Two Paths to Financial Resilience:
From Symbiotic Finance to Megabanks

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Map

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1. Financial resilience: initial experiments

- There is an emerging literature on financial resilience:
- 1. Financial firms and economies with interconnecting claims rise or fall together when shocks hit – Minsky cycles without Minsky (eg, May/Levin/Sugihara, "Ecology for bankers" *Nature* 2008; May/Haldane, "Systemic risk in banking ecosystems" *Nature* 2011)
- 2. The contagion of shocks can be explained by banks' network linkages (Allen/Gale, "Financial contagion," *JPE* 2000)
- 3. Financial accelerators (destabilizing, not stabilizing, dynamics) emerge in evolving credit networks (Delli Gatti, Gallegati, Greenwald, Russo, Stiglitz, *JEDC* 2010).
- But: *why?*

2. Two visions of financial-system growth

- A fundamental question: is the financial system autonomous from the real economy? Two analytical paths:
- First, no; it depends on the real economy's productive capacities; so its growth is bounded by its capacity to add value to the actions/behavior of agents in that economy. And, this real-sector production is the basis of its economic growth.
- Yes; Thorsten Beck has suggested "too much finance" may actually reduce, not increase, economic growth. Again – *why?*
- The answer has to be that finance can grow autonomously from the real sector. It does not serve it, is not dependent on it.
- But recognizing this forces us to new models, approaches.

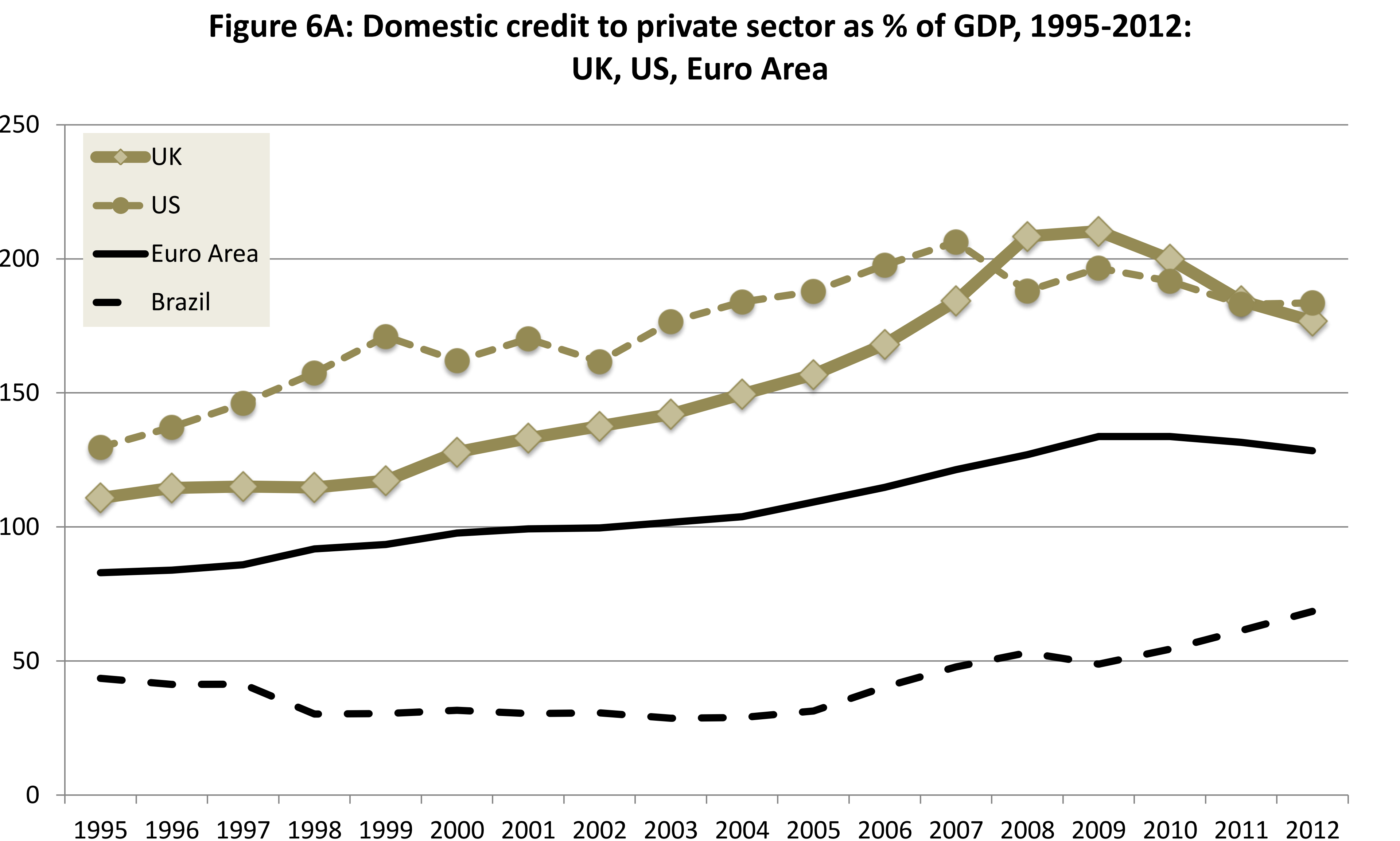
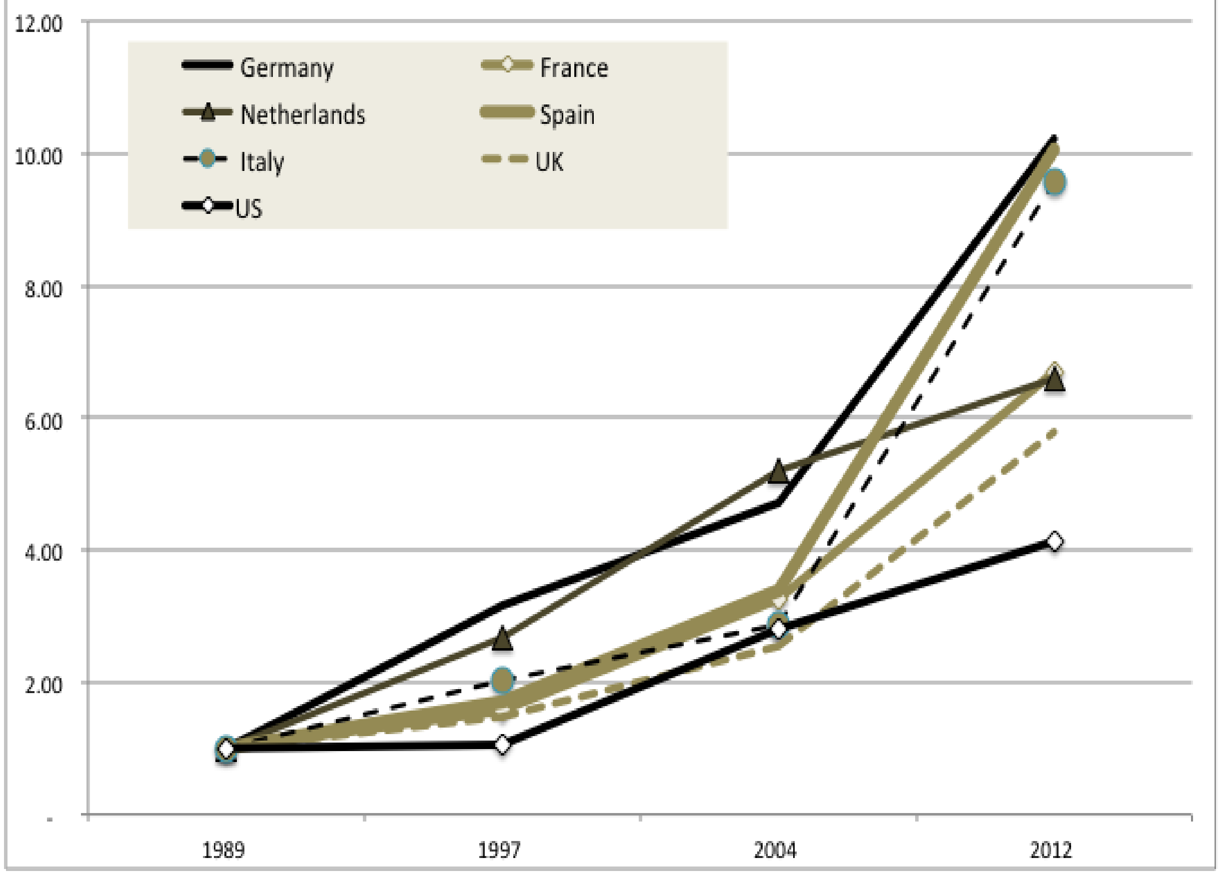


Figure 6A: Domestic credit to private sector as % of GDP, 1995-2012:
UK, US, Euro Area
UK
US
Euro Area
Brazil
250
200
150
100
50
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012

Figure 14: Assets of the largest domestic bank as a percentage of GDP, selected countries: 1989, 1997, 2004, and 2012 (1989 = 1.0)



Accompanying this hyper-expansion of finance relative to income flows is the upward shift in the income of the upper 10% (Piketty) and the parallel growth of megabanks at the "micro" scale.

