

BANKING DYSFUNCTION

James Grant

“Has anyone bothered to study the cumulative effect of all these things?” the chief executive officer of JPMorgan Chase reasonably inquired of the chairman of the Federal Reserve Board at a bankers gathering in Atlanta last June. The CEO, Jamie Dimon, was referring to the combination of cyclical hangover and regulatory constriction. The chairman, Ben Bernanke, replied, “It’s just too complicated. We don’t really have the quantitative tools to do that” (Grant and Masters 2011: 1).

Banking dysfunction is the subject at hand. For what ails us, I am about to blame modern regulation, the asphyxiating philosophy of modern regulation, the bankers themselves, the pure paper dollar, manipulated interest rates, and the human condition. Concerning bank capital, I favor just enough but not too much, the exact amount best known to people who have not been elected to Congress. It isn’t the lack of capital that’s put the American banking system behind the eight ball; it’s a shortage of capitalism.

A Shortage of Capitalism

Let us be clear: on Wall Street, there was never a capitalist Eden. There was, however, an era of capitalist clarity in which the owners of the banks and investment banks not only reaped the profits but also bore the losses. Insolvency, in the case of a nationally chartered bank, meant a capital call for the stockholders, the

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James Grant is the Editor of *Grant’s Interest Rate Observer*. This article draws from Grant (2011).

proceeds earmarked for the depositors and other senior creditors. It was, after all, the investors' bank, not the taxpayers'. Before the coming of the Fed and especially the Federal Deposit Insurance Corporation (FDIC), and even up until the time of the codification of the doctrine that some banks were too big to fail, safety was a valuable banking franchise. The Chemical National Bank, the descendant of which combined with Chase Manhattan in 1995 to make today's JPMorgan Chase, made a lucrative business of it (Lowenstein 1990). However, what with Sheila Bair, Ben Bernanke, and the Troubled Asset Relief Program (TARP), safety has become a virtue without a market value. "Let financial prudence pay again" is my one-sentence contribution to the financial reform agenda.

In his colloquy with Chairman Bernanke, CEO Dimon made the case that the tide of credit is receding. CDOs, SIVs, mortgage brokers, most exotic derivatives—the relics of 2007—are mainly gone, he pointed out. Dimon (2011) went on:

Fannie Mae and Freddie Mac are in the government hospital, higher capital and liquidity are already in the marketplace, we estimate more than double what it was before. There are tougher requirements—boards are tougher, risk committees are tougher, there's an oversight committee. Regulators, I can assure you, are much tougher in every way . . . possible. One of the cores of the problem was mortgage underwriting—mortgage underwriting has gone back to what it was 30 years ago. I think it's a good thing, but there's no more subprime, no more Alt-A.

And to top it all off, Dimon wound up, there's talk of higher capital requirements on the so-called systemically important financial institutions (SIFIs), or—let us call a spade a spade—big dumb banks.

Capital, especially big-bank equity capital, is today's hot-button issue: the regulators want more of it, perhaps 2 or 3 percentage points more (expressed as a percentage of risk-adjusted assets), to protect the taxpayers against the next cyclical pileup. Above all, declared Fed Governor Daniel K. Tarullo in a speech on June 3, 2011, let there be no more TARPs. As it is, Tarullo complained, the big dumb banks have no incentive to carry "enough" capital. By mandating a fat new slug of equity, he said, the regulators would be making the banks stronger, the banking system safer and the competition

between big and small depository institutions more equitable. Is it not unfair that the too-big-to-fail banks can borrow more cheaply than the small fry not similarly favored? Well, then, tougher new capital requirements would return to smaller banks a bit of what the government took away from them when it declared the ultrabig banks federal protectorates.

A week after Tarullo spoke, the Fed announced a new capital-related, box-ticking program. Giant banks, declared the *uber* regulator, must henceforth conduct annual examinations “to ensure that institutions have robust, forward-looking capital planning processes that account for their unique risks and that permit continued operations during times of economic and financial stress.” An alumnus of the Federal Reserve Bank of New York, Dino Kos, commented to Bloomberg thus: “For the past 20 years, bankers have said, ‘We understand derivatives, we understand risk management, we understand risk controls.’ What regulators learned was, no, they don’t” (Matthews and Torres 2011).

Regulators Don’t Understand

We can go further: the regulators don’t understand, either—and they haven’t for a long time. The Bank of United States, the first big domestic commercial banking casualty of the Great Depression, failed nine months after it released its statement of condition on March 27, 1930 (State of New York 1930). No one could have predicted failure looking at that statement. Tarullo himself might have blessed the Bank, for the sum of capital and surplus, \$42 million, represented 17.7 percent of assets, fully 7 or 8 percentage points more cushion than any 21st-century regulator is talking about. (JPMorgan Chase, for contemporary perspective, shows Tier 1 capital equivalent to 12.3 percent of risk-adjusted assets.) But the capital account was soon proved irrelevant by the rot in the asset portfolio. Manhattan real estate was the Bank of United States’ favored collateral. Its tastes ran to the magnificent new apartment towers rising on Central Park West, such as the Beresford and the San Remo (*New York Times* 1932: 30). Each was a monument to the bull market that had recently crashed.

