Revised: March 22, 2019

ARE *WE* (THE CITIZENRY) SAFER FROM EXPLOITATION BY MEGABANKERS?

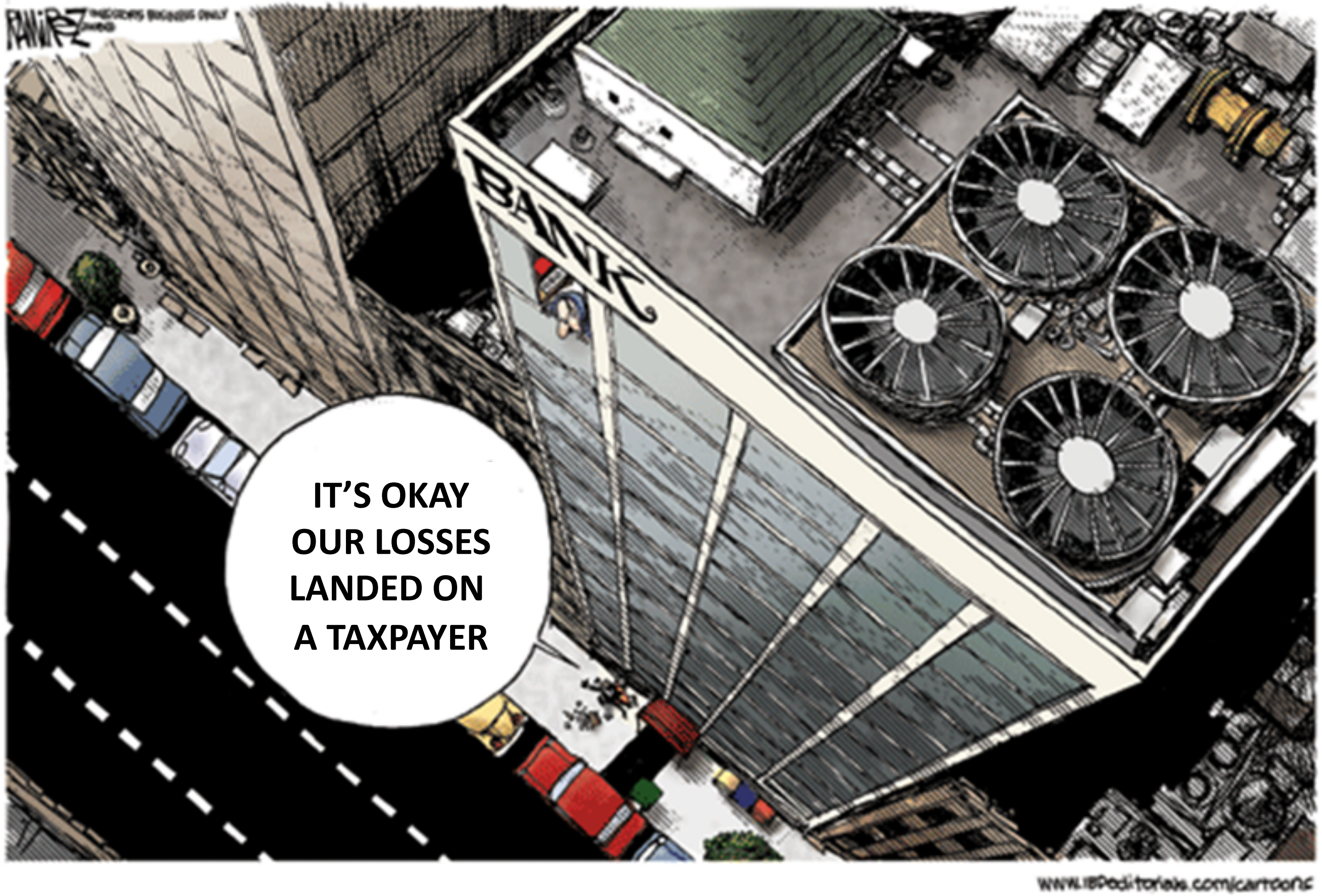
Edward J. Kane

Boston College

I can tell the story of the Great Financial Crisis with two cartoons and one distinction.