3. Symbiotic finance in a productive circuit of capital

- Keynesians and Marxians too view finance in the context of the trajectories of capitalist accumulation. Such as:

M	–	C (MP,LP) …C’		–	M’
Equity, working-capital finance		Trade credit, Risk-management	Consumption credit		Expansion finance

- Here, as in the finance-growth literature, finance is symbiotic: it earns by supporting market flows of commodities, goods markets
- Finance has productive spillovers: it augments the pace of the accumulation and circulation of capital; its size is limited by the scale of accumulation, and its activities by the needs of accumulation.
- Minsky: investment (finance) restores growth after downturn.
- *Well, is finance serving the economy?*

Figure 10A: Trough-to-Peak GDP and Loan Growth, U.S. Commercial Banks, Average annual % change, Five-year time-spans, 1961-1990

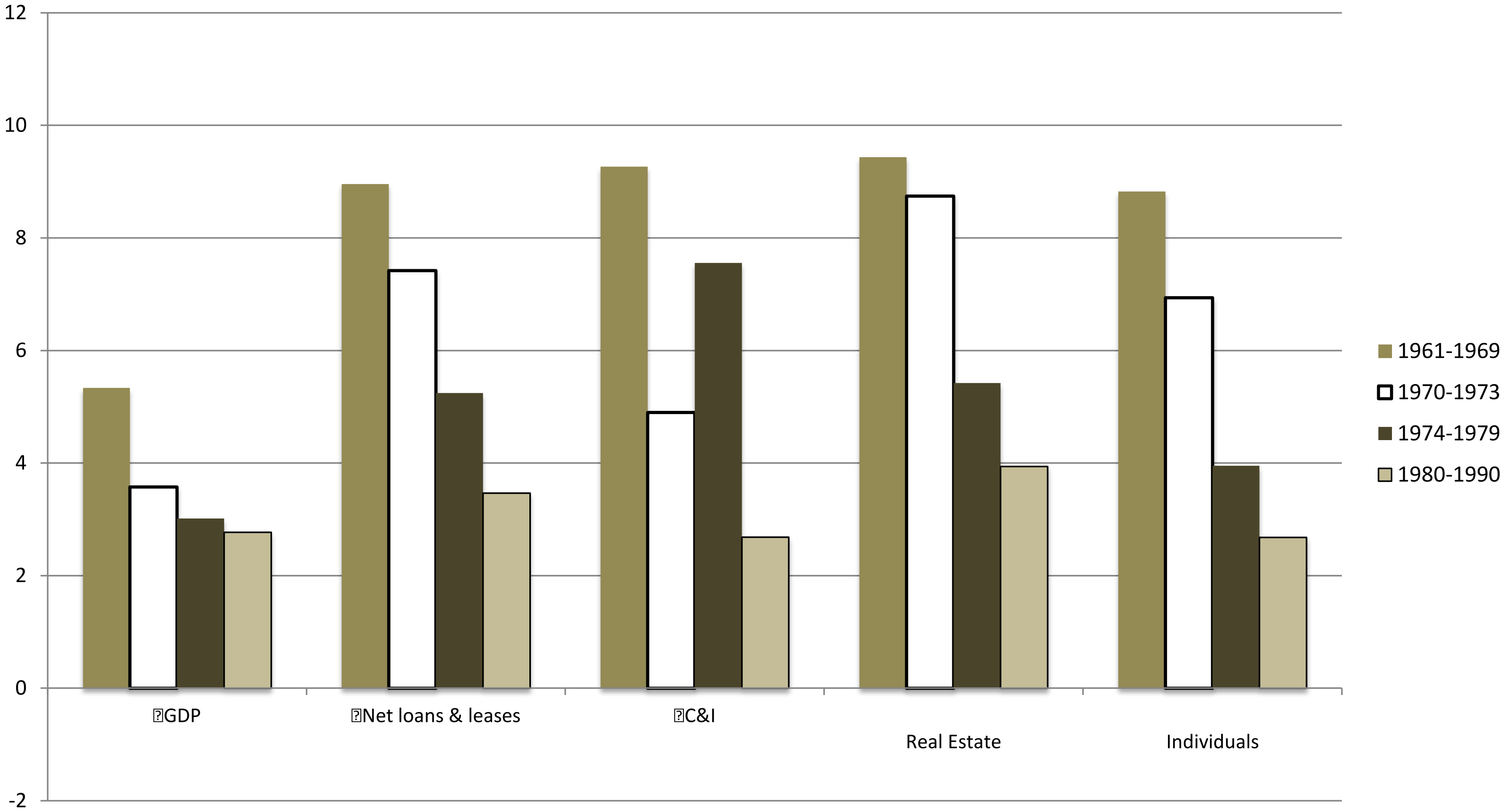
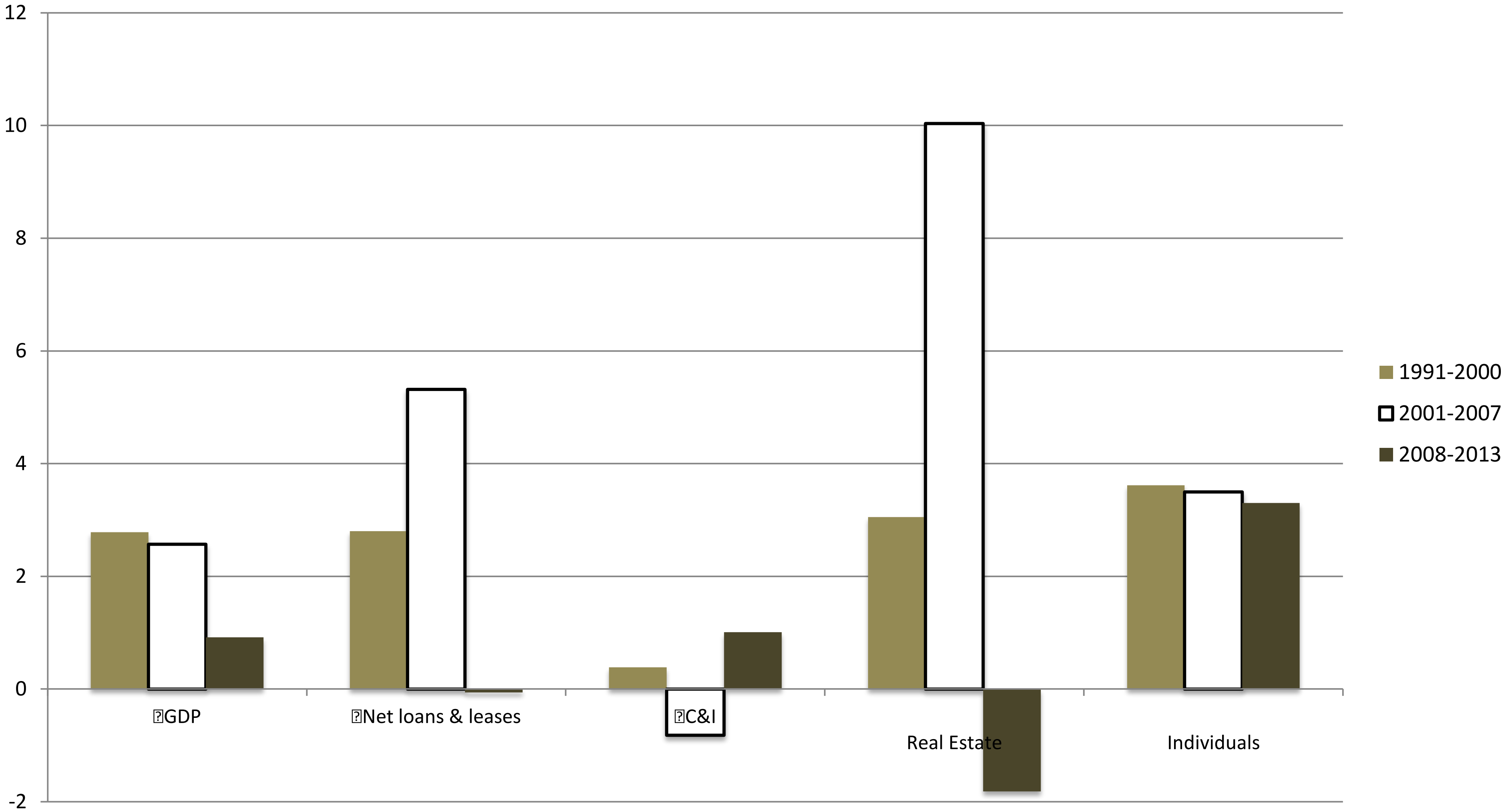


Figure 10B: Trough-to-Peak GDP and Loan Growth, U.S. Commercial Banks, Average annual % change, Five-year time-spans, 1991 to present



