

Book Reviews by Ian Robertson



ODLUM BROWN
Investing for Generations



Ian Robertson, CFA, MBA, MA – Vice President, Director, Portfolio Manager | T 604 844 5424 | Toll Free 1 888 886 3586 | irobertson@odlumbrown.com
Odlum Brown Limited | Suite 1100 – 250 Howe Street | Vancouver, BC V6C 3S9 | Member-Canadian Investor Protection Fund

Title: *The Bankers' New Clothes*
Author: Anat R. Admati, Martin F. Hellwig
First Edition: Princeton University Press (2013)
Reviewed: March 2013



“A clearly written prescription for what ails our banks.”

Many books have tried to explain the origins of the 2008 financial crisis, and many more have offered advice to prevent a recurrence. *The Bankers' New Clothes* is the clearest prescription yet to address the central cause of the crisis: the financial system itself, and in particular modern (overleveraged) banking. An outstanding book that should be read by everyone: politicians, regulators, bankers, and those with an interest in a stable financial system (i.e. anyone with a bank account, who pays taxes, or has a job).

Rating:



Out of 5 Stars

The authors share their motivation in the preface; they had “hoped that the lessons of the crisis would be learned ... but ... were disappointed. There [has been] no serious analysis of how the financial system might be made safer.” They follow with a caution, and then their goal: “The banking system, even with proposed reforms, is as dangerous and fragile as the system that brought us the recent crisis. But this situation can change. With the right focus and a proper diagnosis of the problems, highly beneficial steps can be taken immediately.”

While the motivation for the book was the recent financial crisis, the authors focus much more on the structure of financial institutions and the financial industry than they do on the recent sub-prime meltdown. In one set of examples, Admati and Hellwig link the 1980s U.S. savings and loan debacle and the recent “rogue” traders at Barings Bank, Credit Lyonnais, and JP Morgan to the risk and oversight structure of banks, and the perverse incentives for individual and corporate risk-taking – the same structural issues at the heart of the recent crisis. They also expose the repeated obfuscation of banks and lobbyists, highlight the complicity of politicians, and on occasion correct misinformation promulgated by individuals who should know better (former Federal Reserve Governor Frederic Mishkin).

The authors' explanation of how banks work, in particular leverage and capital requirements, is exceptional. They start with an example everyone will understand – a home mortgage – and link it to the gain or loss the homeowner would experience if their home rose or fell in value over the course of a year. The same methodology is then used to show how a bank would fare given a similar rise or fall in the value of its assets; gains and losses are magnified due to the bank's leverage. An illuminating real world example is highlighted in their diagram of JP Morgan's self-described “fortress” balance sheet. Using U.S. (GAAP) accounting principles the very high leverage is apparent, but using European (IFRS) accounting principles the leverage is almost double again!

The global regulatory response to over-leverage is set out in an agreement called Basel III, which phases in over the coming years a new global agreement on a bank's reserve requirements. The authors ridicule the effort as wholly inadequate: too vague; too easy for banks to manipulate (what exactly are "risk-weighted assets"?); too lax (3% equity to total assets); and too slow to implement (2019 for the risk-weighted assets portion). Their prescription: issue equity immediately or stop dividend payments (i.e. preserve capital within the banks) until the capital equals 30%. Harkening back to the authors' initial example of a home mortgage, the banking system would move from a 3% "down payment" to a 30% "down payment" margin of safety.

Alarming, disheartening, and a call-to-action, *The Bankers' New Clothes* could not be more timely or better written. Written for a general audience, the book explains issues and industry terminology very well; features outstanding examples and analogies; and concludes with specific remedies and an estimate of associated costs. As an added bonus, the book features an unparalleled notes section, which at over 100 pages is a worthy read in itself. A truly outstanding effort.