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Plugging the Leaks: What Caused the Banking Crisis?

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Crisis?***

With pain and misgiving, the United States Congress bailed out Wall Street in order to prevent a meltdown of America's financial system. But the \$700 billion to be used may flow into a leaky bucket, and so may the billions provided by governments throughout the world.

The US financial institutions that went bankrupt in 2008 – or that would have gone bankrupt without government help – were in trouble because they lacked equity capital. They did not lack that capital because they never had it, but because they paid out too much of their abundant earnings in previous years to shareholders, leveraging their operations excessively with debt capital. If no measures are taken to increase the minimum equity requirements for banks and other financial institutions, financial crises like the current one could recur.

Anglo-Saxon financial institutions are known for their high dividend-payout ratios. From a European perspective, the hunger for dividends and the emphasis on short-term performance goals that characterize these institutions is both amazing and frightening. Investment banks, in particular, are known for their minimalist equity approach. While normal banks need an equity-asset ratio of at least 7%, investment banks typically operated on a ratio of only 4%.

The lack of equity resulted largely from the concept of “limited liability,” which provided an incentive for excessive leveraging. Earnings left inside a financial institution can easily be lost in turbulent times. Only earnings taken out in time can be secured.

Lack of equity capital, in turn, made risk-averse shareholders hire gamblers to manage their limited-liability investment companies. The managers chose overly risky operations, because they knew that the shareholders would not participate symmetrically in the risks.

While upside risks would be turned into dividends, downside risks would be limited to the stock of equity invested. Claims against the personal wealth of shareholders would be blocked by the limited liability constraint. The banks' creditors or governments ultimately would bear any losses. The mutual interaction between the incentive to minimize

equity capital and the incentive to gamble in order to exploit the upside risks caused America's crisis.

In theory, bank lenders and the government could anticipate the additional risks they encounter when a company chooses a high-leverage strategy. Lenders may charge higher interest rates, and the government may charge higher taxes or fees.

But this theory fails to match reality. Governments do not tax the return on equity less than debt interest, and lenders do not sufficiently honor the benefits of high equity with lower interest rates, owing to a lack of information about the true repayment probability. This is why equity capital held by financial institutions typically is more than twice as expensive as debt capital and why these institutions try to minimize its use.

The provision of limited liability not only turned Wall Street into a casino, but so-called "Main Street" also was induced to gamble, because homeowners enjoyed a limited liability similar to that of the companies. When low-income borrowers took out a loan to buy their homes – often 100% of the purchase price – they typically could use the home as collateral without warranting the repayment with additional wealth or even their income. Thus, they were protected against the downside risk of falling house prices and profited by speculating on the upside risk of appreciation.

Such homeowners knew that with rising prices they would be able to realize a gain by either selling their homes or increasing their debt, while in the case of falling prices they could simply hand over the keys to their banks. Given the uncertainty about future house prices, they could reasonably expect gains, which induced them to pay even more in the first place. Gambling by Main Street caused the sub-prime crisis.

The crisis spread because the banking system was not sufficiently risk-averse – and in some cases even seemed to relish risk. Mortgage banks kept some claims on their books, but sold most of them to investment banks as "mortgage-backed securities". The investment banks blended these securities into "asset backed securities" and "collateralized debt obligations" and sold them on to financial institutions throughout the world. These institutions, attracted by the high rates of return that were promised, invariably neglected the downside risks.

The buyers of the CDOs were often misguided by rating agencies that performed badly and did not provide reliable information. As private rating agencies live on the fees they collect from rated companies, they

cannot easily downgrade important clients or the assets they sell. The big American investment banks received excellent ratings up to the last moment, and so did the CDOs with which they betrayed the world.

All of this explains why the US had such a formidable period of growth in recent years, despite the fact that household savings were close to zero, and why foreigners were willing to finance a record US current-account deficit of more than 5% of GDP – higher than it has been since 1929. That period is now over.

The US must carry out fundamental reforms of its financial system to plug the equity leaks and recover investors' confidence. But even then it will have a hard time continuing to sell financial assets to the rest of the world. American households will need to learn to accumulate wealth by cutting consumption rather than speculating on real estate. A painful decade of stagnation for America lies ahead.

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