvage operations had cost $12.3 billion, in the vain hope of resurrecting the dying IKB, on February 13, 2008, the German government (incorrectly) decided to throw another €1 billion ($1.3 billion) into the empty coffers of the self-wounded bank, saying that the fallout from an IKB collapse would be "incalculable" (!!). Other German credit institutions were expected to contribute an additional €500 million to the bottomless pit of an industrial credit bank that had become an unsuccessful, indeed ruinous, hedge fund.

According to political commentators, this insistence on throwing away so much money damaged Angela Merkel's political position, which at the time was in decline. Questions have also been posed about the German government's attitude toward other wounded state banks. On February 13, 2008, it was also revealed that the Bayerische Landesbank (already known for its absurd risk taking) suffered losses of €1.3 billion from "other sources" and "only" €150 million from subprimes. Analysts suggested that most likely the numbers were the other way around.

In the week of August 18, 2008, Germany's most prominent casualty of the subprimes (and of bad management), that was rescued three times but kept falling into a coma, found a buyer of sorts. Lone Star, the private equity fund from Dallas, Texas, took a 91 percent stake in it for a mere $223 million (€172 million), while KfW, the wounded bank's owner, assumed a further €3 billion obligation to cover IKB's hidden surprises.

To understand the most unfavorable terms of this deal, the reader should know that IKB's losses from subprimes and other silly trades amounted to €18.5 billion ($24 billion), the third largest in European banking after UBS's $38.4 billion) and Northern Rock's meltdown. To refloat the bank directly and indirectly the German government had poured into IKB about €10 billion ($13 billion), and KfW hoped to reap at least €800 million from its sale. Instead, as IKB sold at basement bargain price KfW got just a few cents to the dollar.

According to a report published by *The Economist*, it was Deutsche Bank that sold the risky financial instruments to IKB, including

investments in American subprime mortgages; and Deutsche Bank was also the first to pull the plug when IKB got into trouble. For its part, this report said, Deutsche Bank blamed other some German banks for taking on risks beyond:

- Their capacity, and
- Their competence.[8]

The blame could be laid all over. In Germany, as elsewhere in Europe, all sorts of institutions have been selling mortgage-backed securities from America, many of them subprimes, and these found a particularly receptive audience among the poorly governed banks. As long as the subprimes market was booming, IKB made fat "advisory" fees of around €50 million a year.[9] Superficially, models "assured" that the portfolio looked sound with:

- 70 percent of assets rated double-A or above, and
- Only 10 percent of them said to be below investment grade.

The problem however has been that neither IKB nor its parent bank were really in charge of the exposure accumulated over the years. Knowledgeable sources suggest that risk increased significantly from 2005 when, with or without KfW's knowledge, IKB was tempted into the most exposed end of the financial market: the mezzanine tranches of American residential MBSs packaged into CDOs.

Not only was that move stupid, but IKB also stayed for too long at the blackjack table. Its main conduit, Rhineland Funding, was the first to go under, as it could no longer secure new short-term funding. In July 2007, it called on a €12 billion ($17.6 billion) line of credit promised by IKB and some other financial institutions. Deutsche Bank exercised its option to cancel its commitment and alerted Bafin, the German banking supervisor.[10] This prompted the August bailout.

Then, in the week of October 15, 2007, while looking around to find a buyer for its off-balance sheet investment conduit, IKB announced it would bring on-balance sheet Rhineland Funding. This increased uncertainty, because it led to significantly higher volatility of financial results. Loading oneself with the toxic waste of subprimes is by no means a stabilizer. By mid-October 2007:

- IKB's losses had mounted to €3.5 billion ($4.7 billion),
- The wounded bank looked around, most unsuccessfully, to sell itself, and

- Finding no takers, a fortnight later, KfW announced that it was setting aside another packet of money to cover the new subprime-related losses at IKB.

There and then, in October 2007, when the toxic waste mounted and IKB management deliberately sidelined the bank's exposure, KfW should have closed down its ailing subsidiary and brought its CEO and senior executives to justice. Instead, it ignored the worries of its risk managers and auditors and kept on having good money run after bad money.

The cases of Commerzbank, Dresdner Bank, Hypo Real Estate, and IKB are by no means the only high-profile instances of mismanagement of exposure in German banking. Back in August 18–19, 2007, while the financial markets were in the early stages of a multiphase unwind of the credit-driven bull market, a German state (Länder) savings banks treasury and an unidentified American financial institution had to be rescued, as the market wondered who was next in the list of failures.

The German outfit that overleveraged itself in subprimes and went bust was Sachsen Landesbank. It was one of Germany's smaller state banks. The exposure that demolished its treasury was the $16.75 billion it had invested in a conduit, though it also had a lot of other subprimes characterized as "assets." To save it from bankruptcy, the Landesbank of Baden Württemberg (LBBW, Germany's biggest LB) took Sachsen LB over,[11] but only after having negotiated and obtained:

- Guarantees for the first €2.75 billion ($3.6 billion) of losses, from the government of Saxony, and
- Pledges of support from public banks, if losses from Sachsen LB went above a certain level.[12]

The demise of Sachsen LB was not really a surprise because among Germany's Landesbanken the addiction to risk is legendary. A special case is that of Düsseldorf's WestLB, which, among other "assets." is said to have owned around half of the €35 billion ($45.2 billion) invested in Brightwater Capital, a conduit like Rhineland (in IKB's case), and lost a great lot by marking-to-market the acquired entity's portfolio positions whose value was till then pure guesswork.

The happy party in this salvage was Sachsen LB's president who had to quit his job, but did not forget to open his golden parachute while his bank went down in flames. As with the Landesbanken, this is a parody of fiduciary duties. It is, as well, an example of the level of irresponsibility chief executive officers show for their duties, and a very bad practice to reward failed CEOs for having destroyed their institutions.

WestLB (or Westdeutsche Landesbank) had itself been a disaster (and saga) of unthinkable proportions for a state bank. It, too, was told by the German supervisory authorities that it would have to halve its "assets" base and change its ownership structure—by the end of 2011—in return for billions of euros in ongoing state aid guarantees. In a deal with the European Commission WestLB agreed to:

- Sell off its subsidiaries,
- Close a number of offices at home and abroad, and
- Pull out of risky areas to focus on its main business.

But while other Landesbanken were, so to speak, latecomers to the high stakes (probably mimicking WestLB), the state bank of North Rhine-Westphalia was a curious sort of "pioneer." This and the other cases of gambling Landesbanken illustrate the need for a profound restructuring of fiduciary duties in this sector, to ensure the German state banks' long-term viability and provide possible templates for dealing with other similar cases.

An example of what state banks and deposit-taking institutions generally should not do is precisely what the Düsseldorf-based WestLB did. In big steps it expanded beyond its regional market, hiring high-flying bankers and building up a trading arm as well as an international project finance business. By doing so in a hurry, many of its enterprises went wrong, with trading scandals and investments in new toxic assets adding woes upon woes. Its owner, the state's authority, pledged €5 billion ($6.7 billion) of help to insure potential losses from a €23 billion structured investment portfolio—but what it offered was clearly inadequate given the bank's mounting exposure.

By November 2009 the state of North Rhine-Westphalia was arguing with Germany's federal government over who should take the hit for WestLB mounting losses on € 85 billion ($110 billion) of toxic waste. The cost of insuring the Landesbank's debt had spiked amid reports that it would face insolvency before the end of 2009.

WestLB was not the global investment bank it dreamed of becoming, but it was still too big to fail. As arguments and counterarguments were spelled out, it was decided that WestLB would inject €3 billion in capital into a "bad bank" that would take over the toxic assets (roughly equivalent to about a third of its balance sheet) while the Stabilization Fund agreed to pump €3 billion in capital into what remained of WestLB. The latter pledged to cut its asset base by 50 percent, emulating Commerzbank's state-imposed solution.

WestLB also agreed to sell businesses that were a part of its extracurricular activities within two years including Westimmo, a property finance

subsidiary; Readybank, a consumer credit business; and Weberbank, a private bank. For its part, the German government looked around for a white knight for WestLB. It was thought to be Helaba, the Frankfurt-based Landesbank of Hessen-Thüringen.

This issue, however, was so politically sensitive that talks were suspended until after the election of the prime minister of the state of Hessen in late January 2008. At stake was a long list of losses, including WestLB's funding obligations of $15.6 billion to two off-balance sheet structured investment vehicles. There was also the case of WestLB's roster of different pledges. With time the state bank's exposure got worse, obliging North Rhine-Westphalia and Berlin to close down WestLB and parcel out its pieces—a most inglorious ending.

## 4. Monte dei Paschi di Siena

Not wanting to be an exception, Italy's banks as well as municipalities got tangled with derivatives and subprimes, and paid for the consequences. Bankers and the municipal authorities got the gambling fever and lost billions. It was left then to the courts to disgorge the foreign banks who sold them the rotten instruments of their gains by applying hefty penalties—on the grounds that municipal employees who engaged the city's taxpayers did not really understand:

- What they were doing, and
- The risk they were taking.

Among financial institutions, all three big Italian banks tried their hand at "investments" that turned out to be a disaster and acquired "assets," like subprimes, which proved to be rotten. Most active of all were Monte dei Paschi di Siena, one of the oldest banks in the old continent, as well as Credito Italiano (Unicredit).

In mid-January 2009 Alessandro Profumo, the chief executive of Unicredit, was under such scrutiny that sightings of him boarding a plane made news. Italian media reported that he spent time in Abu Dhabi seeking new investors to inject fresh capital into his bank. The economic and credit crisis had hit Unicredit harder than other Italian banks, and according to well-informed sources there was plenty to be scrutinized.

There were, for instance, revelations that clients of the bank could lose €800 million ($1.4 billion) from an alleged fraud perpetrated by Bernard Madoff. But it was Unicredit's losses in toxic waste that brought down Profumo. By the end of September 2010 he quit his job as chief executive after a power struggle with some members of the board, having led the

bank for 15 years and for long been considered one of Italy's most influential bankers.

From 2004 to 2007 Profumo had made more than $60 billion worth of acquisitions in Europe, including the purchase of the Munich-based HVB Group and Rome's bank Capitalia.[13] He lost the board's crucial support during the financial crisis when Unicredit was forced into a €6.6 billion ($8.6 billion) recapitalization because of a low core capital ratio of 5.8 percent, partly the consequence of the acquisition spree by the Italian LCBG.

This palace revolution was organized by the Italian "mutual foundations,"[14] or "mutualists," essentially political, nonprofit, regional organizations that (by being major shareholders of the LCBG) dominated the board. They were worried about losing influence, particularly since Profumo had attracted lots of foreign shareholders, including Libya's central bank and its main investment authority (which together owned 7.6 percent of Unicredit and an Abu Dhabi-based vehicle with a further 5 percent stake).

Other Italian mutual foundations, this time socialist party strongholders, have owned one of the world's oldest banks (founded in 1472) and Italy's third largest: Monte dei Paschi di Siena.[15] Heavy losses with derivatives and with subprimes played a role in revealing that its management was cooking the credit institution's books.

Interestingly enough, the finding did not come from regulators at the Bank of Italy or independent auditors (KPMG). Yet, both of them had the duty of keeping the place honest. Those who rang the alarm bell were journalists, based on documents from still another bank, suggesting that there had been a scam with derivative financial instruments at Monte dei Paschi.

According to the law of the land, the Bank of Italy has the statutory responsibility for regulation, inspection, and control of the Italian banking industry. It does so through a powerful auditing division (Ispettorato) that is always on alert. It is virtually impossible that for five years, since fraud and deceit started in 2008 and lasted till 2013 when it was revealed, the governors of the Bank of Italy were unaware of it.

- Theoretically, at the beginning of 2013, the Monte dei Paschi di Siena had €224 billion in assets.
- Practically, how much of these "assets" were real money and how much murky deals hiding derivatives losses, nobody would venture to say.

But there was agreement on responsibilities. Dr. Mario Draghi led the Bank of Italy from December 2005—when he replaced the then governor

Dr. Antonio Fazi—till late 2011 when he succeeded Jean-Claude Trichet as president of the European Central Bank. According to what has been reported, headed by Draghi, the Bank of Italy first became concerned about Monte dei Paschi's finances in 2008 when it reviewed a bank takeover.[16] This was another reason to be extra careful in auditing the commercial bank's balance sheet. Indeed, the 2008 findings:

- Led to two full inspections of Monte dei Paschi, starting in 2010, but nothing came out of them.
- Curiously enough, the central bank notified prosecutors only in March 2012, taking years to bring the scam to justice.

On January 17, 2013, two *Bloomberg News* reporters, Eliza Martinuzzi and Nicholas Dunbar, broke the story that in December 2008 Deutsche Bank designed a derivative instrument for Monte dei Paschi, hiding the Italian bank's losses before it sought a €1.9 billion ($2.5 billion) taxpayer bailout in 2009. This is the now famous *Project Santorini*—one of four of its kind related to Siena's credit institution.

The fact that a scam was left unreported and the Bank of Italy not alerted was suspicious. Also damaging to Draghi's reputation as regulator of the Italian banking industry—a duty he automatically assumed as governor of Bank of Italy—was the fact that he neither made Monte dei Paschi disclose that information nor did he call in the prosecutors. Only in 2012, under Ignazio Visco, Draghi's successor at the helm of the central bank, did Italian prosecutors open a criminal investigation.

A year earlier, in 2011, Monte dei Paschi had searched for ways to justify its acts. It reportedly told the Bank of Italy that the "structured deals" were part of its "carry trade" and were not submitted to its administrative body. Supposedly top management knew nothing about the multibillion euro deals. Evidently, this silly excuse, taken at face value, documents that the bank's management was not in charge of the institution under its watch while at the same time the Bank of Italy turned a blind eye.

Subsequent to these revelations, examiners and prosecutors have been reviewing not only the scam of *Santorini* but also three other money-losing derivatives deals: *Alexandria*, *Nota Italia,* and *Chianti Classico*. Monte dei Paschi said that only in October 2012 did it discover a "mandate agreement" signed by former managers with Nomura Holdings for an ill-fated derivatives deal aimed at covering losses on mortgage-backed derivative instruments. That was the *Alexandria* scam.

There was also another hidden document providing the link between the loss-making *Alexandria* derivatives fraud and a newer one, leading the Siena bank to book a loss of more than €200 million on the original

transaction. Allegedly, a swarm of derivatives deals and heavy financial losses correlated quite nicely in the "assets" portfolio of Italy's LCBG.

*Santorini*, too, was sort of a racket, since it helped Monte dei Paschi obscure a €367 million loss from an older derivative contract with Deutsche Bank.[17] As part of the arrangement, Italy's historic banking institution made a transaction on the value of the country's government bonds, which proved to be a losing bet. Bravo, bankers! It takes ultra-stupidity, or conflict of interest, to go from one losing bet to the next.

Even worse, between 2009 and 2011, the presumed "value" of the Italian commercial bank's bond holdings rose 500 percent to more than €25 billion. The result was a deterioration of its capital base as the sovereign-debt crisis hit and Italy's debt securities plunged. An added strain was its €9 billion purchase of Banca Antonveneta in 2008 (see chapter 9 in connection with the Royal Bank of Scotland and Santander). Over this 2009–2011 timeframe the governor of the Bank of Italy and supervisor of the country's banking industry was Mario Draghi. No corrective action seems to have been taken.

*Chianti Classico* was a different deal. It involved a 2010 securitization of €1.5 billion of real estate loans, reportedly confirmed by documents that include minutes of board meetings. In an emailed statement the bank denied that this deal would produce losses, but, according to experts, Monte dei Paschi risks further losses of as much as €500 million.

In the meantime those responsible for the different gambles and scams have left the scene. Antonio Vigni, Monte dei Paschi's CEO, quit in January 2012, after almost six years in the top job. Giuseppe Mussari, the chairman who led the bank since 2006, stepped down in April 2012 and resigned as chairman of Italy's banking association in January 2013 after the wheeling and dealing at Siena's bank became public.

As for Mario Draghi he was the first to change residence, having been elected president of the European Central Bank. With its losses mounting and its treasury a train wreck, Monte dei Paschi asked Rome for bailout. As it so often happens nowadays, the taxpayer has been requested to pay the bill for other peoples' mistakes and for unresolved alleged swindles.

## 5. Government Bailouts Help in Hiding the Losses

The first of the more recent requests for bailout to hit the news was one for €6.4 billion ($8.3 billion) reduced to €3.9 billion when the Monti government let it be known it could not afford the higher figure. In addition, given that for all practical purposes, Italy's public debt officially stands at €2.1 trillion, and unofficially at €2.5 trillion ($3.3 trillion), even the

€3.9 billion came out of a big national pot of deep red ink that stands very little chance of being cleaned out.

While the government's bailout was downsized, Monte dei Paschi officials played for time and waited for another bailout opportunity. Therefore they said they would not need more funds, but could one believe them? And as president of the European Central Bank will Mario Draghi do a better job of inspecting Siena's bank and a long list of Euroland's other major credit institutions[18] than he did as governor of the Bank of Italy?

Having acquired the bad habit of expected bailouts, Monte dei Paschi had the policy of throwing money out of the window. In 2007, it paid a high and totally unjustified premium for Antonveneta, a banking group based in Venice. Monte dei Paschi bought Antonveneta from Santander, the Spanish bank, for a cool €9 billion ($11.7 billion). But Santander had forked out only €6.6 billion ($8.6 billion) to buy Antonveneta a few months earlier in the wake of ABN Amro's takeover and dismantling. Belatedly, in 2013, prosecutors were investigating if kickbacks accounted, at least in part, for the extraordinary difference characterizing these two acquisition prices of the same financial institution.

With plenty of work to do to clean out the Siena mutualists' Augean stables the likelihood that this will compromise, or at least significantly delay, ECB-led bank supervisory regime (under Draghi) stands high in everyone's mind. With each Euroland sovereign protecting his banks' secrecy of accounts, ECB bank supervision duties will struggle with a credibility deficit before they even get started.

This doubt about the efficiency of a Euroland-wide inspection is widespread. On January 29, 2013, the *Frankfurter Allgemeine Zeitung* published an article with the headline, "Monte dei Paschi Affair Reaches ECB President Draghi." On January 30, 2013, *Die Welt's* feature article was: "Bank Scandal Puts Draghi Under Pressure." In the background of this and other commentaries has been the query: Will cover-ups become the new norm?

