Introduction

What this book is about

Why would anyone who does not work in the banking industry want to read a book about banking? The subject should be a bore. Savings accounts are not fashionable. Mortgages do not entertain. Most of us – well, apart from banking professionals and a few banking professors like myself – have better things to do than think about payment cards or credit transfers. All we want from banks is security and convenience: we want to trust them as the best place to keep our money and to be able to use our money without difficulty, so we can enjoy the things we desire – say a new car, a well-earned holiday, a restaurant meal, the latest DVD or the new jacket that has caught our eye. Some of us also want to be able to borrow reasonable amounts of money at not too great a cost and others – those with some cash to spare – are interested in the return that banks offer on savings. But even interest rates on bank borrowing and lending are only of passing interest, at those times when we have financial decisions to make.

Today, though, banking is attracting unusual attention. The reason is, of course, that banks are in deep trouble. Far from being boring, banks now arouse strong emotions: shock, confusion, anger and fear. Trust in banks has evaporated. Are they safe? How did they get into such difficulties? Who is responsible for their problems? How can we best prevent these spilling over into lost jobs and lower income and financial problems for all of us?

The problems originated with the bubble in US house prices, but have since turned into a global banking and financial crisis more severe than any since the 1930s. This is now producing such a sharp reversal of bank lending – the 'fall of the house of credit' referred to in my title – that the world is now facing the deepest and longest-lasting economic contraction since the great depression of the 1930s. If politicians and policymakers fail to respond appropriately, the present downturn could turn out to be even worse than that terrible economic tragedy. This book explains how and why all this happened and what needs to be done to prevent a new great depression.

The 'how' is the easy part. In these pages you will find a concise account of the key events in the crisis, as they evolved from the initial slowdown in the US housing market in late 2006 until the global banking run of late 2008. These developments are placed in their broader economic and business context. The economic context was the growing global current-account imbalances, with savings from China, Japan, Germany and other surplus countries recycled to finance the consumer credit and housing boom in the United States, the United Kingdom and other deficit countries. The business context was the rise of a system of 'parallel' banking, with credit intermediated not through traditional retail deposits but using new innovative credit instruments, held by banks and financed through short-term wholesale money markets.

The 'why' and 'what' are more difficult. The unsustainable boom of credit and house prices that preceded the crisis had its roots in psychology and culture and what has been aptly called the madness of crowds. This statement in itself is not controversial. Many others have written about the role of euphoria and of mutually self-reinforcing beliefs when the banks were building up their large exposures to household and risky corporate debt, the exposures that are now proving so difficult to manage. The controversial argument made in this book is that psychology, culture and crowd madness are playing an equally important, if not bigger, role in the crisis itself. What has been pushing many banks to the wall is not poor lending decisions but a blind panic, an overreaction to mistakes made during the boom, a panic made possible by the reliance on highly unstable short-term funding, in which professional investors are fleeing from any form of bank exposure.

This panic is being reinforced by a powerful stream of negative commentary on banks, financial markets and the economy. Media commentary and the sentiment of bankers and investors have switched in little over a year from blithe optimism and overconfidence to fatalism and extreme pessimism. Consumers and governments, especially in the English-speaking world, have borrowed far too much. There is nothing else to be done except cut back on our spending and sell off all our assets to reduce borrowing. Banks assets are worth far less than the banks pretend and they may be hiding even worse problems. They must reveal the full extent of their holdings of 'toxic' assets and revert to being cautious, riskless utilities.

Arguing against this fatalism does not mean understating the seriousness of the current financial and economic situation. This crisis has already spread to the real economy, as evidenced by falling economic output and the many millions who have already lost their jobs. This will not be a short-lived recession of a few months' duration, like those that have occurred every few years since the early 1980s. It will be deep and long lasting. Global output and income look as if they will fall by as much as 5 per cent before stabilizing. There will be no return to rapid, consumption-led growth in the deficit countries, the spending that has led the global economic expansion of the past twenty-five years. The world economy will have to adjust to a different pattern of trade and growth, something which will take years, and in the meantime growth of output and incomes will be modest at best.

This is a huge political and economic challenge. Western countries face major long-term changes, shifting the balance of economic activity from consumption and importing to investment and exporting. Politicians have had an easy time during the fat years, courting popularity and winning votes by offering spending or tax cuts paid for out of the fruits of future consumer-driven growth. Now the growth is no longer there, but most politicians continue to be under the illusion that they have the policies to restore the good times and allow the policies of high spending and low taxation to continue.

