

What the subprime crisis means for banking alternatives

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Recovery toward what? Finance, justice, sustainability

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Approach

This session constitutes an exploration of alternatives in banking.

These alternatives are unfolding in a world in which the mainstream banks have been evolving rapidly, in close cooperation with government regulators – and with the shadow-banking system.

Implication: So, eyes wide open. The history of institutional and policy evolution matters.

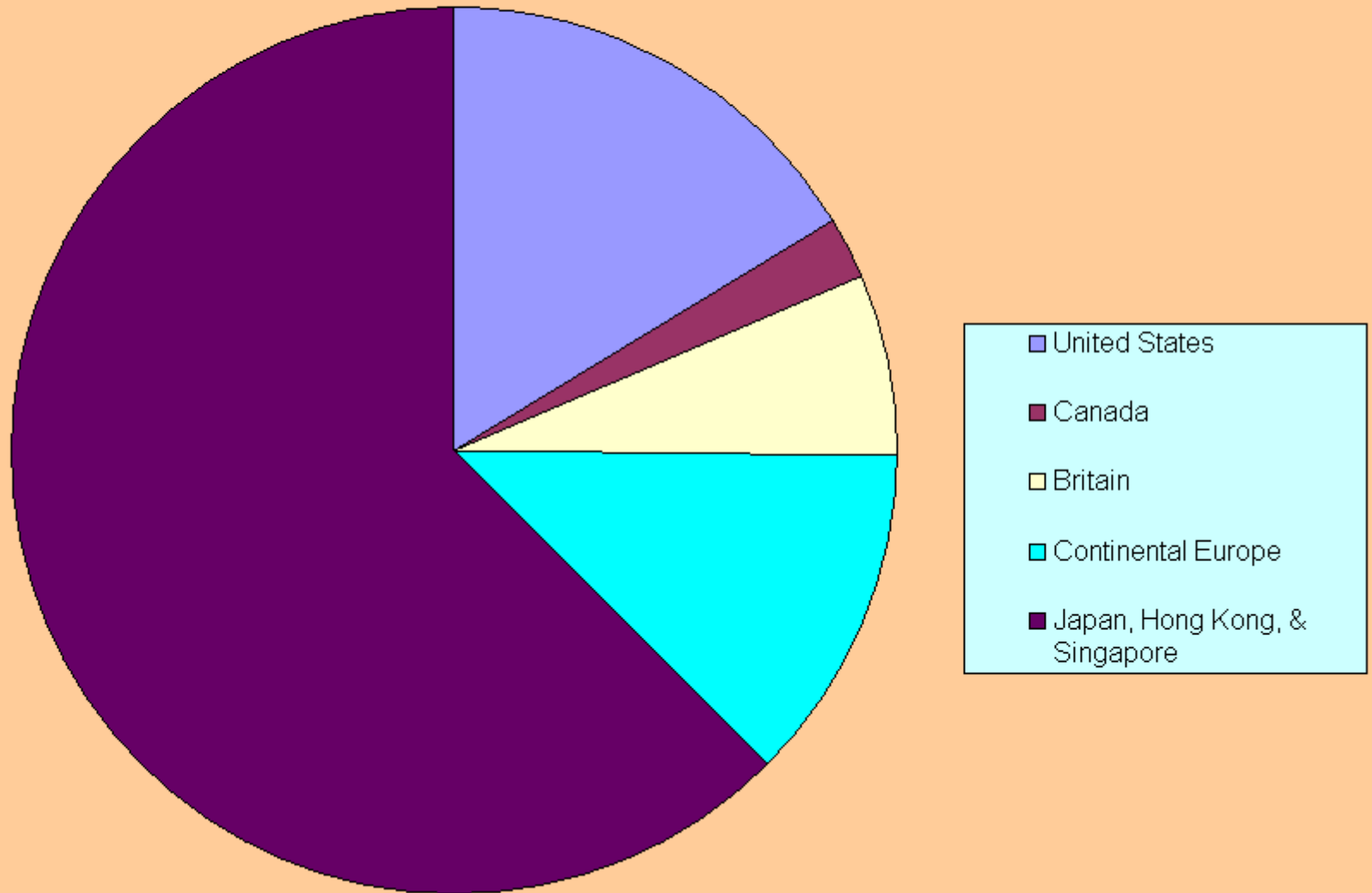
Road-map

1. (3) Roots of the subprime crisis: 1980s-1990s
2. (4) Triggers of the crisis: 2000s
3. (3) Consequences of the subprime crisis
4. (3) Developments toward banking alternatives: 1970s-1980s
5. (3) Developments toward banking alternatives: 1990s-2000s
6. (4) Ways to recapture impetus of banking alternatives for working people, families, communities

1. Roots of the subprime crisis: 1980s-1990s

- (1) Global situation of the US: chronic trade deficit makes it a “global liquidity sink”
- Chronic current-account problems leads to systematic capital-account inflows