This query does not necessarily involve only Draghi, still the president of the European Central Bank, future top boss of pan-Euroland bank inspection authority (under the ECB), and former governor of the Bank of Italy. He had held the Italian central bank's governorship, with full responsibility for regulation and inspection of Italian banking institutions. But from December 2005 till late 2011 when he took over the top job at ECB, the Siena bank outperformed itself in terms of deceit. The scams at Monte dei Paschi were, so it seems, perpetual but *Santorini* (the most damaging of them) happened under Draghi's watch.

Whether or not public money is handed out to repair the damage, covering hoax derivatives deals, and other inappropriate business transactions is an issue with wide repercussions, deeply damaging the banking

industry at large. The revelations come at the most inopportune time as profligate governments (Italy, Spain, and France) press for a *banking union*. Centralized inspection, at least of Euroland's bigger banks, is a prerequisite to the banking union, which is not authorized by the Treaty of Lisbon. The version released in late March 2014 contains too many *ifs* and plenty of interventions by committees to be really effective.

Theoretically, this single supervisory authority will provide a timely and unbiased assessment of banking problems (read: double books, creative accounting, big derivatives and loans losses, deceit, and swindles) identifying the need for resolution. For its part, the single resolution authority would (theoretically) ensure timely and efficient management control. That's what Herman Van Rompuy, the EU president, wrote in a December 2012 paper titled "Towards a Genuine Economic and Monetary Union."[19]

Curiously, van Rompuy forgot to mention in his paper the sovereign bailouts that (to say the least) bias the way a free market is supposed to operate. Evidence has been accumulating that state handouts help in perpetuating scandals by providing plenty of opportunities to hide huge losses and reward the insiders with undeserved bonuses. Who cares? It's taxpayer money anyway.

Eventually, however, the scandals become overwhelming, followed by a public outcry. Not unexpectedly, the Monte dei Paschi extracurricular activities became a headwind regarding the trust that can be put on a pan-Euroland bank inspection. Critics said that politicians and bank regulators have proven to be unreliable protectors of:

- The public purse, and
- Common citizens' interests.

There exist good reasons why Codacons, the Italian consumers association, tried to block Monte dei Paschi's bailout by way of a complaint in Rome's administrative court against the Italian cabinet, economy ministry, Bank of Italy, and Consob, the market regulator. It also sought €3.9 billion in damages from the Bank of Italy for not adequately monitoring the Siena bank's activities.

The Italian consumers association's request followed criticism about the central bank's supervision raised by politicians, including Giulio Tremonti, former Italian finance minister. Critics have not failed to point out that if the Bank of Italy under Draghi did not face up to its duties, it is difficult to imagine that Monte dei Paschi and its likes would be supervised better by the ECB, under the same Draghi.

Giuseppe Di Taranto, professor of financial history at Rome's Luiss University, said that new derivative accounting policies are needed

in Europe to avoid similar situations in the future, adding that there is too much room for interpretation under current rules. Alberto Carnevalle-Maffe, professor of business strategy at Milan's Bocconi University (of which Mario Monti, the former prime minister, has been president), emphasized the importance of original findings and the fact that recently uncovered secret documents don't change their substance.

Other critics of Monte dei Paschi's efforts to persuade European regulators it deserves a bailout suggest that this bank is the worst performer in Europe's benchmark banking index, often reporting bigger-than-estimated quarterly figures. In the second quarter of 2013, the lender's net loss narrowed to € 279 million from €1.64 billion a year earlier, when Monte dei Paschi wrote down goodwill and intangible assets. Still the €279 million was more than the average estimate for a €149 million loss among analysts surveyed by Bloomberg.

According to a letter sent by Joaquin Almunia, EU competition commissioner, to Italy's finance minister on July 16, 2013, Brussels had plenty of reasons for insisting on tougher measures for cost-cutting, executive pay, and treatment of creditors to approve the restructuring. The Siena bank's chairman Alessandro Profumo (of Unicredit fame, section 4)[20] cut more than 1,800 jobs in the first half of 2013 and plans to reach a 2015 target of closing 400 branches—in an effort to revive profits in spite of the acquisition of Banca Antonveneta, in 2008, and unstoppable bad "investments."

In July 2013 Monte dei Paschi shareholders, the mutualists, agreed to remove a requirement for owners to hold a 4 percent stake in order to win voting rights. The step was designed to make a €1 billion share sale to repay state aid and avert nationalization.[21] This happened while prosecutors were still probing whether former managers at Monte dei Paschi, which piled up losses of nearly €8 billion in 2011 and 2012, used derivatives to obscure more than €700 million of other losses.

Italian magistrates are accusing former executives, including ex-chairman Giuseppe Mussari, of withholding information from regulators about how the bank financed its purchase of Antonveneta in 2008. People usually withhold documents in an investigation when they know that such document contains something that might be incriminating.

It is only normal that mismanaged banks fail. What is abnormal is the recent practice that governments refill the bank's depleted treasury with an abundance of taxpayer money. Just as deformed in terms of statutory responsibilities is the policy of looking the other way when ethical issues pop up indicating a lousy behavior at the big banks' vertex that benefits from the dolce far niente habit of some regulators.

## 6. BNP Paribas, Société Générale, Crédit Agricole, and Caisse d'Epargne

In early 2007, Baudouin Prot, the then CEO of BNP Paribas, one of the three largest French credit institutions, had proudly declared that thanks to its "prudent policy on risk" his bank could in no way be affected from the financial crisis of the subprimes.[22] But on August 9, 2007, BNP Paribas admitted that three of its hedge funds could no longer be listed on the exchange.

Critics said that the fate of these three hedge funds was proof that big banks can no more talk of good governance. Their profit goals are very short term and their risk control is wanting. Financial results are proof of this statement. From 1998 to 2007, just prior to the July–August subprimes crisis, profits among the main French banks had increased 20-fold and derivatives played a major role in this stellar profitability, which could not be sustained.

Capitalizing on its trading profits, BNP Paribas had engaged in cross-border mergers and acquisitions. In February 2006 it bought a 48 percent stake in Banca Nazionale del Lavoro (BNL), Italy's sixth biggest bank, and was ready to bid for the rest if regulators approved it. This was the biggest foreign acquisition ever by a French bank.[23] Also the fifth largest cross-border takeover in European banking after Unicredit/HVB, Santander/Abbey, HSBC/CCF, and Fortis/Générale de Banque.

But the tailwind from complex esoteric and largely worthless "new" financial instruments did not last forever. When it stopped, contrary to forecasts and pronouncements, the financial results for 2007 told a different story. Profits at BNP Paribas had fallen by 42 percent in the fourth quarter of 2007 even if they rose 7 percent for the year as a whole. The stock fell in a nervous market. From €95.07 in May 2007 the price went down to €56.20 on March 7, 2008, and it continued moving south.

BNP Paribas was by no means alone in this change in fortunes. Year-on-year from August 2007 to August 2008, French banks lost €20 billion ($26 billion) through their investments in American subprimes. At the top of the honors list were Crédit Agricole/Calyon, Natixis (and its two parent institutions),[24] Dexia, and Société Générale (SocGen).[25] These severe losses, however, did not affect the salaries and bonuses of their CEOs and senior managers—who, on the contrary, increased their pay with the blessing of rubber-stamp boards.

Also on the upswing was the drive for big size banks. When he was president of France, Nicolas Sarkozy[26] hoped to see a merger between BNP Paribas and Société Générale to create a new French banking champion that would be both an international and a domestic financial colossus. It did not work out like that, though both French LCBGs continued to expand through other mergers and acquisitions.

The timing was wrong. BNP and SocGen as well as their competitor big banks were confronted by heavy losses. On December 15, 2007, Société Générale, France's second biggest bank by value, said it would provide a $4.3 billion bailout to its only structured investment vehicle. Its equity price, which had reached €151.64 before adversity hit, tanked to €63.53 in January 2008 as the bank revealed a loss of €3.35 billion ($4.47 billion) in the fourth quarter of 2007.

Jérôme Kerviel, SocGen's go-go trader, had supposedly bet €50 billion ($65 billion)—a high multiple of the bank's capital—and lost 10 percent of it. A variation of this version was that the alleged gambling by the lone trader started in December 2007 and in just a few weeks, by December 31, he had made a profit of €1.6 billion ($2.1 billion) but he stepped up his bets and ended up losing.

As time passed by, more and more has been revealed about illicit dealings and their contribution to super fat bonuses. An item that attracted attention was that back in August 2007 Michael Zollweg, director of the German Trading Surveillance Office (TSO), had detected atypical trading operations connected to big buyers of securities. TSO's computers flashed out the name of Société Générale, and the German supervisory authority informed the French bank's compliance office—but a month passed by before its management informed TSO that "Kerviel's operations are correct."[27]

When between January 21 and 23, 2008, Société Générale unwound its positions the huge size of exposure made the experts of futures markets quite skeptical about the effectiveness of the big bank's risk control. Also puzzling was the fact that in spite of its insistence about having "first class risk management" *that* trader was not alone in wheeling and dealing. As he deposed to the police, many of his colleagues, too, did not have a defined gross-exposure limit.

"We have not been satisfied by this answer whose terms were incomprehensible," said Zollweg.[28] He probably did not know that the boss of the trader who supposedly erred had negotiated more than €500,000 in bonuses, half of that amount due to Kerviel's "brilliant profits." Another SocGen manager got an even bigger bonus for the same reason, though all these were cancelled when the news broke out and the party was over.[29]

Credit Agricole, the third LCBG of France according to size, also faced severe losses from subprimes and other trades. After an initial 2007 announcement of a couple of billions of euros in red ink, before Christmas 2007 Credit Agricole took a €2.5 billion ($3.5 billion) write-down, as jitters about continued credit market turmoil kept weighing on investors and the market downtrend continued.

On January 14, 2008, Crédit Agricole said it would sell its 2.1 percent stake in Suez, a utility holding, to help shore up its balance sheet. Experts

suggested that if the big bank's balance sheet was damaged, then more assets sales would follow. Indeed, this was one of the few safe bets around the Paris Bourse. From a maximum of €33.10 prior to the subprimes crisis, the equity of Crédit Agricole reached €17.05 at the end of February 2008 (later on falling below €3). By then all big banks were in a negative trend.

Commenting on the loss of altitude by the bank's equity, analysts said that Crédit Agricole had been wrongly perceived as a defensive, retail-oriented, low volatile, and risk-adverse franchise. The market has underestimated its exposure because of its relatively "low" 30 percent contribution to profit and loss, compared to its French peers. But the bank's Calyon investments subsidiary[30] had been one of the leading CDO and CLO players in the European market, as well as a leveraged buyout syndication arranger. It was also present in the US mortgage securitization market.

Crédit Agricole, supposedly the bank whose aim was to promote French agriculture, had joined the roster of gambling LCBGs specializing in the mismanagement of risk. It bled as a consequence of poor governance and had to ask its shareholders for money in order to pull itself out of trouble. Indeed, among big European banks, the first to try this approach was Société Générale, followed by the Royal Bank of Scotland, with mediocre results. Crédit Agricole came third in an environment already shaken by uncertainty and pessimism.

It needs no explaining that a call for capital increase with shares offered at huge discount dilutes stockholder equity. For this reason, the market expected that the new shares would be priced at €13, but by scraping the bottom of the barrel to find money Crédit Agricole put a price tag of €10.6 (still a high price). As a result, in a single day, its stock fell by 8 percent at the Paris stock exchange, and fell again thereafter.

In an interview he gave on June 5, 2008, to *Les Echos*,[31] the French financial newspaper, Georges Pauget, the bank's CEO, spoke of future economies at Calyon of €250 million, as well as of an investment of €100 million to improve its risk management system. But he failed to explain what kind of risk control improvements these were going to be or where exactly cost control would be most effective.

As so many LCBGs have found out the hard way, the more people they add to their risk management operations, the less they are able to find out their hidden exposures. Risk control is a matter of methodology and of authority. UBS was employing 3,400 people in risk management and still they lost tens of billions of dollars and had to go hat in hand to the Swiss National Bank and to sovereign wealth funds to get some liquidity.

The damage to the French banking industry spread beyond the three LCBGs. In mid-October 2008 Groupe Caisse d'Epargne,[32] a large French

mutual bank, said that it had lost €600 million ($780 million) as a result of unauthorized derivatives trading for the bank's own account. The market did not believe that this was just a "trading mistake," but the lender, which was in merger talks with a domestic rival, insisted that the loss was due to an error connected to extreme market volatility on stock exchanges.

The Caisse d'Epargne was eager to convey the message that this was a mistake rather than an alleged fraud of the type that trader Jérôme Kerviel was accused of by Société Générale. Whatever its origin, this $780 million loss with equity derivatives rattled the Paris stock market in early 2014, adding to a downward pressure on banks' shares and prompting Société Générale and the French-Belgian bank Dexia to issue denials that they were involved in that deal.

At about the same time, the French government detailed a €360 billion ($468 billion) effort to bolster its banks as part of a coordinated European effort to make cash available to banks unwilling to lend to one another. In addition, afraid that the losses incurred thus far by French banks might be only the tip of the iceberg, the French government rushed to recapitalize Caisse d'Epargne with a cash infusion of €1.1 billion.

According to the media, President Sarkozy was informed of the losses while flying to Canada for an official conference. Prior to meeting with President Bush, Sarkozy asked for the heads of the bank's chairman and its CEO. According to published reports, Charles Milhaud, the CEO, first resisted the forced retirement but then decided that it was better to take the money and run.[33]

But this was not what Sarkozy had in mind. His answer was firing with no indemnities. At Caisse d'Epargne the chairman offered a compromise: half the money. This was rejected by the bank's board (minus one vote). The French president's position did not change: not a penny. Shortly thereafter the bank's CEO decided that it was safer not to enter the litigation tunnel. He made a public declaration that he assumes full responsibility for the losses and asked for no indemnity. Amen.

# 11

# The Challenges Japan Faced with Its Banking Industry

### 1. The Years of the Banking Disaster

After the creation of the Liberal Democratic Party (LDP), in 1955, Japan's iron triangle of party bosses, bureaucrats, and business magnates promoted a breakneck growth of the nation's economy, including international expansion. The pros say that this race to riches distributed its fruits equitably:

- Cheap finance for big business,
- Massive contracts for construction and manufacturing companies,
- Plenty of jobs for the masses,
- Subsidies for farmers including "Sunday farmers,"[1] and
- All the grease the LDP machine needed for reelection.

Critics answer that corruption flourished, tax money went to party friends, and the masses were paid only subsistence wages. Eventually, an economy on steroids and a banking system that tried to conquer the world (in a financial version of World War II), became victims of their own success.

Growth slowed in the 1980s, while the system was too inflexible to adjust to changing market conditions. Voters, too, grew more demanding; they wanted careers as well as doctors, nursing homes, decent schools, and other social services. But big government, sustained by successive LDP administrations, failed to respond to such demands. Timid changes were undermined by party barons and bureaucrats who had their own priorities. At the same time, cracks appeared in the overextended and overleveraged Japanese LCBGs.

In 1989, at the high-water mark of the Japanese banks' brief rise to world power, in terms of loans and capitalization, Japanese banks had some $400 billion in paper profits. A dozen years later several of the Japanese LCBGs had failed, while practically all the others were in the sick list, suffering from severe asset quality problems.

The end of the 1980s and early 1990s were an inflection point for the Japanese economy, and most particularly for the banking industry, but not for the better. The government was undecided on which course to follow, but by 1995, after years of masking Japan's economic and banking problems with stopgap measures, the all-powerful Ministry of Finance finally decided to clean things up.

The ministry outlined a plan to use public money to consolidate weaker players, manage future bank failures, and sell off nonperforming bank assets. The stated goal was to transform the sprawling, but inefficient and overprotected banking system, into a lean, competitive industry. But getting there was not easy, swift, or what the big banks and their bosses really wanted.

Moreover, the Japanese economy was in the doldrums and, as the American and European experiences have proved more recently, money alone was not enough to get the economy moving again. The banks knew that they had a long way to go before they look anywhere near healthy. The Ministry of Finance had put out some big fires, the worst being a $1 billion deposit run on Tokyo's Cosmo Credit Union in July 1995 and the collapse of the Kizu Credit Union and Hyogo Bank in Osaka a month after Cosmo.

By committing more than $11 billion to cover deposits in the banking system, the government managed to temporarily calm fears of a financial meltdown. It was also trying to bail out Japan's *jusen*, the insolvent housing loan corporations saddled with an estimated $82 billion in problem loans. The talk was that the *jusen* might be dissolved gradually, with their more promising assets force-fed to the LCBGs that were shareholders, while uncollectible loans are forgiven and written off.

While having a plan for completing any task is indeed very important, real life rarely if ever works according to script. As the risk of an imminent bankruptcy disaster in the Japanese banking industry increased, the government became inclined to speed up the consolidation that had already begun in the overcrowded Japanese financial landscape.

In April 1996 Mitsubishi Bank and the Bank of Tokyo joined to form the world's biggest LCBG (at that time) with $700 billion in assets (chapter 12). Similarly, 29 credit unions in the Tokyo area were projected to be merged into three new entities, each with deposits of $5 billion and fresh capital from public money—but nobody could be sure that such initiatives would be enough to:

- Turn the economy around, and
- Heal the banking industry's troubles.

Several economists were of the opinion that the problems with Japan's financial system should have been addressed forcefully years earlier, but neither was the diagnosis of the troubles correct nor was there the will to do what it takes to resolve them. Even after the risk of the banking industry's collapse made itself felt, politicians and bureaucrats would not agree on whether Japan's banks as a group suffered from too much capital, or from too little—though it was fairly clear that the increase in bad loans meant the banking industry's net worth was eroded. According to the then prevailing opinion:

- It was precisely this depletion of financial capital that had reduced the ability of Japanese banks to take risks, and
- An injection of capital by the government should aim to strengthen the banks' financial position, not to add to their physical assets.