I submit that there is nothing so very new in the banking experience of the past 20 years. Yes, the erasure from the statute books of the Glass-Steagall Act injected new elements of risk, as did the

explosion of arcane derivative instruments and so-called structured products. However, fractional reserve banking did not suddenly become risky; it has always been risky. Since time out of mind, solvent bankers have juggled the competing demands of liquidity and profitability, of too much capital and too little. They've managed derivatives, too, starting with the first one, the banknote. That bedrock banking liability derived its value from cash—that is, “money here and now,” to quote Hartley Withers, who edited *The Economist* when Teddy Roosevelt was in the White House.

What's truly and importantly new in banking is the definition of cash. When cash was gold, or notes convertible into gold, the basis of credit was gold. There could be only so much credit because there was only so much gold. Today, cash is paper, and paper is the basis of credit. There can be a titanic volume of credit because of paper there is no end.

Withers wrote a book, *The Meaning of Money*, in the wake of the Panic of 1907 that speaks to us today in the aftermath of the Panic of 2008. Following the 1907 crisis, he observed, the people's deposits were frozen or, in 21st-century hedge-fund lingo, “gated” for nine long weeks. Scrip became the coin of the realm. The great JPMorgan personally intervened to keep a very bad situation from getting worse, but it was more than bad enough. Onlookers from London gasped. In Britain there had been no bank run since the Overend Gurney failure in 1866. The pound sterling was the world's currency, and London was the world's financial capital. Across the sea, embarrassed bankers and outraged depositors joined forces to demand remedial action. The action they got was the signing of the Federal Reserve Act in 1913; 20 years later came the FDIC. And here we are today with a banking system not so much regulated by the government as managed by it. Does it not seem strange—would it not befuddle the authors of *The Federalist Papers*—that the U.S. Senate is the institution to which it falls to determine how much an investor-owned bank may charge for a debit-card swipe?

It would have seemed so to Withers. By the Tarullo standard, the banking system around 1907 was unimpeachable. Although there was a near halving in the ratio of capital to assets between 1895 and 1905 (see Figure 1), the average buffer for the national banks at the time of the crisis was 17–18 percent. For perspective, the top six joint-stock banks in the City of London showed an average ratio of capital to assets of a little less than 10 percent. Besides, the dollar was

FIGURE 1
RATIO OF CAPITAL TO ASSETS, 1865–2010



SOURCES: Comptroller of the Currency (1902), Federal Reserve, FDIC.

as good as gold and the risk of loss fell on the banks' stockholders, not on the taxpayers. Yet, there was a panic, and it was a bear.

Withers (1907) put his finger on the essential paradox of regulation. In London, where there had been no panic, banks managed their balance sheets as they saw fit. No national regulator set capital standards, as the Office of the Comptroller of the Currency did for the national banks in the United States. Liquidity standards, too, were imposed by the OCC. American banks with national charters had to keep 25 percent of their deposit liabilities in cash—that is, gold or money lawfully convertible into gold.

According to Withers (1907: 79),

There is no hard and fast rule on the point in England, and it would be absurd if there were, for the circumstances of banking business differ so widely, that what is a barely adequate proportion for one would be wastefully excessive for another. Good banking consists in giving as much assistance as possible to trade in the matter of credit, and at the same time restricting credit as soon as the proportion of cash and liabilities is below the point at which prudence and caution require that it should stand. The exact point at which the mean stands is a matter which he is best able to judge; and though the desire to

earn big dividends and the pressure of competition are strong incentives to him to place his ideal proportion too low, on the other hand the fine traditions of English banking and the wholesome dread of criticism, and of the moods of the multitude, are eloquent arguments in favor of wisdom and caution.

Good banking is produced not by good laws but by good bankers. Just as the most carefully planned constitution will inevitably break down if the men at the helm of government are incompetent or dishonest, so no skillfully devised banking system will make banking good, unless the banking is conducted by straight and able managers.

Elsewhere in this readable and evocative book, Withers characterizes as “perfect” the British banking standards overlaid on the London-managed gold standard. Possibly, he exaggerated. But nobody would characterize the banking and monetary arrangements in place today as perfect, even for hyperbolic effect. “Functional” is about the grandest adjective any impartial observer would apply to the systems of either Britain or the United States, and that at the best of times.