- The distinction is between government support that is *explicit* and that which is *implicit*.
- <u>Explicit support</u> is contractual: Bankers have a right to it.
- <u>Implicit support</u> is conjectural: Though optional, *it is highly incentivized by precedents, industry side payments, and postgovernment career enhancements that regulators can reap for having avoided or stabilized an incipient crisis.*

HOW RECKLESS MEGABANKERS SURVIVED THE CRISIS THEY CAUSED



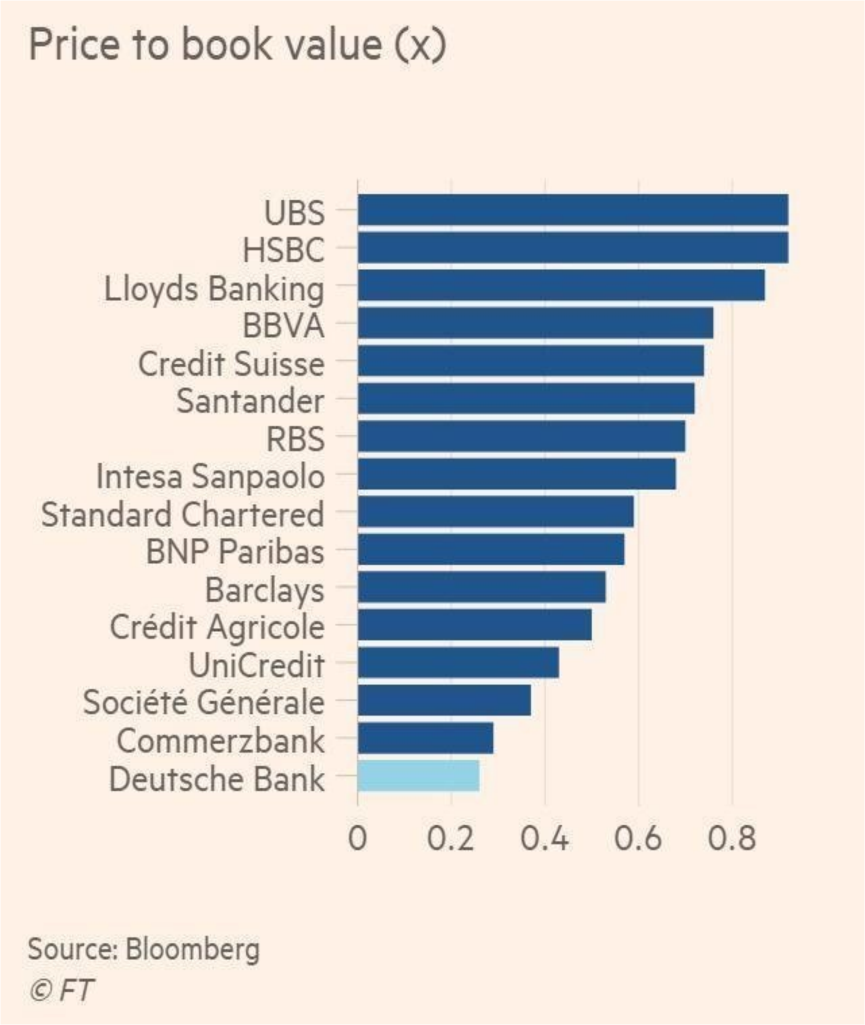
Taxpayers Were Unable to Give Megabank Leaders More than a Slap on the Wrist

AS IN THE US S&L MESS, REGULATORS PUT OUT FAKE NEWS: BANKING HAS BEEN FIXED

Taxpayers are encouraged to believe that EU Bail-in Rules and **Toughened Capital Requirements** have made them safer from exploitation by the world's reckless megabankers. But these encouragements are based on accounting equivalent of Snake Oil.