The official figure for the banking system's bad loans stood at ¥77 trillion (then $600 billion), which proved to be an underestimation. There were also gaping holes in the treasury of Japan in life insurance companies (and their accounts) guesstimated to be another ¥60 trillion.[2] Critics said that the existence of so many underperforming and shaky banks, as well as their survival, was largely due to generous loans from the Bank of Japan and the absence of financial deregulation to add competitive pressures. Therefore:

- The government had to allow weak institutions to fail, rather than help them to limp along, and
- Only if a good bank took over the assets of a failed bank should it be entitled to assistance via public money.

Some financial analysts stated that instead of really helping the wounded banks and insurance companies, Tokyo had even been depreciating the yen to gain advantage during the crisis, thus exacerbating the financial industry's crisis. On the contrary, Japan should have been raising the value of the yen and cutting taxes to boost consumer buying power, as well as absorbing Korean and Thai exports to provide the common citizen with lower cost goods.

Successive Japanese governments had fallen prey to the common fallacy that things would take care of themselves if plenty of money was thrown at the problems. They did not. From 1989 to 2003, as the efforts

to repump the Japanese economy through zero interest rates and lavish spending of public funds by the government failed, economists came to realize that short-term interest rates cannot drop below zero. (For his part, Ben Bernanke learned the same lesson after 2008.) Neither did the Japanese central bank's unconventional measures such as flooding the banking system with cash have any effect. Such measures:

- Did not revive the economy, and
- Did not break the back of deflation.

Finally, policy makers came to realize that the result of unorthodox measures is uncertain at best, and may even be counterproductive. With prices of assets as well as goods and services falling, fears of default prompted lenders to tighten the purse (as it happened years later in America and in Europe), while many of these lenders were themselves overleveraged and loaded with nonperforming loans and worthless "assets."

The plight of the Japanese economy in general, and of the Bank of Japan in particular, teaches another valuable lesson. While central banks normally cannot run out of money, because they own their currency's printing presses, they can be badly hurt when engaged in an enormous spending spree that can burn a big hole in their balance sheet and damage their reputation for:

- Custody, and
- Diligence.

Since 1997, in contrast to repurchase agreements, outright purchases of Japanese government bonds had exploded, to a cumulative total of $471 billion (a big sum at the time). To keep the markets flush with cash, by January 2003, the Bank of Japan had been devouring $10 billion in bonds a month on the secondary market. At that rate, it had positioned itself to absorb about 40 percent of all new Japanese government bond issuance in 2003. Sounds familiar?

On top of that, in 2002, the central bank had announced plans to buy as much as $17 billion worth of stocks from commercial banks, which needed to sell off their corporate shares to raise capital. This led insiders to worry about the huge growth in the bank's potential liabilities as equities, particularly stocks of wounded banks, were risky assets.

After having criticized the government for its failure to get the economy going because of a torrent of half-baked measures financed by a ballooning deficit, by 2003 many economists turned their attention to the Bank of Japan and its "anything goes" monetary policy. They criticized the reserve

institution for seeking to relieve the debt burden of banks and corporations by adding more stocks, corporate bonds, and real estate to its portfolio. These assets plunged in value as the deflationary spiral continued.

Economists also pointed out that the central bank's holdings, including government securities, cash, overseas currencies, and foreign bonds, add up to $1.05 trillion—or 60 percent more than the assets of the US Federal Reserve in the early years of this century. Reflecting on the experience of a dozen years of poor results in getting the Japanese economy moving, skeptics said that more massive central bank bond purchases could set the stage for a bubble that would drive prices skyward—until investors, worried that the central bank had lost all discipline, panic and hit the sell button sending prices crashing.

## 2. Japan's Intensifying Banking Crisis

Japan's banking crisis intensified in 1995 as Kizu, the country's second largest credit union, collapsed under the weight of bad loans. This was the first failure of a commercial bank in Japan in 50 years. (A Japanese bank was closed down by regulators in 1945.) In the aftermath, the government announced that Hyogo, a regional bank, would also be liquidated before bank runs develop.

There was more than loss of money or a merely symbolic significance to these closures. Both Kizu and Hyogo were much larger than Cosmo, which preceded them on the financial precipice. Kizu had assets of ¥1.3 trillion ($13 billion), three times Cosmo's; Hyogo had assets of ¥3.6 trillion ($36 billion), roughly nine times Cosmo's.

Whereas an astonishing 73 percent of Cosmo's loan book was dud, the Osaka government estimated that Kizu's unrecoverable loans amounted to 57 percent of its loan book, but also admitted that the proportion could be higher. According to the Bank of Japan, Hyogo's bad loans stood at around 55 percent of its loan book, and of ¥ 1.5 trillion in this class more than half was unrecoverable.

The year 1995 also saw a crisis at Sumitomo Bank, no 2 in Asia's top 500. Sumitomo had managed to lose a staggering $3.36 billion (¥320 billion), while financial analysts bet that much more red ink was still in store. Tokyo was waking up to the fact that there was no alternative than coming to grips with a growing backlog of wounded:

- Commercial banks,
- Credit unions, and
- Housing finance companies.

Japan simply could not go forward just by reconcentrating the losses onto the ledgers of an ever-shrinking number of ever-larger credit institutions. That has been the scenario practiced by US Savings and Loans regulators up until 1988, when the government was forced to turn to a more expensive but ultimately more successful approach to the US Savings and Loans crisis. (Still the US government repeated the same concentration of bad loans and of toxic waste strategy in 2008 and thereafter. Some people never learn.)

For Tokyo, wrestling with its own banking meltdown, there was a pressing lesson. Japan was reaching the same danger point that US regulators had reached in the late 1980s: The deposit insurance kitty was almost depleted and healthy banks were being leaned on to get the government off the hook by absorbing failing banks and paying off the depositors.[3]

Lacking other options when striking good bank-bad bank merger deals, Japanese regulators had a hard time arguing that they were following the least-cost course. Reportedly, some of them worried about how damaging these pseudo-solutions were likely to be—that is, damaging the healthy banks whose help was being extorted. As for the property and equities held by failing institutions, that was hanging over the market with an unknown aftereffect on the evolution of prices.

On December 19, 1995, after weeks of indecision, the Japanese government announced the outline of a policy to close down the country's seven housing lenders (*jusen*). During the 1980s bubble, the *jusen* had poured tons of money into property ventures that later crashed along with land prices. By the end of 1995 they had at least ¥6.4 trillion ($63 billion) in losses, or almost half of their total loans. But financial analysts suggested that, as in the case of the French government with Crédit Lyonnais, this was a murky deal, essentially aimed at bailing out Japan's agricultural cooperatives, which provided the *jusen* with 40 percent of their funds.

- The agricultural co-ops lent and lent after 1980, despite an official warning not to commit more cash to property.
- Whereas commercial banks heeded the warning, the co-ops were seduced by the high interest rates the *jusen* offered.

Under the government's salvage scheme, the co-ops got back 90 percent of the dud loans that they had made to the *jusen*. All this sounds ridiculous and so it is—but it has been political turf. Meanwhile the banks suffered. Those that founded the *jusen* back in the 1970s had to forgo all of their ¥3.5 trillion in loans to them. Over and above this, they were expected to provide new, cheap loans to the salvaged institutions.[4]

In mid-May 1996, Japan's 11 leading banks, 6 of them the world's largest, wrote off more than ¥6 trillion ($57 billion) in bad loans. This has

been their worst ever combined loss in a single Japanese accounting year (which typically ends on March 31.) Still there was a silver lining. What happened after the huge write-offs indicated that the banks finally began to grasp the issue of bad loans that had been undermining their performance in the first half of the 1990s.

For over five years, Japanese banks had tried to avoid admitting that a problem existed, but this time the losses were too big to ignore. Still, the aforementioned large write-offs represent only a part of the estimated total remaining burden of nonperforming loans held by the 11 city banks.[5] More problems emerged a little later. As details of the balance sheets of the banks' unconsolidated affiliates were revealed, Japan watchers said that the combined effects of:

- Falling interests rates, and
- Soaring securities markets

gave the large commercial banks a vital leeway in writing off the $57 billion in bad loans accumulated since 1991. But most lenders began to appreciate that they had to go much further before the period of asset quality problems could be really behind them. Before the crisis that brought banks to the brink of disaster could be consigned to history, two big questions remained:

- How much higher the overall total might still go, and
- How much of those bad loans were firmly covered by the banks' loan loss reserves.

As if past wounds were not enough, a looming issue for most Japanese banks was the emergence of new problem loans. In spite of the high level of direct write-offs, the total outstanding amount of bad loans had fallen by just 9 percent. This suggested banks were still discovering that the accounts of some of their affiliates were very murky in terms of screening:

- Creditworthiness, and
- Asset quality details of their clients.

Following a period of great uncertainty worldwide, with evident fallout on Japan in the second half of 1998, the turmoil in financial markets finally subsided while global macroeconomic conditions also improved slightly. The signals from the world's financial markets and economic indicators were mixed. The economic performance among major regional

power centers continued to be divergent and deep questions persisted in some emerging markets.

On the positive side, a few emerging market economies in Asia were showing the first signs of economic recovery. On the negative side, in Japan there were only rare signs of improvement while, during the course of the year, external imbalances increased the risks of protectionist measures. By 1999, confronted with a situation that would not take care of itself, the Japanese government decided to create a ¥60 trillion safety net, providing capital injection to 14 LCBGs and 5 regional banks with the aim of restoring stability to the financial system. The newly established financial authorities—the Financial Supervisory Association (FSA) and the Financial Reconstruction Committee (FRC) —also started gaining the market's confidence for their strict inspections and their policy to let marginal banks go under.

A wave of banking industry consolidation was kicked off in August 1999 by the announcement of a three-way merger among IBJ, GKB, and Fuji (chapter 12). This created the world's (then) largest bank with ¥150 trillion in assets. Tokai and Asahi followed suit, establishing the first super-regional bank in Japan. In October 1999 Sumitomo and Sakura agreed to merge, which meant a convergence involving two *keiretsu* groups: Sumitomo and Mitsui.

Analysts projected that the wave of consolidation would spread from city banks to trust and regional banks. Smaller trust banks were on their way to become subsidiaries or affiliates of city banks. Larger trust banks, such as Mitsubishi Trust and Sumitomo Trust,were likely to join LCBGs like Sumitomo/Sakura as, in the analysts' opinions, the mega-banks' massive information technology investments could well allow them to carve out positions in some of the regional markets.

### 3. Japanese Banks in Southeast Asia

In a meeting we had in Tokyo in October 1993 Yoshiro Kuratani, professor of economics at Tokyo International University, told me that though most financial signals at the time were suggesting the wisdom of downsizing, the presidents and boards of major Japanese corporations were not prepared to accept this notion. Their concept was expansion. Yet, that year Japan's gross domestic product was contracting (albeit by only 0.1 percent) and the following year's prospects were no better. Economic results of practically zero growth were alien to post–World War II Japan. Therefore:

- The management of large corporations and financial institutions was not conditioned, psychologically or business-wise, to face facts, and

- There was no evidence of a contingency plan and no roadmap on how to retreat, even if the losses were accumulating and the Tokyo stock market would not take off.

This message was also confirmed by other economists during the Tokyo meetings that followed the Kuratani conference. Statistics provided by a Fujitsu study indicated that profits for the 11 larger commercial banks shrank by an average of 40 percent. Indeed, profits were in retreat in a number of Japanese industries.

In computers and communications, for example, NEC had very severe losses in 1992–1993. So did Fujitsu and Hitachi though NEC was in worse shape than its two competitors. All three were hit by what was then the IBM illness: *mainframes* whose market had shrunk, but who had not worked out a turnaround plan till then. As a senior executive at Fujitsu put it in a private discussion: "Our president understands that a major switch is necessary. But it will take many years to change the company culture."

Slow or no adaptation to a rapidly changing environment meant that troubles could become deeper. By 1993 both the Japanese banks and the computers and communications companies, which had been swiftly expanding through the 1970s and 1980s, were turning their wheels in a vacuum. Times had changed and the leaders of the past decades had lost their clout. So did the institutions under their watch.

This was not a minor or passing trouble. As Kuratani had foreseen about the Japanese banks, in their fight for share (and for profits) in Southeast Asia, they had lent some $88 billion to companies in Hong Kong alone by the end of 1996. In a scenario in which 20 percent of those loans would go bad, Japanese banks were in line to suffer a 5 percent leap in bad debts.

Critics of this out-and-out expansion by wounded LCBGs said that even the "20 percent" may have been awfully optimistic because the bulk of Japanese lending was to Hong Kong real estate companies and real estate was going down rapidly in value, to the point that a real estate collapse would be cataclysmic to the lenders. Just as worrying was the fact that the big Japanese banks stood to suffer the most from the sharp increase in interest rates in Hong Kong. Designed to make it harder for speculators to devalue the Hong Kong dollar, higher interest rates:

- Drove up the cost of bank loans, and
- Discouraged people from buying property.

It needs no explaining that an extended period of high rates could trigger a sharp downturn in the real estate market in Hong Kong. It could also

send bad debt rates soaring at Japanese banks—even if Southeast Asia's troubles appeared to have had little impact on Japan's broader economy, because its own problems still dwarfed those of its neighboring countries.

Indeed, in the opinion of many economists, until the credit-crunch process started to reverse in Japan itself there could be no sustained economic improvement. The Japanese authorities could cut taxes, raise taxes, increase budget deficits, or cut budget deficits—it was all just fiddling around as it got the country no closer to a cure of its fundamental problem: The banks were sick.

The Japanese and subsequently Southeast Asian financial flu was far from running its course. As with the American and European economies after July–August 2007, the underlying policies necessary for a cure were not in place. Also as in post-2008 years when developing countries got the Western financial flu, Asia's woes had some impact on the United States and European economies. Then, as now, it was becoming painfully clear that a "quick fix" was neither quick *nor* a fix.

This mattered greatly to Japanese banks because while reeling from their domestic problems, they were also the world's largest creditors to the collapsed economies of East Asian countries, with some $253 billion in Asia loans. Unavoidably, this led to a credit crunch. Fearing more bad loans, the banks refused to extend any new credit to Asia, making recovery in that part of the world so much more difficult.

- In 1990–1991, Japanese banks had financed 60 percent of all project constructions in Asia.
- But by 1997–1998 nearly all Asian countries were suffering from a collapse of capital inflows.

One of the interesting signs of the banking crisis was the emergence of barter trade. Unable to pay for new F-18 fighter jets, Thailand bartered them to Kuwait, which was expected to pay in oil to the Thai Petroleum Authority. Indonesian airplane producer IPTN was scheduled to deliver 40 propeller jets to Korea, Thailand, and Malaysia. Thailand offered to pay in rice, Malaysia with cars, while the South Korean government proposed a barter of electronics, cars, and textiles in exchange for Indonesian oil, rubber, wood, and coal.

At the same time, the Japanese banks were also confronted by currency strains that have not been easy to overcome. The yen was overvalued because of the enormous upward pressure it suffered due to Japan's large trade surplus. In the past, such pressure was largely offset by equally massive capital outflows. But direct investment outflows were throttled by recession, and portfolio outflows had virtually stopped.

Exchange losses on Japanese foreign investments had been very large. As a result, there was no appetite for new risk. Hit by inertia, the government was not able to instill confidence in domestic investors that the yen has peaked. Therefore, Japanese companies seemed confused:

- They understood that they should be preparing for the worst.
- But, at the same time, they did not wish to abandon their expansionary thrust.

The situation was reminiscent of World War II when, after rolling fast over China, Southeast Asia, and the Pacific Islands, all the way to New Guinea and the Coral Sea, the Japanese army and navy suddenly lost their steam.

- By overexpanding, they practically exhausted themselves and their resources. They had no more reserves to throw into the battle.
- But they did not know how to retract and restructure, because they lacked the concept that Kuratani called "downsizing to preserve the essential."[6]

To a careful observer it would seem that Japan was preparing itself for another defeat, this one on the economic and financial front. With minor exceptions, after decades of exuberance the LCBGs' senior executives were dispirited. There was a loss of direction, which had led to trouble, with no light visible at the end of the tunnel.

When in 1990–1991 the Japanese economy entered a recession, the swing took everybody by surprise. Government officials, bankers, and economists were puzzled. They had never seen this at a comparable scale in the economic cycle. But the more they tried to hide the cracks in this system and its shortcomings, the more these worsened.

The Bank of Japan could buy time, but it could not save the country from the downturn or single-handedly prune the balance sheets of the big banks. The real solution was political. (The same is true of the American and European economies, and their big banks, in 2014.)

## 4. Japanese Banks, Economic Deflation, and Creative Accounting

As the previous sections have brought to the reader's attention, in spite of the crisis, the majority of Japan's big banks acted as if they were still in the "good old times." They extended credit to bankrupt companies they knew

would not be able to repay (while inflation increased the burden of debt), and expanded abroad rather than first restructuring their balance sheet.

Successive governments had implicitly supported these practices by rescuing banks in trouble without asking for a counterpart in the way they conducted their business. For instance, in the aftermath of the economic and banking crisis that started in 2007, Switzerland—home to two big banks, UBS and Credit Suisse, each of which had assets at least twice the size of the country's annual GDP—established strict capital rules and gave regulators a say over its banks' business decisions. The United States, whose banks suffered a great deal of financial losses in the crisis, saw to it that bank supervisors were allowing only the healthy banks to pay dividends or buy back their shares. It also passed the *Dodd-Frank Act* and the *Volcker rule* (chapter 4), restricting the banks' ability to trade on their own behalf.

The Japanese government has also tried to artificially reinflate the economy but while the national debt boomed there was no aftereffect other than the Bank of Japan being obliged to print an unlimited amount of cash—like the Federal Reserve, Bank of England, and European Central Bank did after the Lehman Brothers bankruptcy. The vastly increased public debt did not stimulate the economy, which remained in a longer-term recession. Both the stock index (Nikkei) and the index of the banking industry fell through the 1990s—the latter much farther than the former as Figure 11.1 shows.

