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Causes and Results

Abandoning Capitalism and Limiting Democracy

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Notes

I was invited to speak to a group of approximately 300 small business men Wednesday. The task was to explain, in as concise terms as possible, the state of the financial industry in the United States. There was a desire to know what caused the crisis in 2008; what the reaction to that crisis was; what the consequences of that reaction have been; and what bank stocks look most attractive at this point. Since I never write speeches in advance, there was no record of my comments. I was, however, asked to recreate these thoughts in written form. The commentary below provides the key themes with a little extra thrown in.

Demographics

It is hard to believe but the financial crisis is the result of demographics perhaps more than any other factor. The Noble Laureate Gary Becker in his classic study *Human Capital* presented the following thesis. He argued that the return on investment in children born in complex economic societies is relatively low and, therefore, there are fewer children born per woman in those economies.

For example, in Ethiopia, the average female was giving birth to almost 7 children, 20 years ago, and is still giving birth to about 5 children today. In the United Kingdom the rate of births per female is roughly 1.75, while in Germany the number is closer to 1.35 children per woman. It is true that the mortality rate of children in Ethiopia is greater than the mortality rate in a European country but the end result is still that there are significantly more children being born in Africa than in Europe.

Thus, the United Nations projects that by 2050, there will be more people in Ethiopia than in the United Kingdom and Germany combined. Going one step further, there will be more people in Nigeria, than the United Kingdom, Germany, France, Italy and Spain put together. There are expected to be more people in Egypt than there are in Russia. One of every four people on the planet will be on the Indian sub delta which is composed of India, Pakistan, Bangladesh, Afghanistan and Nepal. Mexico's population growth rate will be relatively low but just about double that of the United States.

There are multiple implications from this shift in the global population. They are political, religious, and economic. What I am interested in is the economic and financial impact. More specifically, the probability is that labor costs, have been, and are going to remain relatively low in the countries which have high birth rates and simple economies.

Trade

In 2005, Thomas Friedman, wrote a popular book entitled *The World is Flat*. This book indicates that manufacturing can be done efficiently anywhere in the world. Systems and transportation have improved to the extent that it is not necessary to produce goods in countries with advanced educational capabilities. The key is to produce in areas which have cheap labor.

This, of course, has been underway in the global economy for multiple decades. In the period leading up to the financial crisis, China's trade surplus with the world kept growing. It was just under $300 billion in 2008, the year of the crisis. It fell meaningfully during the global economic setback but is back to just under $400 billion in 2014. Nigeria actually had a trade surplus of $37 billion in 2014.

Too Much Money is Trouble

The problem with a sudden and dramatic shift in trade surpluses is that they build huge increases in reserves relatively quickly. At the end of 2000, the reserves at the People's Bank of China were an estimated $168 billion. By 2008, they were $1.7 trillion and now they are pushing $4.0 trillion. The rapid growth in this money created a problem for China and other nations with significant increases in their reserves. The funds had to be invested but where could such a large amount of money be absorbed?

The answer, early in this century, was the developed nations and, most importantly, the United States. Initially, the funds were placed into the purchase of Treasury securities. At the beginning of 2000, the Chinese held no U.S. Treasuries. By the end of 2008, the country had purchased a net $770 billion plus. China now holds an estimated $1.3 trillion. Huge as these investments were there was still a need to buy more securities to absorb the rapid growth in that nation's wealth.

The only industry that had the potential to absorb more trillions in investment appeared to be residential real estate. So, trillions of dollars were poured into the purchase of mortgages. In 2000, there were $5 trillion in mortgages outstanding in the United States. By 2008, that number had more than doubled to over $11 trillion.

The problem was that the demand for housing from "legitimate" sources did not require $11 trillion in mortgage money. The number needed was somewhat less. How much, I do not know? What I do know is that there was so much money flowing in that the bankers and others kept adjusting the underwriting rules to increase the households "qualified" to obtain mortgage money. The decision was made to go out on the risk curve.