Because of the implicit nature of the major part of Financial Safety Net protections, nets create powerful incentives for megabankers to pry themselves loose from the bite of higher capital requirements over time. Because tougher capital requirements and bail-in rules do not attack bankers appetite for tail risk or regulator incentives directly, reforms lose effectiveness over time. This converts the global safety net into a Protection Racket operated by and for the benefit of thieving Megabankers.

Whether a Bank is Exploiting Taxpayer Support can be Determined by Looking at its Ratio of Per-Share Market Price to Book Value (Feb 2019)

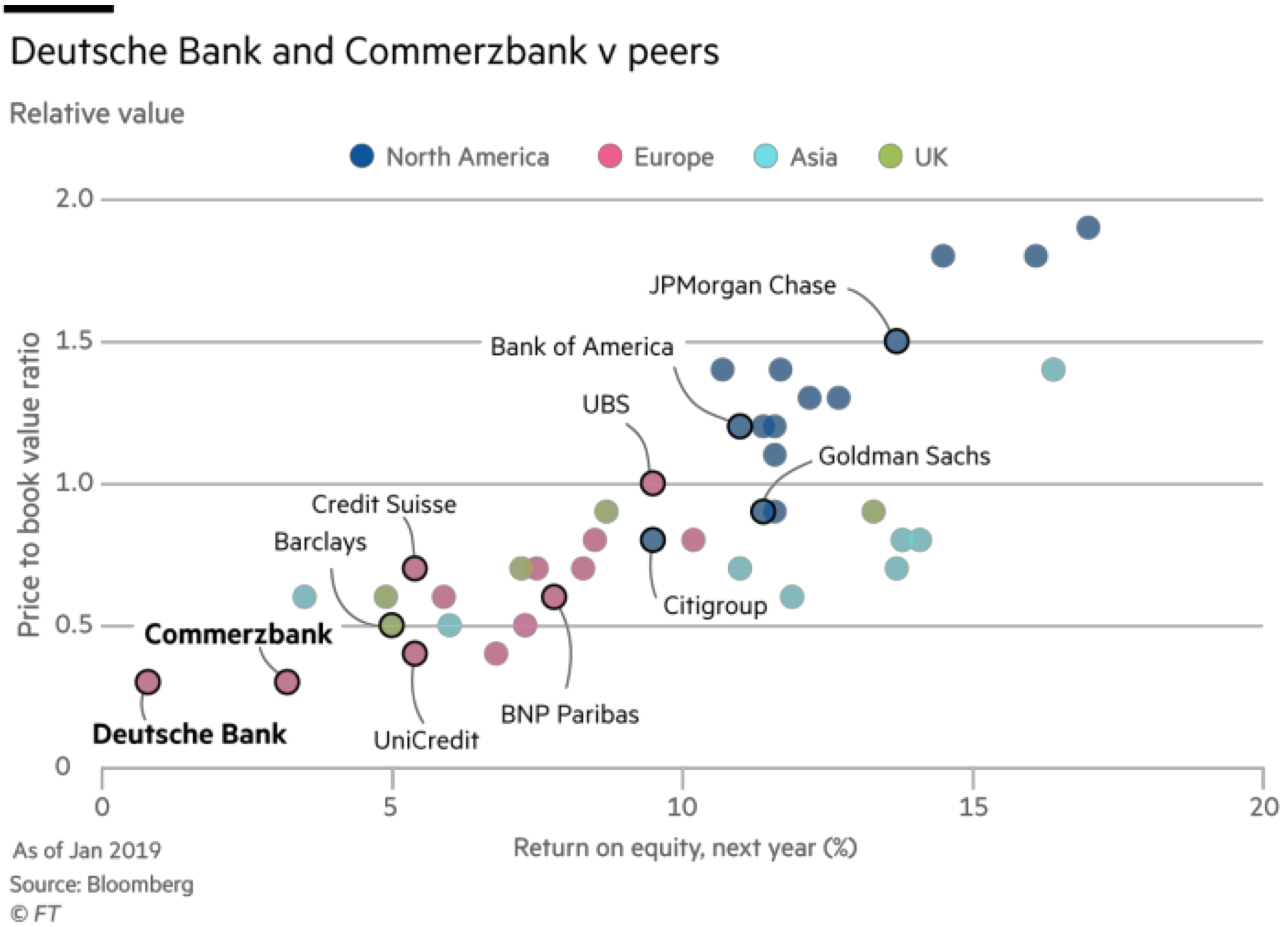


OTHERWISE THESE RATIOS WOULD ALL BE >1

MV–BV difference consists of unbookable ***intangible items*** [principally, franchise value

(≈ capitalized value of monopoly power) and the value of implicit and explicit government guarantees)] and ***unbooked losses***.

- Megabanks have considerable monopoly power and valuable implicit too-big-to-fail guarantees. Hence, unless these intangible values are overwhelmed by **unbooked losses**, MV/BV should be greater than one.
- That these banks’ ratios are so low tells us that most of these banks (and *especially* DB and Commerzbank) are “zombies:” Insolvent Living-Dead firms whose creditors would force them into bankruptcy were it not for various governments’ implicit TBTF guarantees.
- We can approximate the extent to which European and Asian megabank zombies have not written off losses by the extent of their failure to earn the global rate of return on their accounting equity.


Deutsche Bank and Commerzbank v peers
Relative value
North America
Europe
Asia
UK
Price to book value ratio
2.0
1.5
1.0
0.5
0
JPMorgan Chase
Bank of America
UBS
Goldman Sachs
Credit Suisse
Barclays
Citigroup
Commerzbank
BNP Paribas
Deutsche Bank
UniCredit
0
5
10
15
20
Return on equity, next year (%)
As of Jan 2019
Source: Bloomberg