Market value of financial firms, BW 1000, May 1989



Market value of financial firms, BW 1000, May 2004

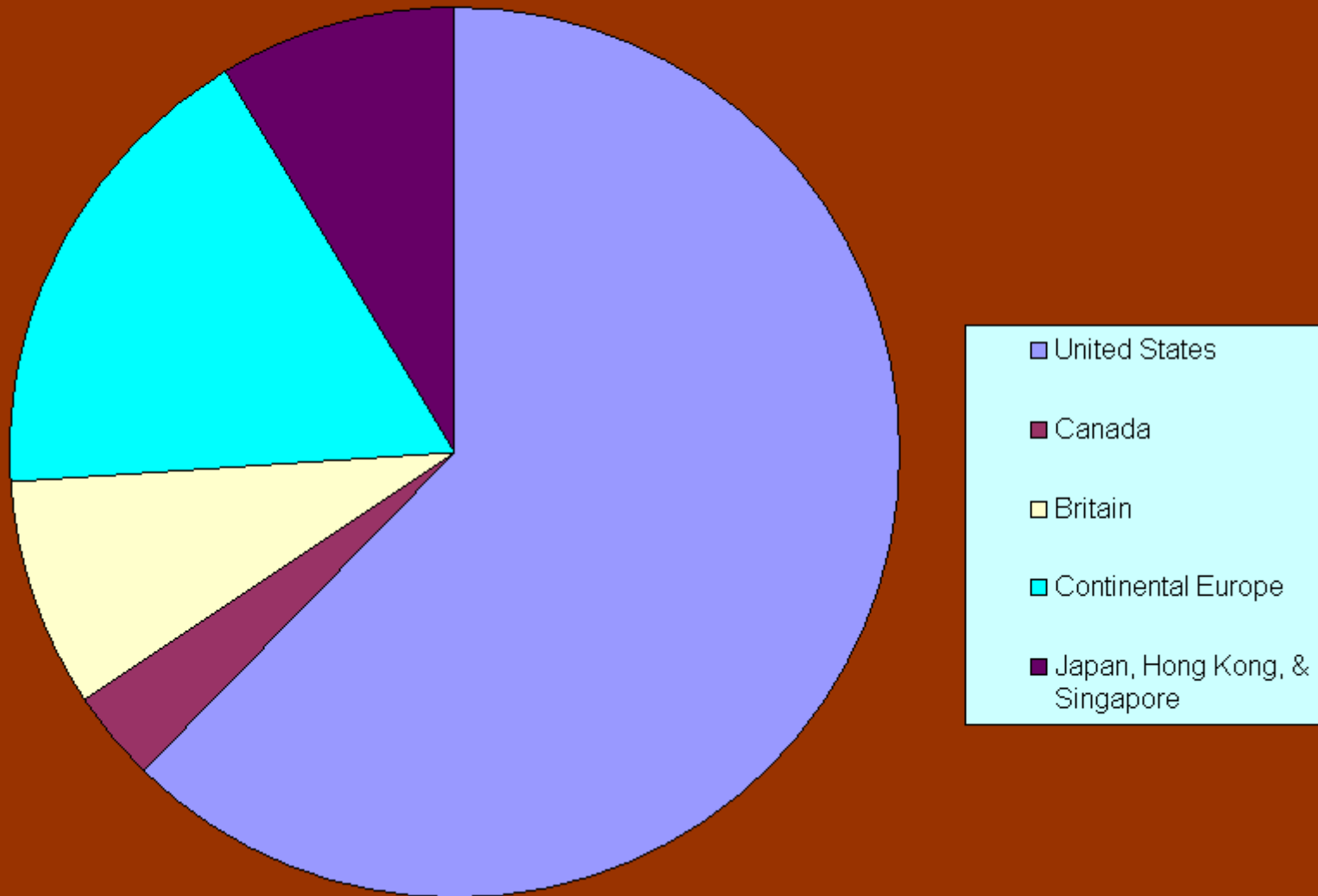
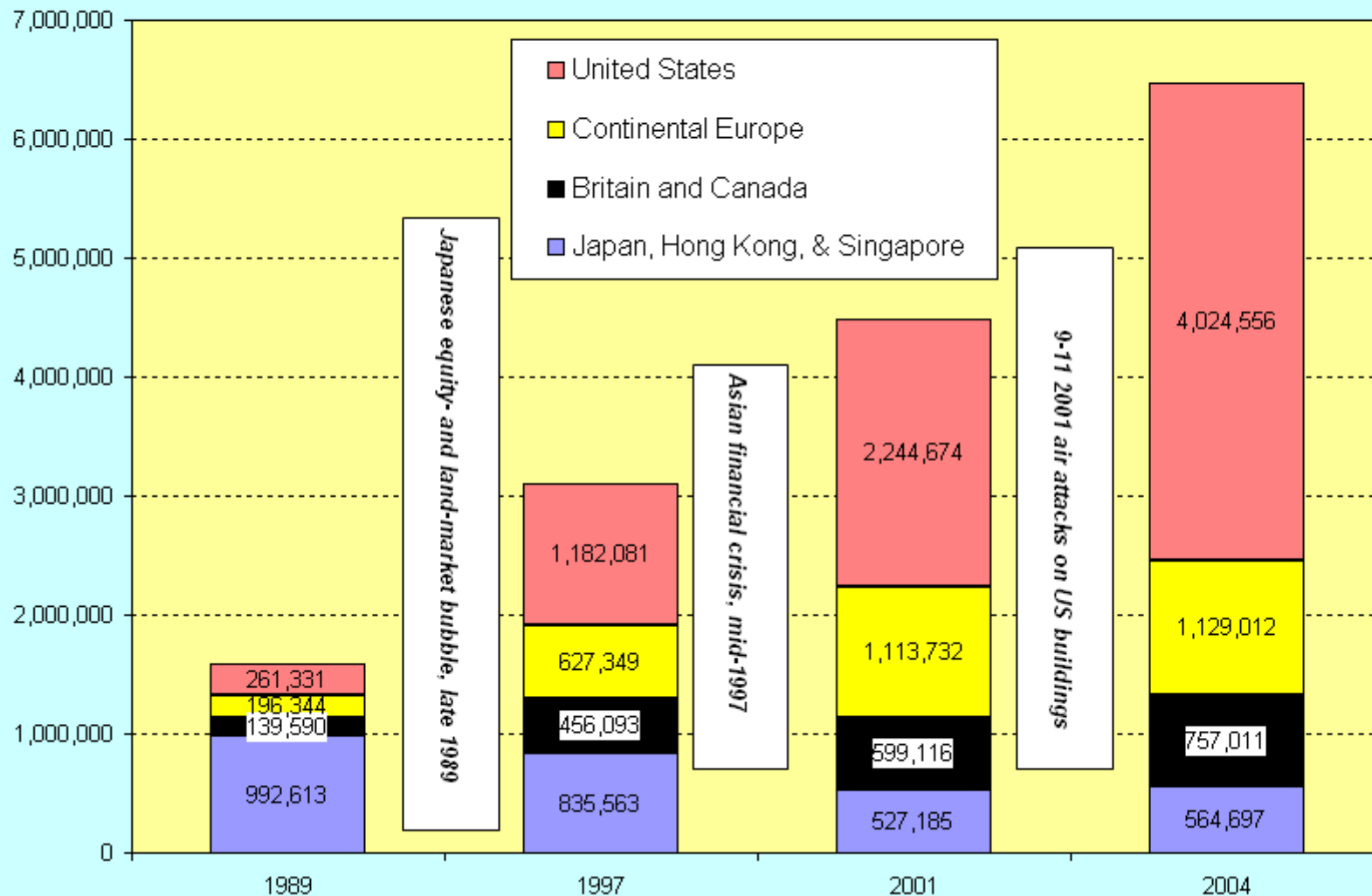