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Even this did not create enough demand to absorb the flow of funds that was now coming from multiple places to be invested in mortgages. Therefore, one more technique was utilized to absorb the excess funding. Financial engineering was used to sell the same mortgage multiple times. This was accomplished by creating new financial instruments like collateralized mortgage obligations, collateralized debt obligations, collateralized debt obligations squared and even cubed.

The inevitable then happened. Debt was expanding at a much more rapid rate than income. Thus, ultimately there was not enough income to pay for the increase in the debt. No income equals no payment, equals collapse in debt, equals financial crisis.

Affixing Blame

What is shocking to most is that this process is not unusual. Charles Kindleberger, now deceased, spent his career tracing financial collapses. His research went back hundreds of years covering multiple countries. In recent times Carmen Reinhart and Kenneth Rogoff did the same, in their case going back to the 13th century. They discovered the same phenomena – i.e., financial collapses are a normal event in western financial systems. Kindleberger's work can be read in his book *Manias, Panics and Crashes* while Reinhart and Rogoff wrote *This Time is Different* (basically arguing that it was not different).

Another economist, Hyman Minsky, also deceased, wrote the theory explaining what drove financial crashes in a book entitled *Induced Investment and Business Cycles*. Professor Minsky believed that in good times there was a buildup of funds that grew at a faster rate than the economy. This led to bad investments and what is now known as a "Minsky Moment" – i.e., a collapse in asset values.

In the 18th and 19th centuries there have been multiple Minsky Moments in the United States. Real estate played a major role in many of these. There was the land grab and collapse just before 1800. Then came what may have been the biggest Depression in the history of the United States. It occurred from 1836 to 1843 driven by a collapse in real estate and banking. Virtually every element of that collapse was mirrored by what occurred in 2008.

However, no one in 2008 wanted to discuss either economic theory or financial cycles. The overwhelming political desire was to affix blame. Someone had to pay for what had happened. The decision made by the President, the Congress, the media, and the American people was that the financial system almost collapsed due to greedy bankers fostering illegal schemes. The simple solution to what had happened was "the bankers did it."

Some of this is true, bankers were a meaningful part of the problem. However, one can make the case that so was the government and so were the homeowners who wanted houses they could not afford. There were many actors in this tragedy each trying to obtain some of the cash coming from countries with huge trade surpluses. But trying to attack them all would have gotten the problem solvers nowhere. A more satisfying approach was simply to say that this was a unique event caused by dishonest bankers.

Fixing the System

Once having determined what caused the problem to the satisfaction of the country, the politicians set to fix it. Two complementary approaches were developed. There would be legal attacks on the evil doers and the system would be adjusted so a collapse of this nature would never happen again.

<u>Legal</u>

The President mandated that a division be established in the Justice Department solely dedicated to suing banks and bankers. This division, once created, then developed liaisons with attorney general offices in states across the country. Each state attorney general was given a subject to pursue in the hopes that a case to sue some bank or banker would develop. Hundreds of such lawsuits were found. Ultimately well over a hundred billion dollars was collected in fines. As part of the legal effort key government housing agencies also turned on the banks and refused to make good on guarantees and insurance. Instead they rejected the loans they had administered and threw them back to the banks that originated them when possible.

This process is ongoing. Billion dollar fines are still the norm. More and more areas are being investigated and the result of the investigations is continued litigation. The difference at this point is that the big irregularities have been attacked and the remaining lawsuits are now much smaller in size.

<u>Legislative</u>

In an environment of almost hysteria, a number of Acts were passed impacting virtually every aspect of the regulated financial systems. Legislators competed with each other to place amendments on the Dodd Frank Bill. So many legislative initiatives succeeded that a number of new agencies were created. Plus, more than 400 new regulations were mandated.

The ultimate goal was to gain control of the banking system so that it would be "safer and sounder." Some core concepts were followed:

- There was a belief that banks could never have too much capital. Following this belief there were regulations formulated which forced the banks to continually add to their capital base.
- It was also believed that bank balance sheets had to be de-risked. This meant;
    - Forcing more liquidity on to bank balance sheets, and
    - Controlling the nature of the loans being originated.