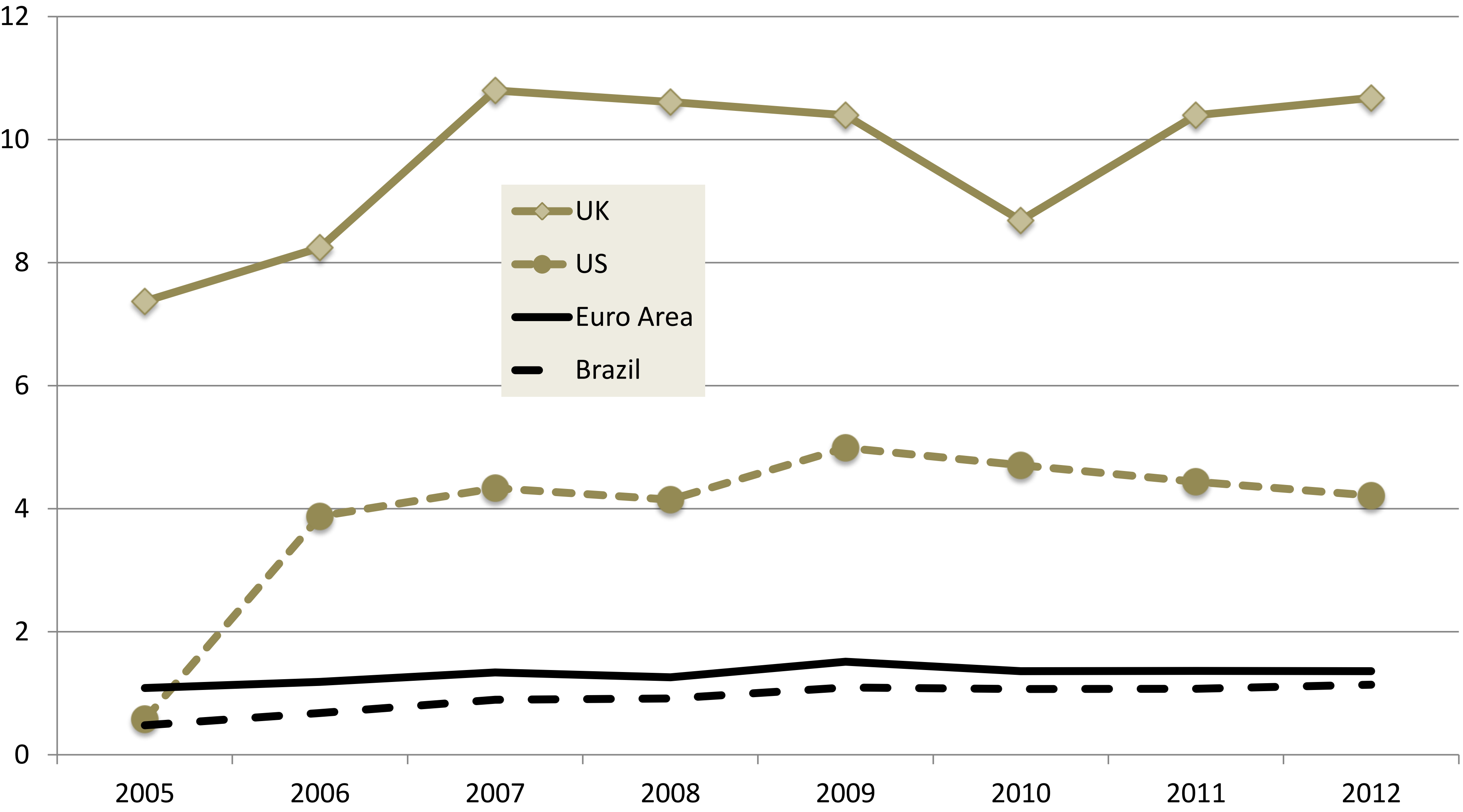
4. The escape of finance: creating value or seeking rents?

- So what happened to growth-enabling finance? And how to understand the huge growth of (financial assets/GDP) given this reduced bank credit growth?
- The very largest financial firms have become autonomous: they have learned to create value by extending (and taking bets in) financial transaction chains: originating and placing credit via securitization, without bearing credit risk.
- Megabanks: (1) Order-of-magnitude larger than other members of their banking systems; (2) complex interrelations with other large financial entities make them "systematically important"; creating (3) a high likelihood of being bailed out ("too big to fail" (TBTF) in event of insolvency, market meltdown.

4. The escape of finance: creating value or seeking rents?

- Spillover losses and predatory contracts: there are huge risks taken for small-margin gains, necessitating hyper-leveraging – as per rehypothecation, which turns money-markets into asset-demand multipliers (while they work…)
- Financial resilience for megabanks:
  - Dependent on access to ever new markets, for fees and new zero-sum speculation games;
  - Dependent on bailouts when their excessive risk-taking turns financial fragility into financial crisis.
  - Not dependent on the health of their region/nation of origin: their income streams have become autonomous; they may prey on their home region's economy to save themselves.

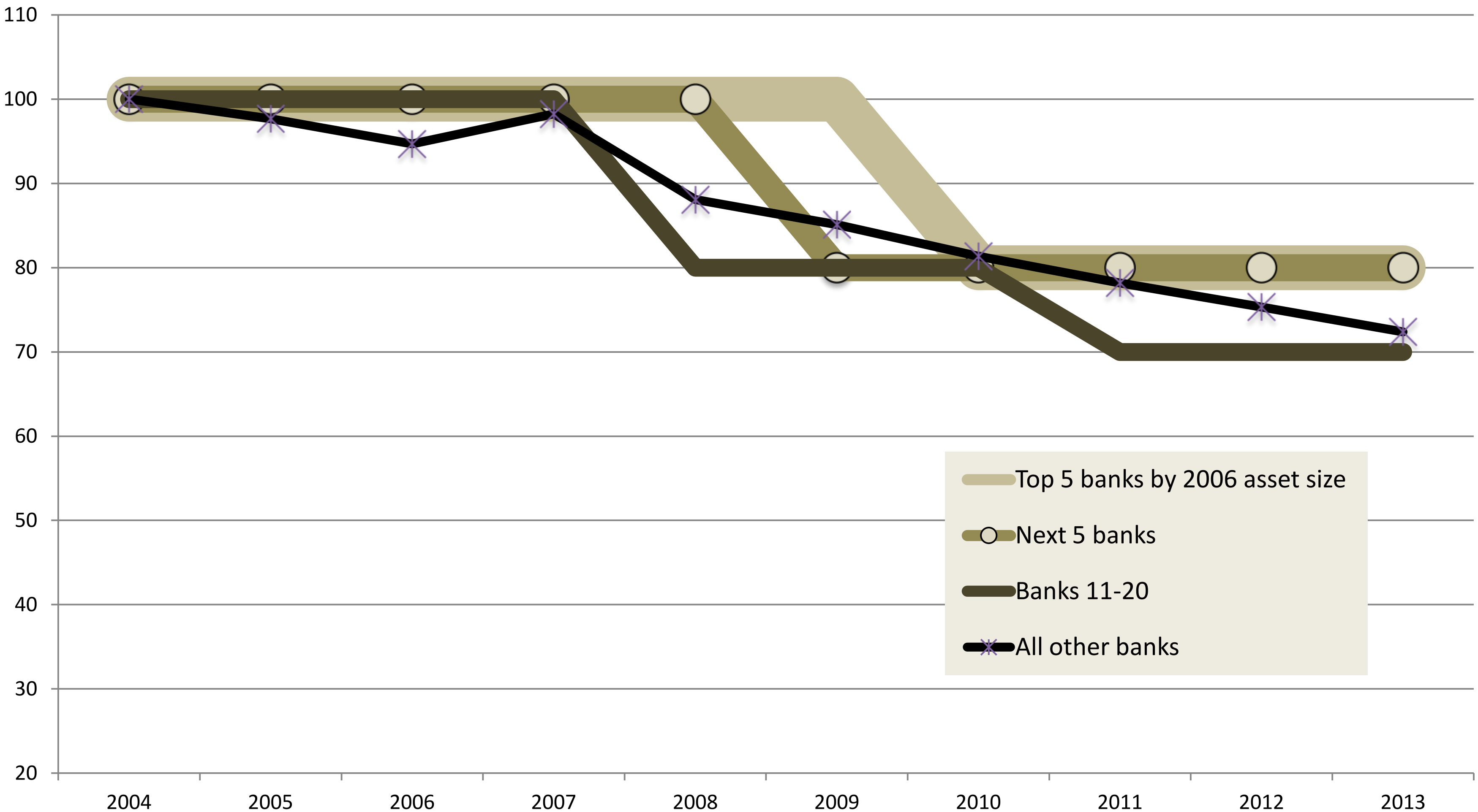
Figure 2A: Financial exports as % of all exports, 2005-2012: UK, US, Euro Area (Source: OECD)



5. Megabanks and their paths to resilience: US and Europe

- US TBTF megabanks emerged through policy choices over nearly 30 years before the subprime crisis:
  - The bailout of Continental Illinois in 1982 – TBTF defined
  - A bank merger wave in response to US's "overbanking"
  - Emergence of securitization for housing-finance
  - Deregulation opened demand for high-risk securities (subprime lending, payday loans, predatory lending)
  - Linked to the US current-account deficit over 30+ years
- The 2008 subprime crisis forced some losses among megabanks, with some emerging as winners of TBTF status

United States commercial bank cohort survival, 2004-2013
(% of base-year banks surviving in every subsequent year)

