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.

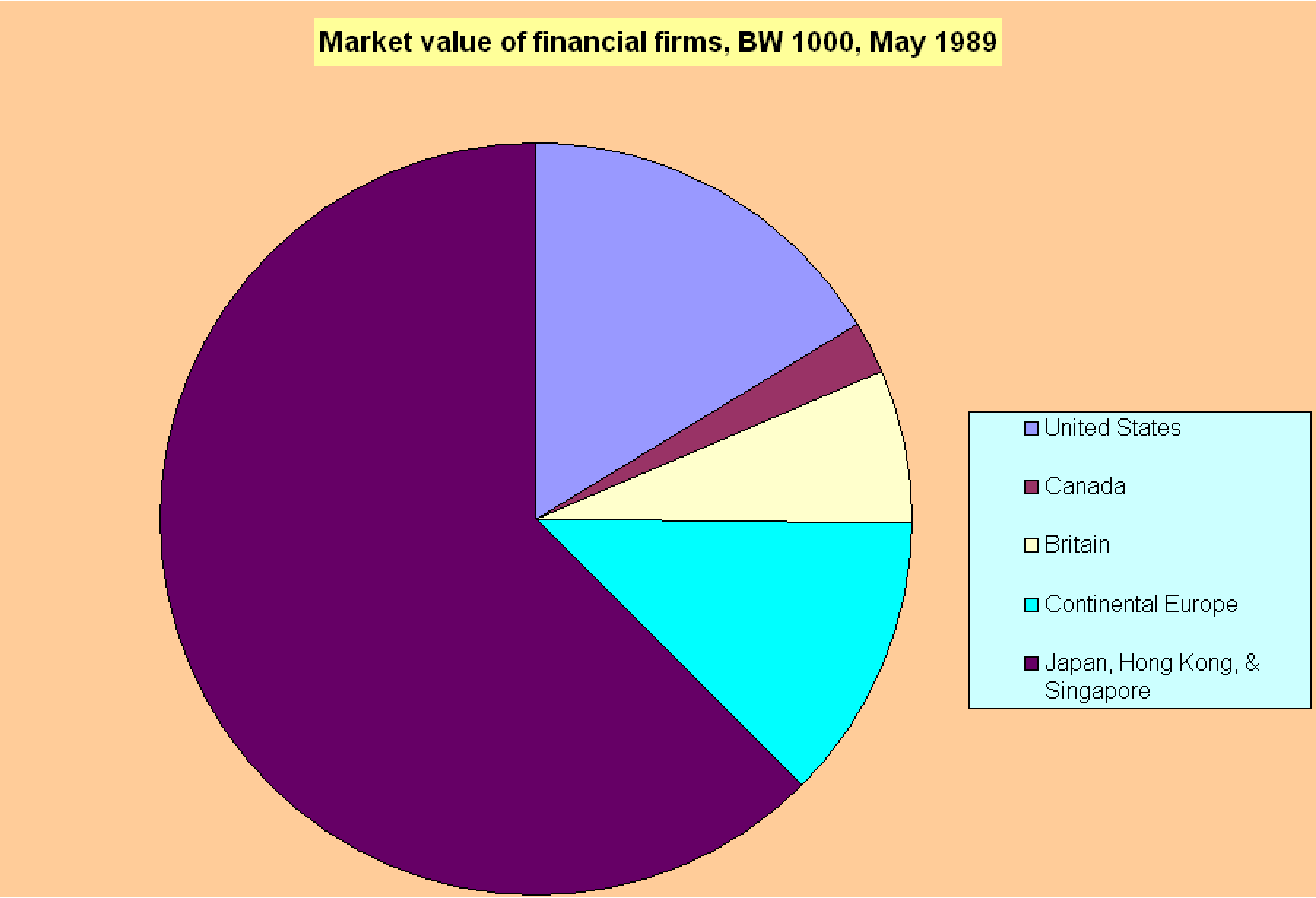
Road-map

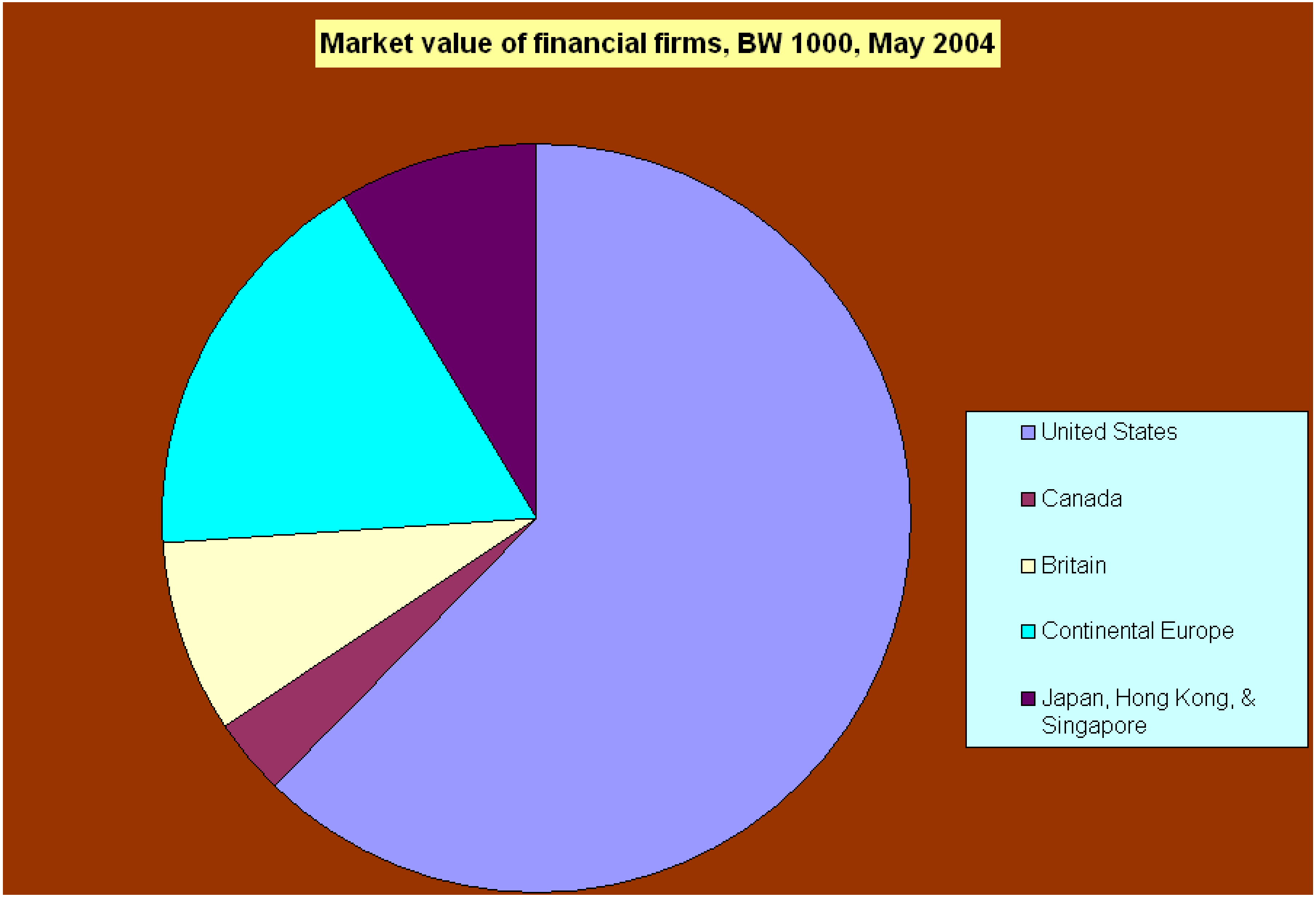
1. (3) Roots of the subprime crisis: 1980s-1990s
2. (4) Triggers of the crisis: 2000s
3. (3) Consequences of the subprime crisis
4. (3) Developments toward banking alternatives: 1970s-1980s
5. (3) Developments toward banking alternatives: 1990s-2000s
6. (4) Ways to recapture impetus of banking alternatives 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
United States
Canada
Britain
Continental Europe
Japan, Hong Kong, &
Singapore


Market value of financial firms, BW 1000, May 2004
United States
Canada
Britain
Continental Europe
Japan, Hong Kong, & Singapore

