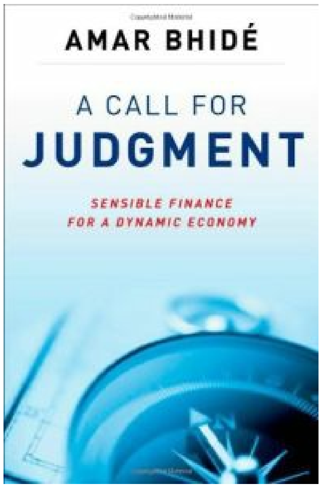

Book A Call for Judgment

Sensible Finance for a Dynamic Economy

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Recommendation

Decentralized decision making is essential to capitalism. Entrepreneurial inspiration and innovation can advance society faster than the slow march of a centralized, government-planned economy. But like government bureaucracies that become unmanageably large, oversized banks also can impede progress. Simply allowing market forces to determine the size and scope of the big banks is debatable public policy, but bank mergers have led to centralization and to the mechanization of lending, thus adding systemic risk to the US banking system. This far-reaching book includes a rich history of this industry's development and a detailed account of its destabilizing role in the 2008 financial panic. Amar Bhidé – a business professor and a trader –describes more than he prescribes, and his prescription is as controversial as it is compact: Limit severely what banks can do. *BooksInShort* recommends the book to readers seeking a deeper understanding of how financial institutions drive, and sometimes derail, the entire economy.

Take-Aways

- Banks increasingly employ centralized and mechanized loan underwriting, thus adding systemic risk to the US banking system.
- The banking industry's consolidation diversified its revenue sources but also made banks more anonymous to their customers – and customers more anonymous to their banks.
- This is a negative force because, in making decisions about granting credit, case-by-case judgment is more effective than rote calculation.
- The immeasurable uncertainty of a one-time event and the calculated, calculable risk of a systemic event are not the same.
- No one can mathematically measure the probability of an extremely unlikely outcome.
- By the 1950s, a century of regulatory reforms had stabilized the US banking industry.
- Deregulation – notably the 1999 repeal of the federal Glass-Steagall Act – eliminated the wall between commercial and investment banking. It's time to rebuild that wall.
- Laws should limit commercial bank activities mainly to taking deposits and lending.
- Reducing banks' operational scope would make them easier to examine and insure.
- Society would benefit if banks were smaller and more keenly focused on loan applicants.

Summary

The Need for Banking Reform

In the global financial panic of 2008, many banks stopped doing business with each other due to widespread doubt about their heavy investments in mortgage-backed securities. Banks and other worldwide financial intermediaries bought piles of US mortgage-backed securities until housing's hyperactive growth began to dwindle in 2006-07. These securities started shrinking in value as defaults degraded the underlying pools of loans, many of them high-risk and subprime.

> "Finance has been on the wrong trajectory for more than half a century. Its defects derive from academic theories and regulatory structures whose origins date back to the 1930s."

The mortgage meltdown provided little evidence that capitalism is fundamentally flawed, or in need of broad reform or replacement. Rather, the 2008 panic forcefully demonstrated a narrower need for regulatory reforms to make banking and investment more supportive of companies in the real, or nonfinancial, part of the economy. The most pressing regulatory need is to limit the scope of diverse businesses that banks can conduct.

> "The sorry, dramatic tale of the housing bubble exemplifies the multifaceted pathologies of modern finance and their toll on the real economy."

Bank mergers spread as the industry tried to achieve efficiencies of scale and cost like other consolidated industries. Banks also enlarged their scope to include more wealth management and securities trading work. This consolidation centralized the extension of credit, reduced loan underwriting to a mostly mathematical exercise and eroded the use of nonquantitative lending criteria. The biggest US banks commonly make rote-lending decisions based on credit scores and other mathematical criteria, relying less on nonquantitative measurements of creditworthiness.

Consolidation and Complexity

Friedrich Hayek, the late Austrian economist and defender of capitalism, extolled the freedom of individuals to choose where to work, what to buy and how to invest. In the 1930s and 1940s, when many critics of capitalism openly questioned its long-term viability, Hayek derided central economic planning. He believed macroeconomic conditions are more potent and remain stronger when microeconomic decision making is diffuse – left to individuals, not a planning committee.

> "It took nearly a century and a half after the first bank had opened in the United States to develop a regulatory structure to stabilize banks."

