Burn ’em Banks

I used to think that banks were a place which kept my money safe. And that they made money lending money out to people who wanted to borrow.

My economics teacher told me all about fractional reserve banking and when I asked her what would happen if everyone wanted their money back at the same time, she said it was a highly improbable scenario. Times have changed.

Somewhere along the way banks decided that if they were going to take risks they weren’t going to be paltry risks. In for a penny in for a few trillion dollars. And why not? The risks after all were not borne by the bankers. They were borne by shareholders.

Take trading for example. Its a great gig. The trader works for the bank for which they get a salary. If they make tons of money, they get a cut of it. If they lose lots of money, they are at worst, fired. Basically these gamblers are given a deal where if they succeed they are paid and if they fail they stop getting paid and can go home. Or to the next casino. If they make an obscene, unreasonable, not even vaguely humorous amount of money, its all kept very quiet, at least until they decide to launch their own hedge fund, when the track record gets trotted out. If they lose a bewildering, can’t be buried in a footnote, solvency threatening amount of money, they are given the perp walk like Nicholas, Jerome and Kweke. And then its all their fault. And all this time these compulsive gamblers are betting shareholders’ money. God forbid they should actually risk some of their own hard won money. So who put them in charge? Its either by design or by accident.

Bank capital rules were developed in part to deal with excessive risk taking. No problem. Banks simply got into agency businesses. For example where once the risk of a loan such as a mortgage stayed with the bank, these risks were later sold on to structured credit vehicles for ultimate distribution to yield hungry, ratings addled, credit drunk investors like pensions and endowments, and not uncommonly to other banks. The whole language of ‘origination’, ‘underwriting’, ‘manufacturing’ and ‘distribution’ draws parallels with the (also) illicit trade in certain Asian and Latin cash crops. At the end of each of these food chains, is always an addict. And agency businesses are always great businesses. There is little capital at risk and the fees are high. As in the Latin cash crop example, the danger lies when one starts to sample ones own (or a competitor's) merchandise. Sometimes, the only way to sell these complex credit products was to have a taste of the product yourself in front of the buyer. You'd think it was smart of the buyer, but you cannot always protect yourself against a reckless dealer (of both the financial or agricultural kind.)

The regulators have woken up (if not wised up.) But what they propose to do is analagous to turning the Medellin Cartel into GSK. One is not sure which is more insidious. After the wheels came off in 2008 and the banks, the great conduits of credit, the brokers between savings and investment, teetered on the brink, public opinion has forced the politicians to scrutinize the banks more closely. Unfortunately, in order to save the patient, governments had to spend a sovereign solvency threatening amount on the equivalent of pharmaceutical morphine. The pain is gone, but the malady lingers on. And seems to have infected sovereign balance sheets as well.

Today, chaos and confusion are the rule. Banks are asked to raise more capital and to apply tighter capital rules to their risky activities. On the other hand banks are encouraged to lend to help resuscitate foundering economies. This is not something they are naturally predisposed to do. Banks prefer to lend to borrowers willing and able to repay. They should know this given how much they borrowed from their now shaky governments. Deadbeat borrowers can sink a strong lender.

I'd like to say that I have ideas for fixing the sinking ship. But I don't. Lifeboats!

Salvation may lie in corners of the Shadow Banking System, not to be confused with the shadowy banking system, that's the one we think we know. While a large part of the shadow banking system consisted of the refuse chutes, read 'distribution', of the banking system, much of it is useful. Guns are useful self defence equipment until placed in the hands of 14 year olds with a death wish and no respect for the law.

With Basel 3 throttling the banking system and as central banks stuff them from the other end with endless useless credit, the banks are little more than highly regulated utilities with litte upside and lots of downside.

