



Simon Johnson on the Unconscionable Risks We Face

By Dan Richards

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Simon Johnson is a professor of economics at MIT and a senior fellow at the Peterson Institute for International Economics. He was the chief economist for the International Monetary Fund from March 2007 through August 2008. Johnson is the co-author, with James Kwak, of [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#), a bestselling assessment of the dangers the US financial sector now poses (published by Pantheon in March 2010).

Dan Richards interviewed Johnson at the American Economic Association in late January.

A video of this interview is available [here](#).

You have said that the global approach to creating financial stability among banks under Basel III – specifically, raising capital requirements – was not sufficient. Can you elaborate?

Capital is the buffer that banks have against loss. It is the shareholder's equity. The shareholders absorb the losses before you go into a situation of insolvency. Well, you are talking about very risky activities. Does anyone think that these big banks are less risky than the overall US economy? No. Surely they've demonstrated if anything they are more risky.

Average leverage, average equity financing, and average debt are around 50% for the corporate sector in the United States; 50% equity, 50% debt. We let the financial sector con us into thinking that was relatively safe, and that banks should be allowed to have a lot of debt and relatively little equity. This is the situation going forward. This is where the Basel III process will take us. It's pretty clear.

This is an unconscionable social risk. It's unnecessary. It's not needed for productivity. It's not needed for growth. It's not needed for jobs. The arguments that raising capital requirements would have adverse social effects are completely specious and fallacious. There is a wonderful study showing this by Anat Admati and her colleagues at Stanford University. Everybody has to take a look at that work.

You are suggesting that we need to dramatically raise capital requirements. Let's talk about some alternative proposals. There have been a number of suggestions that we create a new capital structure, contingent capital, which would be debt until it's needed, at which point it would become equity. What are your thoughts on that as a solution, in part or in whole, to the problem?



As a theoretical proposition it has some attraction, but empirically when you look at how this kind of contingent debt works, it's very complex. It is very hard to implement. It's very hard to get that debt to convert into equity when you need it. You can go through the blow-by-blow. We talk about this on our [website](#).

What about the Volcker Rule that proposed to take the risky forms of bank activity and set them aside and segregate them from the less risky components of bank activity?

That's a good idea. It's a step in the right direction. I've supported it in testimony to Congress and in an opinion I've submitted to the Financial Stability Oversight Counsel, but it is not enough. We need to go beyond that. We've seen a deal just announced in the past few days, with Goldman Sachs' involvement in Facebook, which apparently they believe will comply with the Volcker Rule that is not yet officially written.

So Goldman is taking what looks like a risky bet on a company that could go up or go down a lot in value. It is a bank holding company. It is a financial institution with access to the Federal Reserve discount window. This is a too-big-to-fail financial institution. They have a subsidy. They have an unfair, nontransparent, and dangerous subsidy, and we let them take these kinds of risky bets. It makes no sense.

In April of last year you published *13 Bankers*, which raised some red flags going forward.

Our argument is that the big bankers have won. They have captured the minds, hearts, and pocketbooks of the regulators, particularly in the United States but also in other developed high-income countries.

This is not a brand-new process. This process is been going on for 30 years, and we traced that out in the book, but the extent to which that continues today is remarkable. After the crisis you saw the latest announcement from the White House that the new Chief of Staff to President Obama is one of the most senior bankers in the country, a top executive of J.P. Morgan Chase. It is absolutely incredible what has happened.

This is very dangerous as we move forward.

One of the things that you identified is that there has been a remarkable concentration in banking – not just in the US, but in the UK, Ireland, Scotland, in Switzerland – in terms of the percentage of assets that are held in the balance sheets of the top banks. Is that a relatively new phenomenon?

In the United States it's relatively new. The biggest six banks are all bank holding companies now, and they have assets that are 64% of US GDP. Now if you go back to



1995, those same banks and the institutions around which they were built, because there were a lot of mergers, represented 16% of US GDP.

The US is not traditionally a big-bank country for good reason, because when big banks get into trouble and they blow up it causes massive damage, as we see now in Iceland, Ireland, the UK, and in other parts of Europe.

Are we in a situation now where financial institutions are too big to fail, with governments that cannot afford for banks to run into trouble to allow them to collapse?

Absolutely. I travel around the United States talking to all kinds of business groups and financial groups, and I ask them the same question; if Goldman Sachs were to hit a hypothetical rock today, would it be allowed to fail? And the answer from everybody is absolutely not. You couldn't. The shock would be awful. It would be in other Lehman moment or worse. That is the essence of too big to fail.

What is the solution from a public policy perspective?

In the United States, where my book is focused, we should make the largest banks smaller. The social gains from having a \$2 trillion bank are very small compared to a \$100 billion or \$200 billion bank. We should roll back that size increase over the next 15 years.

In addition, and this is very important, we should greatly strengthen capital requirements. The Basel III process that deals with this has completely failed. It talks about 8% to 10% Tier 1 capital. That is nowhere near enough. We should be going to 20%, 30%, 40%. Banking does not need to be so completely debt-financed.

This is what executives like, because it increases their return-on-equity and their compensation. Shareholders like it, at least sometimes, although they may be deluded at other times.

What we have now is very bad for society. We want to move away from a debt-based financial system. It needs to be much more equity-based, or else it is highly risky.

A lot has been written about the underlying causes of the financial crisis in the US. You have identified two different narratives: a financial industry perspective and an alternative point of view. Let's start by talking about what the financial industry suggests as conventional wisdom, and what led to the financial crisis.