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- There was a strong belief that systems had to be put in place that would allow the regulators to monitor the banks every action.
- It was established that investors in banks were the perpetrators of the evil created by these companies and punishing them by controlling the payout of bank earnings as well as suing them in other venues was a critical part of the program.
- Plus, there was this underlying belief that the bigger the bank the greater the risk of an irregularity that would cost the taxpayer money.

Based on these views a number of core regulations were put in place. The most important may have been:

- The Basel capital requirement with its concept of risk weighted assets;
- The Supplementary Leverage Ratio;
- The Liquidity Coverage Requirement with its High Quality Liquid Asset demands;
- The Living Wills;
- The Total Loss Absorbing Capacity requirement; the expected Net Stable Funding Ratio;
- All backstopped by the annual Comprehensive Capital Analysis and Review

These are only a small number of the rules that were developed. For example, there was a heightened emphasis on the Bank Secrecy Act and the Anti-Money Laundering Laws and I have not touched upon the so-called Volcker Rule. Plus, literally tens of thousands of workers were put in place inside of the banks to assure the government that its rules were being obeyed.

Key Controls Developed

As a consequence of these rules, the banking regulators gained control of the following functions:

- They were able to get the biggest banks to start selling large portions of their businesses.
- They told banks how they wanted assets allocated.
- They controlled the nature of the loans being made.
- They forced banks to reduce their borrowings in short-term markets.
- They demanded that banks build in more capital in two fashions:
    - They forced banks to add more equity.
    - They demanded that banks build their long term debt.

In sum, the banking regulators now have total control over every major decision making function in the U.S. banking industry. I have not read Adair Turner's book *Between Debt and the Devil*. Lord Adair was the key bank regulator in Britain when the crisis hit in 2008. The description of the book on its Amazon page states the following:

> "Turner explains why public policy needs to manage the growth and allocation of credit creation … *Between Debt and the Devil* explains why we need to reject the assumptions that private credit is essential to growth …"

There was a time when this theory was called Socialism. It is the dominant theory now in place in the United States financial system. It is how the regulators run the economy.

Policy Decisions and Their Consequences

There are multiple policy decisions that could be discussed but I will limit this discussion to five: size, asset allocation, loan origination, borrowing long and lending short, and the Durban Amendment.

<u>Size</u>

There is an abhorrence of the concept "Too Big to Fail" in the United States as it relates to banks. Consequently, numerous techniques have been put in place which are oriented toward forcing banks to shrink. So the biggest four banks in the country have taken their share of banking assets down from 58% when the Dodd Frank Act was passed to 51%, at present. Citigroup has actually jettisoned $1 trillion in assets. Bank of America has sold 70 businesses and portfolios. JPMorgan Chase has embarked on a program to meaningful reduce its assets. The result is that the biggest U.S. banks have basically stopped growing.

There are four big banks in China. They have not stopped growing. In fact they are so big that the smallest of the big four, the Bank of China, is bigger than JPMorgan the biggest bank in the United States. The biggest Chinese bank has profits that exceed those of JPMorgan and Wells Fargo put together. In fact, shortly this bank, the Industrial and Commercial Bank of China, will have more assets than JPMorgan and Wells Fargo combined.

Why care? The reason to care is that the United States currency is the world's reserve currency. It is able to maintain that position due in great part to the actions taken by the United States' largest banks. If the biggest banks in the world are Chinese, the yuan could supplant the dollar or at least become equal to it as a global reserve currency. Once this happens the United States will be forced to stop monetizing its debt and pay it down. This will have very negative impacts on the U.S. economy.

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Asset Allocation

Presently, U.S. banks are required to have approximately 1/5th of their assets in liquid form. This means that they must buy high quality liquid assets (HQLA). These assets are basically deposits at the Federal Reserve and Treasury securities.