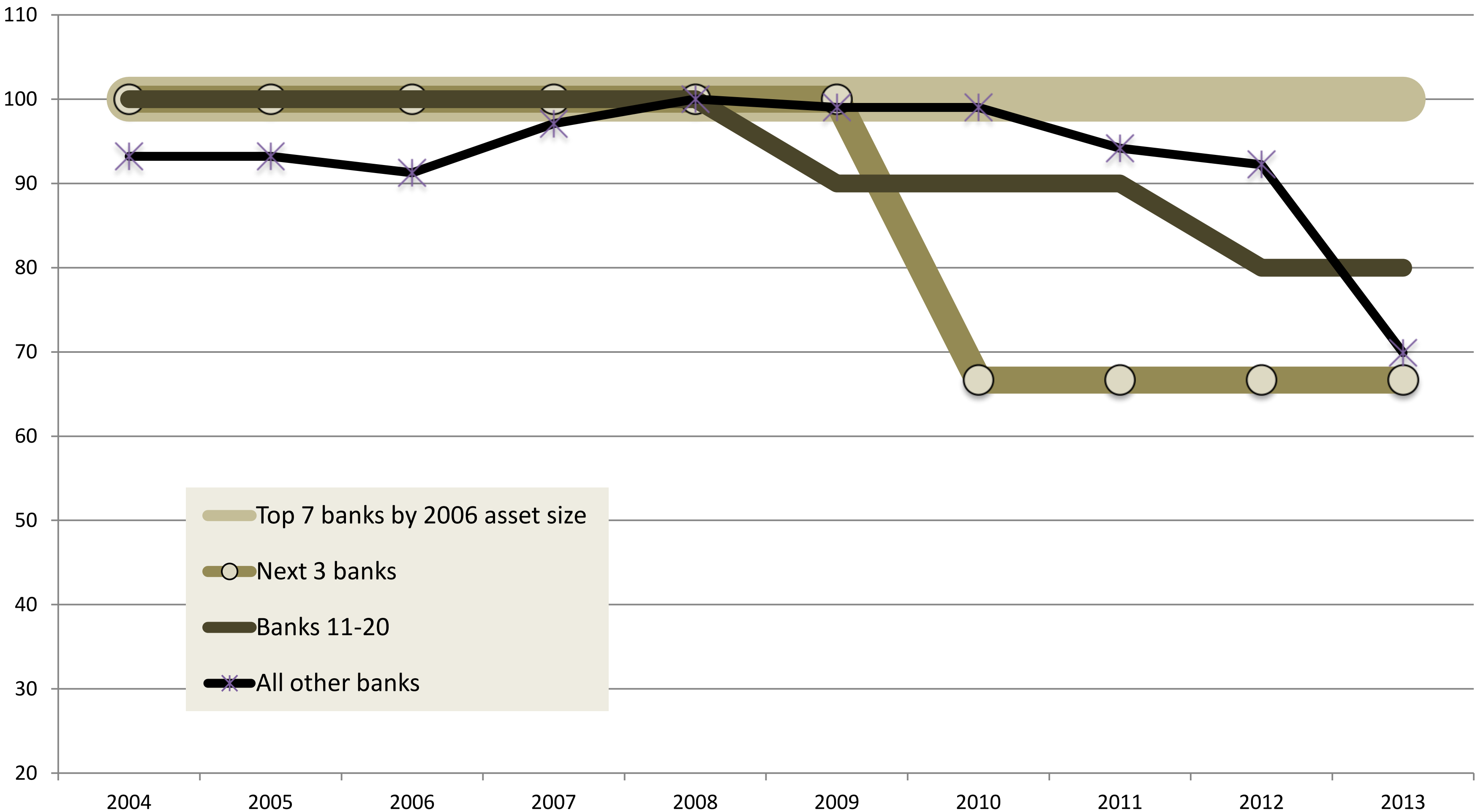


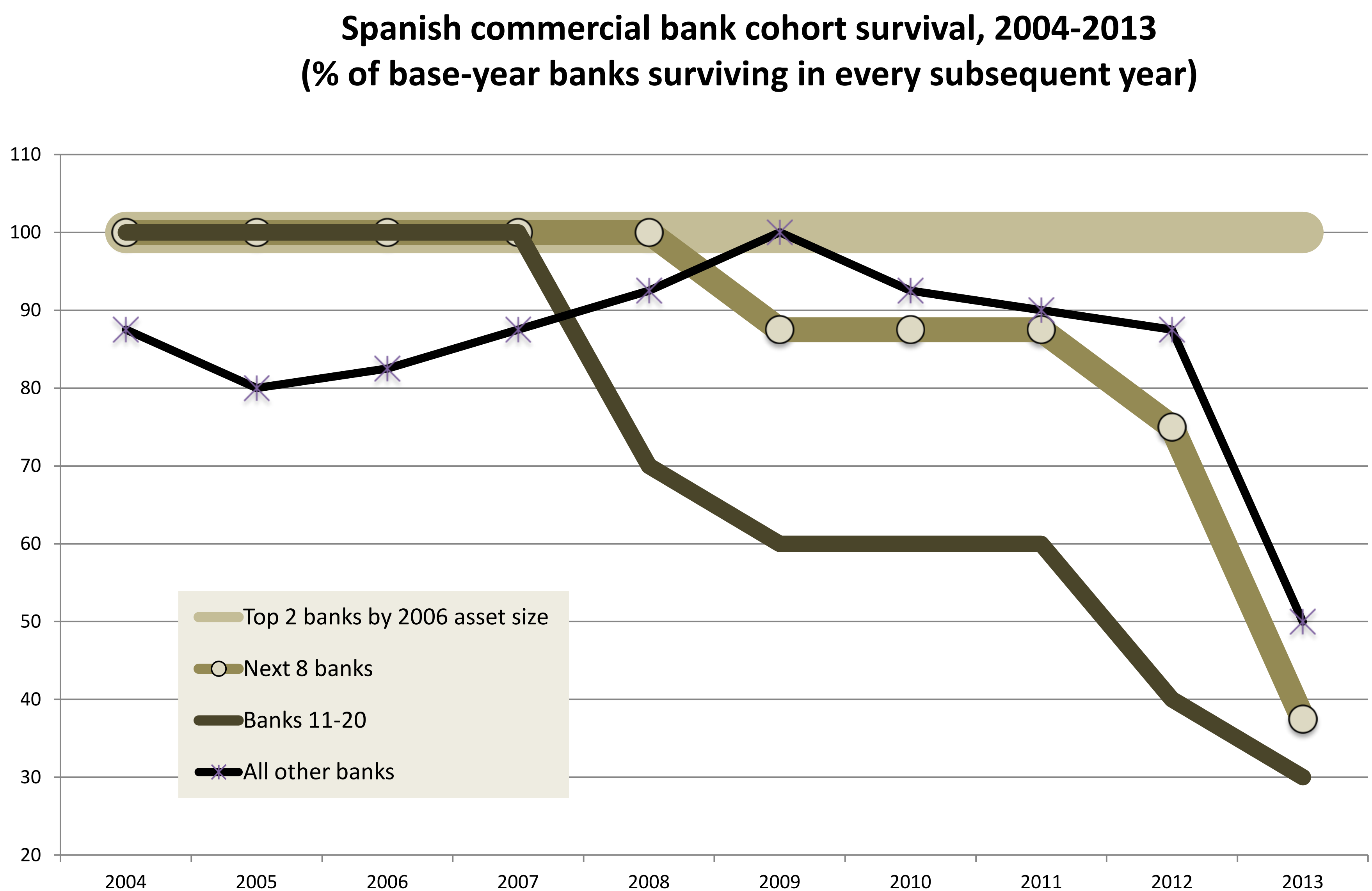
Source: Bankscope.

5. Megabanks and their paths to resilience: US and Europe

- European TBTF banks emerged through policy change too:
  - The City of London created innovations to maintain income flows even after Wall Street's era began
    - Especially, over-the-counter (custom, relationship-based) contracts, derivatives, services – in competition with Switzerland
  - Deregulation in the 1980s ("Big Bang", etc.) spread to the Continent: France and Germany found, expanded niches
  - Defensive mergers in 1990s to create "national champion banks" in preparation for EMU "single-market" competition
  - City of London (outside the EMU) vs Frankfurt/Paris (inside the EMU)

British commercial bank cohort survival, 2004-2013
(% of base-year banks surviving in every subsequent year)




Spanish commercial bank cohort survival, 2004-2013
(% of base-year banks surviving in every subsequent year)
110
100
90
80
70
60
50
40
30
20
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Top 2 banks by 2006 asset size
Next 8 banks
Banks 11-20
All other banks