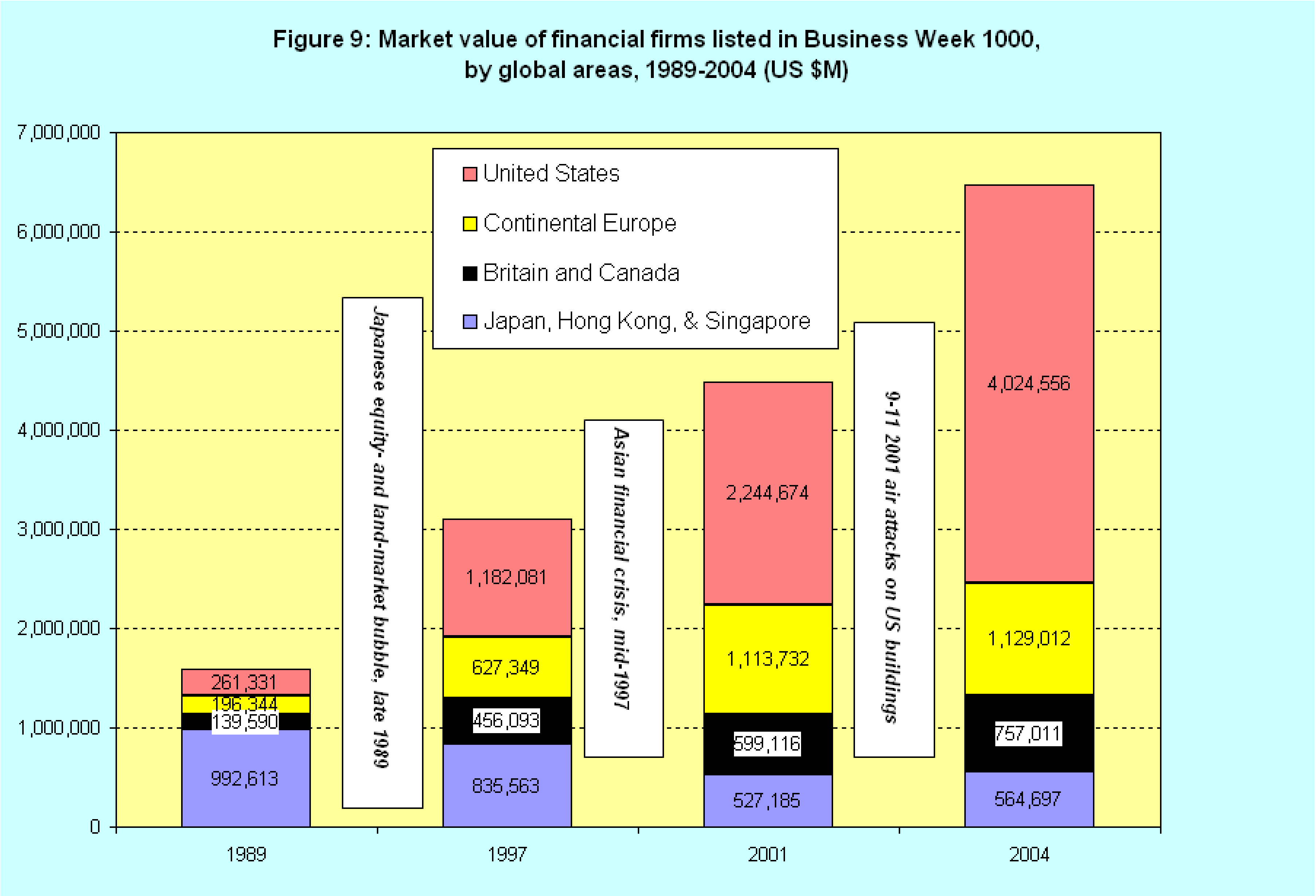


Figure 9: Market value of financial firms listed in Business Week 1000,
by global areas, 1989-2004 (US $M)
United States
Continental Europe
Britain and Canada
Japan, Hong Kong, & Singapore
Japanese equity- and land-market bubble, late 1989
Asian financial crisis, mid-1997
9-11 2001 air attacks on US buildings
7,000,000
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
261,331
196,344
139,590
992,613
1,182,081
627,349
456,093
835,563
2,244,674
1,113,732
599,116
527,185
4,024,556
1,129,012
757,011
564,697
1989