On March 1, 2002, the Japanese government announced that the Consumer Price Index had fallen a full 1.4 percent in January of that year,

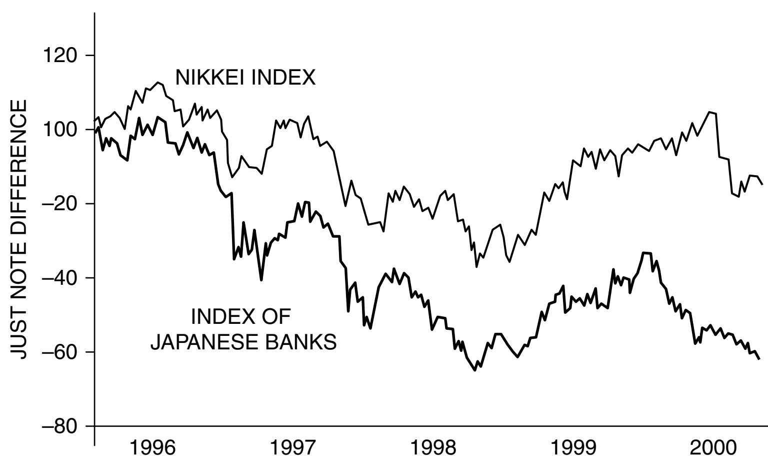



**Figure 11.1** Nikkei index and the Japanese banking industry.

putting the collapse of prices for the previous six months at a 6 percent annual average. The industry was not buying materials and consumers were not buying anything.

Worse yet, as Japanese industrial production continued falling, creative accounting was called to the rescue. Embellished through seasonal adjustments official statistics stated on March 1 that Japan's unemployment rate was slightly down while in reality 440,000 more workers had left work.

Creative accounting did not stop the *Japan premium,* which represented a surcharge on the cost of money the country's banks and other entities had to pay because counterparties doubted the soundness of the financial system as well as the borrowers' creditworthiness. This practice started around 1995 as Japan's banking crisis was rippling across Asia. When in November 1998 Moody's lowered the rating of all securities issued or guaranteed by Japan's government, the *Japan premium* rose.

The stock market was another worry. When testifying on the Japanese government's new package to stimulate the economy (and intervene in the market) before the Diet, Hakuo Yanagisawa, Minister of Financial Services, said that the government would do anything to hold the Tokyo Nikkei stock index above the 10,000 mark until banks and other companies closed their books for the year on March 31. He added that the ministry had run simulations, and believed that if the stock was maintained at 10,000, most banks and industries that hold stocks as capital should legally not be bankrupt—at least in accounting terms.[7]

This, too, was a creative accounting gimmick, which also signalled that the Japanese government depended on smoke and mirrors. It did not intend to take a sensible course of action. Instead, from April 1, 2002, it was committed to withdrawing a blanket guarantee on depositors' funds above ¥10 million (about $100,000). Its hope was that depositors would act as bank regulators, transferring money from troubled banks to their stronger counterparts. Yet depositors are not known to play such a role.

- Their information is poor, and
- They lack the skills for switching funds to punish misbehaving banks.

On the contrary, the systemic risks were real. The Japanese government made reference to fresh bank bailouts if systemic problems made themselves felt. Experts commented that this would be self-defeating with institutions rather than individuals again receiving state protection. Such policies had failed in the previous years, and their repetition delayed a resolution of the banking crisis, while it constituted a distraction from

the solution needed to attack Japan's salient problem: the virtual bankruptcy of its banking system.

Having seen trillions of yen being spent to bail out their country's ailing banks, Japanese citizens were still confronted with nearly zero economic growth, deflation, and plenty of cynicism about Japan's effort at economic reform. Only in late 2002, some of the listed companies began to make money, though falling prices made the business climate tough. Falling share prices and financial pressures prompted many firms to:

- Sell assets,
- Cut costs, and
- Shed excess workers.

But the banks were still groaning under tons of bad debt while the corporate landscape remained littered with zombie companies that survived only because the banks did not foreclose on their loans. Regulators said the problem was under control; it was not. Then on September 18, 2002, Masaru Hayami, governor of the Bank of Japan, announced that the monetary institution would buy up some of the banks' $200 billion in stock holdings.

In the falling market inventoried equities had been eroding the institutions' capital base. Hayami's stock purchase was said to be set at about $24 billion, and it meant to send a signal to the markets that the bank crisis was headed to a new, more perilous level. But after a mini-rally inspired by the central bank's announcement, the Nikkei resumed its slide. Investors saw no real sign of a follow-through by other government agencies.

There was a reason for beefing up the stock market to increase the value of equities in the banks' portfolio. Japan's eight largest LCBGs had an estimated total of $5.5 trillion in assets, but over $600 billion of this amount, or 11 percent, was nonperforming loans. As 2002 came to a close the consolidated group assets of Japan's Big Four banking conglomerates were, on paper, impressive: Mizuho Holdings ($1.3 trillion), Mitsubishi/Bank of Tokyo ($900 billion), UFI Holding ($700 billion), and Sumitomo/Mitsui Bank ($700 billion). The same could also be stated about their toxic assets.

Other than central bank intervention, the big Japanese credit institutions tried to reduce their exposure through risky financial instruments—which added to the toxic assets. In late 2002 Mizuho Bank "reduced" its loan assets by $11 billion through credit derivatives,[8] and Sumitomo/Mitsui Bank also used credit derivatives to slice off $5 billion in loans.

Other measures were counterproductive. Near-zero interest rates are an example. *If* credit institutions could get away with paying their

depositors an interest rate close to zero for time deposits, *then* they would do so for as long as they could, avoiding painful decisions on nonperforming loans. On the contrary if they had to pay their depositors a reasonable interest rate that reflected the time cost, they would be forced to restructure their bad loan portfolios.

Japanese industrial companies also had a stake in not wanting to see monetization of their portfolio's contents, and they understood that rising interest rates would bankrupt many of them (which had been in business only because of abundant government-induced credit from the banks). In turn these bankruptcies would further erode the asset base of the banks—hence the interest in maintaining the status quo.

Creative accounting solutions, however, help only up to a point. In the end, the market catches up with the old methods and new ones have to be found. Deferred tax assets (DATs) are an example (section 5). Still another method is using the average price of share holdings during March to calculate the portfolio's value, rather than the internationally accepted method of using the closing price on the last day of the financial year.

Under Japanese rules, banks may employ either method even if, in principle, they are urged to use the last day's closing price. The decision by Sumitomo/Mitsui, UFJ, and Mizuho to use such creative accounting gimmicks highlights one side of the stark difference in corporate governance between:

- Japan's troubled credit institutions, and
- Their global counterparts in commercial banking.

But even with creative accounting *Nihon Keizai*, Japan's financial daily, reported in early April 2002, that in economic year 2001 losses at Japan's main banks as a result of their nonperforming loans was likely to be ¥1.9 trillion ($14.5 billion), much higher than originally forecast. The system that produced the so-called Japanese economic miracle and was run on leveraging and faith—faith that Japan was a big harmonious family with all its members working together for the good of every Japanese—was falling apart.

## 5. Deferred Tax Assets

Deferred tax assets are created when the regulator allows a bank (or any other company) showing losses in its annual financial reports to set them as claims bills if and when in the future it makes taxable profit (typically in the next five years though this can vary by jurisdiction). Estimates and

judgments have been always required in the calculation of certain tax liabilities and in the determination of recoverability of deferred tax assets whose origins may be diverse:

- Operating losses,
- Tax carryforwards, and
- Temporary differences between the tax and financial statement recognition of revenue and expense.

Different rules govern the calculation and use of DTAs. In the United States, for example, the Statement of Financial Accounting Standards No. 109 (SFAS 109), "Accounting for Income Taxes," requires not only solid evidence but also that deferred tax assets are reduced by a valuation allowance. For its part, any company management worth its salt appreciates that it is quite likely that a big portion or all of the recorded deferred tax assets may not be realized in future periods.

For these reasons, in evaluating their ability to recover deferred tax assets, in full or in part, companies must consider all available positive and negative evidence including past operating results, existence of cumulative losses in the most recent fiscal years, and forecast of future taxable income on a jurisdiction-by-jurisdiction basis. In determining future taxable income, management is responsible for assumptions being made including the:

- Amount of state, federal, and international pretax operating income,
- Likely reversal of temporary differences, and
- Implementation of feasible and prudent tax planning strategies.

DTAs are essentially *deferred tax liabilities* that bear no interest and they are not, by any means, equity. They are debt, but without covenants or due dates attached to them other than the further out day when they might be recovered at the taxpayer's expense. It would be superfluous to add that these assumptions require significant judgment about the forecasts of future taxable income, and such judgment should be consistent with the plans and estimates the firm uses to manage its underlying businesses.

Covered by their supervisors, some banks make huge use of DTAs. The Japanese have been masters in this game. Table 11.1 presents a graphic example of the mountain of DTA regulatory arbitrage in Japanese banking for the fiscal year April 1, 2002–March 31, 2003 (FY3/03) and April 1, 2003–March 31, 2004 (FY3/04). In FY3/03 Resona, the fifth largest bank

**Table 11.1** DTA and consolidated Tier-1 capital among the five major Japanese banks in third quarters of 2003 and 2004 (in billion yen)

| | *FY3/03* | | | *FY3/04* | | | *Y-on-Y Change* | |
|---|---|---|---|---|---|---|---|---|
| *Banks* | *DTA* | *T-1 Capital* | *DTA as % of T1* | *DTA* | *T-1 Capital* | *DTA as % of T1* | *DTA* | *T-1* |
| Mizuho | 2,126 | 3,495 | 60.8 | 1,333 | 3,941 | 33.8 | −793 | 446 |
| MTFG | 1,302 | 3,129 | 41.5 | 656 | 3,859 | 17.0 | −646 | 731 |
| UFJ | 1,522 | 2,560 | 59.5 | 1,396 | 2,175 | 64.2 | −127 | −385 |
| SMFG | 1,912 | 3,256 | 58.7 | 1,666 | 3,572 | 46.7 | −246 | 316 |
| Resona | 522 | 526 | 99.4 | 53 | 898 | 5.9 | −470 | 373 |

of Japan, had 99.4 percent of its Tier-1 capital in DTAs, which was reduced to 5.9 percent a year later after the government recapitalized it to save it from bankruptcy. As of the end of the 2003 fiscal year, DTAs made up:

- A whopping 60.8 percent of the Tier-1 capital of Mizuho, Japan's biggest bank, and
- More than 50 percent of Tier-1 capital of the Sumitomo Mitsui Financial Group, the second biggest bank, and of UFS, the number four bank.

Japan's Resona Bank had to be nationalized in the second quarter of 2003 after its auditors restricted its use of DTAs; consequently, its capital plunged well below the regulatory minimum levels. Soon after he took office, Heizo Takenada, Japan's minister for financial services and the economy, suggested that the banks should limit DTAs to 10 percent of their Tier-1 capital, in line with US practice. This provoked a big negative reaction, and Takenada backed off.

Not just one but nearly all of Japan's major banks suffering from rising bad loans losses and a weak economic environment, resisted any government move to reduce the level of DTAs that could be included as Tier-1 capital. At the same time, there appeared to be an increasing confusion and inconsistency among Japan's four leading auditing firms over how to treat DTAs in the banks accounts.

Yet, this issue was fairly clear. Using illiquid instruments[9] as capital is a flagrant violation of the 1988 Capital Accord (Basel I), which, for international banks, specifies an 8 percent capital adequacy with half of it (4 percent) in Tier-1 core funds. DTAs have essentially been a covert government guaranty, a sort of fata morgana.

The December 2003 monthly report by the Deutsche Bundesbank had this to say on the wider use of DTAs by credit institutions: "The tense situation at Japanese banks can also be seen from the unfavorable composition of their capital. For example, external auditors now have to assess whether the volume of deferred tax assets (DTA) in the balance sheet is appropriate. Given the difficult earnings situation of the banks, the fact that at the end of March 2003 DTA accounted for half the core capital of the big Japanese banks also put pressure on the banks' creditworthiness."

Banks have not been the only entities trying to beef up their balance sheet and capital requirements through DTAs. Deferred tax assets are a favorite ploy used by all sorts of companies.

One of the regular users of DTAs has commented that, although realization is not assured, its management has concluded that deferred tax assets will be realized based on the scheduling of deferred tax liabilities, and *on certain distinct tax planning* strategies that it intends to implement in a timely manner, if necessary, which will allow the user to recognize the future tax attributes.

These and many other similar references indicate that DTAs have become not only a new and powerful tool for creative accounting, joining proforma reporting, EBITDA (earning before interest, taxes depreciation, amortization), and other creative accounting gimmicks, but also a means for tax optimization. The work investors have to do to untangle the growing complexity of financial statements, and understand what lies behind them, is becoming more complex year after year.

One of the major challenges for regulators in the years ahead is to catch a thief basing their judgment on the accounting treatment of loopholes in the law such as deferred tax assets. Many banks around the globe no longer honor the long-standing rule that Tier-I capital comprises high-quality, loss-absorbing items:

- Equity,
- Reserves, and
- Retained earnings.

If the regulators permit it, or look the other way, the overuse of different sorts of hybrid capital can and has created a distinct class of junk. Otherwise serious bankers say that DTAs are favored because credit institutions are forbidden from booking loan-loss provisions as an expense deductible from taxable income at the time the provisions are made. But they also understand very well that in reality the so-called hybrid capital is a cheat,designed to make a bank solvent though this is far from being true.

12

# Japanese Banks That Bled in a River of Red Ink

### 1. Daiwa Bank, Nippon Trust & Banking, Sumitomo Bank

With the collapse of the Osaka-area lenders in September 1995 (chapter 11), Japan's banking crisis began looking as hairy as America's Savings and Loans debacle. There was no telling when Japan would break its vicious economic cycle of near-zero economic growth, which by then was in its fourth year. Successive governments tried to boost demand for goods and services by raising public spending, but stimulative spending had lost its punch.

- Since 1992 Japan has put together five economic pumping-up packages totaling $450 billion, and still the economy lagged.
- Experts argued that either the country was not taking a large enough dose, or the system of economic regulations acted as a break.

The worst news of 1995 came from the Japanese large and complex banking groups, in the form of scandals and (more frequently) as rivers of red ink. Toshide Iguchi was a senior executive and trader at the New York branch of Daiwa Bank,[1] Japan's twelfth largest bank. According to the account revealed by Japan's Ministry of Finance, and by Daiwa Bank itself, Iguchi managed to lose a breathtaking (at that time) $1.1 billion. The announcement came in mid-1995. The FBI arrested Iguchi and charged him with forgery and fraud.

Iguchi had started his career as a car dealer, but for unknown reasons (may be because he spoke English), in 1976, he was hired by Daiwa to work in its New York office. In 1979 he was made manager of the branch's

trading operations, overseeing, among other things, the auditing of his own trades. Controlling one's own trades is a classic example of:

- Faulty internal control, and
- Organizational incompetence.

The pyramiding of losses at Daiwa Bank's New York branch began in 1984 when Iguchi lost $200,000 betting on the American government–bond market. Rather than confess to these losses, emulating Nick Leeson, Iguchi started to cover them by keeping double books:

- Raiding accounts belonging to the bank's customers,
- Selling the securities contained in these accounts, and
- Then forging documents to show that the securities were still there.

While, unlike Barings, the Daiwa Bank had enough funds to cover its losses, which at the high-water mark represented around 8 percent of its capital, the two cases—Leeson's and Iguchi's—mushroomed because of faulty, if not outright incompetent supervision:

- First, by the bank's top management,
- Then, by the regulatory authorities.

Toshide Iguchi, who often bought and sold $1 billion worth of US Treasury bonds at a throw, was not subject to senior management controls. According to the view of an ex-employee of Daiwa Bank Capital Management (DBCM), to Iguchi risk management was absolutely disgraceful. Indeed, the parent firm had to inject fresh capital into the firm at least twice, in 1991 and 1992, but no investigation was made into the reason(s) for those holes in the balance sheet.

While Daiwa Bank's significant financial losses were incurred in New York, its other international operations were hardly better. Daiwa Bank Capital Management has never been known as a money-spinner in its London securities operations. With funds hemorrhaging from all sides, the bank was in business to simply accumulate red ink till the day of reckoning.

On August 8, 1995, Daiwa officials informed the banking bureau of Tokyo's Ministry of Finance about Iguchi's trading losses. But only 40 days later, on September 18,, did the ministry tell regulators in New York and in Washington about Daiwa's trading fraud history. The spirit that prevailed till then was clubby and opaque, characterized by:

- Scant disclosure requirements, and
- Cozy relations between regulators and bank executives.

In terms of appearances, this irrational approach does not seem to do much harm when everybody makes truckloads of dollars or yen. But after the Japanese financial bubble burst, maintaining a loose supervisory structure was akin to throwing oil on the fire.

According to talk at Tokyo's financial district, one of the reasons the Ministry of Finance had little incentive to be tough with the banks it supervised was that they traditionally offered sinecures to retiring ministry officials in a practice known as *amakudari*, or *descent from heaven*. In Greece it would have been called *fakelakia*. This case, however, was different as it involved a breakdown of fiduciary duties—and, in the end, plain fraud.

On November 2, 1995, federal and state banking regulators in the US kicked Daiwa Bank out, ordering the Japanese institution to close its American operations in 90 days as punishment for concealing losses in the $1.1 billion bond trading scandal. It was also a public relations embarrassment as the behavior not only of Japanese but also of the American regulatory authorities had been characterized by inaction for years.

The Federal Reserve Board, the New York State Banking Department, and regulators in five other states said all US banking operations of Daiwa must end by February 2, 1996, although an extension might be granted to permit an orderly departure (The bank had operations in 11 states). For its part, the US Justice Department stated that it would bring criminal proceedings against the bank and its managers accused of covering up the losses.

The case of Nippon Trust & Banking is basically different, but here again the regulators of the banking industry did not do the job for which they got paid. On February 3, 1995, the ailing affiliate of Mitsubishi Trust and Banking announced it would write off a large chunk of nonperforming loans in the second half of the ongoing fiscal year. Nippon Trust was no small outfit. It has been Japan's seventh largest bank.

- The write-off of more than ¥200 billion (then $2 billion) by the end of March 1995 significantly reduced its margins (as well as declared nonperforming loans) of the year, and
- This move came one week after Sumitomo Bank, Japan's fourth largest LCBG, predicted a loss of ¥280 billion (then $2.8 billion) for the year because of a major write-off to cover bad loans.

When it declared its first loss in nearly 50 years, Sumitomo Bank was one of the world's biggest LCBGs. When the loss became known, many people started asking: Why does so much red ink run out of Japanese banks? Many answers were heard in response to this query, but two better ones were:

- Japanese culture tends to discourage investigatory activities and disclosures, and

- The country's regulatory mechanisms have not kept pace with the economy's extraordinary growth.