Adjusting to the new political and economic realities of lower growth and much tighter public finances would be difficult even with well-managed banks and sound bank balance sheets. The banking crisis – a crisis caused by panic and unstable funding arrangements and therefore entirely avoidable – threatens to make the economic situation far worse, triggering a cumulative collapse of credit, output, and jobs that could go as far as to fracture our society, to undermine our political fabric and destroy much of the way of life that we have enjoyed for more than fifty years. This is a far more dangerous threat to Western democracy than terrorism or even, at least within the horizon of the next decade or so, climate change.

Policymakers around the world, led by the new Obama administration in the United States, can avoid this outcome. While economic adjustment will be difficult and painful, there is no need for a collapse of bank credit to worsen the decline of economic activity. The clue to preventing such a banking calamity is to be found in the origins of the word 'credit', derived from the Latin 'credere', meaning 'to believe' or 'trust'. Bankers made many mistakes. Some risky exposures, such as sub-prime mortgages and leveraged loans, got out of control. Traders and senior management were paid outrageously large salaries for taking responsibility for and then losing a great deal of other people's money. Trust was betrayed.

But that was in the past. The task now is to rebuild trust. Despite all those mistakes banking is fundamentally sound. The problem is not, as many claim, that banks are hiding losses. Strict 'mark to market' accounting rules mean that losses have been more than fully acknowledged. The majority of bank assets are still of good quality. Many are worth far more than bank accounting statements suggest. The value of bank investments will bounce back once the economy stabilizes and markets recover. There will then be very many opportunities for banks to lend to creditworthy borrowers.

The reason this is not yet happening is the absence of trust. Panicked global investors no longer believe in banks or bank assets. Banks themselves do not trust in the future. They cannot raise money to lend, and when they can raise money they will not lend it.

This, then, is a time for leadership. The duty of government is to provide that leadership, to demonstrate that, even if right now no one else does, they still support the banks. Money, if necessary extraordinarily large sums of taxpayer money, must be placed on the table and made available to support banks and enable them to start lending again. Of course this must not be done recklessly. Blanket guarantees are not appropriate. There have to be clear arrangements for sharing both profits and losses between government and taxpayers on the one hand and banks on the other. Banks and their shareholders should still be exposed to normal business risks. Central banks, government and ultimately the taxpayer will have to take responsibility for economy-wide disasters, providing insurance against extreme 'systemic' risks. This is needed in order to allow banks to lend freely again, thus beginning the process of ending the market panic and re-establishing investor and customer trust in our banks.

What must banks do in return for this support? What we, as taxpayers and citizens, need to see in return is banks themselves beginning to take actions that demonstrate that they merit our trust. Banks are going to have to do a huge amount more than in the past to explain and communicate their activities to investors and customers. They are going to have to focus on basic simple products and services. There will still be room for some sophisticated financial engineering, such as credit derivative and securitizations, but it will be up to banks to explain exactly how they are using these tools and what they contribute to their business.

Banks are also going to have to develop a new and more persuasive vision of their future role in business and society. Once the banking system and financial markets are fixed the sources of future global economic growth will not be the same as before. We will no longer be able to rely on stimulating consumer spending in the West in order to increase output and employment. We will have to do much more in the developed countries of Europe, North America and Australasia to raise productivity both in private business and in government. Developed and emerging economies will have to work together on rebalancing the world economy, offering the citizens of the emerging world higher levels of consumption and citizens of the developed world more opportunity to earn a living supplying goods and services.

This has further important implications for Western banks. Growth in their consumer lending businesses will be in emerging markets, and not, with the possible exception of Japan and Germany, in the developed world. They need to deal with some of the gross inefficiencies that still pervade basic banking transaction and payment systems. They will need to offer much more effective banking services to the small and medium-sized enterprises that will generate the income that in turn repays the large pool of global savings borrowed by Western consumers.

Who this book is for

I have set myself the goal in writing this book of explaining the banking crisis and to outline how it can be resolved in a manner which does not oversimplify but can be read by any concerned citizen. This decision – to write for a general not a specialist audience – has posed considerable challenges. I have had to explain in straightforward language how the new credit instruments and credit markets at the centre of our financial problems operate. I have also had to provide an account of the evolution of the crisis, from its early beginnings with the weakening of US house prices in the second half of 2006 to the dramatic collapse of confidence in global banks in autumn 2008, which does not assume specialist knowledge but covers all the key developments in sufficient detail to explain not just what happened but also why it happened in this way. Along the way I have had to reveal some of the mysteries of central banking and bank funding and liquidity management, subjects which normally are of concern only to specialists but are key to understanding the current crisis.