1997
2001
2004

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

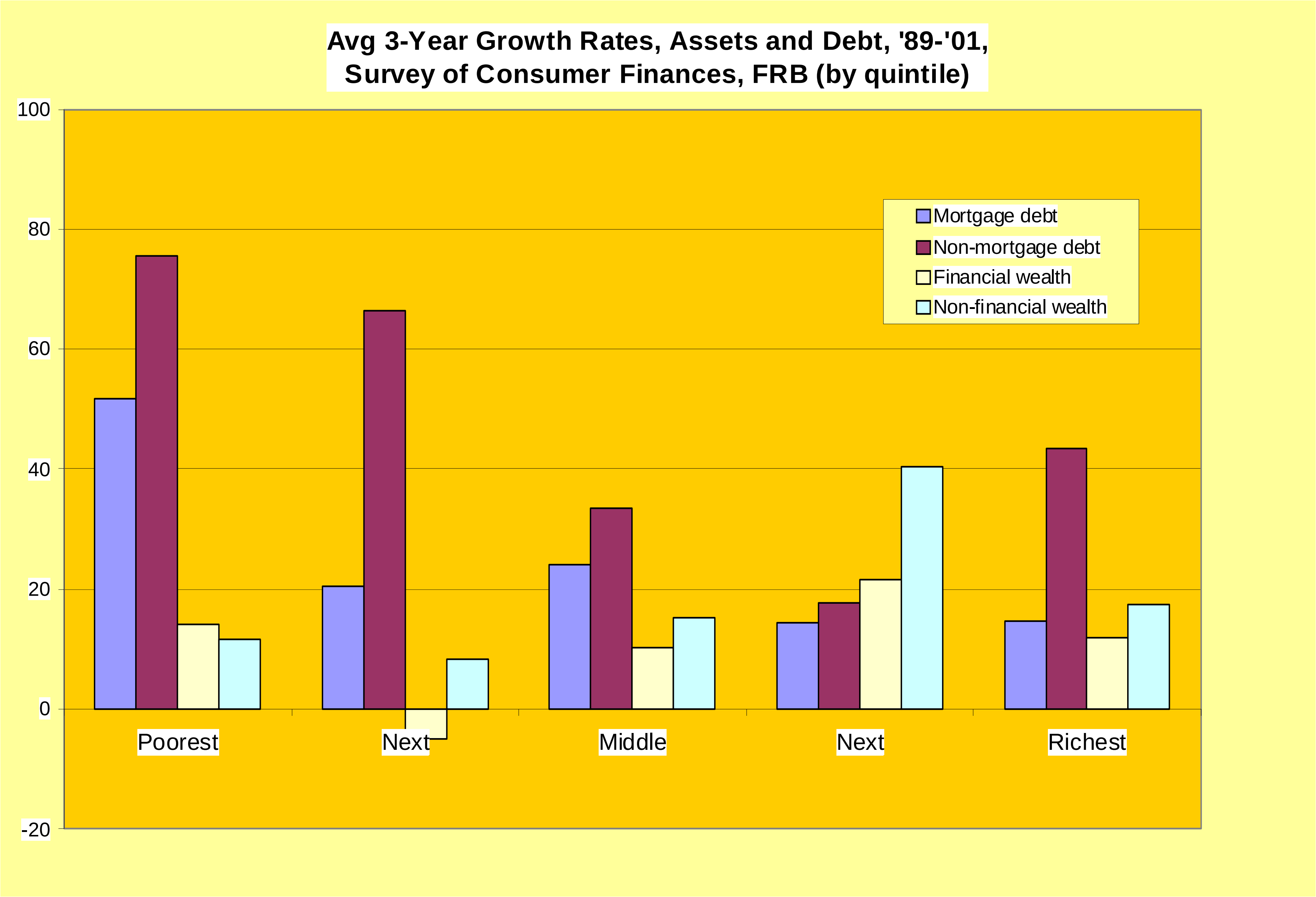
- Interlinked with income, immigration-status exclusion
- Rise of predatory lending and financial practices – debit cards, payday loans, and subprime loans
- Banks begin to compete for fees from remittances

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)
100
80
60
40
20
0
-20
Mortgage debt
Non-mortgage debt
Financial wealth
Non-financial wealth
Poorest
Next
Middle
Next
Richest

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)