There are many people who argue the cause was specific to housing and that it was a one-off event. There were a particularly distorted set of incentives. Some people like to claim the crisis was due to Fannie Mae and Freddie Mac. Other people like to lay the blame differently. But it is a very specific "once in 50 years" or "once in 100 years" flood.



That is the standard view. It is the view of the US Treasury and was the view of very important Senators and other members of the Congress who pushed through the Dodd-Frank reform legislation.

In that view, we have substantially fixed the problem.

You have a different perspective on this.

Yes. Our point is regulatory lapses are pervasive and have continued. It was not changed or undermined at all by the collapse and then the bailout measures. All the top bankers who were in place from November 2008 through March 2009 during this critical period were kept in their positions. There was no change to their pay, how they can pay themselves, their key staff, their Boards of Directors, or anything about how they structured their businesses.

There was an attempt in Dodd-Frank to change some of these parameters going forward, but by the time they started that reform legislation the banks were back. They were profitable. They had a lot of money. As Mark Hanna, the famous American politician from Ohio 100 years ago, once said, "There are two things in politics that matter. The first is money, and the second I can't remember." It's all about the money. So they substantially defeated and watered-down the reforms.

Should there be barriers to movement between senior bankers and policymakers, to prevent someone like William Daley going from vice chairman of J.P. Morgan one day to one of the most influential policymakers the next?

Yes, there should clearly be much more restriction, much more of a cooling-off period, and much less of a reliance on this revolving door. The essence of the problem is ideology. The political elite in this country have become convinced that the financial elite – by which I mean not all people in finance – are the fount of all wisdom, and they should be trusted with such important jobs as Chief of Staff in the White House. That is incredible.

Look, I am not against these people. I'm not a person who wants to bash successful or rich people. I'm a professor of entrepreneurship at the MIT Sloan School of Management. But overreliance on a small set of people who have a very particular self-interest, and who want, for example, to have low capital requirements so they can earn high return-on-equity as currently measured, and then the downside falls to the taxpayer – that is just irresponsible, shortsighted public policy thinking.

What is happening in Europe now with regard to capital requirements for banks?

There is going to be a very interesting debate. There is a debate within the UK by the way. Mervyn King, governor of the Bank of England, is definitely pushing for more restrictions,



and he understands the financial sector has become too big and too dangerous. But there are very powerful interests around the city of London opposing him. So we will see where the British come out on this.

If the Europeans are able to push for higher capital requirements, and I am somewhat skeptical given what we've seen in the Basel III process, that could have a positive effect on the United States. But I am not holding my breath. There needs to be much more pressure put on people directly in the United States.

There is no good theory or empirical evidence that says these low capital requirements for the major banks are a good idea, or a responsible way forward. The officials who claim this is the case are just making it up. They are kowtowing to the financial industry. This has to stop, and we need to have that debate forcefully and directly right now.

You raised a question as to whether the Eurozone is going to survive some of the issues that are going to be coming up in the next 12-24 months. What do you see developing?

There will be another round of crisis in the Eurozone. There are a lot of funding issues coming up in the spring. These will cause further rounds of distress, particularly for the peripheral countries. But the Europeans will come through it.

A Germanic core, and we can discuss who's in that and who isn't in that, will come through it stronger, because the essence of what you need in the modern world is the ability to efficiently run fiscally austere policies when under pressure. The Germans can clearly do that; the Finns, the Austrians, absolutely. The French – we will see. The Italians – we will also see. But this Germanic core will survive and will come through stronger.

There will be a Eurozone. Some countries will leave. At least they will not belong to the Eurozone in the sense that they belong today. They will belong like Montenegro belongs. Montenegro uses the euro, but it doesn't have access to the financial system. It is not a Eurozone member. So we will have more countries with that status.

But Europe is coming back. Europe is not out of the picture, although there will be serious turmoil in 2011.

One of the underlying theses of the euro as common currency is that there will be rules that everyone has to buy into in terms of fiscal stability. But, beyond that, the underlying premise is of labor mobility and flexibility in terms of labor and wages. You suggested that has actually not materialized in Europe.

Everyone recognizes that Europe has not converged to the degree that was expected and hoped-for. But I would focus on a slightly different problem, which is the debt. The incentives that we have given ourselves as consumers, as investors, as bankers, and as



governments – to over-leverage, to borrow too much – these are pervasive. They are throughout the developed world. They are tax subsidies. They are too-big-to-fail subsidies. They are the presumption that government will come in and save you.

The Germans, to their credit, are trying to push the European debate towards the position that where people should expect losses when there are defaults, for example by sovereigns. Now, if they can achieve that, that is a fundamental shift in thinking that is absolutely needed, and I applaud them for it even though I recognize that it is very difficult to get there.

We recently had a case in Ireland where largest bank collapsed and the government intervened and made the bondholders whole. By contrast, Iceland had a problem on the same scale, but they took a different policy in terms of dealing with their debt holders. What is your thinking here?

You are exactly right to draw this distinction. In Iceland, they had banks that were big relative to their economy. They failed. They let them fail. Then they took them over, and they restructured on that basis, but first the banks failed.

In Ireland, the banks were also in trouble. The banks were also big relative to the economy, although a little bit smaller than Iceland, but still huge. The government took over the banks and guaranteed their liabilities. So then these big liabilities become government liabilities.

Take the Government of Ireland, which had relatively low debt and what seemed like a relatively conservative fiscal policy over the past decade or so, and you suddenly realize they have these massive contingent liabilities. Their debt-to-GDP jumped up. If you calculate the size of the Irish economy properly and look at the debt burden going forward, Ireland will not be able to service those debts on a current basis. That is an extraordinary outcome, an absolute disaster and a tragedy for the Irish people.

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