Make Banks Antifragile – Release Washington's Stranglehold

by Eric Grover

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Philosopher, economist and former trader Nassim Taleb's "Antifragile: Things That Gain from Disorder" provides a framework for understanding the financial crisis and, I would argue, how the government's policy response to it increased risk with our current financial system.

Taleb considers risk on a continuum from fragile to "antifragile" systems. Fragile systems break when stressed. Antifragile systems when stressed – up to a point – become stronger. Biological systems and decentralized market-based industries tend to be antifragile.

Chinaware and centralized systems, such as a Washington-directed financial system, are fragile. The housing bubble, mortgage implosion and consequent financial crisis and Great Recession resulted from centralized decision-making, not individual financial institutions' mistakes or failure.

Interest rates are the economy's most important price. They are the price of present versus future investment and consumption. Under Maestro Alan Greenspan, the Federal Reserve persistently underpriced credit. From 2001 to 2005, the real Fed funds rate was negative, distorting decision-making systemwide, and causing a massive overconsumption of and investment in housing.

Washington politicized and gutted mortgage credit standards, to increase homeownership, fuelling an unprecedented bubble with housing prices appreciating 130% from 1996 through 2005, according to Robert Shiller's Real Housing Pricing Index 1890-2012. Before 1992, virtually all mortgages were prime. However, regulators and politicians encouraged a reckless industrywide stampede into ever-riskier mortgages. From 1996 to 2008, the Federal Housing Administration ratcheted up affordable housing goals for Fannie Mae and Freddie Mac, and through 2007 the governmentsponsored mortgage giants met or exceeded them. By 2008, there were 28 million subprime or otherwise high-risk mortgages, three quarters of which were held or guaranteed by Fannie, Freddie or the FHA, according to "Bad History, Worse Policy: How a False Narrative about the Financial Crisis Led to the Dodd-Frank Act" by Peter Wallison.

A popular, but false narrative was that the financial crisis was caused by greed on Wall Street and insufficient regulation. But there's always been greed on Wall Street, and on Main Street! In free-market capitalism, individuals and firms pursue their self-interest by serving others. The system is cooperative, self-correcting and antifragile. Firms not delivering value adapt or perish.

Banking has long been one of America's most heavily regulated industries. Nevertheless, the notion that "if only Washington had more tightly regulated financial services, there wouldn't have been a crisis" propelled passage of the Dodd-Frank Act. Dodd-Frank didn't address the causes of the financial crisis, but it did convert banking into a public utility, stifle financial innovation, further politicize credit and put a damper on economic growth.

Henry Kissinger said power was the ultimate aphrodisiac and, for regulators, Dodd-Frank delivered, big time.

Washington regulatory suzerains now rule the financial services industry. The implications are frightening. A centrally directed financial system with uniform risk management and prescribed products is fragile.

Mistakes occur. In free markets, financial institutions making catastrophic errors fail. Management and shareholders are punished. The industry becomes more robust. However, politicians and regulators making systemwide errors produce global financial crises and recessions.

Washington bureaucrats are brewing the next crisis.

Having learned nothing from Greenspan's greatest error, Fed Chairman Ben Bernanke is stubbornly keeping interest rates near zero.

The mortgage industry is de facto nationalized. The Consumer Financial Protection Bureau, Fannie, Freddie and the FHA define acceptable mortgages. Nine of 10 mortgages originated in 2012 were bought or guaranteed by Fannie, Freddie or the FHA.

Banks design their businesses to pass the Fed's stress tests. But should we rely on regulators' omniscience? Regulators didn't anticipate the Great Depression, the Savings and Loan crisis or the most recent financial debacle. Yet Dodd-Frank puts blind faith in and gives enormous additional power to them.

Testifying before Congress, JPMorgan Chase's acting chief risk officer, Ashley Bacon, suggested that neither JPM nor its regulators fully understood the "London Whale" transactions.

Regulatory myopia is global. The Basel Committee on Banking Supervision's Basel III proposal doesn't require banks to hold risk capital against sovereign debt from countries such as Greece, Portugal and Ireland.

At banks of any size, embedded government overseers look over management's shoulders. Would anyone imagine regulators at Apple's, Fedex's or Google's headquarters would improve performance?

Political rather than economic factors increasingly influence "too big to fail" firms' decisions. Bank of America has reportedly discouraged gun manufacturer deposits; Wells Fargo "invests" in nonprofits like GRID, which brings solar technology to low-income communities. These reek of political, rather than commercial, motivations.

The market ruthlessly manages risk and value. Management and shareholders have skin in the game. New entrants attack incumbents with putative better mouse traps, threatening individual banks but strengthening the system. Thousands of vigorously competing financial institutions crafting different strategies – some failing, many adapting and some prospering – is antifragile.

In contrast, a centrally planned financial system in which a herd of financial Goliaths not permitted to fail follow the same strategy puts the entire economy at risk.

Eric Grover is a partner at Intrepid Ventures, a financial services and payments consulting firm in Minden, Nev.