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Why change the banks?

The fall of IndyMac

In November of 2006, Pasadena's IndyMac Bank, was flying high. Among the nation's largest thrifts,[2] their stock was trading at $75 per share. Riding the wave of the southern California real estate market, and specializing in big loans, they had assets of almost $30 billion, and a string of branches across the lower half of the state. In 2007, they acquired an east coast mortgage company, adding a few billion more in assets, and then it all began to go sour.

IndyMac had specialized in large loans for customers with poor credit. Indeed, IndyMac had been created years before by Countrywide Financial, among the nation's largest mortgage lenders, to do exactly that. Industry procedure for approval of those kinds of loans (called *Alt-A* loans) typically involved a review of the borrower's credit scores, but little else, which is why they were also called *liar loans*. In the fall of 2007, amid a growing wave of foreclosures, investors began to express suspicions about these loans, and IndyMac saw the value of the mortgages in its loan portfolio drop off a cliff. Their stock price dropped too, from $75 to $30 by the end of October.

By the spring of 2008, the stock price had halved again, and the bank barely avoided being forced to give back half a billion in depositors' money by backdating a transfer of money—with the collusion of its bank regulators. By the summer, its stock price was down to 80 cents a share,[3] and on June 27, the bank suffered a

[2] A thrift is a savings banks specializing in consumer lending, especially home mortgages.

[3] At this point, New York Senator Chuck Schumer issued a letter of complaint to the regulators, the FDIC and the Office of Thrift Supervision (OTS) saying the

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classic bank run, complete with thousands of customers crowding its lobbies, just like in the movie, "It's a Wonderful Life," except it was Pasadena in July, so it was more people and hotter than Bedford Falls. Despite frequent public reassurances from the FDIC, customers withdrew $1.3 billion from IndyMac in the course of two weeks. Without enough cash to meet the demands of its customers, IndyMac was shut down by the FDIC. IndyMac cost the FDIC $13 billion, the most costly bank failure to date.

Philadelphia gambles with its schools

THE PHILADELPHIA SCHOOL DISTRICT is the eighth-largest in the country, with a $2.3 billion operating budget for 242 schools serving 150,000 children, over 80% of whom are poor. The finances of the district, along with the rest of the city, are under a lot of pressure these days. That, of course, makes them no different from a lot of urban school districts. With state aid unable (or unwilling) to keep up with their expenses, and local property taxes pushed up as high as politically possible, the department has been in dire straits for some years.

From 2002 until 2007, the city executed a series of "interest-rate swap" agreements with Wall Street banks, including Wells Fargo, Morgan Stanley, Citigroup and Goldman Sachs, to transform their floating-rate debt into fixed-rate debt. Under these agreements, the Philadelphia school district agreed to pay the dollar value of the fixed-rate debts of the banks, and in exchange those banks agreed to pay the floating-rate debts of the school district. The intent was to make budgeting more predictable, and possibly to save some money. Accounts of what motivated it (and whose idea it was) differ at this point, since things did not turn out well.

Unfortunately for Philadelphia, once the agreements were in place, interest rates plunged in the aftermath of the 2008 financial crisis, and they remain at historic low levels today, five years later. Philadelphia's payments to the banks at the fixed rates didn't plunge, but the payments the banks made to Philadelphia went down to nearly zero. Suddenly, what seemed like a bright idea at the time had become a disaster, and as of 2013, the school district and the city have lost $331 million in these deals, including

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regulators had let the situation get out of control. Schumer's letter is frequently blamed for the collapse, but the collapse was well underway before then, with the bank's stock having already suffered a 99% loss over the previous 18 months.

interest rate payments and more than $110 million in cancellation fees. They remain on the hook for hundreds of millions more, and the banks have been utterly unwilling to forgive or renegotiate these deals. As of July 2013, the district has plans to close dozens of schools and lay off thousands of employees to deal with their ongoing fiscal crisis.