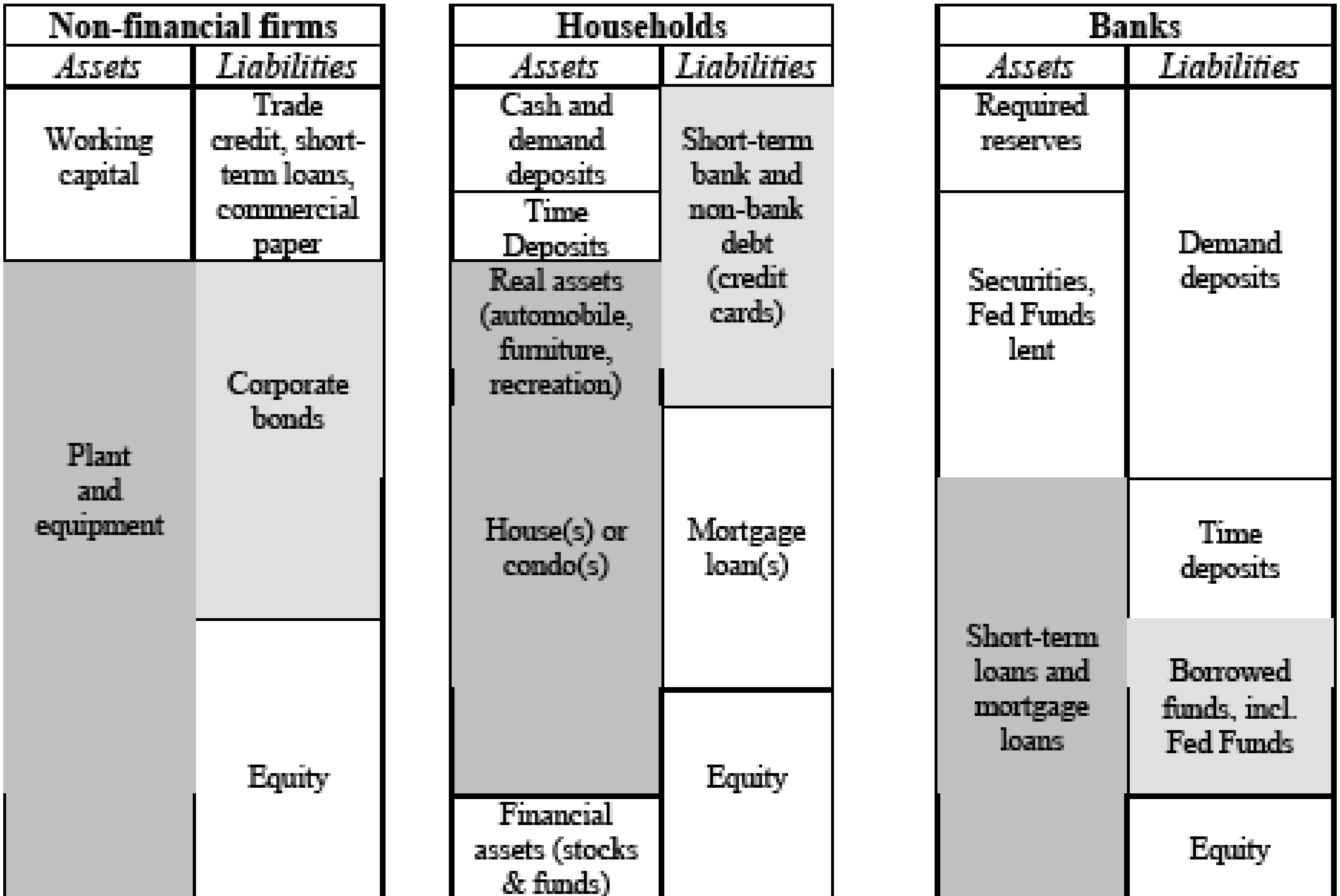
(3) Housing bubble in portions of the US, income collapse in other parts of the US

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

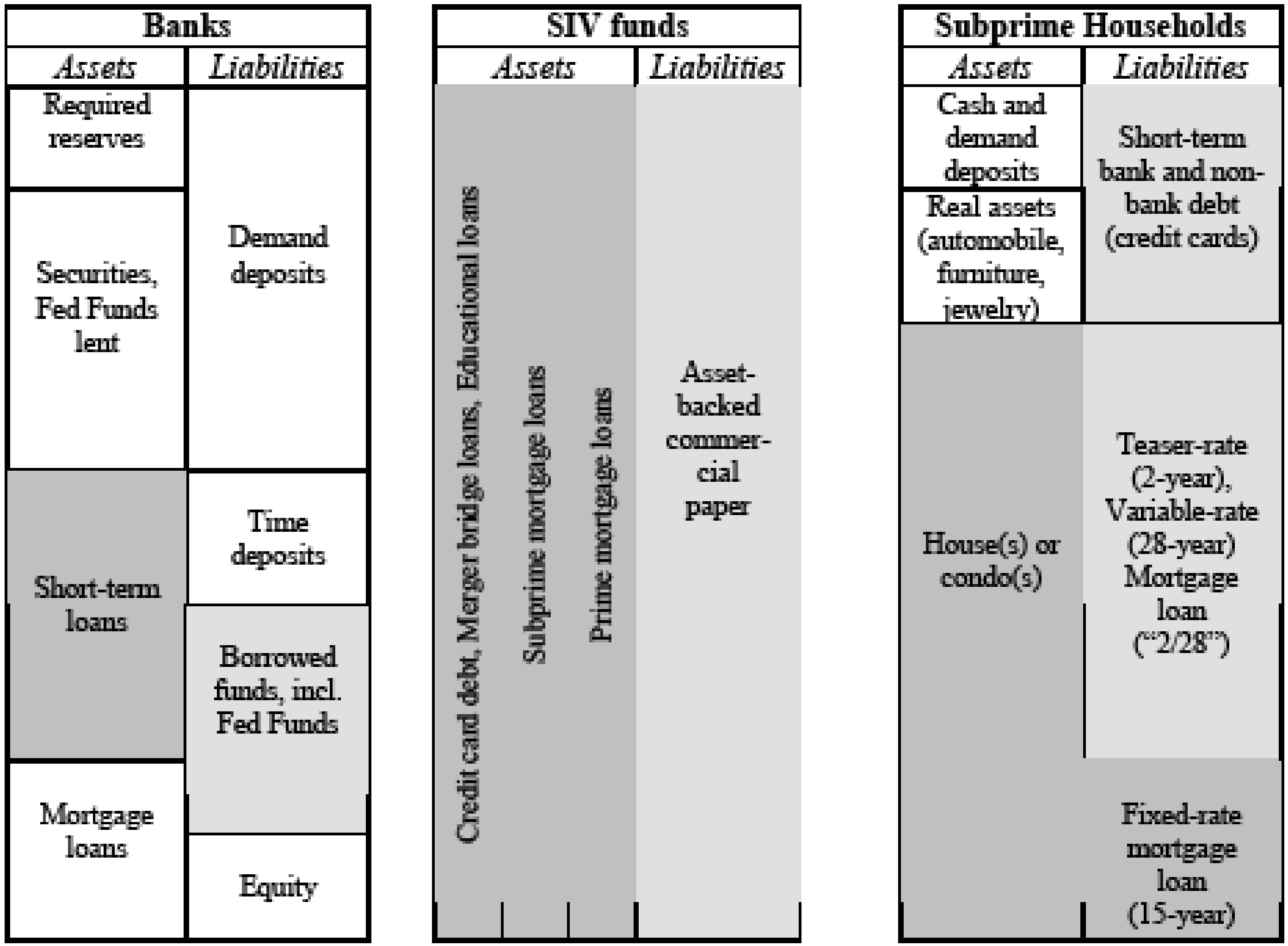
Shift of SIVs toward opacity, off-shore sales