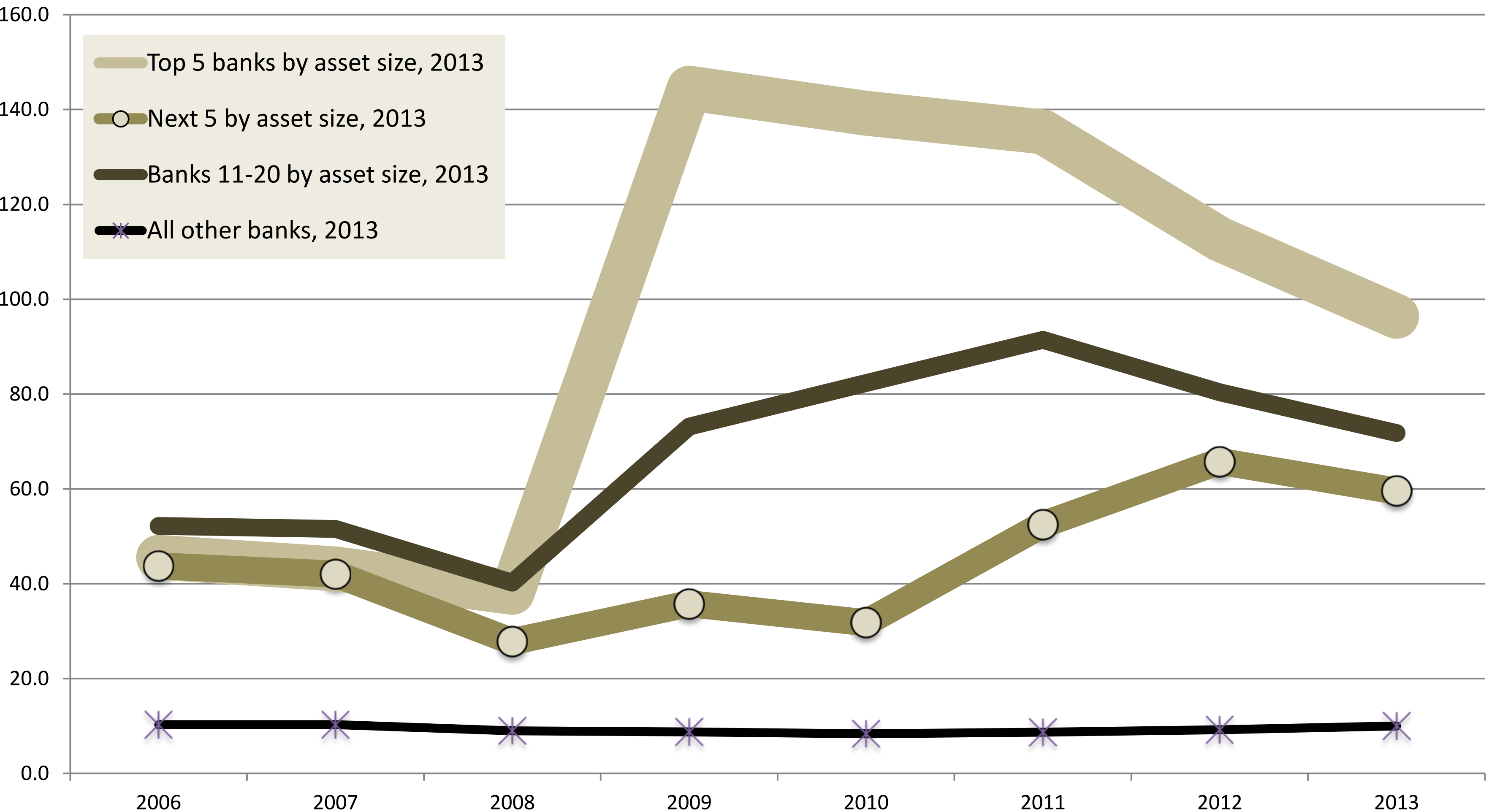
6. The consequences of megabank dominance: financialization as a self-destruct mechanism

- Megabanks' resilience is proven, post-crisis: it is smaller banks that have been failing in much larger numbers
- Local/regional economies are stagnating, as are the smaller banks that are symbiotic in those regions
- Large banks, as ever, seek new instruments to sell, new customers for zero-sum speculation games, new opportunities to buy high/sell low in an increasingly unstable global system.
  - Wall Street and London/Paris/Frankfurt take different risks, and remain vulnerable in different ways
- This scenario of rising risks, imminent spillover costs makes economic democracies increasingly into venues for voter frustration and alienation.

6. The consequences of megabank dominance: financialization as a self-destruct mechanism

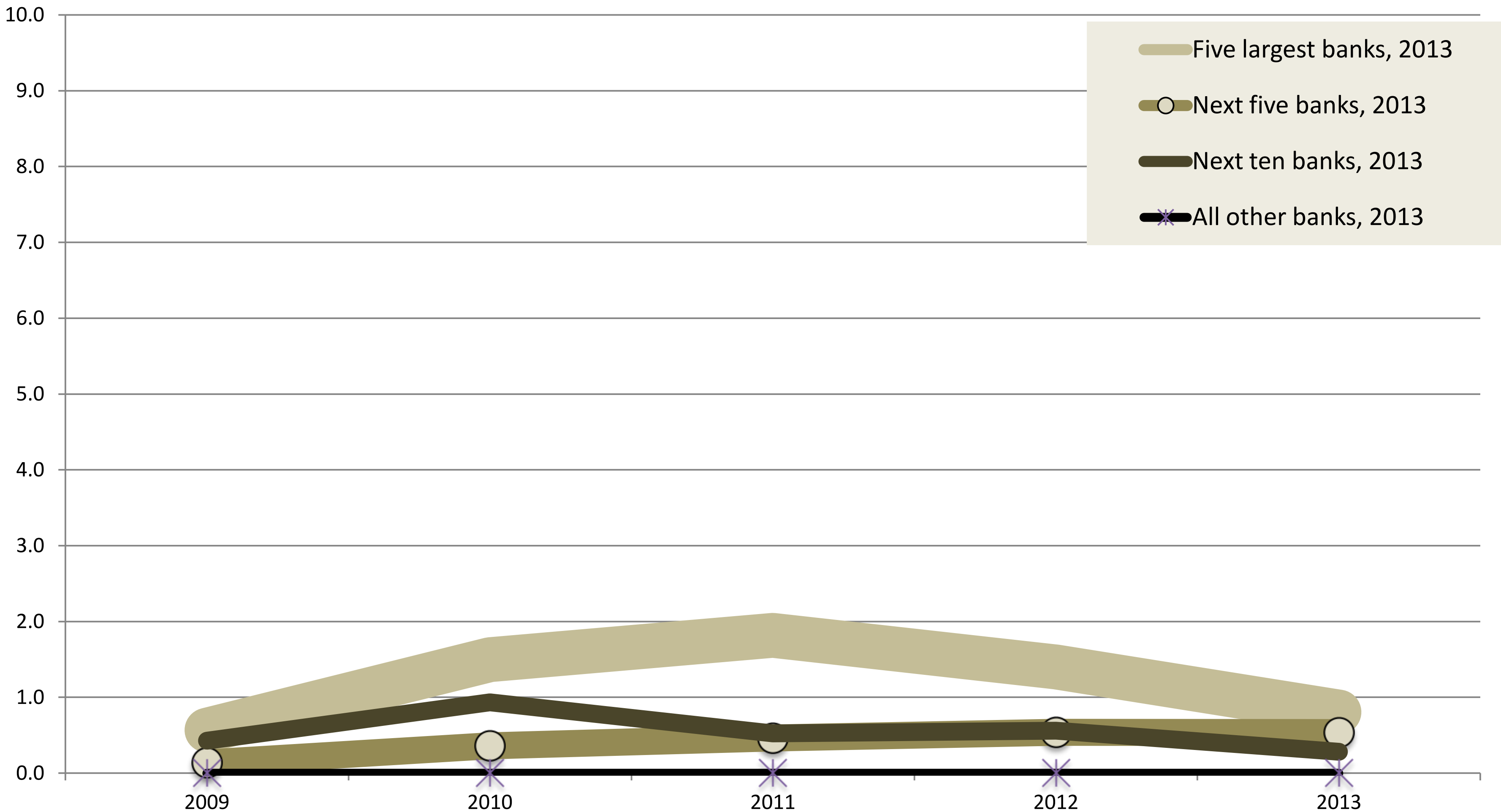
- Wojcik (2013, p. 2736): "the global financial crisis 2007–09 originated to a large extent in the [New York-London] axis rather than in an abstract space of financial markets. The dominance of the axis in global finance can be easily underestimated and evidence suggests that, contrary to expectations the axis is not in decline."
- Janet Tavakoli, president of Tavakoli Structured Finance: "We've reformed nothing … We have more leverage and more derivatives risk than we've ever had."
  - Quoted in Tracy Alloway and Michael Mackenzie, "Investors dine on fresh menu of credit derivatives," *Financial Times*, August 19, 2014.

