

ECONOMICS U\$A  
21<sup>ST</sup> CENTURY EDITION

PROGRAM #20  
BANKING

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(MUSIC PLAYS)

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FRANK STASIO: Economics USA a 21<sup>st</sup> Century Edition Audio Supplement designed to explore 21<sup>st</sup> century challenges to micro and macroeconomic principles. The subject of this addition is banking. I'm Frank Stasio. My guest is Edward D. Van Wesep. Dr. Van Wesep is an assistant professor of finance at the Kenan-Flagler School of Business at the University of North Carolina, Chapel Hill.

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FRANK STASIO: Professor Van Wesep, welcome.

EDWARD VAN WESEP: "Thank you very much, Frank."

FRANK STASIO: The banking industry underwent dramatic changes over; let's say the past, over the last quarter of the 20<sup>th</sup> century. Can you give us an over view? How have things changed?

EDWARD VAN WESEP: "Sure. I think there were a couple major changes. One of the big ones is that in the old days, i.e., 25 years ago and before, banks had two functions. They took deposits from people like you and me that needed a place to stash our savings,

and they made loans to people like you or me, that needed to buy a house; and those two functions weren't sort of obviously connected, but they were two important functions, and banks took care of both at once. In the last twenty-five years that's been less and less true. Perhaps because we are more financially sophisticated; I'm not a hundred percent sure why. People have a tendency to look for higher returns than bank accounts typically give them. Meanwhile banks found that they could take these mortgages and package them up and chop them into securities and sell them to people like you or me, either directly, if we're wealthy, or indirectly through mutual funds that we would buy, and this gave us a higher return in exchange for not giving us quite the same access to our money we always had, but it seemed well worth it. So banks were converted from deposit taking/ lending institutions, more to institutions that, yes, they made loans, but they quickly patched them and sold them. It was more about flow of money than sort of the static pool of money. So that was the first major change in banking in the last twenty five years. I think the second major change was a repeal of the Glass-Steagall act in the late 90's. That act was a depression-era rule separating commercial and investment banking from the banking that sort of we're familiar with—deposit taking banking—and that act connected sort of the low cost deposits that we all provide with a lot of maybe higher risk, higher return uses that banks now found for that money. So while it perhaps sort of improved the flow of capital to more, sort of, important higher return projects, it also seems to have created some risks for our economy.”

FRANK STASIO: So let's talk about those; the role of the banking industry, and the collapse in 2008.

EDWARD VAN WESEP: “Well, it played a number of roles. The biggest was that banks gave loans on easier and easier terms to people that wanted to buy houses. So instead of 20% down, you needed 10% down, then 0% down, then negative 10% down. So maybe you could buy a house and they'd give you some money to boot. Meanwhile interest rates were getting lower, and lower. Banks had figured out ways to price loans to higher risk people at lower rates. So, the banking industry was very helpful in creating a boom in housing, both construction of new houses, and increases in prices of old houses

during the boom years running up to 2007. Well, when people could no longer afford those houses, or decided they weren't going to keep going up anymore, house prices came down. Now the problem is that unlike before when house prices would come down and home owners would absorb a lot of the loss, after all they have to absorb the losses before the banks do. Now home owners didn't have any skin in the game, and so they were able to walk away from their homes, either willingly or unwillingly, leaving the bank with a fairly large expense on its hands. So banks lost a lot of money, which meant a lot of banks were either insolvent or almost insolvent, and that caused the government to have to step in and provide a lot of financing for the banks. So, there were many players in the financial collapse of 2008. Banks were a very large one."

FRANK STASIO: And there's something else called the shadow banking industry. Tell us a little bit about that.

EDWARD VAN WESEP: "Sure. So as I mentioned before, when banks would create mortgage loans they would then package them and sell them to investors, people like you or me. It may not be people like you or me. It may be people who are much wealthier who give money to hedge funds, and those hedge funds then can purchase the assets themselves. For example, I may give money to a hedge fund expecting a 4% return. The hedge funds could then buy a bunch of mortgage loans with a 4.5% interest rate, and earn the half percent, and keep that for themselves. These hedge funds are performing a role that used to be performed by banks, right? They are taking money from people who have money to spare, and they are using it basically to own mortgage loans, and it may be residential mortgages, commercial mortgages, whatever. They are, effectively, banks. Just because they don't have demand deposits, that is, just because they don't have to return the money immediately to investors if investors demand it, they are still serving a function of banks. The big difference between hedge funds and these other so-called shadow banks, and traditional banks, is that they are unregulated. So this is now a very major player in the financial world, all of these sort of shadow banking institutions, but they are largely unregulated."

FRANK STASIO: What's the difference? How are banks regulated in ways that hedge funds aren't, and why would that make a difference in this past crisis?