The disintegration of Lehman Brothers

While the implosion of IndyMac was obviously a sign that the fiscal crisis was deepening, the collapse of Lehman Brothers, the Wall Street investment bank, is regarded as a watershed in the 2008 crisis. Lehman, a bank once worth $600 billion, went bankrupt in September of that year, and it remains the largest bankruptcy filing in US history.

Lehman Brothers was heavily invested in the subprime mortgage market, and owned its own mortgage broker until 2007, when they closed it. The bank was being run with very little margin for error. At the end of 2007, they had borrowed over thirty dollars for every dollar of capital. At this kind of leverage, a loss of just one-thirtieth of the value of their assets would make them insolvent, owing more than they could repay. Lehman was also a heavy user of perfectly legal accounting tricks that allowed them to control investments without having to account for them on their financial reports. If you count the the apparently vast amount of loans they controlled this way—outside of their balance sheet—even smaller losses than that would crash the whole bank.

Unfortunately for a bank relying on such a thin safety margin, Lehman Brothers' assets included a very large quantity of the riskiest mortgage-backed bonds they sold. It's one thing to walk on a tightrope; it's an entirely different thing when the rope is badly frayed. And it's windy. When the market for those bonds began to go south, it didn't take long before Lehman lost all its own money and began to lose money they had borrowed from others. Compounding the crisis, because so many of their assets and liabilities were not on their balance sheet, it became impossible for the banking regulators to find someone to assume Lehman's business. Feeling they had to make an example of Lehman's reckless behavior, Fed chair Ben Bernanke and Treasury Secretary Henry Paulson decided to let Lehman fold, and let the chips fall. And fall they did.

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What does it mean?

Three disasters for taxpayers and other bystanders, three different causes. If you are like a lot of people, these stories are a little hard to follow. Explaining the terms and the components of the processes and deals that make up these stories is the goal of this book. You need the tools to understand what bankers are talking about when they talk about banking.

The examples here were chosen to illustrate some points important to understanding how banks work:

- It's all pretty complicated. If you don't know how banks work, the actions of the various players seem bizarre and even opaque. Certainly greed is behind a lot of bank activity, but it's not the only thing.
- There are different kinds of risk in banking: liquidity risk took down IndyMac, interest rate risk bit the city of Philadelphia, and credit risk sank Lehman Brothers.
- Banks with a lot of leverage are vulnerable to market fluctuations, and the greater the leverage, the less of a drop in value it takes to unleash a catastrophe, and the higher the risk.
- Banks frequently "manage" the risk of banking simply by looking for someone else to take that risk for them, like they did with Philadelphia, or the buyers of IndyMac's and Lehman's mortgage securities. This isn't managing risk at all, but simply shuffling it onto someone less informed about the subject.

The goal of this book is to explain the details of banking so that you can make sense of the causes and effects within each of these examples, to understand the pitfalls of banking as well as the exact location of the magic beans that create much of our economy's money supply. The idea is to try to answer questions like these: *Why* did IndyMac (along with all the other big mortgage originators) think it important to shovel mortgages out the door despite the declining quality of available borrowers? *Why* did Goldman and Citigroup think it important to engage in currency-rate swaps? *Why* did Lehman Brothers continue to think it wise to

create so much leverage,[4] and how were they able to hide the off-books stuff?

Banks are a mainstay of our economy. Few manufacturers could run without a line of credit for buying parts and materials. Few people could afford to buy a home without access to credit, and few governments could operate without credit with which to amortize costs over several years. Nor could any of these operate without a safe place to store money. Banks are essential, and yet they often go very wrong, precisely what makes understanding them so important.

Banks' function encompasses not just technical-mechanical issues, but also social ones. The three examples above also tell us other useful information, not limited to the following.

- Despite what you might think, with few and notable exceptions, banks have no "fiduciary duty" (responsibility) to serve their customers. Not in a legal sense, nor in a practical sense. They're supposed to give you back your money when you ask for it, but that's about it.