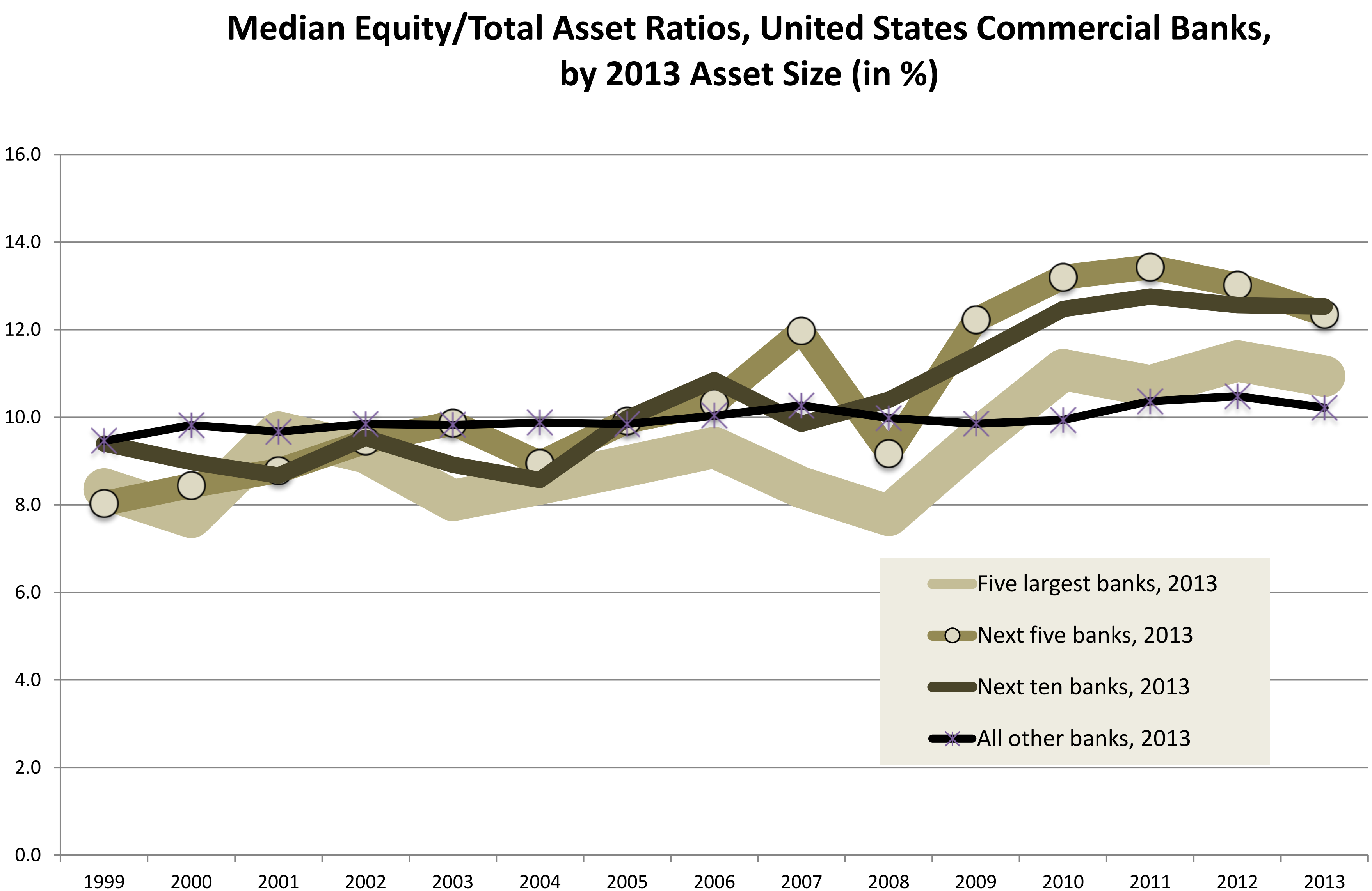
Off-Balance-Sheet Items/Total Asset Ratios, Commercial Banks, United States, by 2013 Asset Size (in %)

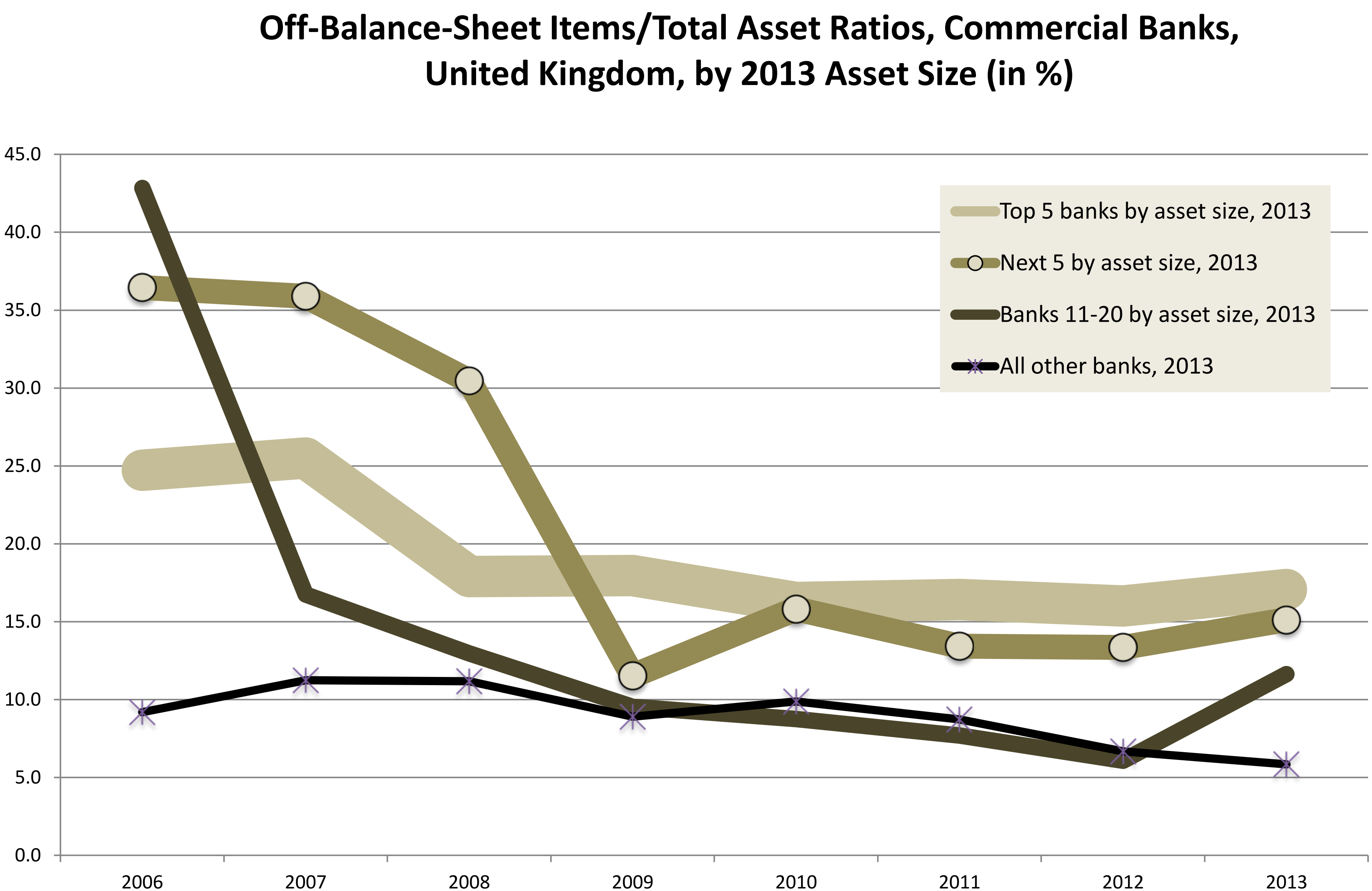


Source: Bankscope

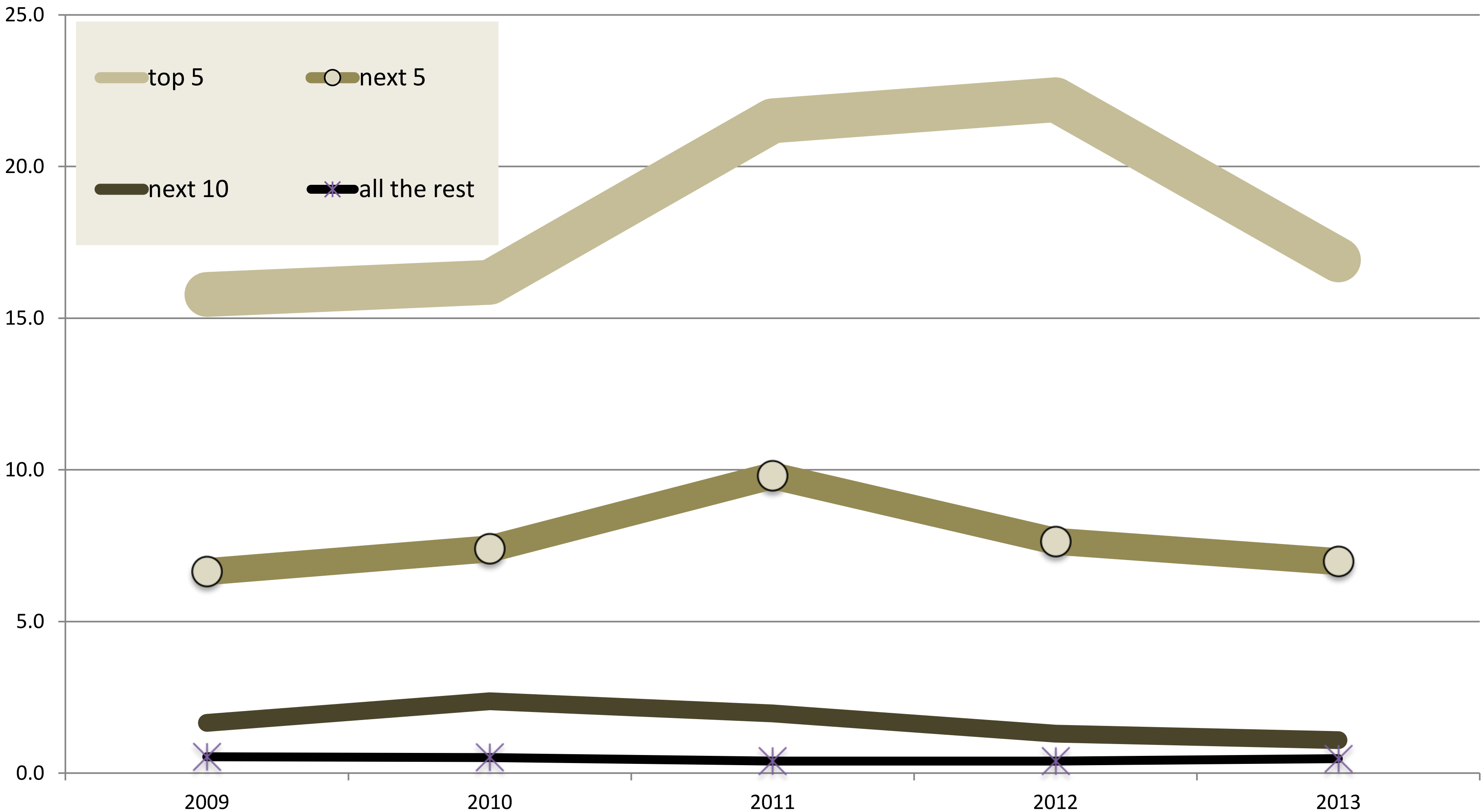
LIability-side Derivatives in the Money, as % of Assets, United States Commercial Banks, by 2013 Asset Size (in %)