Part of Japanese values is that an embedded bureaucratic system places more importance on harmony rather than on looking at things for what they are. Japanese are not more likely than other people to make trading errors and create mishaps, but they are less likely to uncover them until great damage has been done.

Societal factors play a significant role in the way corporations operate. As a result, various cases of staggering losses are offshoots of decades of phenomenal economic growth that characterized Japan's economy after the end of World War III. The new edifice, however, was built upon an archaic structure of:

- Regulations,
- Business customs,
- A code of "protection," and
- Weak internal controls.

In most Japanese banks, as well as in commercial and industrial companies, internal controls did not change sufficiently as the country's postwar economy accelerated. For instance, while traders register losses as everywhere in the world, accounting practices in Japan do not capture them because:

- Accounting rules are outdated,
- Risk management systems are vague, and
- Controls are not always strictly enforced.

There has also been the added fact that until the torrent of red ink could no longer be hidden, bureaucrats at the Ministry of Finance, the Bank of Japan and the Ministry of International Trade forbade major banks to report losses for fear of undercutting confidence in the country's financial system. To cover losses, banks sold off equity as the fiscal year's end approached. But short-term measures can walk only so far and disclosures cannot be avoided forever.

Last but not least, cover-ups have been facilitated by the fact that Japan's opaque accounting system does not exert sufficient discipline in bookkeeping. When these events took place assets were stated at their acquisition price rather than at their market value, no matter how long ago they had been purchased or how much their value had increased or decreased.

As elsewhere in the world, a rigid corporate hierarchy and inflexible compensation system also contributed to the problem. Compensation and

prestige put uncommon pressure on star performance to derive reward from reputation. Not only was anyone who was successful admired, but it was also considered rude and a sign of jealousy to check and double-check whether his achievements were solid.

### 2. Mitsubishi-Tokyo and the Hokkaido Banks

The April 1996 merger of Mitsubishi Bank and the Bank of Tokyo created (at that time) the world's largest LCBG with $700 billion in assets. A year and a half later, on September 11, 1997, Japan's biggest and strongest credit institution, the Mitsubishi Tokyo Financial Group (MTFG), announced a huge loss as it wrote off ¥1.27 trillion ($10.7 billion) in bad loans.

The surprise was so much greater as the Mitsubishi Tokyo Financial Group was widely considered to be one of the strongest banks in Japan in terms of asset quality, profitability, and reserve coverage of bad debts. The heavy losses surprised many market players. It was also an irony that they were revealed just 24 hours after the announcement that the merger of Hokkaido Takushoku, Japan's tenth-biggest city (or commercial) bank and Hokkaido Bank, its smaller regional rival, had been put off indefinitely—allegedly because of losses that were identified only at the eleventh hour.

The two cases were seen by financial analysts as a test of whether the Ministry of Finance was finally ready to make Japan's weaker banks resolve their problems without forcing the stronger ones to foot the bill. The Mitsubishi Tokyo Financial Group write-off followed the announcement that Fuji Bank was slashing its loan book by ¥3 trillion ($25.5 billion). As for Hokkaido Bank, although it was the smaller city credit institution, it had amassed immoderately large amounts of bad loans, ¥935 billion ($780 million), or 13.4 percent of its loan book, and had put in loan reserves only 37 percent of this amount.

The case of Hokkaido Bank is an excellent example on what *not to do* in a highly competitive, globalized financial market. Political patronage and other factors that facilitated old financial and industrial developments are unappealing in a modern age. Companies need to renew and enhance their sources of competitive advantage in order to find a second life.

A bank must be able to reinvent itself as a business services company, with its real strength in the quality of its financial advice and of the support it provides to customers. Betting on politically motivated loans and abandoning prudential counterparty rules can lead to huge losses and from there to a decline in business and a downward spiral. That had been, in brief, Hokkaido Bank's fate. It is also the confirmation of a natural life cycle for a business. The Hokkaido Bank had simply come to the end of its natural life.

- The victim of mismanagement, and
- Of failing to respond appropriately to the evolution of the banking business.

Compared to the other Japanese megabanks and to smaller competitors like Hokkaido, MTFG had a good track record at least in terms of aggressively dealing with its nonperforming loans. It had also been the first bank in Japan to repay government money injected to prevent it from collapsing in the early 1990s, as well as the first bank in Japan to declare that its nonperforming loan problem was over.

Observers said that it was the ability of Shigemitsu Miki, MTFG's CEO and chairman, to reduce problems to their absolute basics that facilitated the other managers' comprehension of the dire situation and made his bank move ahead of the curve. Faced with the challenge of being in charge of a credit institution that was run into the ground as a result of unwise, largely government-directed lending policy, Miki formulated his recovery plan to:

- Lend more,
- But charge more, and
- Control the risk.

In terms of being in charge of assumed risk, Miki appreciated that the MTFG could no longer rely on making huge loans to Japanese corporations that didn't make money and couldn't repay them—even if interest rates were close to zero. New, properly priced loans would have to be made to companies and individuals that were in a position to repay their debts, and the range of financial services on offer to retail clients would have to be broadened to include a portfolio of fee-based personal financial products.

In that sense, under Miki, the MTFG was a good 15 years ahead of other global banks in wealth management. Another crucial decision was to become an active participant in the Resolution and Collection Corporation (RCC), a government body set up to acquire bad loans from banks. The bank sold billions of yen of nonperforming loans (NPLs) to the RCC in its aim to reduce the number of nonperforming loans by half by the end of fiscal 2004.

Another of the CEO's goals was to get the value of the bank's equity holdings below the level of its Tier-1 capital by the end of 2004. But the greater *coup* was the Mitsubishi Bank merger with the Bank of Tokyo. Many observers were surprised to see Mitsubishi Bank join hands with a competitor. While there have been too many bank mergers in Japan, and reducing competition was a retrograde step, available evidence suggests that this particular experiment with very big size institutions paid dividends—at least in the beginning.

This was important in the sense that it provided a counterweight to Japan's recent history of bank mergers, which was not encouraging. According to learned opinion the two main reasons for such a negative outcome were that:

- Japanese banks had suffered time-sapping cultural tensions, and
- Resulting efficiencies seldom proved to be on the same scale as more commercially driven deals.

The mid-1990s, however, was a time for bold decisions. Since Japan's financial and economic downturn in the early 1990s, largely due to overleveraging and overexpansion, the country's banks, which had themselves been overgeared, have had a difficult going. Right or wrong mergers were seen as a way to stem the red ink, though they did not quite work out that way.

For instance, the creation of Mizuho (section 3) delivered endless internal wrangles. Experts pointed out that fast government satisfaction with these mergers was counterbalanced by unhappiness with mass job losses. Still the merger wave continued somehow helped by the fact that in the first half of 1995 there had been an overall improvement in the health of Japanese banking, reflecting increased supervision and a positive operating profit for some of the banks. This was recognized by the rating agencies, which upgraded eight banks.

Ten years down the line the big news was the merger between MTFG, by then the country's second largest bank and UFJ, the fourth largest bank. Scheduled for October 2005, despite the complexity of such a deal, it was thought to signal a return of confidence in the banking industry. With combined assets of about $1.8 trillion, the new merged bank was to be the largest bank in the world.

Heizo Takenaka, Japan's financial services minister, welcomed the merger move although there were no signs that the government had played a role. Some observers said that, on the positive side, the deal gave MTFG access to UFJ's extensive pool of retail clients and its portfolio of loans to Japanese small and medium-sized enterprises (SMEs), while MTFG's deeper capital base benefited UFJ.

Other experts however commented that MTFG may be capital rich, but its return on equity had become modest. This was another reason why the risk of carrying highly indebted borrowers on its balance sheet was simply too high. Indeed, some analysts speculated that after the merger went through MTFG would not hesitate to send UFJ's weakest borrowers to the Industrial Revitalization Corporation of Japan (IRCJ).

The fact was that Japanese banks were still confronted with domestically weak economic activity. Nevertheless, the business of fixed investments had strengthened, corporate profitability had somewhat improved,

and the number of corporate bankruptcies had declined. This explained the decline in nonperforming loans, from 8.4 percent in 2002 to just above 5 percent in September 2004. The decline may also reflect actions taken by banks to meet the target by the Japanese Financial Services Agency to halve nonperforming loans ratios from their peaks by March 2005.

### 3. Mizuho, Industrial Bank of Japan, Fuji, and Dai-Ichi

Mizuho Financial was the result of the 2003 merger between Dai-Ichi Kangyo, Fuji Bank, and Industrial Bank of Japan. This and the mergers of Mitsubishi Tokyo Financial Group, Sumitomo Mitsui Financial, UFJ, and Resona (section 4) led to a new generation of Japanese megabanks. The first three LCBGs went successfully through the crisis, but UFJ and Resona, particularly the latter, were giants with feet of clay.

Some analysts have contested this argument, saying that the financial condition of the first three *megabanks* was far from stellar. Those making such an argument provide as evidence that on April 28, 2003, Mizuho said it would report a loss of ¥2.38 trillion (then $19.8 billion)[2] for the year ending March 31, 2003, racking up the largest loss in Japanese corporate history.

Several analysts have noted that Mizuho confronted integration problems. Its management struggled to find a balance of power between executives from the three original major banks. Mizuho had been run like a federal system, said David Threadgold of Keefe, Bruyette & Woods in Tokyo. "It has a lot of the same tensions as under the US constitution, where powers are formally devolved from operating companies to the holding company, but many powers have actually been retained by the operating companies."[3]

In October 2013 Mizuho admitted that loans of about ¥200 million ($2 million) had found their way to gangsters through Orient Corp., the banking unit's consumer credit affiliate. This revelation triggered business improvement orders from Japan's Financial Services Agency, as well as a financial industry inquiry into banks' efforts to shut off funding to so-called antisocial forces.

On January 23, 2014, Mizuho president Yasuhiro Sato stepped down from running the group's main banking unit following the yakuza loan scandal. Takashi Tsukamoto, the chairman of Mizuho Financial Group, also tendered his resignation, while dozens of senior executives took pay cuts. These events capped a challenging period for Mizuho, adding to the 2013 findings by an independent investigation that Japan's second biggest bank repeatedly noted lapses in communication between its units. It also lacked awareness of the legal standing of some of its clients.

Typically, albeit not always, megamergers are accompanied by lots of problems that may last over a dozen years. When Mizuho was created in 2003 as

a financial conglomerate with the assets and liabilities of Dai-Ichi, Fuji, and Industrial Bank of Japan, the entity that resulted signaled significant write-downs on equity holdings. It should, however, be remembered that its portfolio contained both equities (which had lost much of their market values) and toxic waste of three big banks that had merged. More disquieting was the fact that the reported loss was nearly 20 percent bigger than the forecast made in January 2003, which spoke of a projected group net loss of ¥1.95 trillion—though that was prior to the decline of the stock market to a 20-year low.

Together with the bank's other losses of ¥546 billion, the dive in equity prices added to the prevailing burden of bad-loan charges. In the aftermath, Mizuho's shares fell to an all-time low of ¥58,300, its operational and market decline compounding existing fears over its core financial strength. To raise additional capital and stave off the threat of government takeover, Mizuho sold ¥1.1 trillion in preference shares to clients before its financial year-end on March 31, 2003.

Mizuho's was by no means the only revision of the depth of red ink in the treasury of the Japanese LCBGs. It was one of several, which closely followed an announcement by the Financial Services Agency, the Japanese banking regulator, that its special inspections of the country's largest banks had unveiled an additional ¥1.3 trillion in bad loans. Depressing news was all over and it came as no surprise that in late April 2003 the benchmark Nikkei 225 stock market index closed at another 20-year low.

The combined market value of Japan's four largest banks had more than halved over the preceding economic year to less than ¥6.0 trillion. The decline in the share prices of Japan's LCBGs had a knock-on effect across the Japanese economy, as a result of the financial links that existed between the country's major lenders and their major borrowers.

As Table 12.1 demonstrates, in terms of megalosses, which have the nasty habit of bringing a financial institution to its knees, Mizuho

**Table 12.1** Consolidated net losses of Japanese big banks (in billion yen)

| | *March 31, 2003* | *March 31, 2002* |
|---|---|---|
| Mizuho | 2.380 | 976 |
| Resona | 838 | 931 |
| UFJ | 650 | 1.230 |
| SMFG | 470 | 464 |
| MTFG | 185 | 152 |
| Sumitomo Trust | 73 | 42 |
| Mitsui Trust | 50 | 278 |

managed to be by far at the no 1 position in March 2003 and in no 2 position in March 2002. In both cases, Resona, another of the top five Japanese city banks (section 4), was one notch behind.

To better appreciate the problems Mizuho confronted we need to return to its origin. On August 20, 1999, three of Japan's largest banks agreed to an alliance that created what was then the world's largest bank. One of the partners, the Industrial Bank of Japan (IBJ), was the only remaining Japanese bank making long-term loans to business customers, after the bankruptcy of its competitors (see also section 5). Dai-Ichi Kangyo Bank (DKB) and Fuji Bank, the other members of the alliance, were two of Japan's largest city banks.

Executives at these institutions said the three banks had reached a broad agreement on a plan to create a single holding company that would pave the way for a more formal integration. Their operations were to be consolidated into three main divisions:

- Retail,
- Commercial, and
- Investment.

The single entity forged from the three (at the time) had combined assets of ¥141 trillion ($1.26 trillion). IBJ was the primary beneficiary of the proposed alliance, because for over a decade it had been handicapped by rules preventing it from taking deposits from individuals. This shortcoming was finally overcome through the city banking licenses of DKB and Fuji.

Analysts had, for some time, suggested that the IBJ constraint had developed into a weakness that played a key role in the demise of its competitors in long-term credit: Long-Term Credit Bank of Japan (section 5) and Nippon Credit Bank, which were nationalized in 1998. For their part, Fuji and DKB had among the largest individual deposit bases in Japan, but they lacked powerful international presence as well as wholesale securities operations.

Behind this tripartite merger was the fact that all three banks were wounded, though Dai-Ichi was less so than the other two. In 1998, all three credit institutions had lost money and by the time of their virtual merger none was in a truly good condition. Problematic loans poured cold water on statements by analysts in Tokyo who hailed the merger saying that:

- It would help the recovery of the nation's economy (a vast project), and
- It would speed up the restructuring of Japan's troubled banking sector.

It was preferable to face the truth. The implosion of Japan's stock and property bubble in the early 1990s had left the country's big banks buried under trillions of yen in nonperforming loans. Their inability to shed unprofitable assets, cut costs, and resume regular lending activity was widely regarded as the primary reason for Japan's failure to shake off its worst recession since World War II.

Some time prior to these mergers and alliances, in 1998 Yamaichi Securities, Japan's fourth largest securities house, and a go-go broker as well as technology leader, had failed in spite of the fact the Japanese government had passed an array of emergency measures designed to prop up the country's shaky banking system and to jump-start a depressed economy. Critics said that these various measures had only made matters worse. Japan was on the brink of a systemic crisis, and there was talk of:

- A coming Weimar Republic–style hyperinflation due to the huge increase in money supply, and
- A simultaneous collapse of the real economy because a deep recession was at risk of turning into a depression.

The depression was avoided but not the economic breakdown that hit Japan. Norio Ohga, the chairman of Sony, said at a press conference that the Japanese economy was on the verge of collapsing and chastised the Hashimoto government for fixating on budget deficit–slashing, while the economy was facing a deflationary collapse; he described Hashimoto as "being worse than Herbert Hoover."[4]

The joke in Japan then was that following the failure of Hokkaido Bank (section 3), Yamaichi Securities, and other financial institutions, the Japanese had discovered their own low-tech definition of *home banking*: Money was now going into household boxes like the time-honored method of French farmers who hid money in their mattresses.

Consumers were not the only parties who had lost their trust in the economy and the financial system. The corporate sector, too, suffered from dwindling demand at home, loss of some export markets, excess inventories and declining profits—resulting in a reduced need to invest. Confronted with this scenario, the government's response was widely judged to be inadequate.

In announcing a ¥30 trillion package in February 1998 to prop up the banking system, Tokyo's politicians crossed another important political threshold. The Japanese government made a commitment to salvage operations equivalent to 6 percent of the gross domestic product, which some economists judged as inadequate given that the Japanese real estate market, too, had crashed.

The bureaucratic elite in the Ministry of Finance was criticized for both past and present mismanagement. At the same time, because of various scandals, it lacked the confidence to act, while the policy makers'—hence, the politicians'—stop-go decisions led to the absence of private sector initiative.

Weighing heavily on these criticisms was the fact that the Japanese banking system was confronted by a continual depletion of hidden reserves, which stood at ¥37 trillion ($272 billion) in 1991 and were estimated to be just ¥4 trillion ($30 billion) in 1998.[5] At Wall Street many analysts said that a Nikkei below 14,000 would wipe out all of the hidden reserves of the Japanese big banks and the country's banking system could well face another major crisis.

There was also the fact that, on average, the Japanese large and complex banking groups had lost an estimated 180 percent of their equity in nonperforming loans alone. They also registered huge losses with derivatives. Precisely because of derivatives losses the plight of the Japanese banking industry in the late 1990s was by far worse than the one faced by US banks in the early 1990s during the Savings and Loans crisis.[6]

### 4. UFJ and Resona

Like Japan's other megabanks, UFJ was the result of mergers involving several financial groups, centered on Sanwa Bank, Tokai Bank, and Toyo Trust and Banking. Its mark of distinction was that as Japan's fourth largest megabank it had a somewhat better standing than Resona, but it was still loaded with bad loans and this eventually led to its takeover by MTFG (section 2).

Critics have often said that UFJ's principal shortcoming was the history and corporate culture of Sanwa, which succeeded in dominating the other credit institutions that had merged into UFJ, but was widely considered to be narrow-minded and stingy. At the same time it was highly aggressive in marketing its services during Japan's bubble years of asset inflation, collecting in the aftermath, an inordinate amount of toxic waste.

The result of the shortcomings briefly described in the preceding paragraphs was that the Sanwa Bank had lost 90 percent of its equity even if it fared no worse than any of the 19 top Japanese banks of the early 1990s. However, its financial staying power depended solely on reserves, and these reserves were hurt by the stock market crash.