© FT

Zombie Banks are created by reckless Megabankers with the help of Captured Regulators.

a. During the post-WWII era, every financial crisis has begun with financial regulators helping their megabankers to hide two problems:
   1. One (but usually more) of the Too-Big-To-Fail banking institutions that their agency supervises has become a zombie institution.
   2. They are allowing (and often encouraging) their zombie "clients" to gamble for resurrection on risky long-tail projects.

b. In trying to manage the deepening crisis that these forbearance policies eventually produce, governments create precedents that stretch their safety nets further and further above formal coverage limits. This policy of throwing megabanks' accumulated losses onto national, regional, and global safety nets has created an implicit (i.e., unrecognized and untradable) class of **dividend-free** equity shares in the form of loss-absorbing funding that taxpayers are compelled --without compensation-- to supply in increasing amounts to the zombie megabanks of the world.

- Recognizing the existence of **Regulators' Forbearance (or Cover Up) and Gambling "Reflexes"** implies that EU legislation requiring creditor bail-ins at giant banks is wishful thinking at best and cynical industry-driven bullsh*t at worst.
- What do I believe keeps dead European banks walking?
  1. Precedent established by US Fed's support of European megabanks during the GFC.
  2. US Federal Reserve leaders' signaling firmly in Oct 2013 that until further notice it is going to back up Europe's vulnerable banks *de facto* by institutionalizing its so-called "reciprocal" central-bank swap arrangements and thereby affirming the Fed's self-proclaimed role going forward as the **global financial hegemon**.

- To see the strength of GFC precedents, we need only to examine the massive funding support that the Fed shelled out to European megabanks during the first 20 months of the GFC.