Hayek's preferred decentralized economic structure, however, is at odds with the centralized management of Bank of America, Wells Fargo and other major US banks. They have consolidated through mergers and acquisitions, and have diversified their revenue sources. But for many customers, big banks also have become more anonymous. Traditional face-to-face lending, based on both subjective judgment and objective assessment of creditworthiness, is almost an anachronism. In a century, the biggest US banks evolved from one-office operations to international franchises. As banks became more far-flung, loan applicants' fate increasingly depended on risk calculations by faceless bankers in faraway locations.

> "Investor protection rules, not deep-rooted traditions or values, have fostered the unusually fragmented and anonymous stockholding that we find in America today."

Hayek's focus on individual choice and responsibility is far removed from the survival instincts of massive financial conglomerates that – as the crisis showed – can qualify for government rescue if deemed "too big to fail." The bailout suggests that not only are some banks too big to fail but that they also are too complex to manage. Simpler banks might be safer. Banks can diversify risk by expanding into new businesses, of course, but the rise of financial conglomerates has not contributed to society's economic or financial stability. History is replete with financial calamities, and more seem likely. The International Monetary Fund lists more than 300 major crises since 1980 that centered on problems in banking, currency exchange or sovereign debt.

Elusive Economies of Scale

Large manufacturing companies gain from centralized control, quantitative decision making and standardized production. As they grow, they can gain economies of scale by, for example, cutting unit production costs or negotiating lower raw material prices. But in banking, each borrower has distinct needs and circumstances. No two loans are the same. So expanding the size of a bank makes it more complicated but not necessarily more efficient. Bigger is better in some industries, but not banking. The complexities of commercial finance and other types of lending "tightly restrict the scale and scope of healthy financial organizations." Managing a single business generally is less complex than managing a portfolio of loans to many different businesses. Indeed, an eclectic, expanding loan portfolio quickly can become financially lethal for a poorly run bank.

> "Banks turned precisely to the activity that sponsors of the Federal Reserve Act had wanted to discourage – financing securities."

Life insurance companies have outperformed banks in achieving economies of scale. Life insurers are better suited for large-scale operations than any other type of financial service. Pricing life insurance policies is a quantitative process based on actuarial analysis. In estimating their risks, insurers apply life expectancy data to large populations. The mass-market approach to selling policies is less labor-intensive than the case-by-case methods of commercial bankers who should evaluate and judge loan applicants one at a time.

Reducing Threats to Numbers

Managing or reducing risk in the way equations derive solutions is difficult and hazardous, especially if questionable assumptions underlie the mathematical estimates of potential loss. Bankers often see lending-related truths in numbers that words cannot convey. But assuming that bankers can measure the probability of all possible losses can produce a false sense of security and increase the likelihood of unpleasant financial surprises. In 1921, Chicago-school economist Frank Knight published *Risk, Uncertainty and Profit,* a book that defied the notion that all risk is measurable. Knight doubted historic data's predictive power. (That year, John Maynard Keynes came to similar conclusions in *A Treatise on Probability*.) While some financial threats are mathematically measurable, Knight argued that one remains immeasurable: the chance of a highly unlikely – or "one-off" – outcome. He said no basis exists for calculating the slim chances of rare events. Estimating the probability of an asteroid falling from the sky and landing in a lake, for example, would produce only a "wild or whimsical guess." Knight labeled immeasurable, one-off threats as "uncertainty" and called measurable probabilities "risks." He said uncertainty about odd outcomes is quite different from risks assessors can reduce to math-based probabilities. But many financial institutions ignore these distinctions, choosing to handle risk and uncertainty as if both were measurable threats.

> "The losses from making bad loans are...usually much greater than the opportunity costs of not making good loans."

In theory, banks can shrink the potential of portfolio losses by holding loans and other assets that are vulnerable to a wide variety of threats, not just a few. The theory revolves around hedging: With well-diversified risk, some assets may depreciate, but not all at the same time. This widely adopted portfolio management tactic stems from influential work by Harry Markowitz. He was a University of Chicago grad student when he wrote a 1952 *Journal of Finance* article explaining how investors can construct portfolios to get "the highest returns per unit of risk."

> "Financing became concerned about securities and derivatives markets, and the decisions made by the participants in these markets, rather than the choices faced by, for instance, lending officers in banks."

But Markowitz and many other financial and economic theorists since the 1950s have embraced a homogeneous view of threats that does not distinguish measurable risks from the uncertainty of unique happenstance. Mathematical convenience is one culprit. Immeasurable uncertainty doesn't fit into neat equations of market "equilibrium," that magical point where the demand for anything will equal its supply. Such equations lack a variable value for one-off outcomes, that menacing point where the market may fail to function, as in the 2008 panic, when bank-to-bank overnight lending and the short-term commercial paper market both suddenly froze temporarily.