Figure 9: Market value of financial firms listed in Business Week 1000, by global areas, 1989-2004 (US \$M)



1. Roots of the subprime crisis: 1980s-1990s

(2) Strategic crisis and transformation of banking firms: from “one size fits all” to “upscale retail banking”

- Superregional banks (Nationsbank, Corestates, Bank America) gather strength while money-center banks struggle (Citibank, Continental Illinois, Chase Manhattan)

- Bank merger wave due to shift in competition (anti-trust) policy and in public commitment to regulatory oversight

Mortgage market reinvention: from housing finance by localized savings and loans that “lend and hold,”

to channeling of most mortgage finance into mortgage-backed securities, certified as “plain vanilla” (not risky) by FNMA/FHMLC – and *implicitly* underwritten by US government guarantees (too *privileged* to fail)

- Creation of a small private-insurance market for super-sized mortgages too large to qualify for FNMA/FHLMC

1. Roots of the subprime crisis: 1980s-1990s

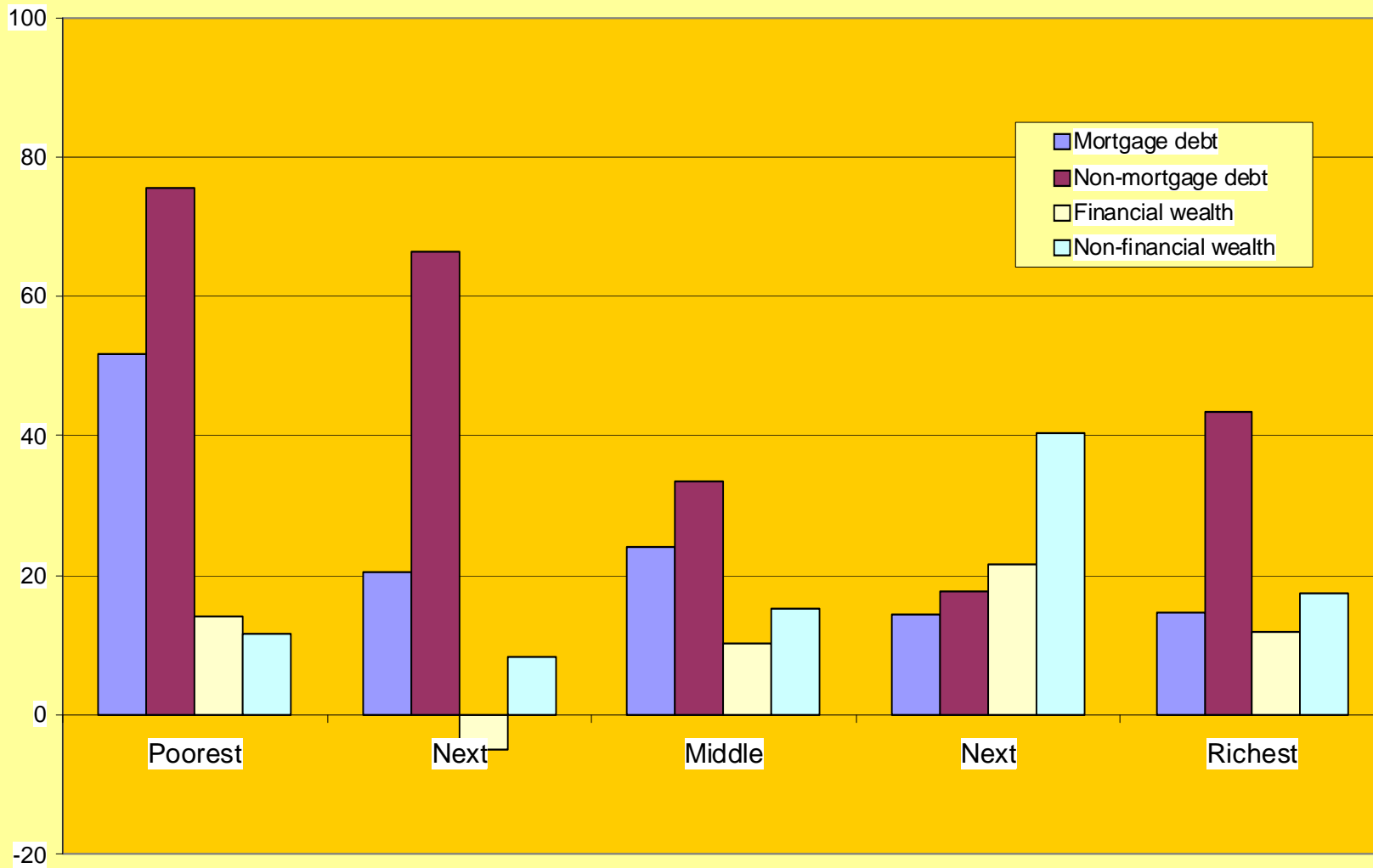
(3) Racial exclusion in US credit and financial markets: from “redlining” and credit-market discrimination (“denial of credit”) to financial exploitation

- Interlinked with income, immigration-status exclusion
- Rise of predatory lending and financial practices – debit cards, payday loans, and subprime loans
- Banks begin to compete for fees from remittances

2. Triggers of the crisis: 2000s

- (1) Deregulation (1999 Gramm-Bliley Act) unleashes deepening of the extent of return-seeking, regulation-avoiding behavior: hedge funds, private-equity funds
- (2) A further shift in banking strategy: the surviving money-center banks reinvent themselves as **megabanks**:
 - Consumer banking is redefined: “originate and distribute” credit; securitization and loan-servicing; volume-based, fee-based income emphasized over interest income
 - Increasing focus on lower-income customers – due to increasing inequality, and rise of cross-border labor (guest and undocumented workers).
 - Remittances as emerging market opportunity, both in sending countries (fee capture) and in receiving countries (consumption-focus or investment-potential)