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



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



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

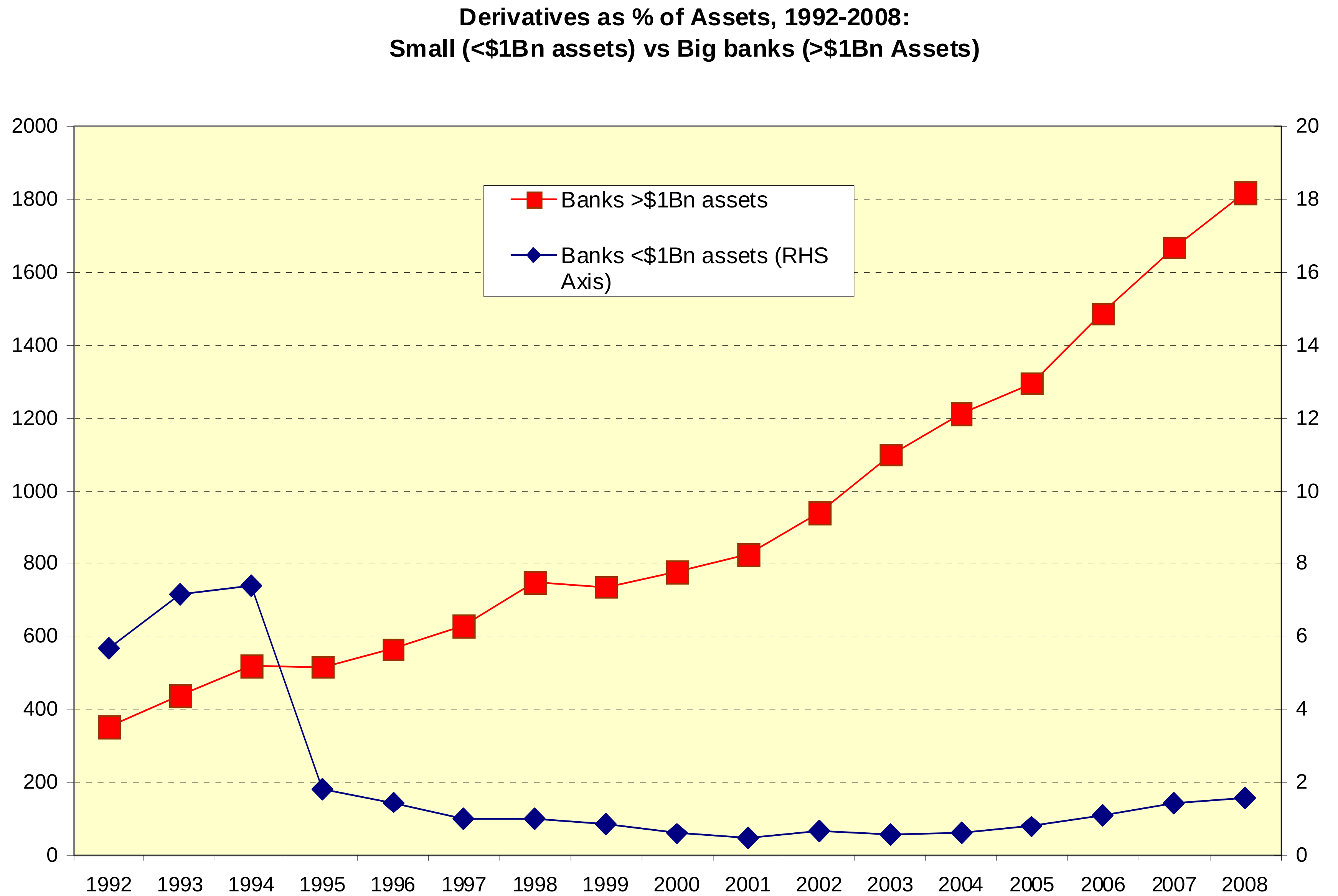
(3) Financial regulation has centered on consumer protection and on clean-up of misaligned incentives – because regulatory arbitrage problem prevents deeper reform discussions (it remains a world of neoliberal design mechanisms)

