

Ifo Viewpoint 100

What Can be Learned from the Banking Crisis

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No. 100**What Can be Learned from the Banking Crisis***

Now that the countries of the west have agreed to a three-trillion dollar bailout programme to rescue their banking systems, it is time to look forward and to draw lessons from the crisis. To do this we must understand the causes of the crisis. The claims that the model of American capitalism has self-destructed are just as misguided as putting the blame on the greed of investment bankers and other groups in society. They only touch the surface of the problem.

The core of the crisis lies in the legal provisions of limited liability: creditors of corporations have no claims against the personal assets of the owners (shareholders) of these corporations. These liability constraints lead to a systematic disregard of disaster risks – occurrences with only a slight probability bring about gigantic losses. Investors that opt for high-risk projects with high potential gains and losses instead of safe projects with similar average profits can expect to gain, since they only have to bear a portion of the possible losses. If things go well, investors reap the full profit. If things go badly, at worst their losses would be limited to the stock of equity invested, because claims against private assets have been ruled out. This asymmetric situation encourages bold behaviour and risk-taking.

The conclusion that the limited-liability constraint should be eliminated would be too rash, however, because risk-taking also has its merits. Limited liability was introduced in the nineteenth century in the United States and Europe in order to avoid uncontrollable burdens being placed on equity holders and to enable entrepreneurs to make enterprising economic decisions that they otherwise would not have had the courage to make. It brought about the productive forces that have created the wealth of today's generations.

In times of great economic insecurity, however, limiting liability can become a problem because it induces entrepreneurs to become gamblers. As always it is a matter of weighing up the advantages and disadvantages and finding the proper middle ground. The problem of gambling is particularly serious when corporations are allowed to determine the extent of their liability themselves by choosing the ratio of equity to business volume as they see fit. Then they tend to operate with too little equity and distribute to their shareholders too large a fraction of their

profits as dividends. The five large US investment banks, of which three have already fallen victim to the crisis, unscrupulously pursued this strategy, their motto being that you can't lose what you don't have. The risks created incentives to minimize the stock of equity kept inside the firms, and the small amount of equity capital in turn created incentives to pursue overly risky operations. The interplay of these incentives is the actual cause of the crisis – and this is where reform must begin.

The privilege of limited liability is not a creation of the market; it was granted by the legislator, and because this is the case, the legislator himself must define his real intention. He cannot allow the beneficiaries themselves to make this definition. If they can, they will define the limitation in such a way that they assume almost no liability, as we have seen. US investment banks, which were not subject to American bank supervision, practised their business with equity-asset ratios in the region of four percent, which is much lower than the rate at which private commercial banks operate. In addition, they carried out very complex credit operations outside of their balance sheets, placing them thus away from investor control.

Some may point out in defence that gambling is prevented by the rating agencies. They argue that rating agencies give poor ratings when risks are excessive, forcing the banks to pay higher interest for the money they themselves have borrowed. In this way, so the argument, the market corrects itself and creates the proper amount of caution. The miserable failure of the rating agencies during the present crisis shows, however, how illusory this reasoning is. The agencies did not give sufficient warning, and their AAA ratings were only withdrawn when there was no other alternative. Since they live on the fees they collect from the financial institutions they rated and were dependent on their good-will, they could not afford to tell the truth. The nearly bankrupt major customers of the rating agencies in America were glamorised while comparably robust but smaller customers in Europe were downgraded. This is also how the credit packages with claims against American homeowners, which were already in risky territory, were offered to the world far above value.

The best proof that the rating agencies and other information channels do not function and are not able to reliably inform purchasers of bank bonds and credit packages about the true circumstances lies in the fact that on the capital market equity capital is always more expensive than debt capital. If the purchasers of bank bonds had been correctly informed about the true repayment probability, they would have demanded adequate risk premiums on interest or sufficient reductions in the prices

of these bonds, which would have made these liabilities just as expensive for the banks as equity. Finance theory designates this finding as the Modigliani-Miller theorem, after its authors. But this theorem fails to match reality. Everyone uses the leverage effects of debt capital up to the limit that the rating agencies establish in order to achieve higher yields from equity capital. Whoever does not do this and instead raises his equity-asset ratio to increase repayment probability is not rewarded for his virtue by the capital market.