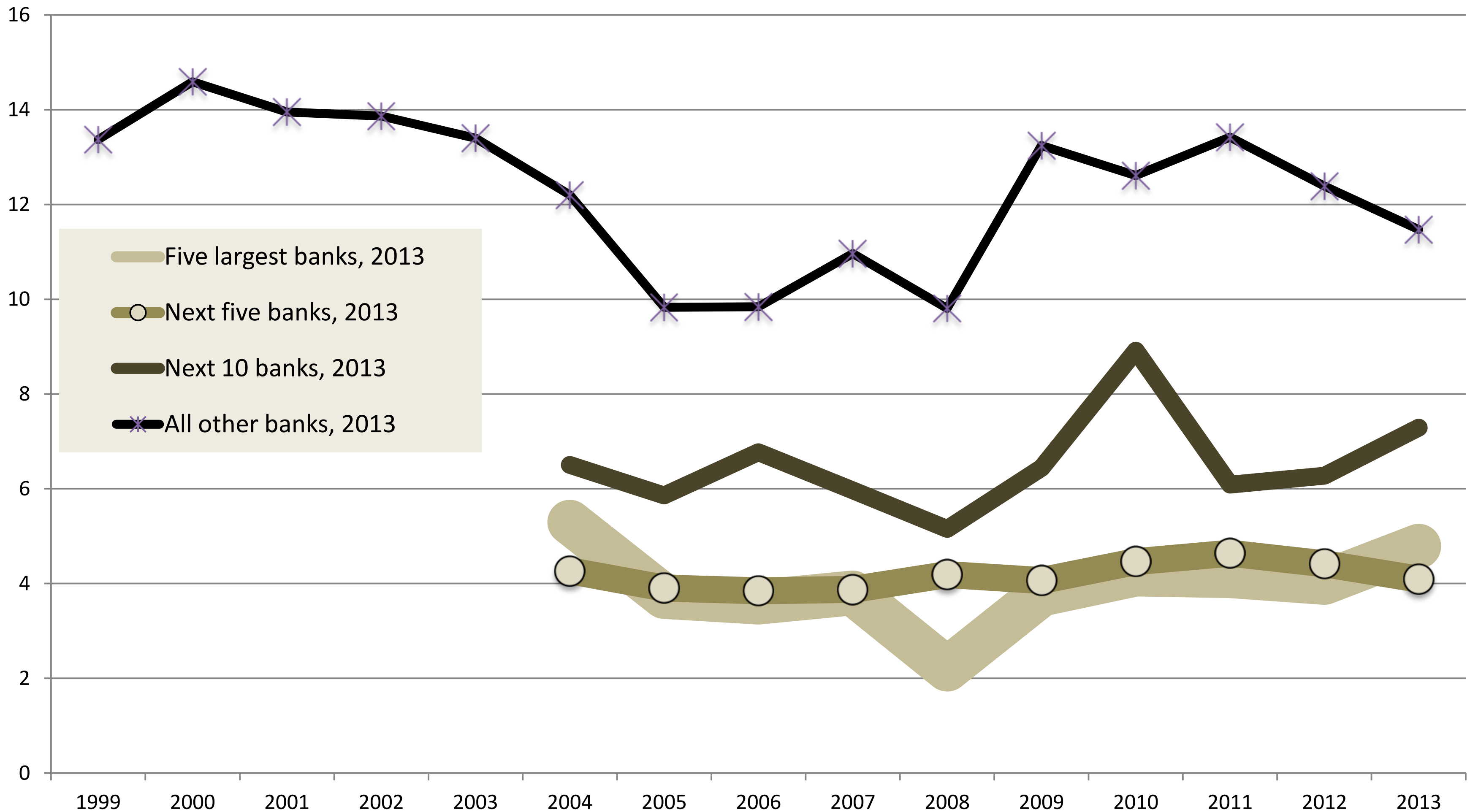

Median Equity/Total Asset Ratios, United States Commercial Banks,
by 2013 Asset Size (in %)
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
Five largest banks, 2013
Next five banks, 2013
Next ten banks, 2013
All other banks, 2013


Off-Balance-Sheet Items/Total Asset Ratios, Commercial Banks, United Kingdom, by 2013 Asset Size (in %)
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
0.0
2006
2007
2008
2009
2010
2011
2012
2013
Top 5 banks by asset size, 2013
Next 5 by asset size, 2013
Banks 11-20 by asset size, 2013
All other banks, 2013

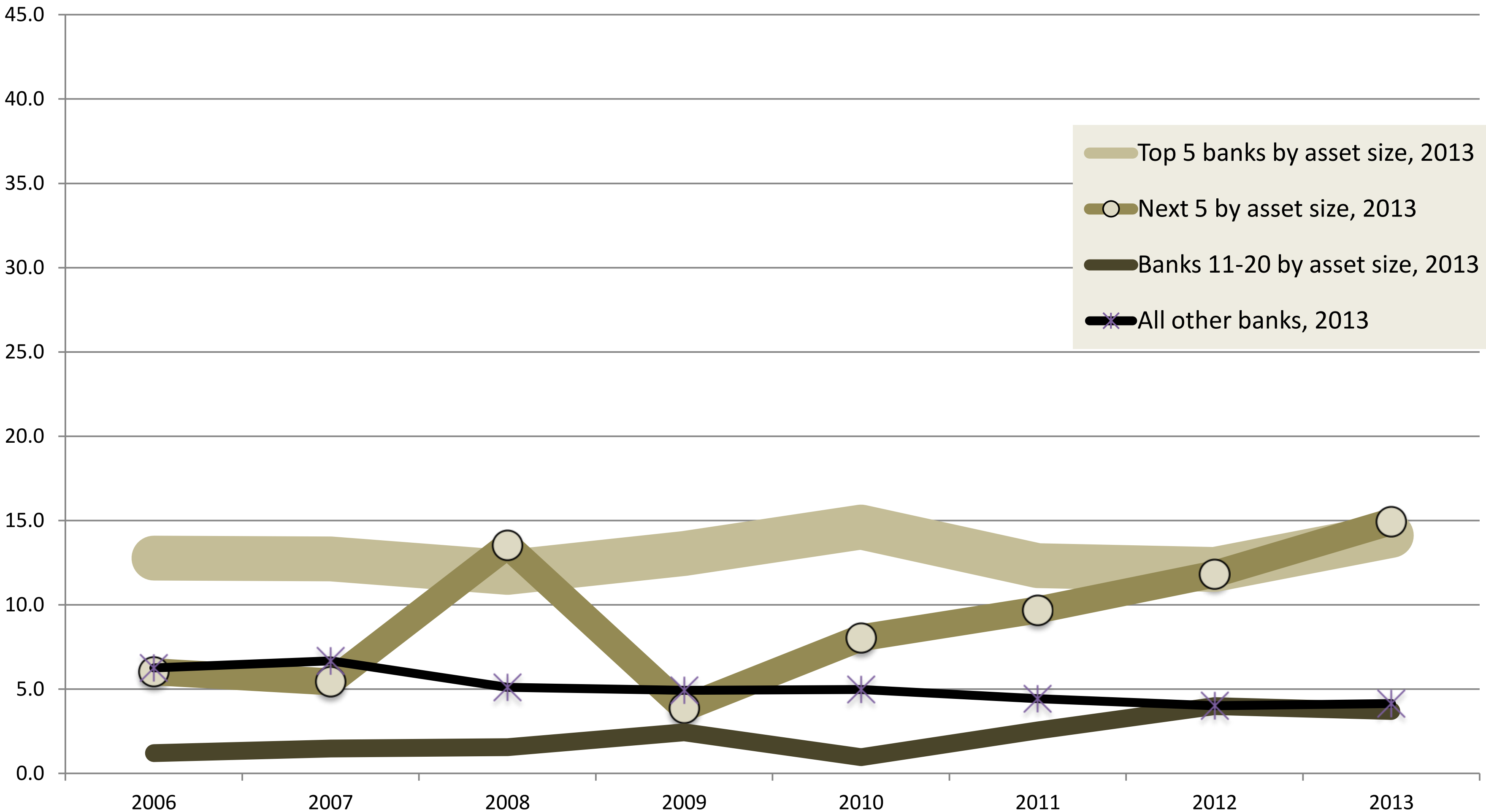
LIability-side Derivatives in the Money, as % of Assets, Great Britain Commercial Banks, by 2013 Asset Size (in %)