Headed for Trouble

Deregulation in the 1990s allowed US banks and their holding companies to cross state lines to acquire other banks and to expand into securities, insurance and other financial services. Banks hailed deregulation as an opportunity to increase their geographic and commercial diversification, but the results have been mixed. Banks got bigger, not safer. The failures and forced mergers of major banks and investment houses during the 2008 crisis provide scant evidence that deregulation strengthened the banking system.

> "We need to separate utility banking from casino banking."

More than a century of US reforms preceded modern banking deregulation, which diluted the older controls. In the early 1800s, states began to require financial condition reports from banks. For most of the 19th century, banks issued currencies, backed by specie, usually gold or silver. The US adopted a national currency in the early 1860s and formed a central bank, the Federal Reserve, in 1913. Thousands of Depression-era bank failures led to the Banking Act (the Glass-Steagall Act) of 1933, which split commercial and investment banking and also established the Federal Deposit Insurance Corporation to rebuild confidence in checking and savings accounts.

> "Bank lending and venture capital are bookends on the risk-return shelf."

By the 1950s, banking had entered a new era of stability. In 1955, the decade's calmest year in financial terms, only five banks failed. Since that time, the biggest US banks have morphed into modern-day financial "department stores" with massive assets, multinational operations and famous brands. As their size and scope made them increasingly remote from average customers, megabanks strayed far from their decentralized roots. A surge in loan securitization put further distance between borrowers and the end owners of their debts. In 1999, the US repealed the Glass-Steagall Act, which had kept commercial banks out of securities underwriting. The repeal enabled an explosion in mortgage-backed securities and related derivatives, with banks acting as both loan originators and securities investors.

> "Diversification is a kind of free lunch at which you can combine a group of risky securities with high expected returns into a relatively low-risk portfolio."

During housing's rapid, pre-2007 expansion, credit agencies routinely granted the highest possible ratings to securities backed by mortgage loan pools – before those securities plunged in value. Among other analytical flaws, the big three credit rating agencies, Moody's, Standard & Poor's and Fitch, applied oversimplified views of risk, failing to account for a one-off outcome that seemed implausible during housing's boom: a national epidemic of mortgage defaults and foreclosures.

What to Do Now

Banks should do less. That would make them easier to operate and examine. Any effective effort to improve the stability of the banking system must reinstate Glass-Steagall to rebuild the old "wall between investment and commercial banking," and must decentralize bank supervision, putting extra examiners in the field and improving regulatory compliance with onsite observation.

> "The financial system has given up, albeit unwittingly, on the decentralization of judgment and responsibility."

Simplifying banks, thereby giving examiners less to audit, is essential. Regulators and political leaders should restrict commercial banks to taking FDIC-insured deposits, making loans to individuals and nonfinancial businesses, and hedging against losses in a limited way. This would allow nondepository intermediaries to offer other financial services. Hedge funds, investment banks and other nonbank financial businesses could "innovate and speculate to the utmost." Of course, financial panics, economic recessions, and speculative manias will persist, but separating commercial banking and investment banking would make these swings less severe. Simplifying bank operations would make bank failures less common and deposits less costly to insure.

> "I propose we reinstate old-fashioned banking, where bankers know their borrowers."

Major changes in financial regulation tend to happen slowly, so a return to limited-menu banking could take years. After a financial panic in 1907, Congress debated for six years before creating the Federal Reserve. After the 1929 crash, lawmakers took four years to establish the Securities and Exchange Commission. After the federal government tried and abandoned wage-and-price controls in the early 1970s, Paul Volcker became chairman of the Federal Reserve in 1979 and lowered inflation by tightening monetary policy. But while the simplification of deposit-taking banks is overdue, broader reforms appear unnecessary. For example, neither increased regulation of hedge funds nor bans on issuing credit default swaps would enhance banks' key public service role: acting as cash depositories and, collectively, as the national payment system.

> "Like criminal trials and faculty hiring decisions, the traditional lending process implicitly took into account unquantifiable uncertainties and the uniqueness of individual circumstances."

With fewer ways to get into financial trouble, banks would have fewer opportunities to misuse FDIC-insured deposits, though they could still take calculated risks within a confined scope of operations. This proposal envisions a return to "old-fashioned" banking, a more decentralized approach based on enduring relationships between lenders and borrowers. But by limiting the range of bank services, government also can get better control of "the pathologies of modern finance that have almost wrecked capitalism."

About the Author

Amar Bhidé has served as a professor of business at Columbia University, a consultant at McKinsey & Company and a proprietary trader at investment firm E.F. Hutton.