So why go to such trouble to explain technical details which many experts will already know and understand? In part this is because such explanation is one of the pleasures of my chosen profession. There is little more satisfying to a professor than introducing students and others to subjects that at first seem difficult and challenging and showing that they are not really so hard to follow after all. But the main reason for writing this book for a general rather than a specialist audience is because I want to do my best to tackle one of the root causes of our present economic and financial difficulties, the excessive faith placed in 'experts' such as financial engineers, derivative traders, investment advisers, equity and banking analysts, fund managers, risk managers and economists, and the resulting excessive specialization that is hampering our response to the crisis.

In fact, as I shall show, the new financial instruments and our current global financial situation are not really that complicated or difficult to understand. Bankers have often preferred to conduct their business in as sophisticated and roundabout a way as possible. That way, it is not too clear when they are doing a good or a bad job; they can charge high fees and not be too worried about competition from other professionals doing the same task just as well for a smaller fee; nor, then, do they have to be too concerned about customer complaints, because few customers can tell whether they are getting good value or not.

This lack of understanding of how financial instruments and financial markets work suits the specialists in good times. But it has come back to haunt them. This is another reason why the blithe optimism of the recent credit boom has given way so quickly to confusion and excessive pessimism. The experts on banking and financial markets and global economics are themselves all so specialized and so compartmentalized that, while they have a detailed understanding of their own small part of the credit and financial system, few can join up all the dots and present a complete picture of what has been going on and how the problems of the banks can be repaired. This practice – of bankers and financial experts working in compartmentalized silos without any need to pay attention to the operation of the business as a whole – is one of the main reasons why the industry and financial markets are in such disarray.

Financial journalists who report on these events are also struggling to make sense of them and have tended – in rather herd-like manner – to run in the same direction as investors from one extreme viewpoint to its opposite, from naive faith in the efficiency and power of markets to great scepticism about market forces. The dominant voices in the media now call loudly for much closer supervision, regulation and controls of financial institutions, for the clearing out of 'toxic' assets, and for a massive 'deleveraging' – that is, reduction of private-sector borrowing and lending.

A sensible book written for a general not specialist audience can help restore some much-needed balance to these debates. Yes, there are serious problems with bank loan portfolios, but the overall quality of bank assets is far better than the broadcast media and other commentary suggest. A lack of long-term funding – in the professional jargon a lack of bank 'capital' in the form of both equity and bonds – is the main factor undermining bank balance sheets. This is a chicken and egg problem. The global downturn is being driven by shortage of bank credit. A sufficiently large injection of capital into the entire global banking system will allow banks to lend to all creditworthy borrowers looking for funds. This will stabilize the global economy and ensure that most bank borrowers are able to repay their loans. But the fear that borrowers will not repay their loans prevents investors providing banks with the necessary capital. So the cumulative global collapse of output and activity continues. The global economy will not stabilize without new bank capital and private investors will not provide banks with new capital until there is stability in the global economy. Only decisive government action on a grand scale to recapitalize banks can end this downward spiral.

This does not mean igniting another unsustainable credit boom. Many households and companies will have eventually to 'deleverage', reducing the amount of borrowing against their incomes, but there is no need for this process to take place in a hurry. On the contrary, the sooner the banks are adequately recapitalized and the supply of bank credit restored, then the slower the reduction in leverage and the more it will take place through increases in incomes rather than sale of assets and repayment of debt. Generous recapitalizing of the banks is essential if we are to have an orderly adjustment to our present financial and economic challenges.

A closely related chicken and egg problem is the closure of the new markets for mortgage-backed and other structured credit securities. These are a key source of both long-term funds and liquidity for many banks. But now, because there is no functioning secondary market for buying and selling these securities, investors will not touch even the safest versions of them. The market cannot reopen because no investors will buy these securities and no investors will buy these securities because the market remains closed. This is another fixable problem undermining bank balance sheets.

In short, this book presents a clear statement of how government support can give the banks the opportunity to recover from their present difficulties. This book, if you like, places a flag on the high ground – presenting an intellectual and practical case for the large sums of money now being offered by financial authorities in the United States and other countries to repair bank balance sheets.