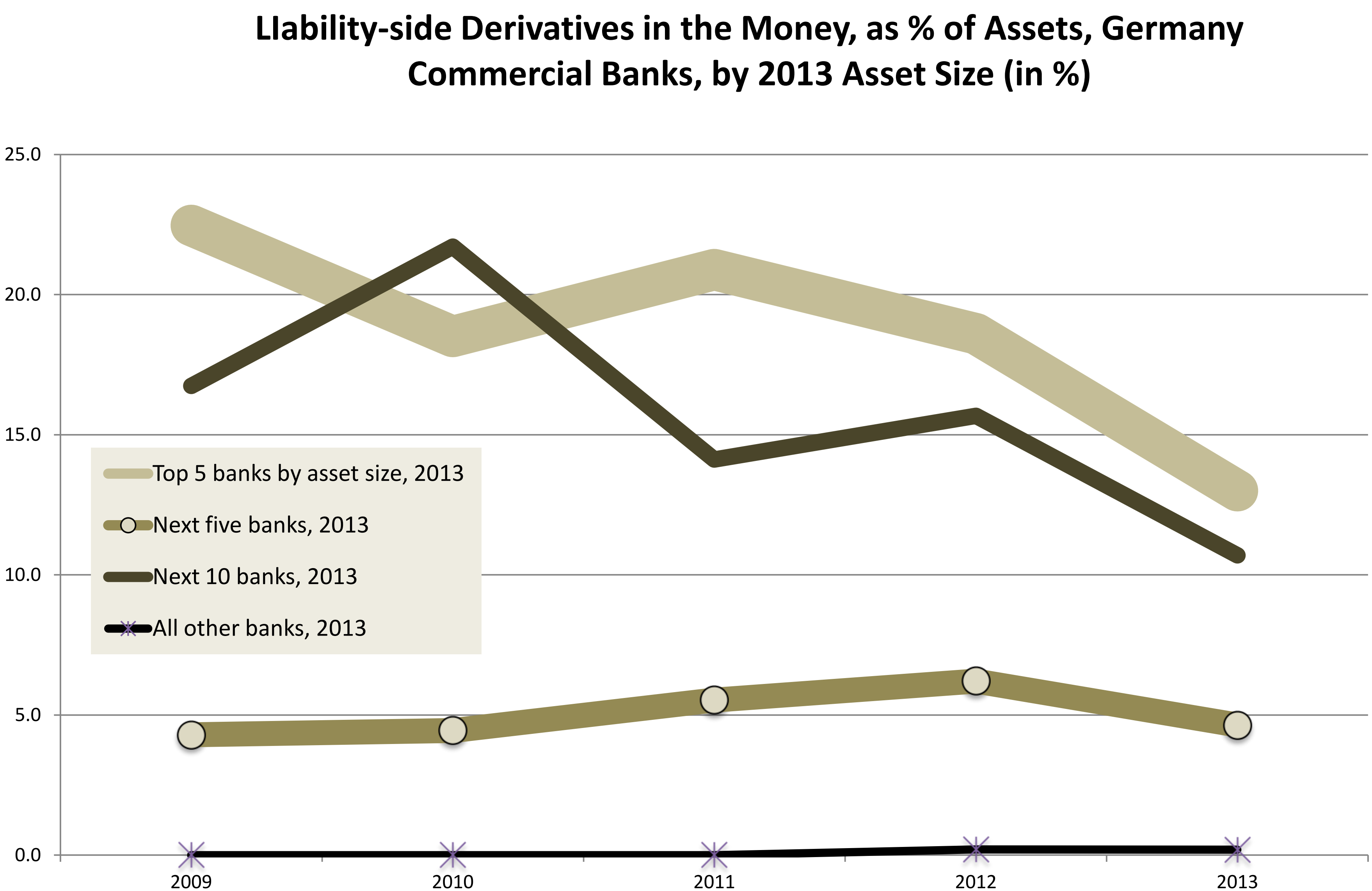


Median Equity/Total Asset Ratios, Commercial Banks, Great Britain, by 2013 Asset Size (in %)

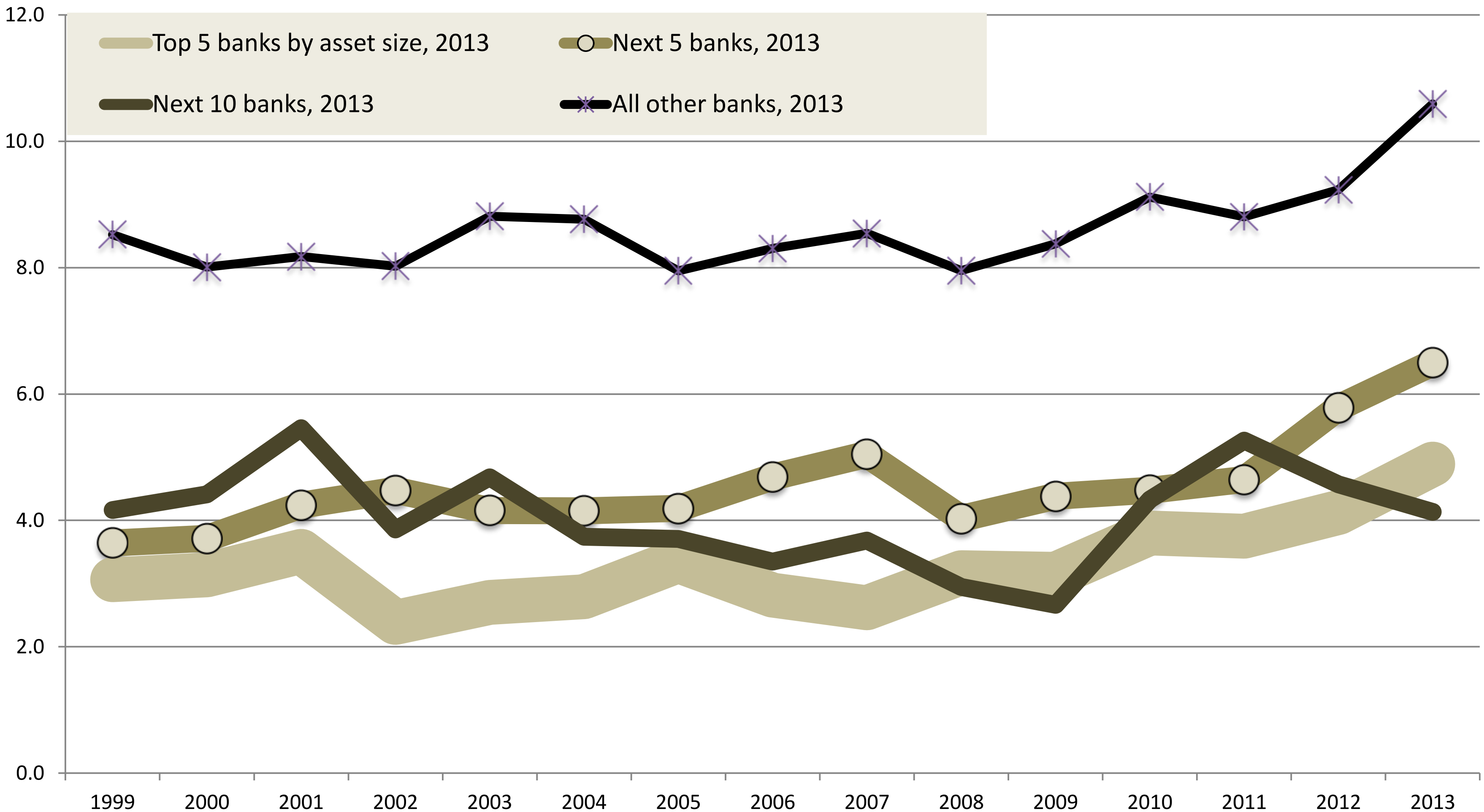


Off-Balance-Sheet Items/Total Asset Ratios, Commercial Banks, Germany, by 2013 Asset Size (in %)




LIability-side Derivatives in the Money, as % of Assets, Germany Commercial Banks, by 2013 Asset Size (in %)
25.0
20.0
15.0
10.0
5.0
0.0
2009
2010
2011
2012
2013
Top 5 banks by asset size, 2013
Next five banks, 2013
Next 10 banks, 2013
All other banks, 2013

Median Equity/Total Asset Ratios, Commercial Banks, Germany, by 2013 Asset Size (in %)



6. Consequences of megabank dominance: financialization as a self-destruct mechanism

- Smaller banks without guarantees of national-state bailouts (outside of LLR spaces) depend for their resilience on regional resilience in their home markets.
- Megabanks have entered into a no-holds-barred, coercive competition with one another (London-New York-Frankfurt-Paris) which justifies their resilience as long as their host nation-states can support them (they form part of national competitive advantage, and have financial webs too complex to untangle).
- Banks of this kind will persist until:
  - Their host-nations' fiscal/tax capacity is exhausted; or
  - They co-participate in a financial meltdown sufficiently large to break their hold over financial law-making and regulatory processes (a repeat of FD Roosevelt's closure of all US banks?)