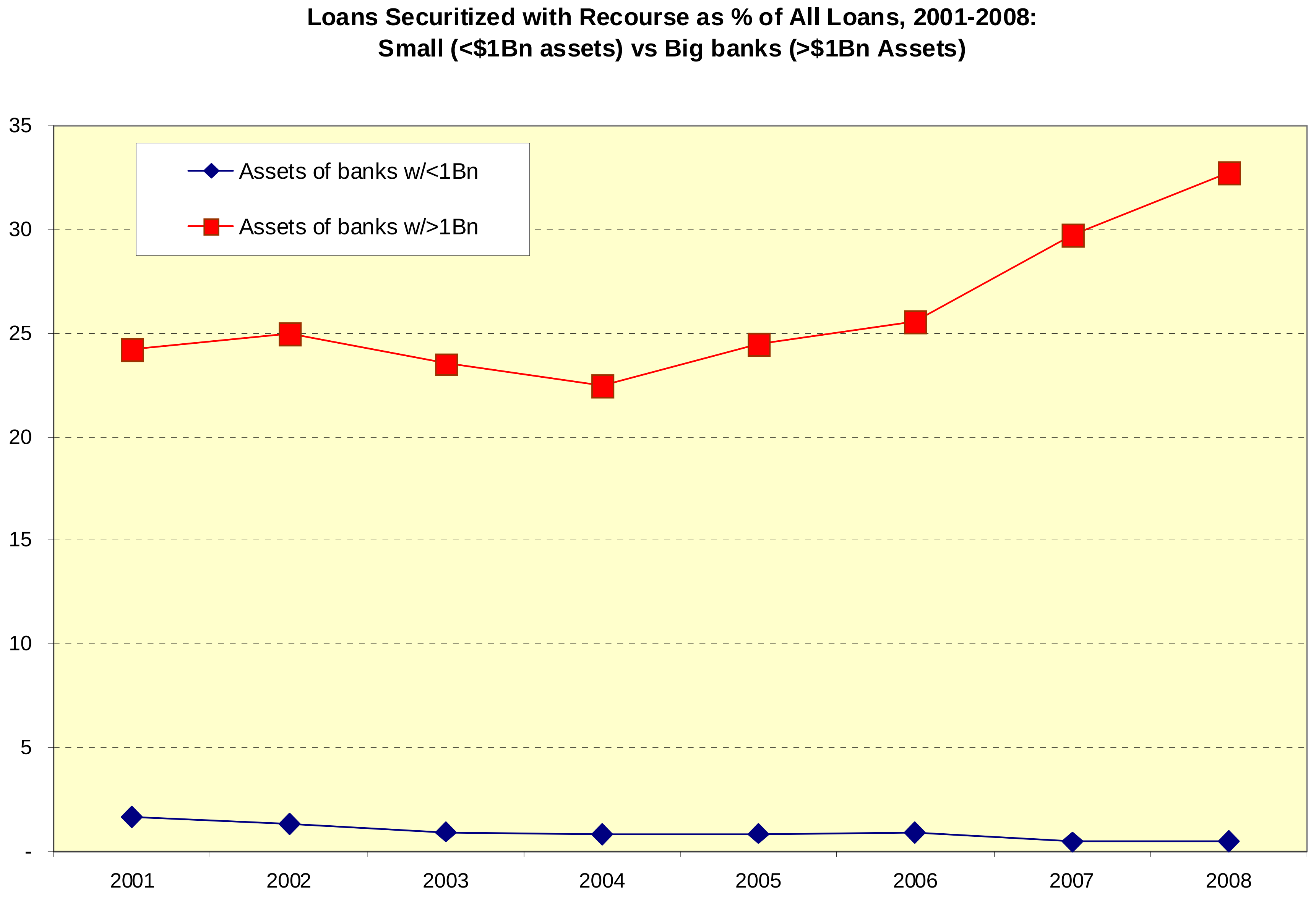
Policy "pragmatism" meets the financial crisis