- The form or size of the bank isn't particularly important. IndyMac was a thrift, a kind of bank meant to do small-scale local consumer lending: single-family mortgages, car loans, and so on. But in reality, IndyMac was taking deposits from southern California, their community, and using them to buy jumbo mortgages from Countrywide, who was arranging loans, well, countrywide.

- Lots of bankers aren't particularly good at their trade. It's astonishing to look at the historical accounts of 2004–2008 and realize that many of the bankers in charge thought their bank's activity was sustainable. Banking is complicated, and it's a fallacy to assume that all bankers understand it equally well.

There's a lot to fix as well as a lot to understand about the incentives that face banks and bankers. Discussion of fixing incentives cannot, of course, excuse the astounding lack of social responsibility exhibited by the CEOs of the nation's largest banks. Bankers at Goldman Sachs and Wells Fargo would rather see

[4] Yes, I know, but I mean *besides* the bonuses.

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Philadelphia schoolchildren denied music education and guidance counselors than re-assume some of the risk (and resulting losses) they persuaded Philadelphia to take. Bankers at IndyMac felt their bonuses were more important than the potential devastation the wave of foreclosures caused in neighborhoods where they were heavily invested. Bankers at Lehman Brothers were heedless of the risks they were creating for the world financial system, including institutional investors, like pension funds. Sadly, one can go on. These were (and are) appalling lapses, but in many ways, these bankers were responding to incentives external to their banks.

The banking industry lobbied intensively for changes in banking law that produced most of these incentives, so we could just blame it all on greed and be done. Nonetheless, you learn more by studying the incentives and the actors separately than by condemning them all together. The appalling part is how enthusiastically, blindly, and greedily many bankers responded to the incentives, but that's a different matter than understanding the incentives themselves. To do that, you need to understand banking, and how it has evolved over time, first.

Climate change

Some important and even popular reforms of the last 30 years—such as the democratization of the bond market, the deregulation of interest rates, or the approval of interstate banking—created financial motivations to do what banks have done, both by increasing the rewards, but also by increasing the risks of banking. Other changes, such as the astonishing growth and consolidation of banks, the proliferation of derivative investments, and the devil-may-care culture that encouraged foisting off risk onto unsuspecting clients, were internally generated.

An example will help. In 1980, Congress deregulated the interest rates banks could pay their customers. This was a relatively popular reform,[5] and banks responded by raising the rates they paid, and advertising them. But what also happened was that customer money began to flow *from* the smaller banks who were invested in less-profitable consumer lending *to* the larger ones who

[5] I, at least, was delighted at the time, and can't honestly say I understood the consequences until 1991, when the nation was waist-deep in failed S&Ls and Rhode Island, my home state, was suffering its own banking crisis.

could earn more with bigger deals and had alternate sources of income. The small banks were getting squeezed and had to raise the rates they paid to avoid losing their depositors. That, in turn, meant they had to make their lending more profitable. IndyMac found an answer to this puzzle, but not a very good one. The S&L crisis of the late 1980s was largely brought about by bankers at small banks seeking more profitable opportunities and finding more risk along with them. Presumably cupidity drove some of them, but the fact is that the changing regulatory climate had eliminated the stable savings-bank business they had known, so some response was essential.

The growth of banks, made possible by Congressional repeal of rules against interstate banks, has had consequences, too. Banks originally came to exist because of a need to aggregate savings for the purpose of investing. Through the course of history, similar structures developed in several different societies, leading one to the suspicion that there is something fundamentally necessary about banking, at least once you invent money (or debt). But the banks of our history were relatively smaller affairs than the ones dominating the scene today. There was a place for bankers to get to know their customers personally, to be able to assess and manage the risk of banking via their respective ties to the community. In the modern jargon, one calls this *relationship banking*, usually contrasted with the more anonymous *price banking* where price-sensitive customers flow from one bank to another, and decisions about risks are made on the basis of experience with customers and statistical models to identify which customers are relevant to which experiences. One can picture the terms being invented to grace a slide presentation by some banking executive, meant to assure the audience that it was no problem that the bank was to grow far beyond the possibility of maintaining personal relationships with its customers.

