2015 IMF/Federal Reserve Board/World Bank Conference On Policy Challenges For The Financial Sector

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From Washington to Wall Street to Main Street

How Do We Get Banks To Better Serve The Real Economy: Ethics, Incentives and the Role of Supervisors

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Lay of the Land: Big Banks Have Become Bigger Since The Crisis

- More Assets – 41.4 % increase
- More Deposits – 82.4 % increase
- More Cash – 400 % increase
- More Counterparty Risk
- Top Four Banks (JPM Chase, Citigroup, Goldman Sachs, Bank of America) hold $219 trillion, or 93 % of US derivatives.
- Settled to Pay around $130 billion in fines for crimes ranging from mortgage-related fraud to LIBOR fixing to FX rigging.
- More Trading Influence – Top 10 US Banks hold 97 % of bank-trading assets. (JPM Chase holds 43.8 %. Citigroup holds 24.5 %.)
Rising Risks: Problematic Liquidity

- Excess liquidity used by banks to sustain and fortify themselves, does not directly translate into stimulating the general economy.

- Bank of America noted 56% of global GDP and 83% of equities were being sustained by Zero Interest Rate and QE policies.

- By the end of 2015, the Federal Reserve and European Central Bank will hold a nearly $7 trillion book of securities.

- Unwinding or holding them to maturity poses dangers, as banks would become more defensive relative to customers in response to liquidity retraction and more aggressive in selling “toxic” securities.
Rising Risks: Volatility Issues

- The BIS, IMF (and others) have warned of growing volatility.
- The Fed noted increased activity in riskier, high-yielding securities due to low interest rate environment.
- Codependent (layered) events that in isolation don’t impact markets severely can coalesce with horrific results.
- Four Volatility Factors: Central Bank Rate Hikes, Geo-Political Tension, Credit Events, Bank Confidence Breakers (Fines/Crimes).
Rising Risks: Credit Issues

• For Consumers – Credit Delinquencies and Defaults are rising in Subprime Auto Loans, Student Loans, Credit Cards, Home Equity Loans and Structured Securities.

• For Corporations - CLO issuance in 2014 dwarfed 2006. Corporate Default Rates are artificially low due to low cost of funds, but that could change, causing banks to tighten credit to companies and consumers, and corporations to lay people off.
To a Better Future: We must be realists, not optimists

- Wall Street (and global private banks) operate on Perverse Risk-Reward Incentives.
- Bankers get paid to be ‘commercial’ not to help the economy.
- The more complex a deal, the more money bankers make from it.
- Prolonged easy liquidity causes moral hazard that impedes ethical conduct, spurs easy risk-taking, leveraging, and fraudulent activities.
- Stress Tests Can Mislead.
To a Better Future:
We must be realists, not optimists

• Global Central Bank Policy has provided ample liquidity, but not inducement for private banks to use it to strengthen the Real Economy.

• Supervisory Bodies must be proactive in:
  – preventing *Pending* Risks (bubbles, market and price manipulation, etc.)
  – punishing recidivist bank offenders, and
  – holding CEOs accountable and banks responsible.
To a Better Future:
What Else Can Be Done

• Structure: Make Big Banks smaller from a market share and complexity perspective.

• Focus: Smaller banks would be more engaged in localized economic matters rather than riskier securities creation and trading activities.

• Money: Stricter compensation rules. Big Bank shareholders reward their CEOs, despite lawsuits and investigations that take their toll on public funds and confidence.
To a Better Future: What Else Can Be Done

• Require some capital/liquidity be used to enhance customers’ stability.

• Reducing customer instability, enhances real economic stability. (QE-direct for consumers.)

• Engage with banks so as to fortify the financial system from the ground up, not just the top down.