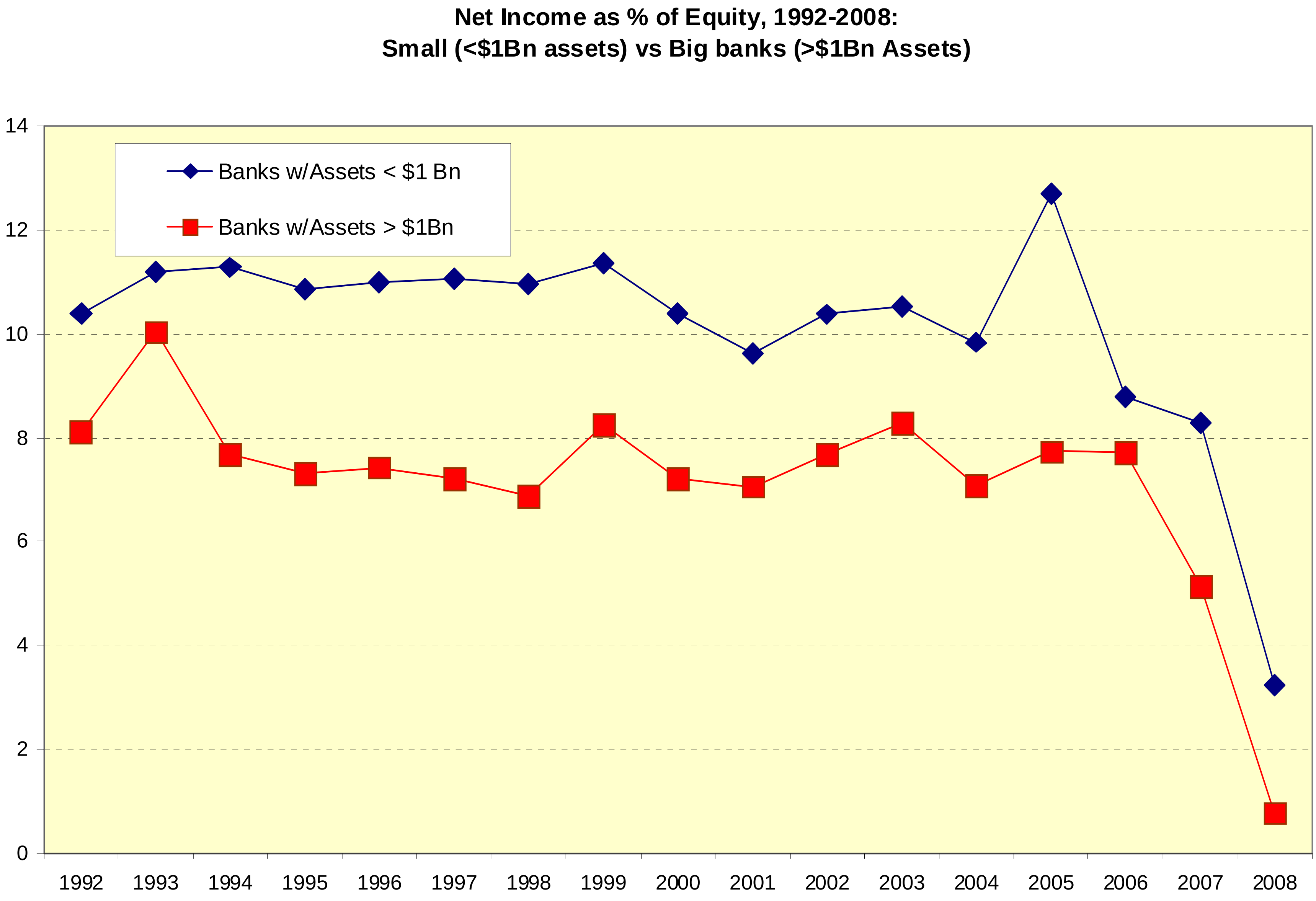
The megabanks are too complex to be unwound, with too many unforeseeable consequences of closing them. And it's only fair to make all the megabanks too big to fail (Goldman Sachs, Morgan Stanley).

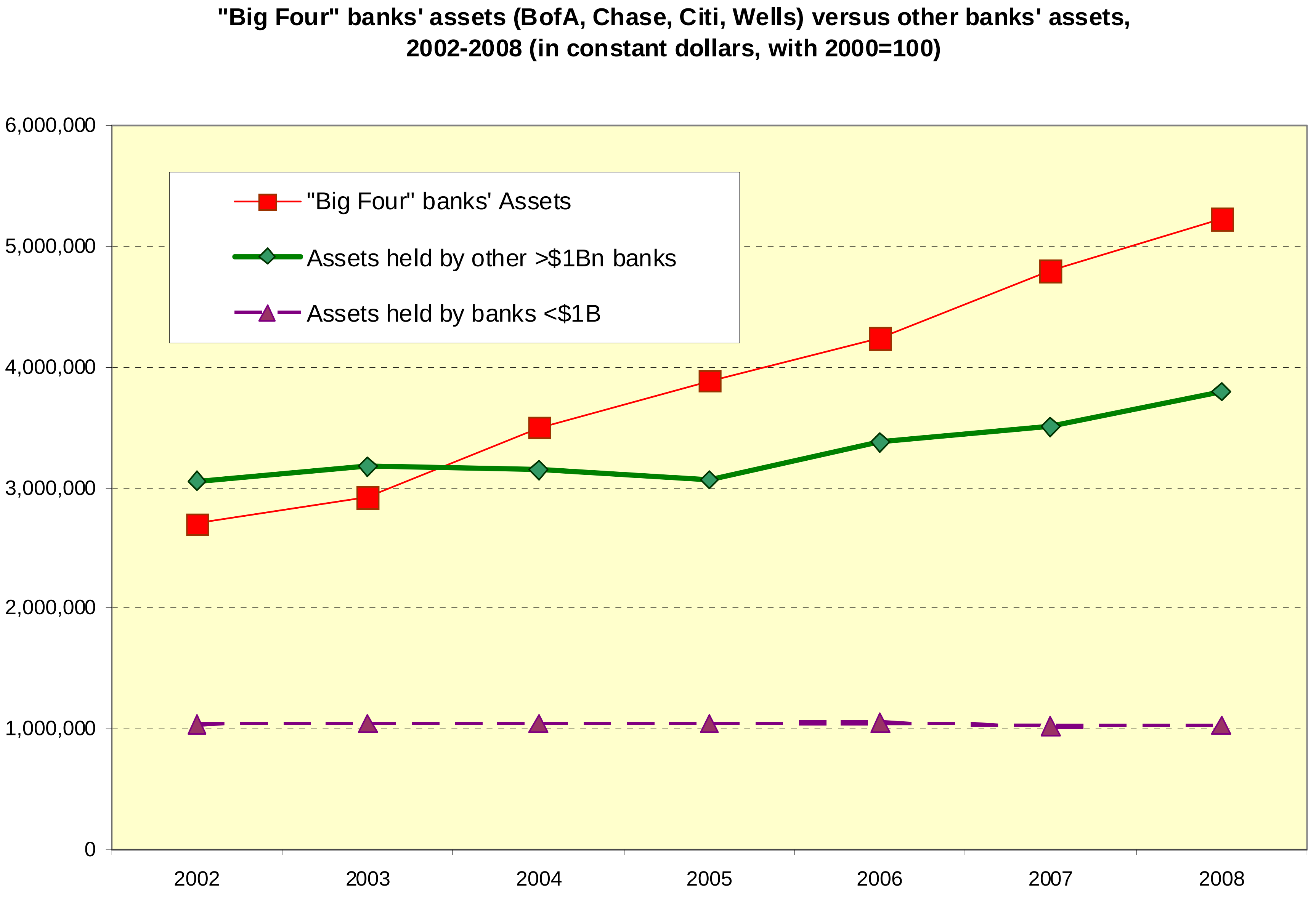
It is convenient to regard these financial complexes as a economic sector, which generates surplus autonomously.