Risky business

The growth of banks from small institutions to large has had profound effects on all of us, not least because of the necessary change in strategies to manage banking risk. When a bank makes a loan, it takes a risk that the loan may not be repaid. Banking is fundamentally about managing that risk, and other risks associated with the enterprise. But there are many ways to manage a risk.

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One way is to get to know your borrowers, to assess their needs, perhaps even to help them repay the loan with the occasional extension or refinance. In the case of a business loan, a bank could sometimes ease the risk through introducing the borrower to potential customers for his or her business. Another way to manage risk is simply to find someone else to assume it. One way manages risk by reducing it; the other simply foists it onto a sucker.

Done on a grand scale, these different strategies can have radically different effects on an economy. As banks grow and relationships with customers become more anonymous, relationship banking is necessarily supplanted by price banking. Managing risk through relationships must give way to managing risk by finding suckers, with all that this entails.

In these and many other ways, the climate of the banking market has changed dramatically since a generation ago. The important thing about changing climate is that it changes ecological niches in fundamental ways. Some ways of living cease to be possible. Organisms that cannot adapt to the new climate, die—which is why we live in a world dominated by mammals instead of dinosaurs. The banks and financial institutions that dominate our world a generation from now may look nothing like the ones that do today, for better or worse. At some small risk of cornballery, it's worthwhile to point out that we have a democracy, more or less, so therefore the job of ensuring that the coming changes are for the better falls to each of us.

As you read this book, please do so while asking the question, how can you use the information here to help build those better financial institutions.

- Can you figure out a way to start a credit union, that perhaps improves on the models widely used today?

- Can you imagine a bank that does a better job of supporting its community and the kinds of economic activity you want to encourage?

- If you are an official of a city, town, county, or state, can you see a way to stop being a mere customer of Wall Street, and create financial institutions to wield the financial clout your government's assets should merit?

None of these questions will be easy to answer, but the future belongs to the people who figure out the right solutions.

Reading this book

We begin with the basics. Chapter 2 of *Checking the Banks* covers the basics of banking, including balance sheet accounting and the regulatory ratios that bank regulators use to analyze a bank's condition. You'll find a discussion there of bank capital and why it's so confusing, sample balance sheets of actual banks, and a look at the kinds of measurements bank regulators use to assess a bank's health.

Chapter 3 discusses the actual operation of a bank, including the kinds of risks a bank's management must navigate, and the tools at their disposal, the other players in the field, and the financial terrain. It also describes where bankers hide the magic beans with which they grow money.

Chapter 4 looks a little more deeply at some important regulatory issues and developments, including the questions of how banks and regulators evaluate risk and what they do about it. All of these chapters are meant only as introductions to the subjects. Any of the subsections are worth a book of their own.

The second half of this book is addressed not just to the student of banks, but to the activist who might attempt to establish something new. Chapter 5 discusses the mechanics of starting a bank, from the conceptual level, along with some of the basics of preparing a believable business plan. This material is only meant as a supplement to what is available from the bank regulators themselves. The FDIC and OCC web sites contain a wealth of information on the subject, too, including sample business plans, FAQ lists, and sample financial reports from startup banks. There are thousands of ways to go about starting a financial institution, but one hard and fast rule is that no one should contemplate an endeavour like this without spending quality time browsing those web sites.

Chapter 6 is a brief look at the ways in which local, county, and state governments are customers of banks. A great deal of Americans' collective wealth is held by these governments; these are assets that could be harnessed to reshape the banking market.

Finally, Chapter 7 presents some possibilities for new institutions. None of these will be usable as presented, due to differing

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state laws and local economic and fiscal conditions. They are presented here as a stimulus to the imagination of those who read that far.