**Avg 3-Year Growth Rates, Assets and Debt, '89-'01,
Survey of Consumer Finances, FRB (by quintile)**



2. Triggers of the crisis: 2000s

These two trends lead to:

Expansion of housing-finance market: Subprime, alt-A mortgages

Structured investment vehicles – collateralized debt obligations, financed by asset-backed commercial paper, and “insured” by credit default swaps (AIG dominated)

(3) Housing bubble in portions of the US, income collapse in other parts of the US

Everything was ready: suppliers of credit, demand for it; bundlers, services, insurers

(4) Financialization of consumption: credit cards, automobile loans, student loans, as well as mortgage loans

Shift of SIVs toward opacity, off-shore sales

Figure 1: Firms, households, and banks: pre-deregulation balance sheets

Non-financial firms		Households		Banks	
<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
Working capital	Trade credit, short-term loans, commercial paper	Cash and demand deposits	Short-term bank and non-bank debt (credit cards)	Required reserves	Demand deposits
Plant and equipment	Corporate bonds	Time Deposits	Mortgage loan(s)	Securities, Fed Funds lent	
	Equity	Real assets (automobile, furniture, recreation)		House(s) or condo(s)	Short-term loans and mortgage loans
		Financial assets (stocks & funds)	Equity		Borrowed funds, incl. Fed Funds
					Equity

Note: Dark gray indicates locii of default risk; light gray indicates locii of liquidity risk. Household

**Figure 5: Banks, structured investment vehicles, and households:
Subprime balance sheets**

Banks		SIV funds		Subprime Households	
<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>	<i>Assets</i>	<i>Liabilities</i>
Required reserves	Demand deposits	Credit card debt, Merger bridge loans, Educational loans	Asset-backed commercial paper	Cash and demand deposits	Short-term bank and non-bank debt (credit cards)
Securities, Fed Funds lent				Real assets (automobile, furniture, jewelry)	
Short-term loans	Time deposits			Subprime mortgage loans	House(s) or condo(s)
Mortgage loans	Borrowed funds, incl. Fed Funds	Prime mortgage loans	Fixed-rate mortgage loan (15-year)		
	Equity				

Note: Dark gray indicates locii of default risk; light gray indicates locii of liquidity risk. No equity tranche is shown for SIV funds.

3. Consequences of the subprime crisis

- (1) Global financial-system near-collapse – so a shift from “subprime” crimes to financial speculation, gambling, risk-taking
- (2) Focus of bailout has been on **megabanks** because their vulnerability has pushed the problem of instability / stability of the markets as a whole in front of the question of banking-sector functionality
- (3) Financial regulation has centered on consumer protection and on clean-up of misaligned incentives – because regulatory arbitrage problem prevents deeper reform discussions (it remains a world of neoliberal design mechanisms)

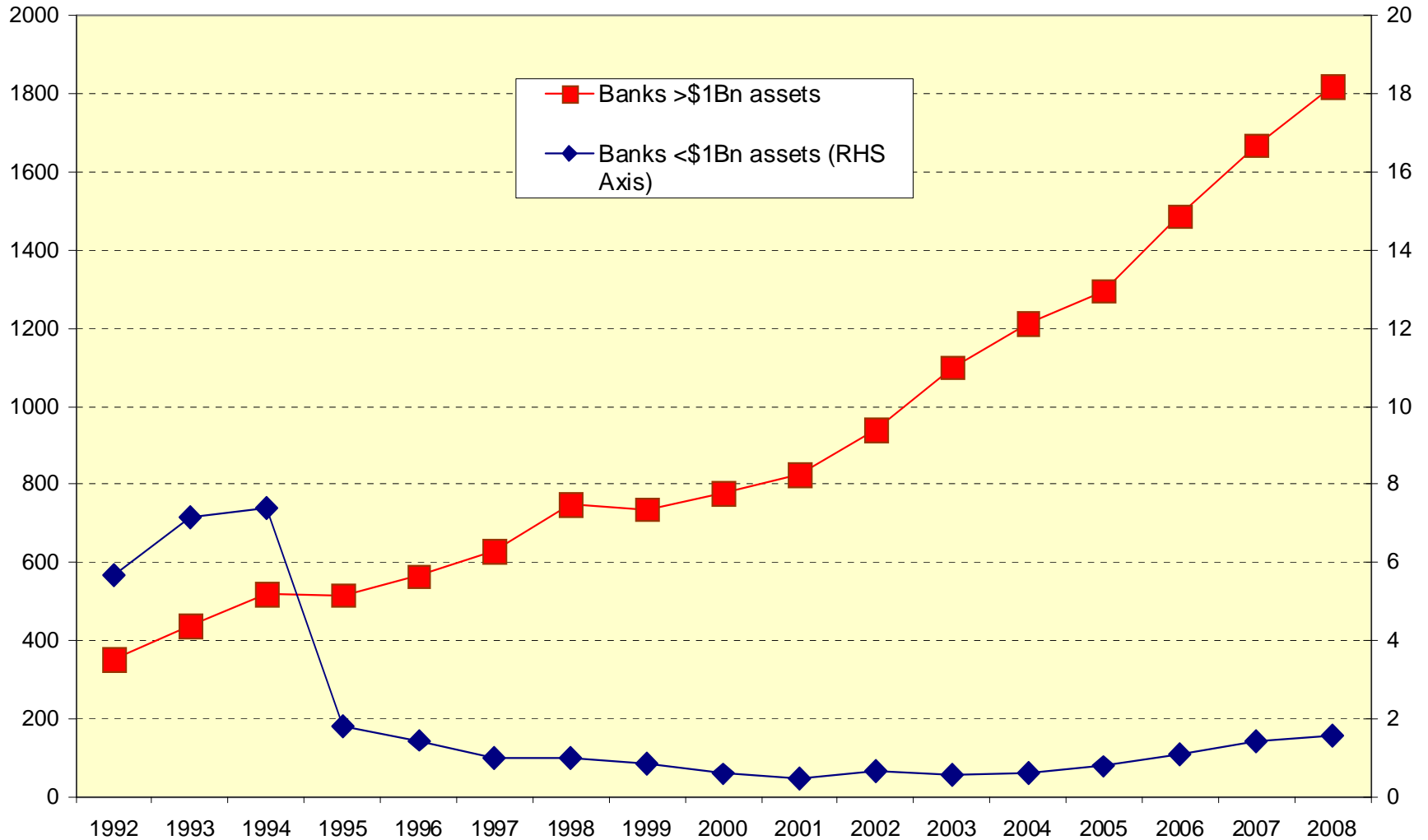
Policy “pragmatism” meets the financial crisis

The megabanks are too complex to be unwound, with too many unforeseeable consequences of closing them. And it's only fair to make all the megabanks too big to fail (Goldman Sachs, Morgan Stanley).