One of the problems Sanwa faced was its lack of a *keiretsu* group of friendly corporate customers. Other than this, it was based in Osaka, which largely meant it had to deal with up-and-coming companies that were themselves becoming financially stretched in order to expand their services. This left Sanwa with huge loans to troubled companies such as:

- Daiei, the retailer,
- Towa Real Estate, and
- Kaikyo, a condominium developer.

Moreover, by mid-2004, UFJ still owed the government ¥1.4 trillion (then $12.8 billion) and it reported a ¥402 billion loss in the financial year ending March 31, 2004. At the Tokyo stock market it was nobody's secret that UFJ badly needed new money, but it was not forthcoming.

Indeed there was speculation in 2004 that Toyota, which was close to the Tokai Bank, might step in to help. This proved to be nothing but wishful thinking. And in June 2004 the bank was penalized by FSA for hiding documents and inflating lending records, leading the regulator to consider filing criminal charges against it. "UFJ is already virtually a nationalized bank," said Yukiko Ohara, banking analyst at CSFB in Tokyo.[7]

UFJ had become a takeover target; even its equity performed much better than the equity of MTFG, its suitor. The high-water mark in Figure 12.1 is impressive. When the takeover came the surviving banking group was evidently MTFG.

Resona, Japan's fifth biggest megabank in size, was created in March 2003 by the merger of Asahi Bank and Daiwa Bank (section 1). Both were troubled credit institutions and, between them, the recipients of ¥1 trillion

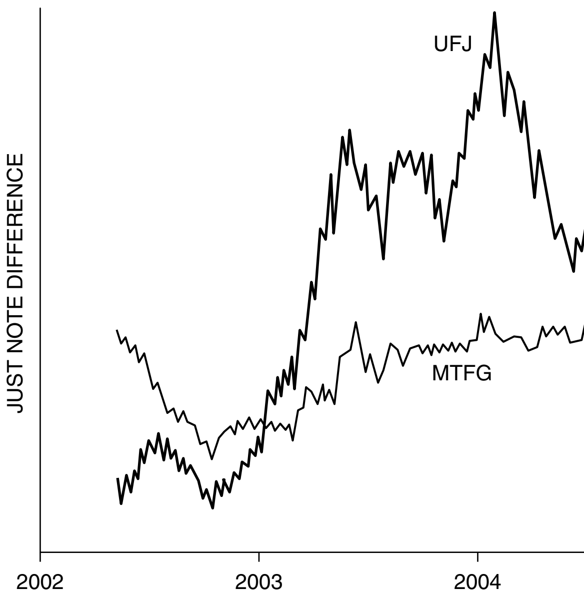



**Figure 12.1** MTFG and UFJ share prices do not reflect financial health.

of public cash a few years earlier. When they merged to form Resona, Asahi and Daiwa were known to be in a bad condition, even by Japanese standards. The resulting financial conglomerate inherited the troubles, once again documenting that when they merge two self-wounded institutions don't make one institution that is in good health.

To say that Resona's situation bordered on the financial precipice may well be the understatement of the year. On May 17, 2003, it admitted that its capital adequacy ratio had fallen to around 2 percent, half the required minimum for domestic banks and a quarter of the required minimum for international banks. A few weeks earlier, Resona had reported a capital adequacy ratio of 6 percent.

To avoid a new major banking crisis, the Japanese government agreed to inject public money into the LCBG in order to prevent its collapse. By early July 2003, Resona was at the receiving end of some ¥2 trillion (then $17 billion) in return for new shares.[8] In effect, the big bank was nationalized, with the government owning more than half of its equity.

Most interesting in the Resona story is what really went wrong in just a month to turn a supposedly 6-percent capital ratio—itself inadequate by Basel I standards for an international bank—into a mere 2 percent. The answer is that like many other Japanese banks that tried to pull themselves out of the deep red ink, Resona counted a large lump of *deferred tax assets* (DTAs, chapter 11) in its capital base.

As the reader will recall from chapter 11, DTAs materialize only if a bank (or any other company using them) makes enough taxable profit in the following five years to recoup the losses. By contrast, if these losses continue to mount the DTAs are nothing more than instruments for cooking the books, which means a dangerous creative accounting gimmick.

Depending on the law of the land, and *if* there is a strong stream of profits, deferred tax assets could mean money. The big *if* is profits *now* or in the near future, not at some unspecified time in the further-out future, which is both unpredictable and uncontrollable. Here is a positive example. In the early 1950s Kayser Motors, a big money loser, got a loan from Bank of America, using some of the profitable assets of the Kayser empire as collateral. With that money it bought Willys Overland. Willys, the maker of the famous jeep, was a very profitable company that had paid lots of taxes.

After the merger, Kayser Motors recovered the taxes paid over the years by Willys to the government, paid back the Bank of America loan, and kept Willys Overland as a prize. But in Japan there was no profitable big bank left to make the Kayser *coup*. For all practical purpose the DTAs were worthless though Resona's capital adequacy was calculated on the basis of an inordinate amount of them. Worse still, Resona was not the only bank whose deferred tax assets accounted for a large proportion of its capital base while it continued making big losses.

Economists stated that as long as the outlook for banking profits remained weak or nil, there was the risk that the capital of other Japanese institutions, too, which relied on deferred tax assets, would be called into question. With the whole economy in recession, and with deflation showing no signs of abating, more and more LCBGs were getting into trouble, as their borrowers sank.

Beyond the creative accounting practices, the Resona episode also raised questions about Japan's regulator, the Financial Services Agency, which was promising reforms but to little effect. In the end, it was not FSA but, Asahi & Co., one of Resona's two auditors, who disputed the bank's rosy profit forecasts and quit.[9] The bank's management wanted to include ¥700 billion of deferred tax assets in its Tier-1 capital, making up 70 percent of the total, in its accounts for the year ending March 31, 2003.

Shigeru Iwamoto, Asahi's president, told the upper house financial affairs committee that Resona would indeed have become insolvent if deferred tax assets had been entirely excluded from its capital, which, in Asahi's opinion, was the right policy. During that testimony, it was further revealed that Resona's ability to make profits was highly questionable.

The government's decision not to carry out due diligence before it injected public funds into the bank added to public concern. Critics stated that the Ministry of Finance should have examined Resona's assets carefully. "You want to know the true state of the bank. It's the duty of the regulator to do a more rigorous assessment of the assets," said Jason Rogers, credit analyst at Barclays Capital in Tokyo.[10]

It took several months for Resona to come up with a plan for its own revival, after being rescued by the Japanese taxpayer to the tune of ¥2 trillion ($18 billion) in July 2003. Analysts who expected pay cuts, layoffs, and branch closures were deceived. On November 14, 2003, the fifth largest Japanese bank made a vague statement about:

- Aggressive cost-cutting,
- Sale of cross-shareholdings, and
- Action to tackle bad loans.

Analysts doubted the credit institution's assertion that this was sure to produce a turnaround and it would report a net profit of ¥160 billion ($1.47 billion) in the year ending on March 31, 2005. There were two major reasons for such a doubt. One was that calling-in bad loans was political suicide in Japan. The other, that depressed retail and corporate loan demand intensified competition in the industry from Japan's other "reviving" banks while macroeconomic uncertainty continued to undermine Resona's attempts to recover.

Resona split its assets, transferring ¥26.7 trillion (then $245 billion) to a so-called *new account* and ¥3.6 trillion (then $33 billion) to a *revival*

*account* that comprised problem loans, listed securities, and losses on property assets—in short, a "bad bank." However, the LCBG did not have the skills necessary to manage the split and doubts existed about the likelihood that Resona would form an alliance with one or more foreign or domestic investment banks to oversee the recovery or disposal of *its* bad loans.

### 5. Long-Term Credit Bank and Its Resurrection as Shinsei Bank

Besides the gloom of the East Asian and Russian markets, a major concern of Tokyo in mid-1998 was the fate of Japan's Long-Term Credit Bank (LTCB). After uninterrupted banking failures (described in the preceding sections) the big question was how LTCB's deteriorating situation could be resolved. According to expert opinions the problem was that the big bank had to be saved, one way or another, largely because:

- It was sitting on some ¥50 trillion (then $367 billion) in derivative obligations, and
- If LTCB were to fall, it would default on those derivatives, creating systemic risk.

There was also another problem: Nobody really had a clear idea of the balance sheet risk of many of the other Japanese banks. At the Tokyo stock market, as well as in the government bureaucracy itself, the speculation was that their exposure could be even greater than it appeared; based on what they were willing to admit it might have been much greater.

The huge exposure to derivative financial instruments by LTCB came over and above the colossal losses in nonperforming loans, which, as of mid-1998, amounted to 180 percent of the bank's equity—a statistic that made depressing reading. In addition, six other large Japanese banks were worse off than LTCB, which meant that, for all practical purposes, they were bankrupt.

Nippon Credit had lost an amount equal to 370 times its equity capital in nonperforming loans. It was indeed difficult to see how bankers could make these sorts of blunders. Even a bunch of other large Japanese banks were a little better than LTCB; still 11 of them had lost more than their equity. The answer for LTCB was its resurrection as a different bank and under a different name: Shinsei Bank (*Shinsei* means "new birth").

After being nationalized in 1998 with nearly $40 billion in debt, as a money center LCBG, the reincarnation of Long-Term Credit Bank of Japan was expected to play by a new and unconventional (for Japan) set of rules.

Its new boss was Masamoto Yashiro, the former Citibank Japan chief who had done the unthinkable: shown deadbeat corporate borrowers the door.

The Shinsei Bank was owned by a group of foreign investors, including the Mellon Bank, GE Capital, PaineWebber, and Ripplewood Holdings.[11] All four international partners were determined not to return to the policies that led to the bankruptcy of the Long-Term Credit Bank and so many other Japanese banks. The Japanese government had sold the LCBG for $1.12 billion in March 2000 in a campaign to modernize Japan's financial industry, but the resurrected credit institution still faced daunting challenges:

- The loan book Shinsei inherited from the government was shakier than promised, and
- Efforts to move out of the low-margin corporate loan business and into more profitable sectors like asset management and investment banking were a struggle.

The new owners had to build a retail banking operation and investment bank mostly from scratch, while being distracted by vociferous political pressure to give Shinsei borrowers a break. But to no avail. One borrower, consumer finance company Life Co., revealed a $1 billion negative net worth, double the original estimate. Shinsei cut it off and it also opted to sell back its Sogo[12] loan to the government, as authorized by the purchase contract. Other companies without viable turnaround plans were sent packing—an un-Japanese business practice but a sound banking procedure.

With a tough stance about loans and other banking services Shinsei's credit rating improved. Its management bet on the likelihood that Japanese attitudes to corporate governance would change faster than outsiders realized. It is often said that, ever since the arrival of the Black Ships that opened up Japan in the nineteenth century, the Japanese have allowed foreigners to initiate changes that are known to be needed but are politically hard to make.

Shinsei was hoping that history would repeat itself, even if the needed changes would not come easily. It had no choice but to push on with changes even if the politicians objected. The old LTCB was a huge bureaucracy that provided low-margin corporate loans under political patronage. To the new owners this practice was anathema, and for good reason.

When the Japanese government seized a bankrupt LTCB, it absorbed $37 billion in bad loans from its books. The new owners were resolved not to repeat that experience. Masamoto Yashiro hired an international team, of mostly ex-Citibank executives, restructured the institution's channels,

overhauled its archaic IT system, rolled out a menu of financial products for retail customers, and started to transform the bank under his watch from:

- A low-profile industrial lender,
- To a top-flight commercial bank.

The new management also cleared up the balance sheet, which the Japanese government approved. It was when it started calling in loans to deadbeat borrowers that the government grew tense, and the Japanese press attacked. But the new, clean balance sheet policy paid dividends. Shinsei had $501 million in profits for the year ending March 2002, while other Japanese LCBGs lost billions.

By early 2004 the rebirth of LTCB as Shinsei Bank was confirmed by its auditors and the market. But the successful public offer of its equity led to a crackdown by Japan's Ministry of Finance on foreign investors using offshore companies to avoid paying capital gains tax on investments in the country's banks. This move came as a response to criticism over the profits by the consortium that had acquired Shinsei.

Led by Ripplewood, the Shinsei consortium sold about half its 67 percent stake in the bank when it listed in mid-February 2004, but was prevented from selling the remainder for 180 days from the date of the listing. According to Japanese law, this allowed it to avoid Japanese capital gains tax when selling its shares. Since the consortium was headquartered in the Netherlands, the Ministry of Finance said it was in talks with the Dutch government to add a clause to their tax treaty allowing it to charge capital gains tax on share sales in banks that have received public funds. (Japan has made a similar change to its tax treaty with the US.)

The Shinsei story had a happy ending for its investors but when a new management took over it softened the credit policies and this undermined potential returns. Shinsei eventually became like other Japanese LCBGs where politics rather than sound banking practices hold the high ground. It needs no explaining that for this it paid a price with its balance sheet, with its profitability, and with the toxic residues that again showed up in its portfolio of assets.

Niels Bohr, a physicist and one of the founders of quantum theory, once said to Wolfgang Pauli, another well-known physicist: "We all agreed that your theory is crazy. The question that divides us is whether it is crazy enough to have a chance of being correct."[13] To a traditionalist Japan under the politicians' sway, the credit policy of Shinsei looked as being crazy—but it was correct. This lasted as long as its top management resisted political pressures. Eventually a new management made of soft wax took over and the politicians had the last word.

# Notes

## 1 Banks "Too Big to Fail"

1. BIS, *74th Annual Report*, Basel, June 29, 2009.
2. Ibid.
3. The latter three saved from outright bankruptcy at the eleventh hour, with US taxpayer money.
4. Which is the philosophy of the cancer cell.
5. Till the next bust.
6. D. N. Chorafas, *Public Debt Dynamics in Europe and the US* (New York and London: Elsevier Insights, 2014).
7. As was the case of the US government rescuing General Motors and Chrysler.
8. Deposits above €100,000 from individuals, SMEs and liabilities to the European Investment Bank (EIB) would rank next in line. Insured depositors (up to €100,000) would maintain the right to all of their funds, ranking senior to all other creditors.
9. *The Economist*, January 30, 2010.
10. If not a corporatist, socialist state.
11. *The Economist*, May 9, 2009.
12. Stated on January 13, 2010, in the course of a Congressional hearing by the Angelides Committee.
13. Richard W. Fisher, lecture at the Conservative Political Action Conference, National Harbor, Maryland, on March 16, 2013.
14. A statement made by Holder during his US Senate testimony, *Wall Street Journal*, March 6, 2013.
15. A news flash at *Bloomberg News* stated that, according to a study, *if* JPMorgan Chase was divided into four independent banks, their collective capitalization will be double the LCBGs' current equity (*Bloomberg News*, August 23, 2013).
16. In a Brussels meeting that took place in late June 2013.
17. Such as perpetuals.
18. Credit Suisse, *Research Monthly Switzerland*, July 30, 2013.
19. Credit Suisse, *Research Monthly Switzerland*, April 30, 2013.
20. First of *all,* depositors, which was a violation of European deposit insurance guaranteeing €100,000 ($130,000). Then, of private deposits beyond that level.

21. Judged under the perspective of global size, the Bank of Cyprus and Laiki Trapeza were relatively small, but both were big under local conditions and both were badly wounded by Private Sector Involvement (PSI), which was ill-conceived and poorly executed by the same players: EU, ECB, and IMF. (Chorafas, *Public Debt Dynamics in Europe and the US*.)
22. The "entitlements."
23. See also the discussion on leverage ratios in chapter 2.
24. D. N. Chorafas, *Basel III, the Devil and Global Banking* (London: Palgrave Macmillan, 2012).
25. This might also explain the further substantial declines in many bank stock prices and persistently elevated credit default swap (CDS) spreads in the last quarter of 2008 and in early 2009.
26. Which might happen with the bail-ins.
27. *The Economist*, October 2009.
28. Noncurrent loans.
29. The projected implementation date is July 2014 and the delay would be of one year.
30. *The Economist*, October 10, 2009.
31. *Financial Times*, November 18, 2013.
32. *Le Canard Enchainé*, July 24, 2013.
33. *The Economist*, August 2, 2008.
34. As of June 30, 2009.
35. *Bloomberg News*, May 1, 2012.
36. *Bloomberg News*, June 31, 2012.

## 2 Banks and Regulators

1. Essentially by setting minimum supervisory standards—a common denominator.
2. D. N. Chorafas, *The 1996 Market Risk Amendment: Understanding the Marking-to-Model and Value-at-Risk*(Burr Ridge, IL: McGraw-Hill, 1998).
3. Such enhancements strengthened Basel II's Pillar 1 minimum capital requirements, by raising the risk weights for resecuritization exposures such as collateralized debt obligations (CDOs) of asset-backed securities. They also introduced stricter standards for short-term liquidity facilities regarding off-balance sheet conduits.
4. D. N. Chorafas, *Economic Capital Allocation with Basel II: Cost and Benefit Analysis* (London and Boston: Butterworth-Heinemann, 2004).
5. D. N. Chorafas, *Basel III, the Devil and Global Banking* (London: Palgrave Macmillan, 2012).
6. By Ralph Musgrave, January 11, 2013.
7. *Financial Times*, September 30, 2013.
8. The EU will provide the legal framework via the Capital Requirements Directive IV (CRD IV).
9. *Bloomberg News*, September 26, 2012.