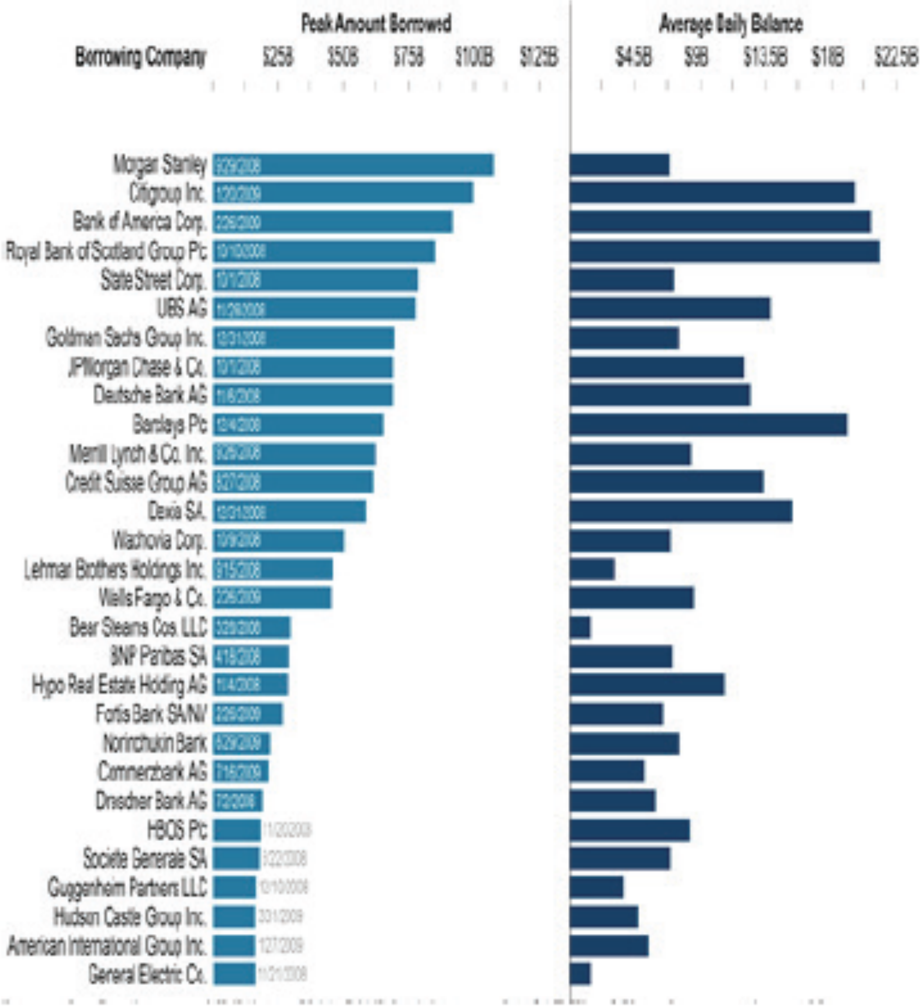