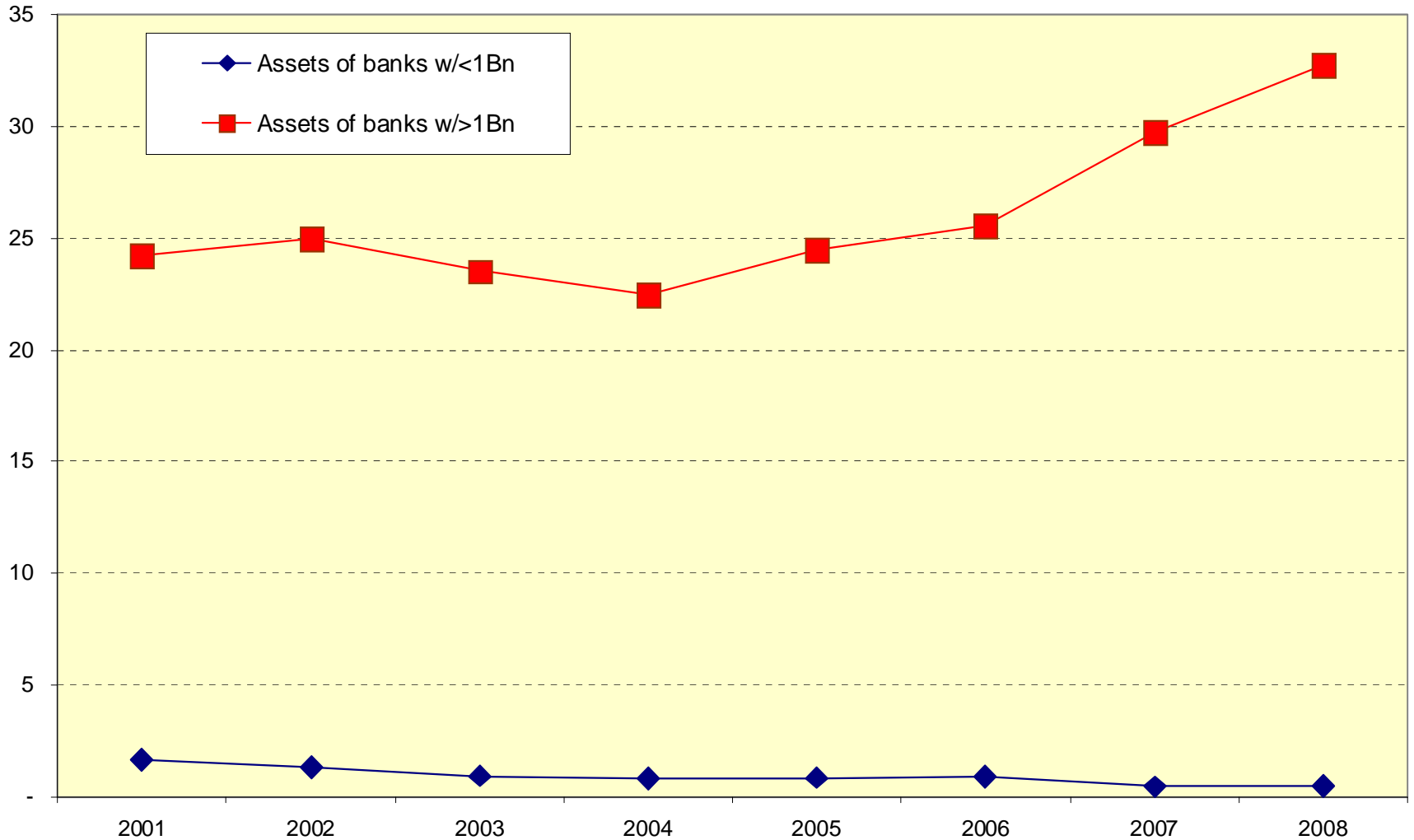
It is convenient to regard these financial complexes as a economic sector, which generates surplus autonomously.

- Megabanks' business model depends on fee-based activity, securitization, and off-balance sheet position-taking in global finance circuits.
- Alternative banks' business model depends on local economies – on local circuits of business activity, housing construction, everything linked to employment.