10. Procyclicality capital buffers were first introduced by the Bank of Spain, well before Basel got interested in them. They are an improvement but not the Holy Grail.
11. D. N. Chorafas, *Breaking Up the Euro: The End of a Common Currency* (New York: Palgrave Macmillan,, 2013) and D. N. Chorafas, *Public Debt Dynamics in Europe and the US* (New York and London: Elsevier Insights, 2014).
12. More precisely, the study was done by a consulting firm, but EBA presented it.
13. The Geneva Association, *Progress Newsletter* No. 56, December 2012.
14. This followed the fall of the Second Empire.
15. This became the theme of the excellent novel *L'Argent* by Emile Zola. (A required reading.)
16. Jean-Maria Mayeur and Madeline Reberioux, *The Third Republic from Its Origins to the Great War 1871–1914* (Cambridge: Cambridge University Press, 1984).
17. Fiat money is government-sponsored money by way of regulations and laws, and as a government monopoly. From Hammurabi of Babylonia (circa 1700 BC) to Solon of Athens (in the sixth century BC) the sovereign established laws institutionalizing the money that it issued. This has been instrumental in promoting coinage and it has been carried all the way to paper money.
18. According to the 2009 *World Wealth Report* from Merrill Lynch and CapGemini (*The Economist*, July 4, 2009).
19. *The Economist*, May 19, 2012.
20. As quoted by Milton Friedman, Clemenceau said: "Monetary policy is far too important to be left to central bankers." See Milton Friedman, *Dollars and Deficits* (Englewood, NJ: Prentice-Hall, 1968).
21. CNBC, May 15, 2012.
22. *International Herald Tribune*, March 21, 2013.
23. Ibid.
24. *The Economist*, July 20, 2013.
25. The job of the auditor merges poorly with that of the risk controller because both the timing and the nature of their actions are different.
26. *The Economist*, May 16, 2009.
27. I would like to see a bank president driving to his office in a car dating back to 1992. I am told there is no such president. Yet bank CEOs and regulators find it normal to use models dating back to 1992, which present misleading data.

## 3 Banking Practices and the Evolution of Trading Rules

1. A barbarous but widely used expression.
2. Deutsche Bundesbank, Financial Stability Review 2012, *Financial Stability in 2012—An Overview*.
3. *The Economist*, May 16, 2009.
4. As well as high-frequency trading
5. *Financial Times*, October 1, 2012.
6. CNBC, October 2, 2012.

7. D. N. Chorafas, *Financial Boom and Gloom: The Credit and Banking Crisis of 2007–2009 and Beyond* (London: Palgrave Macmillan, 2009).
8. AFP, 20/12/2013 @ 16.22.
9. *Financial Times*, December 18, 2013.
10. In proprietary trading banks bet on their own accounts rather than those of their clients. Hence they expose the common citizen deposits to major risks.
11. *Bloomberg News*, December 25, 2013.
12. *Financial Times*, November 8, 2013.
13. Hugh Trevor-Roper, *The Rise of Christian Europe* (London: Thames and Hudson, 1965).
14. With other than depositors' money.
15. *Financial Times*, September 11, 2013.
16. *Financial Times*, November 8, 2013.
17. A job that, to a large measure, falls to the lot of the G20.
18. *Financial Times*, December 19, 2013. The charges relate to a large controversial transaction involving Anglo Irish and Irish Life & Permanent at the height of Ireland's financial crisis. It is alleged that between March and September 2008 the three top executives conspired to transfer €7.2 billion to Anglo Irish to make it appear financially stronger than it was.
19. *Bloomberg News*, December 17, 2013.
20. *International Herald Tribune*, March 29, 2000.

## 4 Euroland's Banking Union and Its Stress Tests

1. The large-value European payment system. D. N. Chorafas, *The Changing Role of Central Banks* (New York: Palgrave Macmillan, 2013).
2. CNN, December 4, 2012.
3. Stress tests are a relatively recent discipline in banking, but they have a long history in engineering. Osram has been testing lamps under higher voltage to estimate their lifecycle under normal conditions.
4. This solution has nothing to do with value at risk (VAR), which is an obsolete and limited model albeit still popular among retrograde banks and regulators. The first nearly 15 standard deviations event on record has been the sharp fall in the Dow Jones in October 1987. Many others followed which 5 standard deviations financial events have become nearly "normal."
5. UBS CIO WM Research, December 5, 2013.
6. As expected, Royal Bank of Scotland was the weakest performer, with a 6.3 percent ratio, followed by Barclays with 7.3 percent, Lloyds with 7.7 percent and HSBC with 8.5 percent.
7. Of that €98 billion in Greek sovereign exposure, 67 percent was held by Greek banks, 9 percent by German banks and more than that by French banks (section 5).
8. *Financial Times*, July 16–17, 2011.
9. *Le Canard Enchainé*, August 17, 2011.
10. Deutsche Bundesbank, *Financial Stability Review 2013*.

11. Deutsche Bundesbank, *Monthly Report*, November 2013.
12. There are nearly 55 million people living in the Italian republic, but there are only 30 million in the kingdom of Spain.
13. This process could involve nine committees and up to 140 votes cast. Fill bureaucracy.

## 5 Lehman Brothers and Bear Stearns

1. D. N. Chorafas, *Financial Boom and Gloom: The Credit and Banking Crisis of 2007–2009 and Beyond* (London: Palgrave Macmillan, 2009).
2. D. N. Chorafas, *Capitalism without Capital* (London: Palgrave Macmillan, 2009).
3. By comparison, Britain's current network mileage is 11,000 miles.
4. In the second half of the nineteenth century America, too, was shaken not by one but by a bunch of railroad busts.
5. Merrill Lynch, *The RIC Report*, April 8, 2008.
6. L. G. McDonald and P. Robinson, *A Colossal Failure of Common Sense* (New York: Crown Business, 2009).
7. D. N. Chorafas, *Alternative Investments and the Mismanagement of Risk* (London: Palgrave Macmillan, 2003).
8. On September 11, 2008, other financial stocks were also down sharply. Washington Mutual, the regional lender that went bankrupt a couple of weeks later, fell 19 percent to $1.88. AIG fell 11 percent to $15.53 and Merrill Lynch was down 17 percent.
9. *The Economist*, September 20, 2008.
10. *The Economist*, August 24, 2013.
11. *Financial Times*, September 15, 2008. With the crash of Lehman and AIG Fuld and Greenberg, AIG's long-term boss, allegedly lost $7 billion between them.
12. This is now touted but was not even a concept in mid-2008.
13. *The Economist*, September 20, 2008.
14. *The Economist*, June 23, 2007.
15. *Financial Times*, October 17, 2007.
16. Analysts had even predicted that Bear Stearns's first-quarter earnings would climb back to $1.35 per share, because of fewer write-downs at the start of 2008 (*Business Week*, March 24, 2008).
17. *The Economist*, March 22, 2008.

## 6 American International Group

1. Compare this to the less than 1 percent in year 2007.
2. *Bloomberg News*, October 11, 2008.
3. *Bloomberg News*, February 26, 2013.
4. Statistics by ECB *Financial Stability Review*, June 2009.

5. "After W., Le Deluge," *New York Times*, October 18, 2008, http://www.nytimes.com/2008/10/19/opinion/19dowd.html?ref=maureendowd&_r=0
6. Ibid.
7. Who had replaced AIG's legendary boss Maurice "Hank" Greenberg in a palace coup.
8. *New York Times*, October 19, 2008.
9. Since then, OTS has been absorbed into the Treasury's Office of the Comptroller of the Currency, but the idea of having a regulator focusing on small savings and loans (thrifts) was not bad. The problem was that some of those thrifts, like Washington Mutual, had become very big and then there was the loophole that AIG exploited to come under OTS's necessarily weak supervision.
10. The interest rate of the first bailout was set at 12 percent, a ridiculously high level for a badly wounded company.
11. *The Economist*, March 21, 2009.
12. Ibid.

## 7 Federal National Mortgage Association and Federal Loan Mortgage Association

1. Section 2 briefly describes their CV.
2. "Citigroup Agrees Freddie Mac Mortgage Claim Settlement," BBC News Business, http://www.bbc.co.uk/news/business-24237900, September 26, 2013.
3. A GSE originally set up to deal with student loans, known as Sallie Mae, gave up its government-sponsored status in 2004.
4. A third entity, the Government National Mortgage Association (GNMA, Ginnie Mae), guaranteed by FHA and VA, has somehow disappeared from the radar screen of securitized mortgages' secondary market. Yet, it was the first to start offering such products in 1975.
5. Which thought that Fannie was becoming too big.
6. *The Economist*, July 19, 2008.
7. In which investors sell shares they do not yet possess, which makes it easier for them to manipulate equity prices.
8. *The Economist*, May 27, 2006.
9. Ibid.
10. *The Economist*, September 3, 2011.
11. *Executive Intelligence Review* (*EIR*), March 14, 2003.
12. *The Times*, June 26, 2003.
13. *Executive Intelligence Review* (*EIR*), June 20, 2003.
14. *Financial Times*, August 13, 2013.
15. Merrill Lynch, May 12, 2008.
16. *Bloomberg News*, December 26, 2009.
17. The vice industry in Australia alone is growing at a rate of 8 percent a year and the country spent $11.3 billion on prostitution and strippers in 2007.

## 8 Citigroup

1. *Financial Times*, September 24, 2013.
2. Foreign banks and nonbanks operating in the US, typically wholesale market borrowers, account for roughly $2 trillion of banking assets.
3. In Euroland all monetary financial entities can have direct access to Eurosystem open market operations and standing facilities.
4. *Fortune*, February 17, 1986.
5. Who eventually took over from Walter Wriston.
6. *Fortune*, February 17, 1986.
7. In July 2013 it ranked twentieth in size in the Fortune 500 list.
8. Board members reportedly asked Rubin: "Would you be willing to take the post?" He declined.
9. *The Wall Street Journal Europe*, April 14–15, 2000.
10. Better known by his nickname "Chuck," Prince did not leave an enviable memory as the CEO who succeeded Weill. Instead, he was sometimes called bumbler-in-chief.
11. Justified by the large public debt.
12. Over the $25 billion Citibank had already received along with other big banks a short time earlier.
13. By contrast, the British government has been more generous in its rescues of badly wounded banks, taking coming equity, and putting good money to run after bad money.
14. The only commitment the US government got in Citigroup's case, for the lavish amount of money, is that for three years it will pay no dividends greater than 0.01 cents per share vs. the 0.26 cents it had been paying in spite its huge losses.
15. Who anyway resigned. Charles Prince, Citi's chairman and chief executive left Citigroup. Win Bischoff, the former head of Schroders, was catapulted into the LCBG's chairmanship in December 2007.
16. On top of the 23,000 already announced since the beginning of 2008.
17. Even Citigroup's own employees admitted that, in spite of the bank's promises to cross-sell a broad range of products to consumers, its various channels and product offerings were never properly integrated.
18. *Financial Times*, October 17, 2012.

## 9 British Banks at the Edge

1. At least the first recorded public bond is dated January 1150 when the municipality raised 400 lire by guaranteeing investors with the tax revenue from stallholders in the marketplace.
2. Ireland did not put limits, therefore fully guaranteeing all deposits.
3. And why not before all expenses?
4. Also that HBOS and Lloyds would have to downsize the terms of their merger to qualify for capital injections.

5. Alliance & Leicester, another troubled British bank, was taken over by Spain's Santander, which had previously purchased Abbey National.
6. Iain Martin, *Making It Happen : Fred Goodwin, RBS and the Men Who Blew Up the British Economy* (London: Simon & Schuster, 2013).
7. *Business Week*, March 7, 1988.
8. To deleverage its balance sheet RBS also sold its stake in the Bank of China, one of the mainland's big four lenders.
9. *Financial Times*, March 7, 2012.
10. *The Economist*, March 7, 2009.
11. These millions did not come out of RBS's profits, but from public funds related to the salvage.
12. HBOS's share price had plunged early in the week of September 15, 2008, prompting fears that its 22 million customers could start withdrawing deposits.
13. It was said that HBOS itself rebuffed an attempt by two former Scottish banking chief executives to stop its rescue merger with Lloyds.
14. *Financial Times*, September 22, 2008.
15. CNBC, November 24, 2009.
16. Northern Rock's equity had reached a high-water mark of £12.70. On September 26, 2007, it had fallen to £1.65.
17. In early February 2009, after debt reorganization, Bradford & Bingley shareholders were wiped out.
18. *Financial Times*, June 26, 2013.

## 10 Euroland's Banks

1. Correspondingly the American and British governments had committed to make available to their banks up to $2.5 trillion for guarantees of newly issued debt, purchases of troubled assets, and for capital injections, and roughly $480 billion for recapitalization and guarantees of unsecured securities.
2. *New York Times*, October 18–19, 2008.
3. D. N. Chorafas, *Public Debt Dynamics in Europe and the US* (New York and London: Elsevier Insights, 2014).
4. *Executive Intelligence Review* (*EIR*), January 16, 2009.
5. In 2001, Allianz, Europe's biggest insurer, paid €24 billion for Dresdner, but the business did not go well and the deal dragged down profits.
6. Each state of the German federation has a Landesbank, which acts as state treasury and fiduciary of the savings banks and performs other duties akin to a central bank short of money issuance.
7. Some 9,000 jobs were projected to be shed as the combined bank and operations will shrink at Dresdner Kleinwort, the investment-banking division that accounted for huge write-downs at Allianz.
8. *The Economist*, September 8, 2002.
9. Peanuts when compared to its subsequent huge losses.
10. *The Economist*, August 11, 2007.
11. Eventually, as a recipient of government help such as Commerzbank and Hypo Real Estate, Landesbank Baden-Württemberg, too, had been told to cut its balance sheet by half.

12. *The Economist*, January 12, 2008.
13. The former Banca di Roma, itself the result of a merger of Banco di Roma and the savings banks of Rome's province.
14. See also the discussion on mutualist institutions in chapter 7.
15. Monte dei Paschi is not quoted in the exchange. It was founded by the municipality in 1472 to give loans to the poor at better rates than those offered by the moneylenders. Nowadays, it is controlled by local "mutualist" foundations that fell under the control of leftist power brokers. They colonized the bank's board and devoted the bank's energy and money not to public service but to profits at any cost.
16. Of Banca Antonveneta. More on this later.
17. According to over 70 pages of documents outlining the deal obtained by *Bloomberg News*.
18. As boss of the new regulatory authority of the ECB.
19. In reality Van Rompuy is one of the three EU presidents. The other two are José Manuel Barroso, president of the EU Commission and one of Euroland's chiefs of state whose *tour* of duty lasts six months, and Martin Schulz
20. Appointed in 2012 to around the Siena bank.
21. Arranged by JPMorgan Chase.
22. *Le Canard Enchainé*, August 15, 2007.
23. BNL has been seen as a takeover target for three years. In 2005, Spain's Banco Bilbao Vizcaya Argentaria (BBVA), which owns 15 percent of BNL, tried to buy the rest, but was practically blocked by the Italian authorities. Unipol, an Italian insurer, then tried its hand as a national white knight, only to see its bid rejected by the central bank.
24. Banques Populaires and Caisses d'Epargne.
25. *Le Canard Enchainé*, September 10, 2008.
26. *Financial Times*, January 15, 2013.
27. *Le Canard Enchainé*, April 23, 2008.
28. Ibid.
29. Ibid.
30. The former Crédit Lyonnais. The person responsible is Georges Pauget, Crédit Agricole's CEO, under whose watch Calyon lost over €5 billion.
31. *Les Echos*, June 6–7, 2008.
32. The French savings banks' treasury and fiduciary.
33. "Je prends mes indemnités," which amounted to three years of full salary (*Le Canard Enchainé*, October 22, 2008).

## 11 The Challenges Japan Faced with Its Banking Industry

1. Who, during the week, held a different job.
2. Instead, the losses of Japanese insurance companies run in the billions of dollars. In October 2000, when valuation losses on invested premiums by the top five Japan insurance companies were revealed, in dollar billions these were: Nippon $3.6, Daiichi $2.2, Sumitomo $1.9, Meiji $1.3, and Asahi $1.2 (*Business Week,* October 23, 2009).

3. US regulators repeated that policy with the 2008–2009 banking crisis, force-feeding Bank of America with Merrill Lynch, while the acquisition of a falling Countrywide was Bank of America's own mistake.
4. Other lenders like smaller banks and insurance companies were forced to cancel another ¥1.7 trillion in *jusen* borrowing. Taxpayers, too, contributed ¥685 billion (about $6 billion).
5. Commercial banks.
6. Yoshiro Kuratani was educated in America (we studied together at UCLA under Karl Brunner) and had a vision different from that of his colleagues.
7. *Executive Intelligence Review* (*EIR*), March 8, 2002.
8. D. N. Chorafas, *Credit Derivatives and the Management of Risk* (New York: New York Institute of Finance,, 2000).
9. Which would not even become liquid *if* and *when* the bank becomes profitable, since all it gets through a DTA is a credit for taxes (though it might retain earnings, but this means paying a much lower dividend).

## 12 Japanese Banks That Bled in a River of Red Ink

1. No kin of Daiwa Securities.
2. Which was nearly twice the write-off by Mitsubishi Tokyo in the fiscal year following their merger (section 2).
3. *Financial Times*, January 24, 2014.
4. *Executive Intelligence Review* (*EIR*), April 17, 1998.
5. This was important because the 1998 Capital Accord allows 45 percent of the total amount of hidden reserves to be counted toward bank's minimum 8 percent capital adequacy ratios.
6. In 1991 derivative exposure was trivial compared to 1998 levels, let alone current levels, and this added a great deal to systemic risk making inevitable a recapitalization of the Japanese banking system by the government.
7. *Financial Times*, July 15, 1994.
8. Two days later, the lower house of parliament passed a new law allowing Japan's ailing life insurers to cut the rates of return they guaranteed to policyholders, and take freedom in breaking unprofitable contracts. This slashed future payouts to consumers, as shares of life insurers tended to become worthless.
9. It is interesting to notice that shortly after Asahi quit, Shin Nihon, the other auditor and Japan's largest accounting firm, got cold feet and refused to put its name to the accounts unless Resona cut its deferred tax assets by 40 percent.
10. *Financial Times*, June 14–15, 2003.
11. Ripplewood Holdings was the leading entity of the international consortium. Its animator was Chris Flowers, a Goldman Sachs alumni, who became the largest single owner of Shinsei.
12. Sogo, a sprawling Japanese merchandising company and department store, went bankrupt.
13. *The Economist*, August 24, 2013.