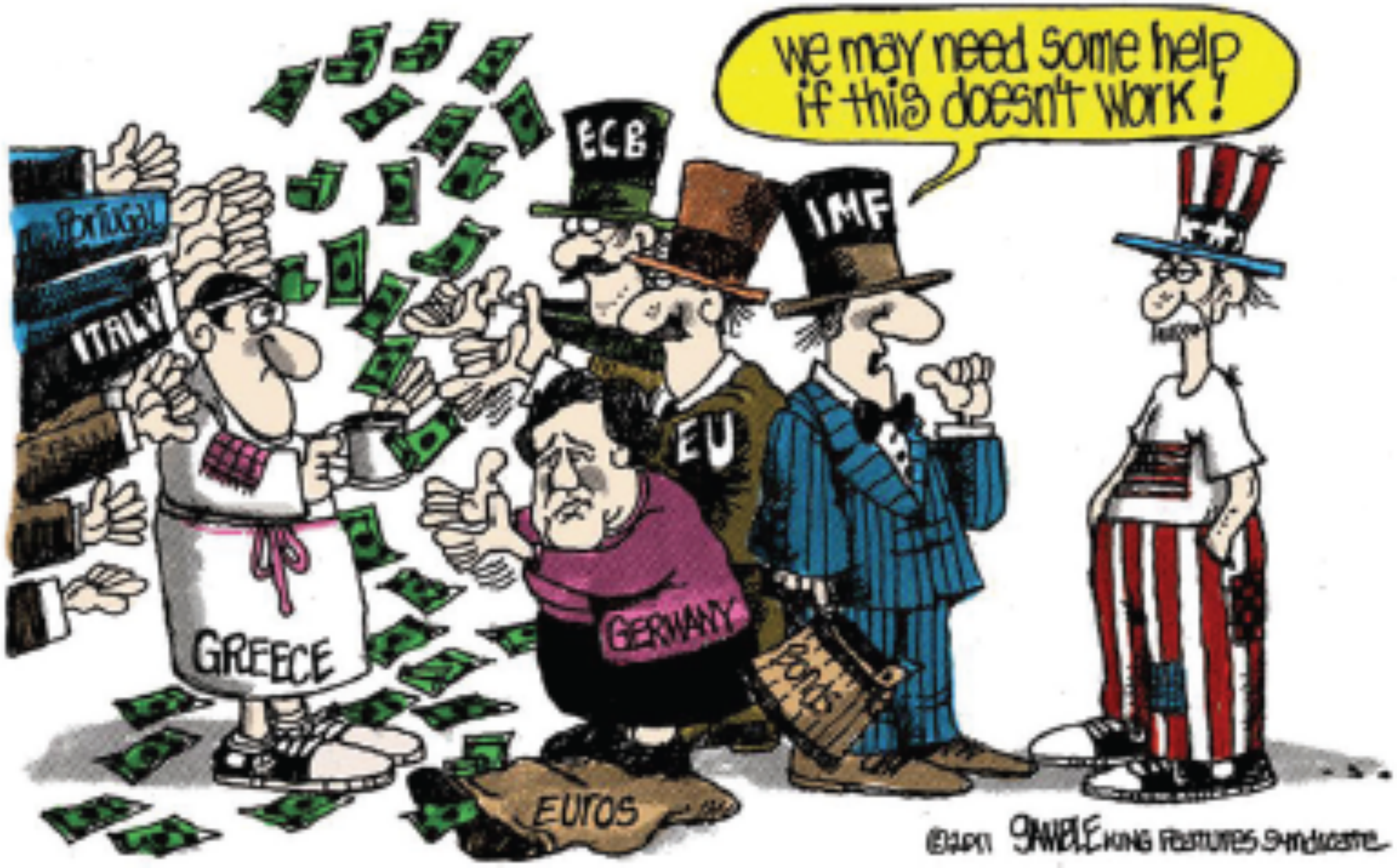