EDWARD VAN WESEP: “Well one example might be the following; banks have what are called capital ratios. What that means is, suppose a bank wants to lend out a hundred thousand dollars for somebody to purchase a house. Well, where do they get the hundred thousand dollars? They might get ninety thousand dollars from depositors who just have ninety thousand dollars in checking accounts, and they might get ten other dollars from people who say, ‘Look, we are willing to give you the money. We know we might not get our money back, but hopefully we will get a pretty high return if we do get our money back.’ Those are called equity holders, and a capital ratio is a requirement that the government imposes on banks that they can only use so much money from depositors, or other so called “lenders”. So, why does this matter? Well, imagine that you have this hundred thousand dollar house that is only worth ninety thousand dollars anymore. If the bank financed that by only borrowing ninety thousand dollars, and getting the other ten thousand from equity holders, then the equity holders are out of money, but that's sort of okay. They did badly. They knew they might do badly. That's sort of the end of that. But if they funded it by borrowing ninety five thousand dollars, and getting only five thousand from equity holders, well now they don't have enough money to pay back their depositors. The bank is insolvent, and the government takes over the bank. Now, you may say that's sort of the end of that, not a big deal. Well it is a big deal, because the people that were owed ninety five thousand dollars by the bank—it might be people like you or me, that now may not have access to our deposits. It may, however, be other banks, and those other banks now are not going to necessarily get the full ninety-five thousand dollars that they are owed. They may get less than that. Well, that reduces the value of their assets, and if they financed all of their assets with too much debt, they may be insolvent as well, and this is called contagion. It happened in the Great Depression, and we therefore implemented capital ratios back then that were sort of designed to minimize the amounts of contagion that could occur, and they were very successful for about seventy years. Those capital ratios are basically not in place for the shadow banking industry. If I'm a hedge fund and I want to fund a one-hundred thousand dollar

loan I can do it by raising a thousand dollars from investors, and borrowing ninety nine thousand dollars, and that makes for a very contagious, very risky environment.”

FRANK STASIO: When you talk about the differences between borrowing, and having an equity stake, if I have an equity stake I bought into the property, or the thing that’s at stake here, I know that the value of that might go down. If it does, I’m a loser; but, a loan is a different thing. You have promised to pay me back, and so that’s what you’re saying, when those ratios change, when more of that money they’ve promised to pay back is involved in these transactions, more risk is at stake, and the collapse can be all the more painful, and the ripple effects are more broadly felt.

EDWARD VAN WESEP: “That’s absolutely right.”

FRANK STASIO: So why did these things change, and to what extent does working in a globalized economy have an impact on those regulations. Or, did it?

EDWARD VAN WESEP: “Well, I think there were a few reasons those changes came into place. A big one is perhaps that it’s more efficient to have a situation where people don’t have access to deposits all the time. They say, ‘Ok, I’m going to give up the right to access the money at any time. I’ll give it to you for a year, two years, or three years, and in exchange I will get a higher return,’ that may be a more efficient way of doing business. I think the other potential reason that this happened is somewhat more nefarious. If you are trying to decide how to finance a bunch of assets that you own, you’re a bank, you are going to lend out money to a lot of people, and you are trying to figure out, how do I raise the money to sort of finance these loans? One way to raise it as we’ve discussed is through debt, through promising to pay people back a certain amount, and the other way is through equity. Now debt is, in regulation, very different from equity. Most people I think who lend money to banks know that if the bank collapses the federal government will step in and will make them whole. That means that banks will be able to pay the same interest rate on their debt that the federal government pays on its debt. It’s the risk free interest rate, because lenders know that they will be bailed out

when the time comes, and so there's a very strong incentive for banks to finance themselves as much as possible through debt, and not through equity, and indeed that is what we saw."

FRANK STASIO: Has the nature of banking changed in a globalized economy?

EDWARD VAN WESEP: "Well yes, absolutely it has. So imagine that we went to impose the following rule: any bank has to have at least 10% equity in its capital structure. That is, to say, any bank that owns a hundred million dollars in assets can have no more than 90 million dollars in debt. Well suppose now that Germany has a different rule, and Deutsche Bank comes in and it actually has 95 million in debt for a 100 million in assets. What are we supposed to say to that? Are we supposed to say, 'Deutsche Bank you're not allowed to operate in the United States'? Ok they probably wouldn't like it, but we can probably enforce that; but Deutsche Bank probably trades with a lot of U.S. institutions abroad. Well that's a problem, because if Deutsche Bank goes down, which is more common or more likely, because of this high-leverage ratio, then that is going to affect U.S. institutions. That is more likely to make our institutions to go down as well. So what you actually need to do is you need to harmonize the rules for banking across different countries, and indeed that's what's happened. In just the last decade the Basel II accords were put in to place, which did harmonize capital requirements across a variety of countries, including most of the developed world. The problem was Basel II was put into place to very low capital requirements. While they were harmonized, that is they were the same across many different countries, they were also very low, and they were set at a level that almost guaranteed contagion, and indeed that's what we had."

FRANK STASIO: Are we at a point where we need to look at all of the institutions that perform banking roles, brokerage houses, hedge funds, banks, credit unions? Do they need to be regulated the same way? Would that make things better, or would it in some way impede some functions that those particular institutions do now?

EDWARD VAN WESEP: “I think they absolutely have to be regulated the same way. As we were talking about before, a hedge fund today serves many of the same functions that a bank did twenty years ago and frankly that many banks do today. These are not structurally different institutions, but they are regulated as different institutions. Now, you can say, ‘Why would it be more likely for money to flow to the unregulated sort of set of institutions?’ Well as we discussed, if a financial institution goes down, and this is going to include potentially hedge funds; the government will step in a back debt holders whole. This means that any institution that is able to finance itself more with debt than other institutions is going to have an advantage competitively. Money will flow to those institutions. So I think my view is that any firm whose business is trading money needs to be treated the same way and needs to be subject to the same capital requirements.”

FRANK STASIO: Professor Van Wesep, thank you very much.

EDWARD VAN WESEP: “Thank you very much, Frank.”

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FRANK STASIO: I’ve been talking with Edward D. Van Wesep. Dr. Van Wesep is a professor of finance at the Keenan Flagler School of Business at the University of North Carolina Chapel Hill. I’m Frank Stasio.

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