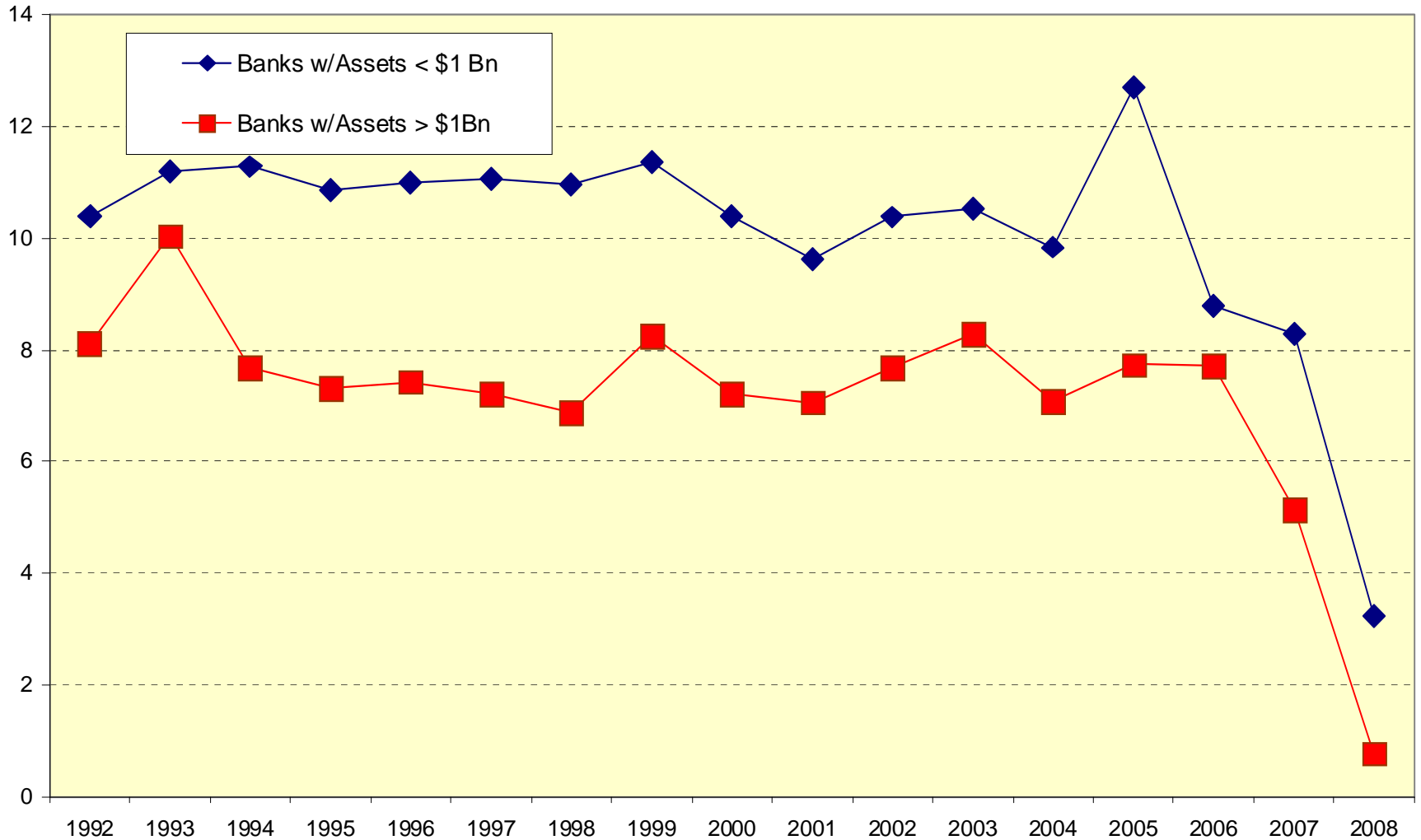
**Derivatives as % of Assets, 1992-2008:
Small (<\$1Bn assets) vs Big banks (>\$1Bn Assets)**



**Loans Securitized with Recourse as % of All Loans, 2001-2008:
Small (<\$1Bn assets) vs Big banks (>\$1Bn Assets)**



**Net Income as % of Equity, 1992-2008:
Small (<\$1Bn assets) vs Big banks (>\$1Bn Assets)**



**"Big Four" banks' assets (BofA, Chase, Citi, Wells) versus other banks' assets,
2002-2008 (in constant dollars, with 2000=100)**