Figure 1. Globalization of Us Net Occurred *De Facto* During 2007–2010 Crisis: The Fed Used Its Last-Resort Lending Powers Creatively to Provide Subsidized Funding to Many of the Largest Banks in the World (Fed Loans 8/2007–4/2010).

Source: Bradley Keoun and Phil Kuntz (2011), "Wall St. Aristocracy Got $1 Trillion," Bloomberg.com, August 22 (transmitted to me by Richard Herring).

THIS IS WHAT THE GLOBAL SAFETY NET TRULY LOOKS LIKE

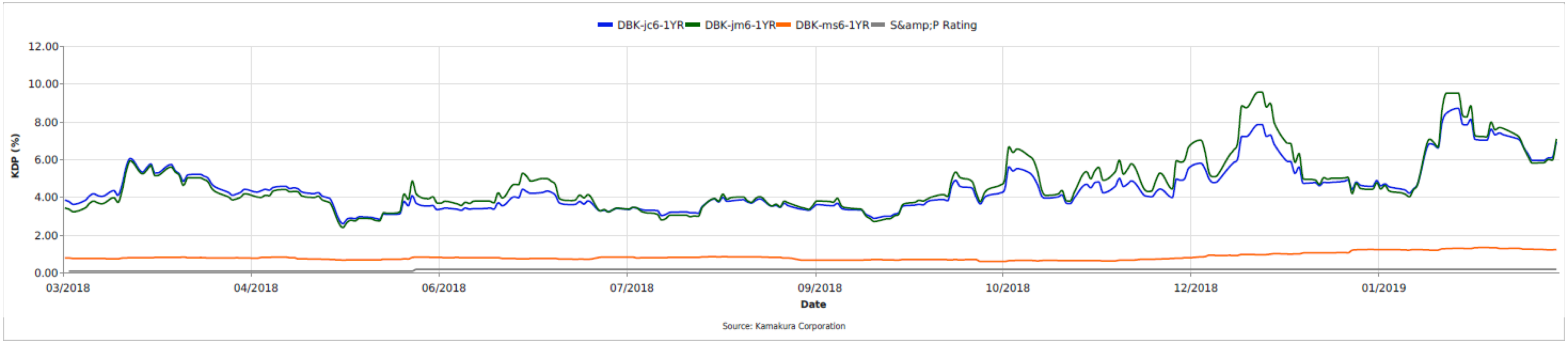


- Additional **evidence** that most European megabanks have been in and out of a zombie state ever since the Great Financial Crisis began can be found in the **interest spreads on their bonds**. Several Italian banks, Spanish banks, and Deutsche Bank are particularly vulnerable to runs today. My evidence consists of comparing the selected banks’ probabilities of default (as modeled by Kamakura) with their bond spreads.

OBSERVABLE INTEREST SPREADS ON PRIVATE DEBT CONSIST OF DEFAULT PREMIA & LIQUIDITY PREMIA, BUT --WHEN A BANK IS IN TROUBLE—THESE PREMIA MAY BE MORE THAN OFFSET BY THE VALUE OF TAX PREFERENCES AND IMPLICIT GUARANTEES.

Kamakura Corporation
KRIS
Kamakura | Contact
CREDIT NAME
CREDIT PORTFOLIO
MACRO FACTOR SENSITIVITY
PORTFOLIO MANAGEMENT
Logout
Overview
Default Probabilities
Bond Spreads
CDS Spreads
Implied Ratings
Chart
Watch List
Download
Security ID
Go
Date 2016 Aug 30
DEUTSCHE BANK AG
Issues
History
Term Structure
Callable Y
Seniority Senior
View By
Based on
Matched Maturity
Closest on the run
Compare:
+ Add
- Remove
Range: 1Mo 3Mo 6Mo 1Yr 2Yr 5Yr 10Yr Max Custom Date
Spread
Volume
Percent (%)
Daily Volume (USD)
Month/Year

DBK' s l-yr Default probabilities in 2018-2019 have been as high as 8 percent. Well above the spread on any of its bonds, indicating that DBK bonds are trading on the credit of the global safety net.