There is plenty of room for debate over the exact form of this support. The media and the public, understandably, are suspicious of the apparent use of large sums of taxpayers' money to protect banks from the consequences of their own mistakes. Details of the rescue plans can be challenged. It is arguable that the authorities are doing too much to help shareholders and bank bond holders, and that the interests of taxpayers would be better served if financial support for banks were accompanied by corporate restructurings, so that shareholders receive nothing and bond holders' interests are written down to cover part of the overall costs.

But these are side issues. The priority is ensuring that enough is done to remove all concerns about the quality of bank balance sheets and the stability of the banking system. The exact way this is done is secondary. Failure to act, because of disputes over how to act, will impose ultimate costs on taxpayers, from lost output and jobs, far greater than any undeserved subsidy to bank management, bond holders or shareholders.

The curse of excessive specialism is also affecting politicians, government officials, central bankers and financial regulators. They have struggled to come up with a coherent, common approach to the crisis. As this book documents, policymakers around the world have been groping their way towards a sensible and appropriate response to our present problems. Governments and central banks worldwide have taken firm action and committed very large sums to dealing with the crisis. But these responses have been halting and sometimes inconsistent, with policymakers switching from one approach to another and giving the impression that they were trying out anything to see what works, rather than having a clear understanding of what they were trying to do. Government officials and central bankers have also struggled to present a clear account of their actions to their political masters and to the electorate, whom politicians and officials alike all serve.

Creating a bridge between these different specialisms, between credit specialists and managers and between officials and bankers, is a further reason for writing for a general rather than specialist audience. I have sought to provide a clear picture of the crisis that can be understood by all these different groups, explaining how the new banking and credit markets worked, why they have got into difficulties, and how support from taxpayers and investors will allow the new credit markets and the banking industry to recover from their present problems. If I have been successful, then this book will also help officials, politicians and industry to engage in a more constructive policy debate.

A key point is that we need to move beyond blame and accusation and think about how, as we go forward, credit and loan risks will be shared between investors and taxpayers. Taxpayers are already, implicitly, providing extreme 'disaster insurance' to banks, since if banks fail then the taxpayer must pay the bill to protect depositors and the financial system. An obvious further step – to rebuild and sustain trust in the banks and restore confidence in the new credit instruments, so avoiding an unnecessarily large economic contraction – is making this disaster insurance open and explicit. This is in fact exactly the rationale behind many current policies, such as widespread guarantees of bank assets and liabilities.

The writing of this book

The text was written over an eight-month period between July 2008 and March 2009. Figures and tables have been updated to the end of December 2008. I have not attempted to take account of the most recent developments – for example the emergence of the Madoff investment fraud – in any systematic fashion. I have, however, included references to some of the most prominent events in the weeks while I was finalizing the manuscript. Inevitably, even much of what has taken place to date has been left out. The focus is on the major banking and financial markets. Marshalling this amount of material has left no further space for discussing the truly devastating impact of the crisis on global trade and industry, on the periphery economies such as those of eastern and central Europe, or even on secondary financial centres such as Dubai, or the painful impact on the economies of Ireland and Spain.

My own background and experience impelled me to write this book. I know the new credit instruments well, from teaching courses at a leading UK business school on credit products and credit risk management, covering topics such as mortgage-backed securitizations, credit default swaps, and collateralized debt obligations. I have worked on problems of bank risk management and regulation for more than a decade. The earlier part of my career was spent in macroeconomics, during which, among other responsibilities, I worked on monetary policy and also researched and analysed the UK housing boom and bust of the late 1980s and early 1990s. This places me in an ideal position to explain both the details of how the new credit markets and instruments work and the bigger picture of how they led the industry and the wider economy into crisis.

Like most others I thought that the worst was already behind us by summer 2008. In fact many of the most dramatic events – such as the loss of confidence in the giant US mortgage institutions Fannie Mae and Freddie Mac, the failure of Lehman Brothers and the run on the global banking system that followed, and the massive interventions by central banks and by governments worldwide – took place while I was working on the manuscript.

A danger in writing any book such as this about current events is that it may date quickly. I have no crystal ball that allows me to foresee what other dramas might yet affect banks and financial markets, and I am not attempting to predict the future. Nevertheless much of this material will remain current. A central concern of this book is with the perennial debate that arises in every financial crisis and is at the heart of this crisis. On the one side are those who insist on