Private equity, venture capital and mezzanine financing funds, part of the shadow banking system, provide the conduit between savings and investment without the liquidity mismatches inherent in fractional reserve banking. Flying under the radar of Basel 3, they allocate capital more efficiently with greater alignment of interest. Investors funding hedge funds or private equity where the managers do not risk a reasonable amount of their own capital deserve to be permanently separated from their capital. Managers who risk all of their own capital in their funds are either lying or psychopathic risk seeking maniacs and should be avoided. Where the fractional reserve system may be dysfunctional, private finance may fill the void.

Structured credit, that shadowy world of CDOs and MBS, is really an ingenious array of securitization and tranching technology. This technology has been demonized for facilitating excessive credit. It should not be demonized generally. Securitization can provide liquidity management solutions. Tranching technology can provide risk management and allocation solutions. But how do we keep these potentially mass destructive technologies a
way from the gleeful cowboy traders.

While structured credit derivatives have been blamed for the 2008 Grand Financial Crisis, the fact is that the problems mounted only when the demand for buying debt outstripped the demand for borrowing money. When that happens, grown men and women with single digit mental ages go in search of borrowers and collateral. In the old days credit was created when someone wanted to buy something or invest in something, needed the money, went to a bank hat in hand and had to prove themselves worthy of a loan. Today, yes, even today, a trip to the mall involves running the gauntlet of pimply youths who couldn’t legally buy their own alcohol trying to sell you financial products that their bosses would not understand, to make a buck for their banks, a buck which their shareholders would never see.

Retail financial products need to be regulated. But they need to be regulated sensibly. A banking system frightened into submission will over-regulate and miss the real risks. Ask any bank which has ever sold a toxic structured product to an unsuspecting investor. Financial education is a basic necessity. It needs to be taught in schools before the effects of drugs, alcohol and a sense of entitlement set in. Given its glamorous propensity for spectacular destruction, finance might even supplant knife fighting and agri-chemical skills in secondary schools. With a financially competent public, rational regulation can be a reality. Most people know that cholesterol is bad for you but how about short volatility financial instruments, a financial carcinogen?

A financially educated public should be protected from misrepresentation and fraud, but they should not be protected from themselves. Fully cognizant of the risks, psychopathic risk takers must be allowed to go for glory or destroy themselves in equal measure. Additionally, no financial intermediary or advisor can reasonably be expected to prevent suicide.

Back to structured credit. Take the European sovereign debt situation for example. Nothing bolsters a bailout war chest better than a ton of leverage. Into the valley of debt one must ride to the rescue with no reservation. Behind this doomed cavalry of first loss capital can follow senior tranches of debt with lower cost to hapless borrowers. With open ended liabilities, solvency can and does hinge on borrowing cost.

Cash flow waterfalls can save a country like Greece. Actually, maybe not. They need to get off the Euro first. But let's assume that. In a post restructuring financing, providing first claim to a portion of tax receipts, subordinated debt can be raised to facilitate raising further senior financing at lower cost.

Asset backed securitizations and tranching technology can be employed in emerging markets to finance their economic growth. Lessons need to be learnt from the US experience of course. The LGFVs in China look suspiciously similar to the SIVs and SIV lites whose demise preceded the financial crisis of 2008. Principal agent issues need to be addressed to prevent 'made to fail' structures perpetrated by some hedge funds, gambits without which it seems, some hedge funds cannot survive.

Finally, there is no systemic risk solution better than risk of total and final financial failure. Drivers are more reckless with airbags and seatbelts. That is not to say that there won't be the moron who will corner at over 25 mph in an SUV. These must be stopped. Where a manager's failure results in systemic damage or losses beyond the limited liability of their firms, direct and personal recourse should be available. That'll teach 'em.

Oh and ratings agencies. That's like England's tourism board paying an American weather forecaster for a sunny forecast for last week. Hedge funds have been known to hover around ratings news seeking lemmings to pick off. Their creed is a noble one, 'a fool and his money must be separated, by me.'

Its time to end this rant. But anyone who regards this as advice is smoking a different brand… I’ve always considered the advice of others, I’ve never taken any of it blindly.