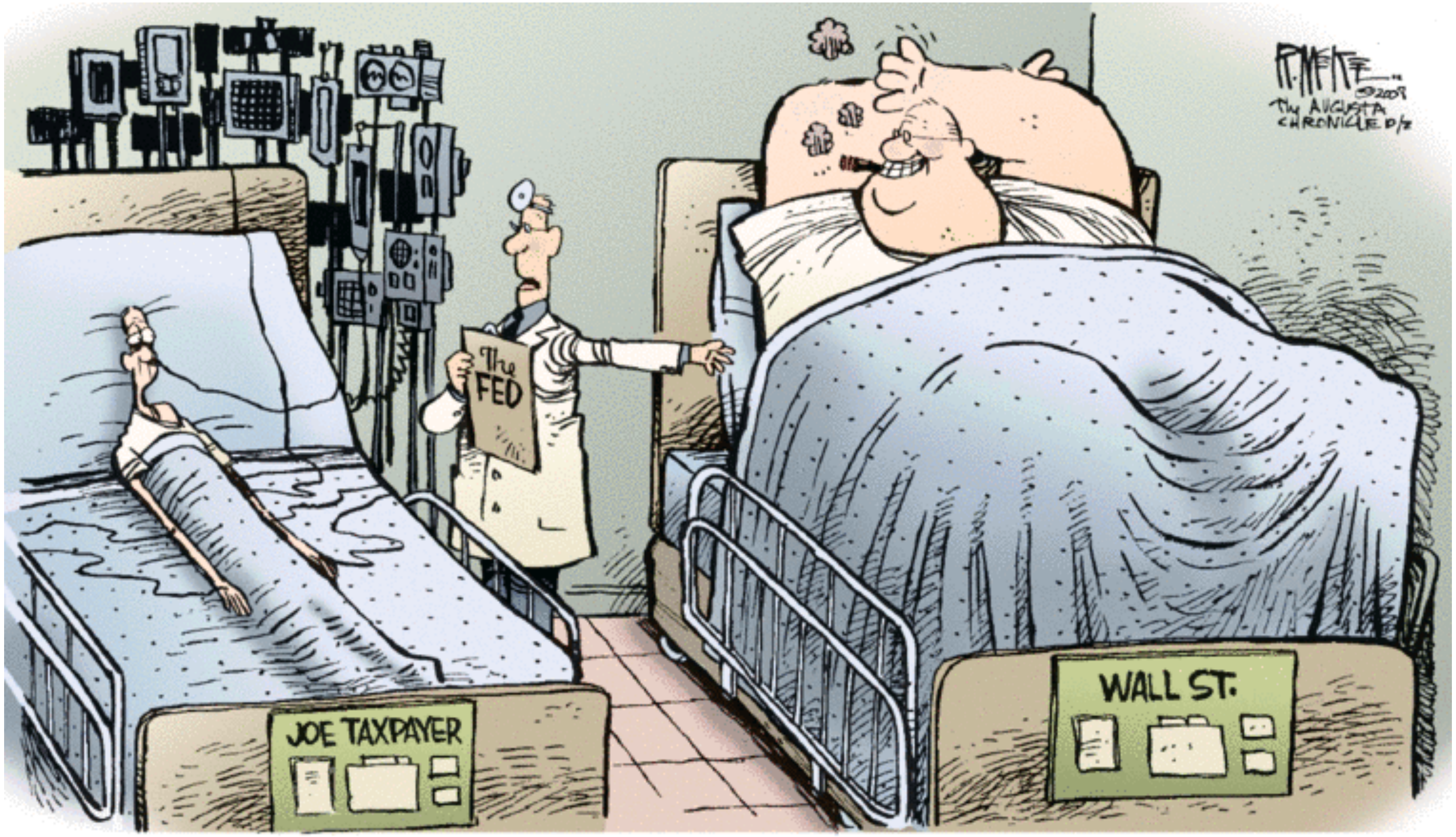


- Trump has called the Fed “loco” (in 2016) for raising interest rates in an election year. Lord knows what he will say and try to do if, during his term in office, the Fed starts again to commit vast amounts of explicit US resources to fend off a worldwide crisis. We should all hope we don’t have to find out.

Can the G20 do anything to stop, slow down, or limit the damage caused by European Megabanker train wrecks? Governments could:

a. Rework corporate law to recognize explicitly the disadvantaged secondary class of loss-absorbing shares that taxpayers implicitly hold in megabanks.
b. Focus supervisory activity on making megabanks estimate and service taxpayers' stake honestly.
c. Punish reckless **individual managers** for engaging in a new operationally defined **crime** of **theft by reckless banking**. This would be an especially easy place to start (UK has begun this process).

GENUINE REFORM MUST SHIFT THE FOCUS OF RESCUE POLICIES FROM HELPING BANKS TO HELPING SOCIETY



"I DON'T WANT TO ALARM YOU, BUT IF YOU DON'T GIVE THIS MAN a TRANSFUSION RIGHT NOW, YOU COULD DIE."

AS THE MEMORY OF THE GFC FADES, “NATIONAL CHAMPION” BULLSH*T AND THE MOMENTUM OF RECENT RULE CHANGES HAS BEGUN TO SEND OPPOSITE MESSAGE TO TAXPAYERS