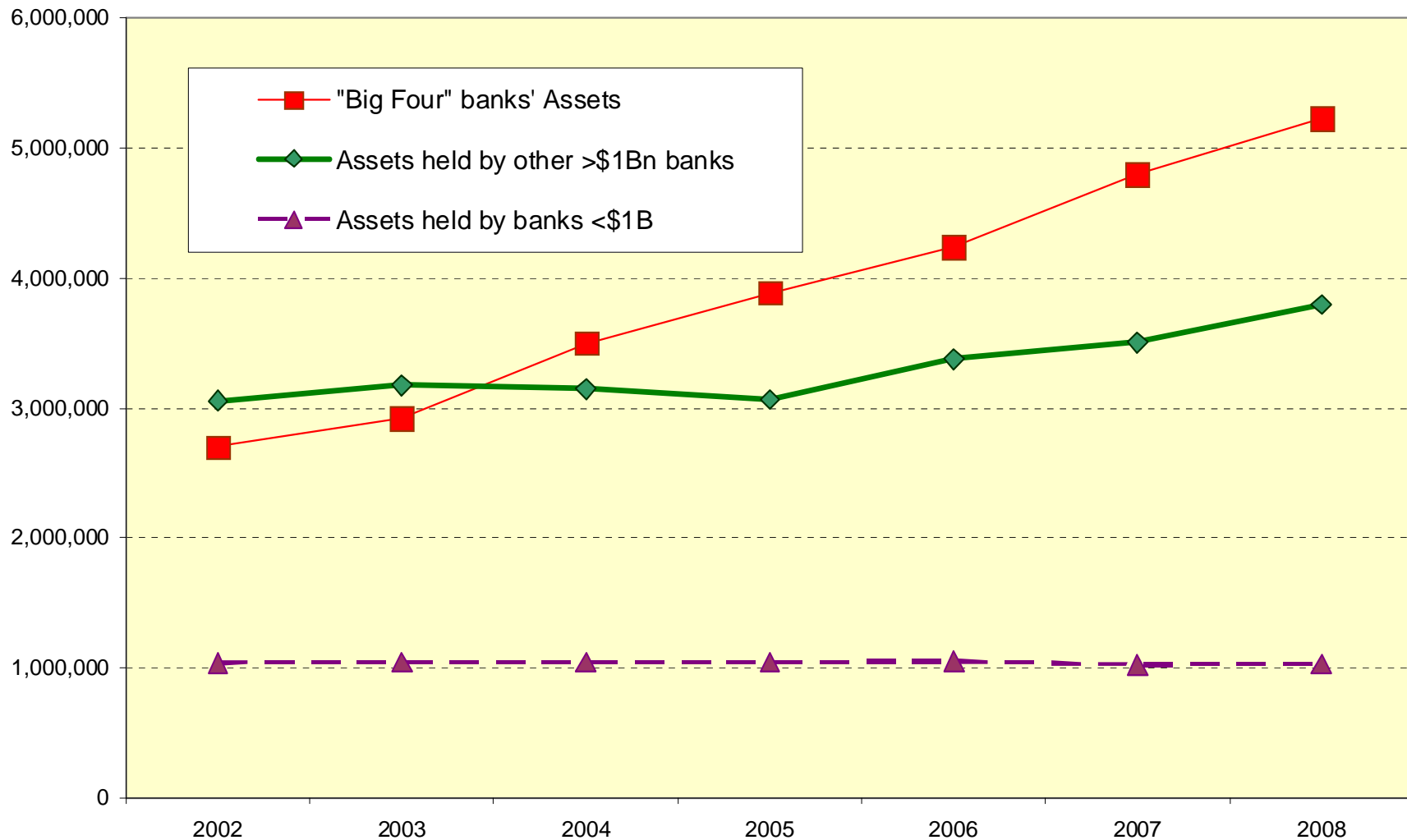
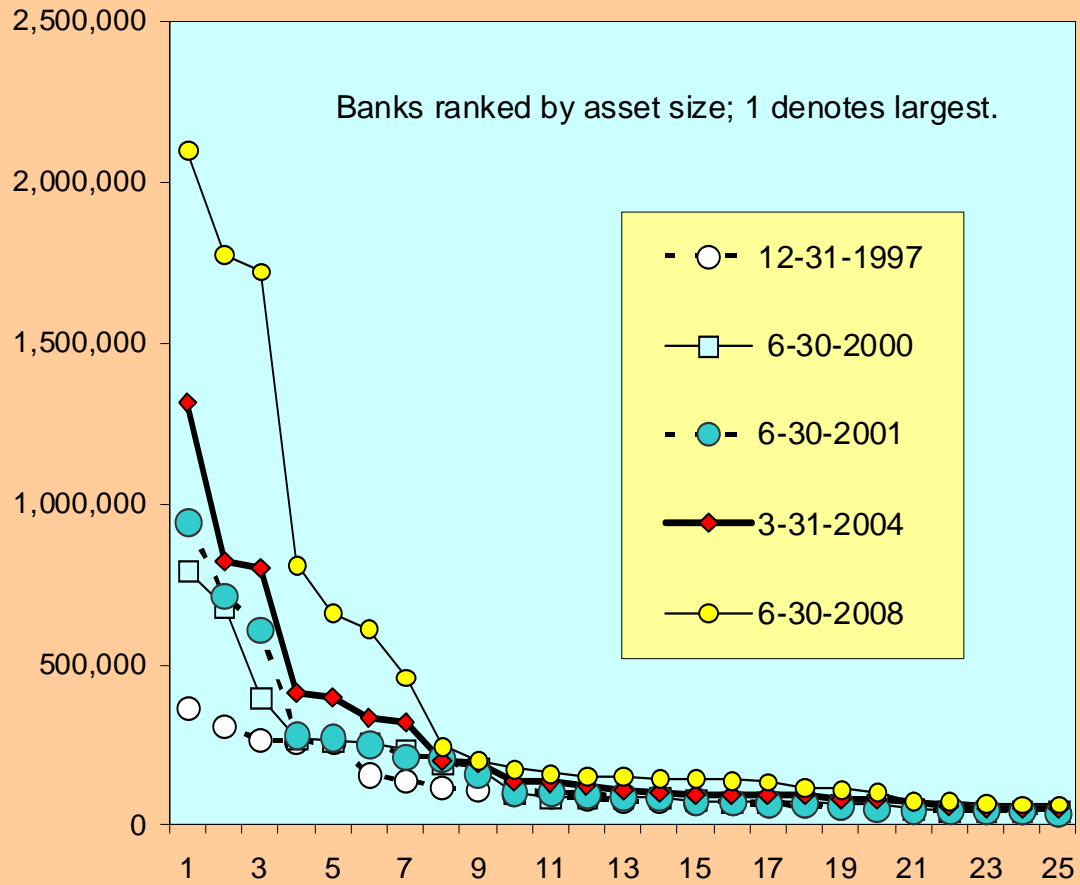
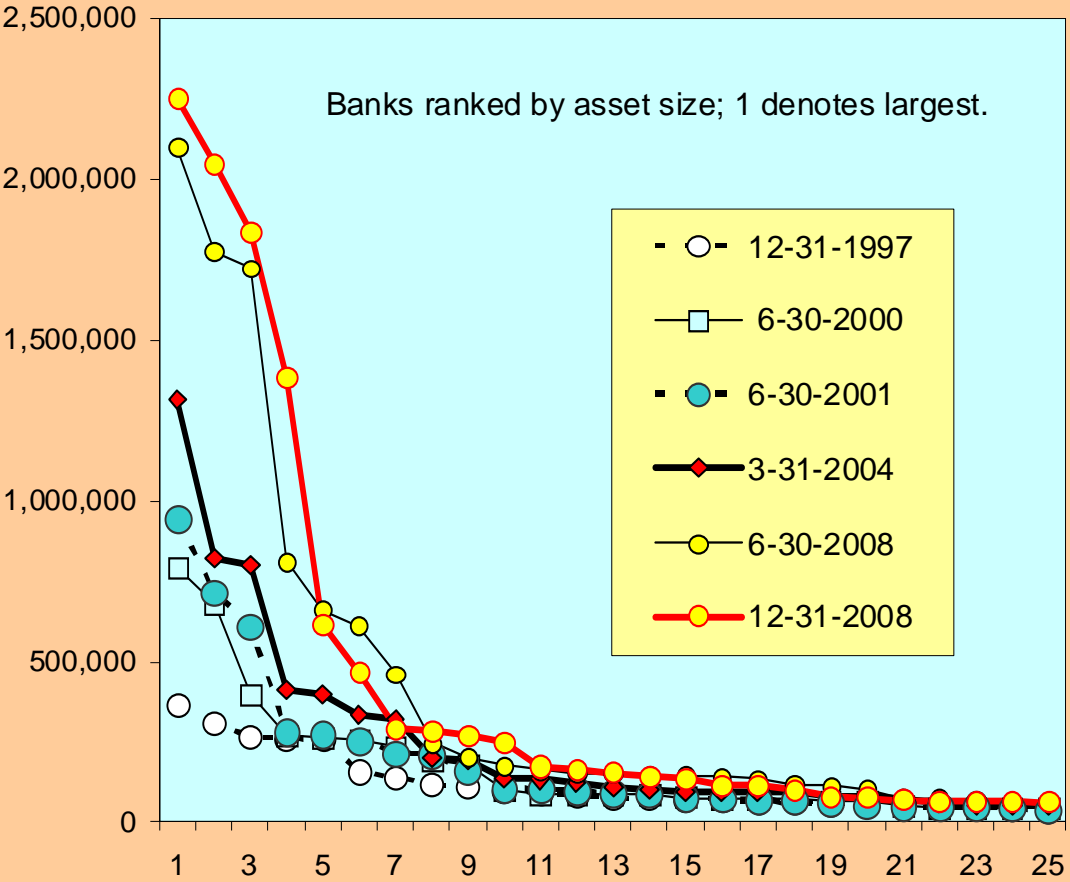