In normal times in the past, the Federal Reserve would be holding $10 billion to $15 billion in bank deposits on its balance sheet (bank deposits on the FRB balance sheet are called reserves). At present, because the banks are required to buy HQLA, the Federal Reserve is holding $2.7 trillion in reserves on its balance sheet. This is approximately 22% of the nation's M-2 defined money supply.

The Fed is holding so much money on its balance sheet that it is reducing the velocity of money in the country. There have been times in the past when $1.00 of M-2 would buy $2.00 of nominal GDP. At present this ratio has dropped to $1.00:$1.50. This decline means lower growth in economic activity and nominal GDP. In essence by forcing the banks to directly and indirectly (through FRB reserves) monetize the nation's debt, the banking regulators have taken economic growth and jobs away from the American people.

Loan Originations

The regulators are favorably attracted to some types of loans while they shun others. To assure that the banks make the loans that the regulators favor, every asset in a bank is given a risk weighting. A loan that is considerable desirable, like a qualified mortgage, has a low risk weighting requiring very little capital backing on a relative basis. A loan that the regulators do not like such as a highly leveraged credit may be hit with a high risk weighting or simply a demand from the Fed for banks to stop making these loans.

The Justice Department has jumped into this discussion and actually prohibited banks from making loans to businesses that the Justice Department does not like. Thus, a business that is operating under the laws of this country and not involved in any illegal activity can be and has been cut off from funds if the Justice Department tells the banks to back off.

The Consumer Financial Protection Bureau also has some say in this matter. It has opined that if a bank makes a type of mortgage that the CFPB does not like and that loan goes bad, the borrower can sue the bank for making the loan. The FHA goes further. If an FHA loan originated by a bank goes bad, the FHA reneges on its promise to insure that loan. Instead, it throws the loan back at the bank so that the bank loses money on it. Then the FHA fines the bank for making the loan. This policy has virtually stopped banks from making FHA-insured loans or mortgage loans that are deemed to be non-qualified by the CFPB.

Borrowing Long and Lending Short

The Total Loss Absorbing Capacity (TLAC) rule mandates that 18% of a bank's assets be funded by long term debt. Long-term debt costs roughly 5% to 6%. The High Quality Liquid Asset guidance requires that banks put an estimated 20% of their funds into Fed Funds and Treasuries. These yield 25 basis points. In sum, for a portion of their money, the government is demanding that the banks have negative returns.

The theory is that banks are safer if they are long funded. My theory is that banks are vulnerable to upset if they lose money on the liabilities that they gather. If banks are to generate capital, they must attract investors. They cannot attract investors if the investor is not allowed to make a reasonable return.

Durban Amendment

The reason for pointing this part of the legislation out is because it demonstrates how targeted the government has been in imposing its will on the banking industry. The Durban Amendment to the Dodd Frank Act requires the Federal Reserve to establish the price a bank can charge when a debit card is used. It was explained prior to the amendment being passed it was nothing more than a decision by the government to take funds away from the banking industry and give the money to the retailing industry.

This is exactly what happened. However, while Congress was paying off the retailing industry with a multi-billion dollar windfall, an unexpected development occurred. Banks stopped providing free checking and they increased service fees on bank accounts. The consumer provided the windfall to the retailers not the banks.

This concept that the government is allowed to reward whomever it chooses with funds taken from the banks may be expanded. There is currently a highway bill before Congress in which it is mandated that the revenues from the investments that the banks are forced to make in the Federal Reserve are to be reduced and given to the contractors who rebuild the nation's highway system.

Democracy

I want to make one quick point about Democracy before talking about which stocks are most attractive. The Consumer Financial Protection Bureau (CFPB) was established as an agency within an agency. Its funding comes from the Federal Reserve and the ability of the CFPB to sue companies and individuals. There is no oversight to the Director of this agency. The President has no control over him or her. Congress has no say in what s/he does. There is no oversight group within the CFPB. There is no Board of Directors.

The CFPB was established in this fashion to make it immune to political pressure. The Congress and the President felt that this was necessary since this Bureau was set up to regulate and sue anyone it chooses associated with consumer and small business finance.