# Index


Abbey National, 189
ABN Amro, 174, 178
Abu Dhabi Investment Authority, 161, 162
AIG, 1, 31, 44, 80, 93, 109, 110, 117, 118, 121–4, 164
AIG Financial Products, 113, 115
Allianz, 112, 197, 198
Allied Irish Banks, 79, 190
Almunia, Joaquin, 212
Alstom, 119
Alt-As, 47, 148, 190
al-Waleed bin Talal, 158, 159, 161
AMEX, 59, 60
Anglo Irish Bank, 62, 65, 190, 191
Antonveneta, 177, 210, 212
AOL Time Warner, 160
Appleby, Paul, 191
Aristophanes, 173
Arthur Andersen, 140, 141
Asian crisis, 30
Asset Protection Scheme, 179
asset-backed securities (ABSs), 34
*asset-quality review*, 75
Attali, Jacques, 81
AXA, 101, 112

bad assets, 92
bad banks, 92, 93, 96
Bagehot, Walter, 103
bail-ins, 5, 6, 11, 17, 24, 92
bailouts, 5, 11, 17, 24, 103, 106, 110
Bain Capital, 96
Bair, Sheila, 27, 46
Baker, George F., 152, 164
Banca Nazionale del Lavoro, 177
Bank Austria, 177
bank consolidation, 53
Bank for International Settlements (BIS), 1
Bank of America, 6, 7, 31, 48, 54, 92, 190, 248
Bank of China, 105
Bank of England, 15, 32, 35, 111, 173, 188, 197
Bank of France, 34
Bank of Ireland, 79, 190
Bank of Italy, 75, 76, 207, 210
Bank of Japan, 219, 220, 227, 228, 230
Bank of New York Mellon, 31, 96
Bank of Scotland, 176, 177
Bank of Tokyo, 230
bank runs, 37
Bankia, 65, 79
banking union, 65, 68, 86, 211
Barclays, 54, 92, 100, 101, 105, 151, 175
Barofsky, Neil M., 126
Basel I, 23
Basel II, 23
Basel III, 15, 23, 24–6, 32–5, 39, 60, 86, 168, 188
Basel Committee on Banking Supervision, 15, 23, 25, 26, 29, 32, 33, 188
BAWAG, 20
Bayerische Landesbank, 202
Bear Stearns, 5, 53, 92, 94, 95, 101, 102–4, 106, 108, 135
Bensinger, Stephen, 117
Bernanke, Ben, 64, 220
Bernstein, Richard, 8
Black Monday, 29

Black Rock, 96
blackstone, 49
*Bloomberg News*, 8
BNP Paribas, 47, 179
Bohr, Niels, 252
Borg, Anders, 72
Bradford & Bingley, 176
Brendsel, Leland, 139
British Asset Protection Scheme, 187
British Treasury, 173
Brown, Gordon, 36, 173, 176

Caisse d'Epargne, 215, 216
Calyon, 214, 215
capital adequacy, 3, 24
capital market lenders, 45
Capitalia, 207
Carnevalle-Maffe, Alberto, 212
Carney, Mark, 111
Cayne, Jimmy, 103, 108
CDS protection, 119
central clearing house, 57, 58
central counterparties (CCP), 56, 57, 59, 60
central supervisory authority, 66
Chicago Mercantile Exchange (CME), 120
chief financial officer (CFO), 29
chief investment officer (CIO), 8, 29, 40, 41
China Construction Bank, 104, 105
Chrysler, 109
Citadel, 1, 58
Citibank, 154, 156, 157, 169
Citic, 101
Citic Pacific, 41
Citicorp, 157, 158, 159
Citigroup, 6, 13, 18, 47, 54, 93, 104, 109, 149, 160, 161, 163
Clark, Vaughn, 139
claw backs, 117
clearing participants, 58
clearing risks, 58
collateralized debt obligations (CDOs), 100, 115, 181, 198, 203, 215
commercial mortgage-backed securities (CMBSs), 48
Commerzbank, 110, 197, 198
Committee of European Banking Supervisors, 21
Committee on Payment and Settlement Systems (CPSS), 59
Commodity Futures Trading Commission (CFTC), 52, 60
conditional VAR, 42
Congressional Budget Office (CBO), 146
*Conservatorship*, 148
Consob, 211
Constâcio, Vitor, 85
contagion, 45, 80
Continental Illinois, 157
contingent convertibles (CoCos), 11
Corbat, Michael, 171
Corker, Bob, 128
Corrigan, Gerald, 159
Cosmo Credit Union, 218
Countrywide, 6, 53, 54, 149
creative accounting, 140, 229, 231
Crédit Agricole, 177, 178, 213–15
credit default swaps (CDSs), 94, 95, 106, 113, 116, 123, 147
Crédit Lyonnais, 119, 222
Crédit Mutuel, 54
credit rating agencies, 94
Credit Suisse, 11, 33, 228
cross-border banking, 19
cultural change, 3
Cuomo, Andrew, 117, 126

Dai-Ichi Kangyo Bank, 242
Daiwa Bank, 235, 236
*dark pools*, 46
Darling, Alastair, 72
de Bardi, 173
De Frias, Arturo, 101
debt obligations, 138
deferred tax assets (DATs), 232, 233, 248
deferred tax liabilities (DTLs), 232, 234
deleveraging, 5

Dennis, Bengt, 164
DEPFA, 200
deposit insurance, 12
deregulation, 35
*Detroitization*, 7
Deutsche Bank, 13, 54, 101, 142, 202, 203
Deutsche Bundesbank, 200, 234
Dexia, 19, 20
Di Taranto, Giuseppe, 211
Dimon, Jamie, 9, 40, 42
Dinallo, Eric, 123
Dodd-Frank Act, 18, 50, 129, 228
domestic debt bubble, 137
dot-com bubble, 30
Dow Jones Industrial Average, 29
Dowd, Maureen, 117
Draghi, Mario, 75, 207, 209, 210
Dresdner Bank, 13, 198, 199
Dresdner Kleinwort, 198
Drew, Ina, 40
Dunbar, Nicholas, 208

ECB Governing Council, 70
Enria, Andreas, 18
equity capital, 3
Euroland's debt crisis, 31
European Bank of Reconstruction and Development, 81
European Banking Authority, 18, 33, 71, 75, 78, 79, 83
European Central Bank (ECB), 14, 65, 72, 74, 75, 82, 83, 85, 193, 209, 228
European Commission, 65, 67
European Securities Markets Authority (ESMA), 60
European Stability Mechanism (ESM), 67, 84
European Union, 14, 47, 48
exchange-traded funds (EFTs), 39, 43
expected losses, 77

Falcon, Armando, 140
Fannie Mae, 1, 31, 49, 80, 88, 93, 109, 111, 115, 127–9, 131, 132, 135, 136, 142, 143–5, 148, 150
Farmers Home Administration, 132
Fazi, Antonio, 208
Federal Deposit Insurance Corporation (FDIC), 18, 27, 47, 51, 68, 89
Federal Financial Supervisory Authority (BaFin), 200
Federal Home Loan Bank Board, 135
Federal Home Loans Bank (FHLB), 149
Federal Housing Administration, 132
Federal Housing Finance Agency, 148
Federal Reserve, 2, 18, 51, 113, 129, 145, 150, 237
Federal Reserve of Chicago, 46
Federal Reserve of New York, 21, 43, 159, 167
fiduciary diversification, 93
financial deregulation, 219
financial guarantors, 4
Financial Markets Stabilization Fund, 200
Financial Reconstruction Committee, 224
Financial Services Agency, 242, 243
Financial Services Authority (FSA), 174
Financial Services Commission, 20
Financial Services Compensation Scheme, 189
Financial Stability Board, 44, 59, 112
Financial Stability Oversight Council, 38
Financial Supervisory Association, 224
fire sale, 121
Fisher, Richard W., 10, 11
Fitz-Patrick, Sean, 191
Flowers JC, 116
Ford Credit Division, 137
Fortis, 13, 177
Frank, Barney, 125
Freddie Mac, 1, 31, 49, 80, 88, 93, 109, 111, 115, 127–9, 131, 132, 135, 136, 140, 142, 144, 145, 148, 150

Friedman, Milton, 37
Fuji Bank, 239, 242
Fuld, Richard S. Jr, 93, 96

G-20, 5, 13, 17, 171
Gazit Globe, 20
Geithner, Tim, 93, 125, 167
General Motors, 22, 109, 110
Generali, 112
Giraud, Gaël, 19
Glass-Steagall Act, 36–8, 68, 155
Glenn, David, 139, 141
GMAC, 137, 150
golden parachutes, 12
Goldman Sachs, 21, 31, 42, 50, 93, 105, 106, 147, 151
Goodwin, Fred, 176, 180, 182, 183
government-sponsored enterprises (GSEs), 131, 138, 139, 145, 146
Grassley, Charles, 125
Greenberg, Maurice "Hank," 116
Greenspan, Alan, 123, 134
Griffin, Ken, 1, 58
GSE Credit Facility, 148
Gutfreund, John, 107

Hayami, Masaru, 230
HBOS, 13, 54, 174
hedge funds, 13, 43, 131
Helaba, 79
Hellman & Friedman, 96
Hester, Stephen, 180, 183
high frequency trading, 46
High Grade junk, 102
Hokkaido Bank, 239, 245
Holder, Eric, 10
Household Finance, 54
housing legislation, 132
HVB, 177, 178
hybrid capital, 234
Hyogo Bank, 218
Hypo Real Estate, 193, 200, 204
HypoBank, 13

IKB Deutsche Industriebank, 201–3
Iksil, Bruno, 38
illiquid assets, 34
IndyMac Bancorp, 54, 146
Industrial and Commercial Bank of China, 105
Industrial Bank of Japan, 242
Industrial Revitalization Corporation of Japan, 241
ING, 101, 195
interbank Lending, 193
interest rate risk, 28
International Monetary Fund (IMF), 13, 16, 21, 88
International Organization of Securities Commissions (IOSCO), 59
International Swaps and Derivatives Association (ISDA), 94
Iwamoto, Shigeru, 249

Jackson Hole, Wyoming, 102, 115
*Japan premium*, 229
JPMorgan Chase, 5, 8, 9, 18, 31, 38, 40, 42, 50, 105, 108, 109, 187
Julius Baer, 7
junk bonds, 144

Kayser Motors, 248
Kerviel, Jérôme, 214, 216
King, Mervyn, 35
Kizu Credit Union, 218
KKR, 96, 116
Korea Development Bank, 90, 91
KPNG, 207
Kreditanstalt für Wiederaufbau (KfW), 96, 201
Kuratani, Yoshiro, 224, 227

large and complex banking groups (LCBGs), 1, 3, 4, 6, 8, 9, 13, 15, 16, 22–4, 27, 32, 35, 36, 40, 88–90, 93, 97, 99, 108, 118, 125, 133, 159, 170, 193, 196, 217, 218, 224, 225, 230, 242, 249, 252
Leeson, Nick, 236
legacy assets, 184
legacy burdens, 72

legal risk, 63
Lehman Brothers, 1, 14, 17, 23, 31, 53, 55, 80, 88, 90, 94, 98, 109, 116, 119, 135, 167, 193, 228
lending exposures, 99
letters of credit, 4
leverage, 28
leverage ratio, 28, 29, 33
leveraging, 98
Levin, Carl, 41
Lew, Jack, 52
LIBOR benchmark, 129
Liddy, Edward, 126
liquidity coverage ratio, 26, 33
liquidity regulations, 24
liquidity risk, 32, living wills, 16
liquidity transformation, 43
living on debt, 138
Lloyds Banking Group, 14, 111, 124, 174, 175, 184, 185, 187, 199
lobbyists, 9
Long-Term Capital Management (LTCM), 30, 140
Long-Term Credit Bank of Japan,(LTCB), 63, 244, 250, 252
long-term refinancing operations, 82

macro stress test, 77, 78
Madoff, Bernard, 206
market capitalization, 1, 163
Market Risk Amendment, 23
Markets in Financial Instruments Directive, 46
Martinuzzi, Eliza, 208
Mathewson, George, 180
McDonald, Lawrence, 90
McFadden Act, 155
Medicis, 173
Meinl Bank, 19
Meinl European Land, 19
Meinl International Power, 20
Merkel, Angela, 197
Merrill Lynch, 6, 18, 53, 54
MetLife, 38, 112
Miki, Shigemitsu, 240
Milhaud, Charles, 216
Mitsubishi/Bank of Tokyo Financial Group, 230, 240, 242, 246, 247
Mitsubishi Trust, 224, 237, 239
Mizuho Holding, 230, 233, 241, 242
model risk, 27
money market funds, 44
Monte dei Paschi di Siena, 75, 76, 178, 209, 211, 212
Monti, Mario, 212
Moore, George, 154
moral bankruptcy, 164
moral hazard, 185
moral risk, 10
Morgan Stanley, 31, 50, 151
mortgage lenders, 9
mortgage lending to minorities, 133
mortgage real estate investment trusts (REITs), 49
mortgage-backed securities (MBSs), 21, 44, 134, 135, 142
Mussari, Giuseppe, 209, 212

naked shorting, 135
NASDAQ, 30, 59
national banking supervisors, 75
National Currency Act, 152
National Westminster Bank, 177
Natwest Markets, 180, 181
negative feedback loops, 62
net capital outflows, 71
*net stable funding ratio*, 36
Netherlands Bureau for Economic Policy, 195
New York Stock Exchange (NYSE), 46
Nippon Credit Bank, 63, 244, 250
Nippon Trust and Banking, 237
Nomura, 95, 100
nonbank banks, 4, 38, 43, 44
Northern Rock, 37, 65, 173, 174
Noyer, Christian, 188
NYSE Euronext, 59

Office of Fair Trading, 185
Office of Federal Housing Enterprise Oversight (OFHEO), 133, 136, 140, 141

Office of the Comptroller of the Currency (OCC), 41, 52, 132
Office of the Director of Corporate Enforcement (ODCE), 191
Office of Thrift Supervision, 116, 118
Ohga, Norio, 245
O'Neill, Mike, 171
Osborne, George, 111
Ospel, Marcel, 2
OTC derivatives, 56
over the counter (OTC), 56, 99

Pandit, Vikram, 166, 167, 171
Parseghian, Gregory, 140
Parsons, Richard, 169
*patterns of risk*, 90
Pauget, Georges, 215
Pauli, Wolfgang, 252
Paulson, Hank, 93, 106, 134, 145, 147, 167
Ping An, 112
Preil, Sebastian, 117
PricewaterhouseCoopers, 140
primary dealers, 155
Prince, Charles, 161, 162, 166
*Private Sector Involvement* (PSI), 196
procyclical capital buffers, 27
procyclicality, 27
Prot, Baudouin, 213
Profumo, Alessandro, 206, 212
proprietary trading, 15
Prudential Insurance, 112
public money, 6
Pyne, Percy, 152

quantitative easing (QE), 2

Reagan, Ronald, 127
real estate exposures, 99
Reed, John S, 159
regulatory authorities, 17
repurchase agreement, 57
Resolution and Collection Corporation (RCC), 240
resolution and recovery directive, 6, 11
Resona, 233, 242, 249
return on assets, 160
return on equity, 163
ring-fencing, 17
Ripplewood Holdings, 251, 252
risk control, 2, 9
*risk identification*, 77
risk management mythology, 17
risk profiles, 28
risk weights, 28
risk-weighted assets (RWA), 26, 28, 48
Rockefeller, William, 153, 154
Rogers, Jason, 249
Rose, Charlie, 125
Royal Bank of Scotland (RBS), 13, 19, 101, 111, 174, 176, 182, 190, 196, 199, 209
Rubin, Robert, 161, 166

Salomon Brothers, 107
Santander, 47, 178
Sanwa Bank, 246
Sarbanes-Oxley Act, 83
Sarkozy, Nicolas, 213, 216
Sato, Yasuhiro, 242
savings & loans (S&L), 118
Savings and Loans crisis, 4
Schäuble, Wolfgang, 67
Schwartz, Alan, 105
Securities and Exchange Commission (SEC), 51, 105, 118, 137, 139, 141
securitization, 26, 46, 47
securitized products, 45
securitized subprimes, 4
security risk, 106
Senate Banking Committee, 128
senior unsecured debt, 6
shadow banking, 43, 45, 60
shareholder and creditor losses, 6
Shinsei Bank, 250–2
single supervisory mechanism (SSM), 72–4
SMEs, 10
Société Générale, 213, 216
Solveig, Michael, 214
Sony, 245

sovereign debt, 78
sovereign debt defaults, 166
sovereign risks, 81
special purpose vehicles (SPVs), 43
Standard & Poor's, 41, 128, 148
Standard Chartered, 100
State Street Bank, 31
*State Supermarket*, 14
Steinbrück, Peer, 195
Stillman, James, 153
stress testing, 42, 76
stress tests, 42
structured investments, 4
subordinated debt, 6
subprimes, 25, 161
Sumitomo Bank, 221
Sumitomo/Mitsui Bank, 230, 233
Sumitomo Trust, 224
Swap Execution Facilities, 58
swaps exposures, 97
syndicated loans, 9
systemic risk, 56, 62, 100

Takenada, Heizo, 233, 241
Target 2 imbalances, 71, 72, 82
TARP, 119, 122, 166
Taylor, Moses, 152
Thai Petroleum Authority, 226
Threadgold, David, 242
Tier-1 capital, 25, 29, 190, 233
Tier-2 capital, 25
Tokai Bank, 224, 246
Tolstoy, Leo, 192
too big to fail, 10, 52, 76
too big to jail, 62
toxic assets, 125
toxic securities, 47
toxic waste, 108, 169
Trading Surveillance Office, 214
Travelers, 160, 166
Trichet, Jean-Claude, 208
trust preferred securities, 53
Tsukamoto, Takashi, 242

UFI Holding, 230, under-rating risks, 9
unexpected losses, 77
Unicredit, 177, 194, 206, 207
Union Générale, 37
UBS, 13, 18, 42, 101, 151, 202, 228
US Prudential Financial, 112
US Treasury, 39

*value at risk* (VAR), 42
Van Rompuy, Herman, 73, 211
Veterans Administration, 132
Vigni, Antonio, 209
Visco, Ignazio, 208
Volcker, Paul, 50
Volcker rule, 49–51, 53, 228
Volksbanken, 79

Wachovia, 7, 20, 54
Warner, Mark, 128
Washington Mutual, 53, 109, 118, 149
Weill, Sanford, 160, 161
Wells Fargo, 7, 20
Westdeutsche Landesbank, 204, 205
Willys Overland, 248
Wriston, Walter B., 154–6

Yamaichi Securities, 63, 245
Yanagisawa, Hakuo, 229
Yashiro, Masamoto, 251