Figure 7: Asset Size of Top-25 Bank Holding Companies, Dec. 1997 to June 2008 (US \$000)



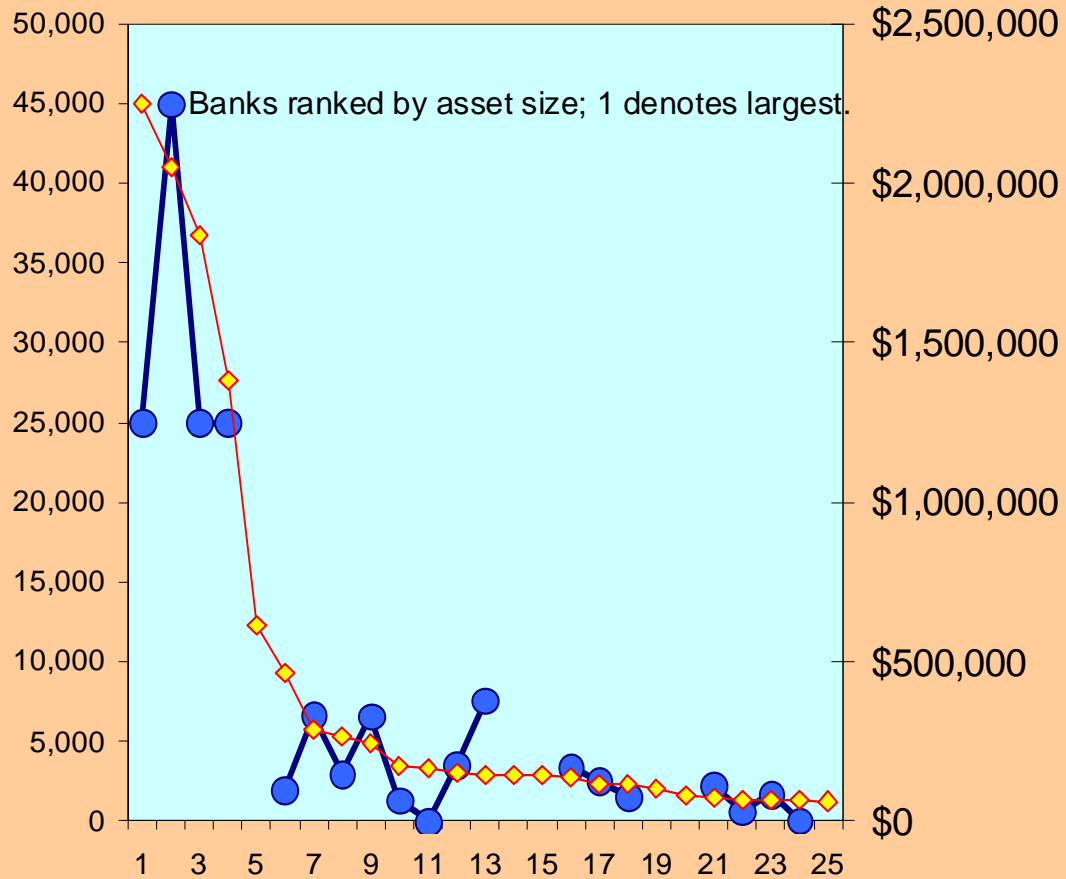
Source: National Information Center, FFIEC; FDIC.

Figure 7: Asset Size of Top-25 Bank Holding Companies, Dec. 1997 to Dec. 2008 (US \$000)



Source: National Information Center, FFIEC; FDIC.

Figure 7: Capital Injections for Top-25 Bank Holding Companies from TARP, January 10, 2009 (\$000)



4. Developments toward banking alternatives – 1970s and 1980s

- (1) Community reinvestment movement: Home Mortgage Disclosure Act (1975) and Community Reinvestment Act (1977) in US [accountability]
- (2) Socially-responsible investment & banking movement (South Shore)
- (3) Microfinance movement (Grameen)

Common features:

These alternatives were linked to broad-based, diverse social movements

They reflected bottom-up demands for democratic voice
Corporations and gov'ts held accountable by the people

5. Developments toward banking alternatives – 1990s and 2000s

- (1) 1992 US Community Development Finance Institution Act
- (2) Adoption of microfinance as an official development policy, and its “commercialization”

(2005 – the World Bank “year of microfinance”)

- (3) Emphasis on “access to finance” for the poor and lower-income communities

“Discovery” of the unbanked and financial exclusion

Asset-based development – Savings schemes for poor

Common features:

Developed on a market basis, or in partnership with market-based institutions

They have reflected top-down policy adoption

People are understood as proto-entrepreneurs (De Soto) or as proto-consumers

6. Ways to recapture impetus of banking alternatives for working people, families, communities

- (1) Renew the principle of broad-based corporate responsibility in the financial sector: not just stability, but reinvestment intra-nationally and globally
Tithing of megabanks into global investment funds/banks that are democratically controlled
- (2) Renewal of and public-institutional support for greenlining
Support for green technology
Renewed linkage of pension funds with labor and with communities – long-term investment
- (3) Develop alternative models of commercial banks & finance: eg, “utilities” providing public services?
- (4) Encourage the growth of new waves of development and investment banking