Think about this, however, political pressure stated differently is democracy. It is the will of the people. Congress has set up this agency to tell the American people what to do and the American people cannot in any way have any say in what this agency does. I assume that the agency will be run by Plato's philosopher king and, therefore, needs no oversight from the people of this country. However, even philosopher kings need some accountability in a democracy. In this country the CFPB director has none.

Bank Stocks

So how can one make money in banks stocks when the industry they are in has been effectively nationalized?

- These companies are restricted in their ability to grow their balance sheets.
- They are being forced to load up on low yielding assets.
- They are being told to fund these assets with high cost liabilities.
- They must absorb unusually high regulatory costs.
- They are losing market share to unregulated financial companies (another issue that requires discussion at some point because the regulators have effectively de-regulated the financial system by incenting transactions to move away from regulated companies).

Based on this information it would appear that banks which are cash rich with large securities portfolios of short duration have an advantage. When interest rates go up, banks are likely to experience a rise in the yield on their assets while holding back on raising the cost of their liabilities. If these banks have also built up a significant amount of long-term capital they will not be forced to pay up for these funds at all.

This suggests that one should be focusing on universal and trust banks. In a rising rate environment they do not need take any action and their profits will move sharply higher.

	Millions					As a Percent of Assets			
				Cash &				Cash &	Cash/
	Assets	Cash	Securities	Securities		Cash	Securities	Securities	Common
Universal Banks									
Bank of America	$2,153,006	$176,911	$391,651	$568,562		8.2%	18.2%	26.4%	75.7%
Citigroup	$1,808,356	$159,661	$342,439	$502,100		8.8%	18.9%	27.8%	77.6%
JPMorgan	$2,417,121	$397,454	$306,660	$704,114		16.4%	12.7%	29.1%	180.9%
Wells Fargo	$1,751,265	$17,395	$345,074	$362,469		1.0%	19.7%	20.7%	10.2%
Trust Banks									
BNY Mellon	$377,371	$110,662	$120,105	$230,767		29.3%	31.8%	61.2%	310.7%
Northern Trust	$119,995	$40,673	$37,368	$78,041		33.9%	31.1%	65.0%	484.4%
State Street Corporation	$247,274	$72,021	$97,560	$169,581		29.1%	39.5%	68.6%	383.2%
	Assets	Debt	Preferred	Common		Debt	Preferred	Common	Total
Universal Banks									
Bank of America	$2,153,006	$237,288	$22,273	$233,632		11.0%	1.0%	10.9%	22.9%
Citigroup	$1,808,356	$213,533	$15,218	$205,630		11.8%	0.8%	11.4%	24.0%
JPMorgan	$2,417,121	$292,945	$26,068	$219,660		12.1%	1.1%	9.1%	22.3%
Wells Fargo	$1,751,265	$185,274	$22,424	$170,627		10.6%	1.3%	9.7%	21.6%
Trust Banks									
BNY Mellon	$377,371	$21,430	$2,552	$35,618		5.7%	0.7%	9.4%	15.8%
Northern Trust	$119,995	$2,892	$389	$8,396		2.4%	0.3%	7.0%	9.7%
State Street Corporation	$247,274	$12,025	$2,703	$18,797		4.9%	1.1%	7.6%	13.6%

Conclusion

From my perspective the United States largest banks have been nationalized in every respect but the taking away of shareholder equity. The nation now operates under a financial system whereby:

- The supply of money is regulated by a government agency;
- The cost of money is also set by this agency; and
- The flow of funds through the economy is further set by a government agency.
- Policy concerning the financial sector is also set by this same financial agency

The direction of the economy is being established by the vote of less than a dozen people and no one in the Congress or Executive Office has any say in the decisions being made. To me this is extremely unhealthy particularly given the history of decision making at the Federal Reserve. I still believe in two core parameters:

- In a capitalist system the use of funds is determined by need at the grass roots; and
- In a democracy elected officials should be making the key decisions based on the demands of the American people.

This system has been meaningfully adjusted in this country.

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