Bank bonds and securitised risks are entwined in a cascade of interlinked legal claims at whose end there is somewhere a real investment project. These are products that even specialists cannot properly appraise. The purchasers are almost never able to assess the true repayment probabilities correctly. Only the sellers that assemble the securitised packages have some idea of what they are selling. In the language of economists, these bank products are lemon goods, that is goods whose quality can only be partially assessed by the customers at the time of purchase and for this reason are usually offered at inferior quality. The sellers exploit the customers' lack of information by reducing their costs at the expense of quality, knowing that the customers are not able to punish them by refusing to purchase or by demanding price discounts. Quality declines below the quality that would prevail in a market of informed customers. In order to prevent lemon markets, most countries have, for example, food regulators who set the lower limits for quality in food in the form of upper limits for unhealthy ingredients. In the case of pharmaceuticals, quality is safeguarded by the licensing procedures. The loans given to homeowners in the United States – and that ended up as mortgaged-backed securities and collateralized debt obligations – are lemon products. In America higher rates of indebtedness are more common than in Germany. But the banks do not have the same claims to the private assets or income of homeowners than in Germany. If a low-income US homeowner chooses, he can hand over his house keys to the bank and has no repayment obligation. Conscious of this limited liability, US homeowners were much too cavalier in taking on real-estate which they could only afford if housing prices continued to rise. The real-estate bubble that began to burst one and a half years ago and that gave rise to the banking crisis arose this way.

Since the Reagan presidency a quarter century ago, Americans have increasingly become indebted to foreign creditors and have made a good life for themselves. They financed their investments from the capital streaming in from foreign countries and instead of saving relied on the increasing value of their real-estate. The deficit on the current account

balance, that is the surplus of imported products and services over exports, reached a peak of 5.5 percent of GDP. This was financed with increasingly more sophisticated investment products that were certified with the stamp of the rating agencies – in the end even the last investment manager of the German state banks noticed what junk was being sold here. The wheeling and dealing has now come to an end. No European bank escaped the painful experience that the expensive value-at-risk models of the investment bankers were just as worthless as the agency ratings.

Politicians must finally face the task of defining legal liability limitations for corporations by establishing strict minimum standards for equity capital requirement for the various business models of the banks, both in America and in Europe. Stricter rules are not a disadvantage for the economy, since the apparently so much more expensive equity capital, whose use is thus made compulsive, is not economically more expensive than debt capital, as shown by the burdens that the taxpayers must now bear. Furthermore, no scarcity of funds would arise as a result, since the savings of the world just suffices – independently of such rules – to finance the investments.

The necessary steps are as follows:

1. The US must finally participate in international agreements on the harmonisation of banking supervision. These agreements can be based on the Basel-II system, which must be under government control.
2. Europe needs a common system of financial supervision. Every state must pay for the losses of its own banks.
3. Investment banks, hedge funds and private equity firms must be subjected to the same rules as commercial banks.
4. Personal liability limitations for mortgages and other real-estate loans must be lifted in the United States and wherever else they exist.
5. Conduits and other constructs for the shifting of investment banking business from the bank balance sheets should be limited in such a way that the risks that the banks take on are transparent in the bank balance sheets.

Free market advocates that argue against these remedies, without which a market economy cannot survive, confuse the market economy with anarchy. The market economy can only function when it is subjected to traffic regulations. Civil codes in many countries are full of rules that limit private contracts. Only a portion of the contracts that an uncontrolled market economy would develop is allowed, and because of

this the system functions. Europe and the world need stricter rules for financial traffic. Such rules do not constitute a systemic break. They are vital for the functioning of the financial capital markets.

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