The famously fractured American bank-regulatory apparatus played a part in the Panic of 1907 as it has in subsequent crises all the way up to 2008–09. In 1907, as noted, national banks had a liquidity test to meet (which is not to be confused with a capital test): for every dollar in deposits, they had to show 25 cents in liquid assets. Today, no reserve is charged against savings balances, and only 10 percent against checking accounts. The state-regulated trust companies had a lower liquidity bar; in New York, it was 15 percent. In 1907, disclosure of some speculative razzle-dazzle at the Knickerbocker Trust Co. of Manhattan precipitated the run that touched off the national panic. Though the Knickerbocker went down in history as an especially ignominious kind of failure, the depositors emerged whole in 1910.

Withers, writing a century ago, wondered if the American regulatory system wasn’t self-defeating. “The mere fact of legal regulation of the amount of cash,” he proposed, “probably makes the banks in America less careful with regard to the nature of the rest of their assets. Some of their managers are apt to think that, as long as they comply with the law, they have done all that is necessary, and so make inadvisable advances and hold unrealizable securities” (Withers 1907: 80). Amen. If Withers were around today, he could

apply the same critique to the Tarullo capital cure. One starts to wonder if the world wouldn't be safer if the bankers and the central bankers (I'm talking about you, Ben Bernanke) performed fewer calculations and read more history.

In the panics of the 19th century, the Chemical National Bank of New York faithfully paid out cash when other banks couldn't or wouldn't. George G. Williams, its longtime chief executive, seemed to personify the institution's bedrock virtues. "The fear of God," Williams would say when asked the secret of his success. So the Chemical was the fortress to which many repaired in 1907. They called it "Old Bullion" (Grant 1992: 112).

As a nationally chartered bank, Chemical was bound to abide by the OCC's liquidity dictum. What the OCC required in the way of capital, I'm not sure, but Chemical showed capital and surplus on the order of 20 percent of its assets. The depositors, foremost of whom was the rich and dotty Hetty Green, earned no interest on their deposits but rather seemed to regard the Chemical's impregnability as an adequate form of compensation. Charging 5–6 percent on its commercial loans, the bank was consistently profitable (Comptroller of the Currency 1907).

For Old Bullion, however, the panic was a decidedly mixed blessing. Deposits piled up faster than management could secure the required offsetting reserve balances. Called on the carpet for this shortcoming, the president contritely addressed the OCC after the panic had abated. "The deficiency in Reserve upon our total deposits, including U.S. deposits, was unavoidable [sic], owing to the extraordinary increase in our deposits in November," Williams's successor, William H. Porter, wrote to the deputy comptroller of the currency, T. P. Kane, "which increased deposits consisted entirely of checks upon other banks and for which we received payment only in Clearing House Loan Certificates [i.e., the scrip that circulated in lieu of federal currency]. Notwithstanding that we imported \$2,000,000 of gold from Europe, we found that we could not consistently increase our supply of cash in the existing panic, proportionate to the rapid and extraordinary increase in our deposits" (Comptroller of the Currency 1907).

When the storm passed, the panicky depositors of 1907 decamped in search of the interest income that Chemical chose not to pay. In 1913, the year of the signing of the Federal Reserve Act, Chemical's balance sheet footed to just \$41.4 million, down from the aforemen-

tioned panic-swollen \$64.5 million. Liquid assets represented more than 29.2 percent of deposits, while capital, surplus, and undivided profits—attention, Daniel Tarullo—amounted to 26.1 percent of assets. But, of course, there's no mistaking a sound balance sheet for human perfection. It would come to light in 1917 that Joseph B. Martindale, who had succeeded William Porter as president in 1910, was a forger and an embezzler (*Wall Street Journal* 1917: 7). The bank could easily absorb the defalcation—the theft of \$300,000 compared to \$10 million of capital and surplus and undivided profits of \$1.5 million—but, still, what was the world coming to?

Back on the straight and narrow, Chemical survived the Depression while merging and acquiring its way to the grand total of \$3.8 billion of assets by 1959; it was, in that year, the fourth-largest bank in the United States. Growth remained the watchword—nobody was calling it “Old Bullion” any more—through the 1980s. In 1986, Texas Commerce Bank came into the Chemical fold. Not only had the Chemical brain trust reached for growth, however, it had badly overreached. The year 1990 delivered a succession of blows in real estate, junk bonds and leveraged lending, favored Chemical asset classes. The debentures of the Chemical holding company traded at the condemning yield of 14.5 percent, by which time the bank showed a ratio of equity to assets of just 3.1 percent, weakest among the big-city field. Now Chemical answered to a derisive new nickname. Through a succession of acquisitions, the “Comical Bank” became a major constituent part of today's JPMorgan Chase, which—certifiably—is too big to fail.

Conclusion

Withers was right: good banking is produced not by rules but by good bankers, and the 2011 regulatory thrust is misdirected. Leveraged financial institutions are among the wobbliest of human contrivances. They are dangerous enough in a time of monetary orthodoxy and individual responsibility. In a world of paper money and socialized risk, they are positively combustible.

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