- 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)
Banks >$1Bn assets
Banks <$1Bn assets (RHS Axis)
0
200
400
600
800
1000
1200
1400
1600
1800
2000
0
2
4
6
8
10
12
14
16
18
20
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008


Loans Securitized with Recourse as % of All Loans, 2001-2008:
Small (<$1Bn assets) vs Big banks (>$1Bn Assets)
Assets of banks w/<1Bn
Assets of banks w/>1Bn
35
30
25
20
15
10
5
-
2001
2002
2003
2004
2005
2006
2007
2008


Net Income as % of Equity, 1992-2008:
Small (<$1Bn assets) vs Big banks (>$1Bn Assets)
Banks w/Assets < $1 Bn
Banks w/Assets > $1Bn
14
12
10
8
6
4
2
0
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008


"Big Four" banks' assets (BofA, Chase, Citi, Wells) versus other banks' assets, 2002-2008 (in constant dollars, with 2000=100)
"Big Four" banks' Assets
Assets held by other >$1Bn banks
Assets held by banks <$1B
6,000,000
5,000,000
4,000,000
3,000,000
2,000,000
1,000,000
0
2002
2003
2004
2005
2006
2007
2008

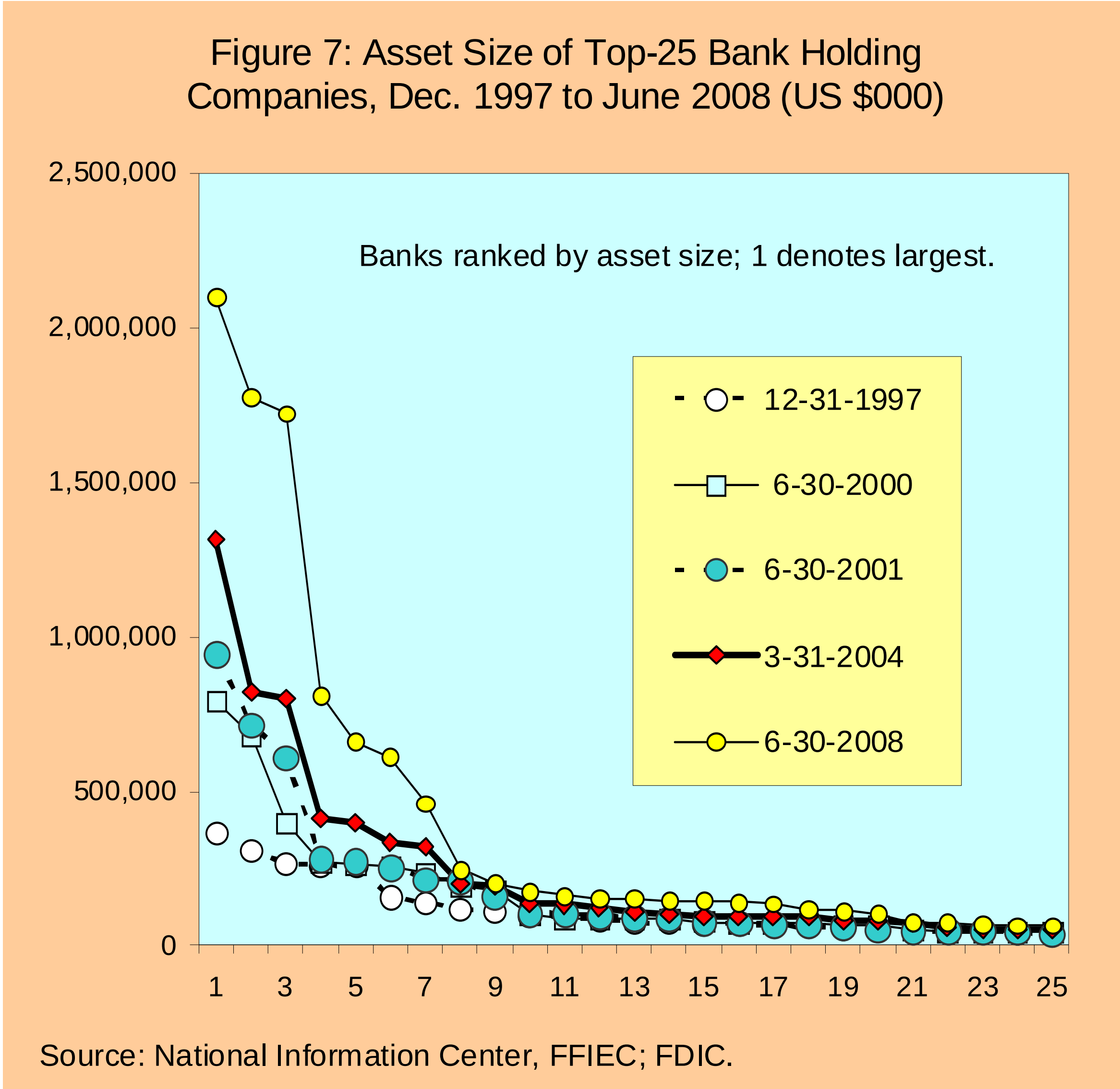
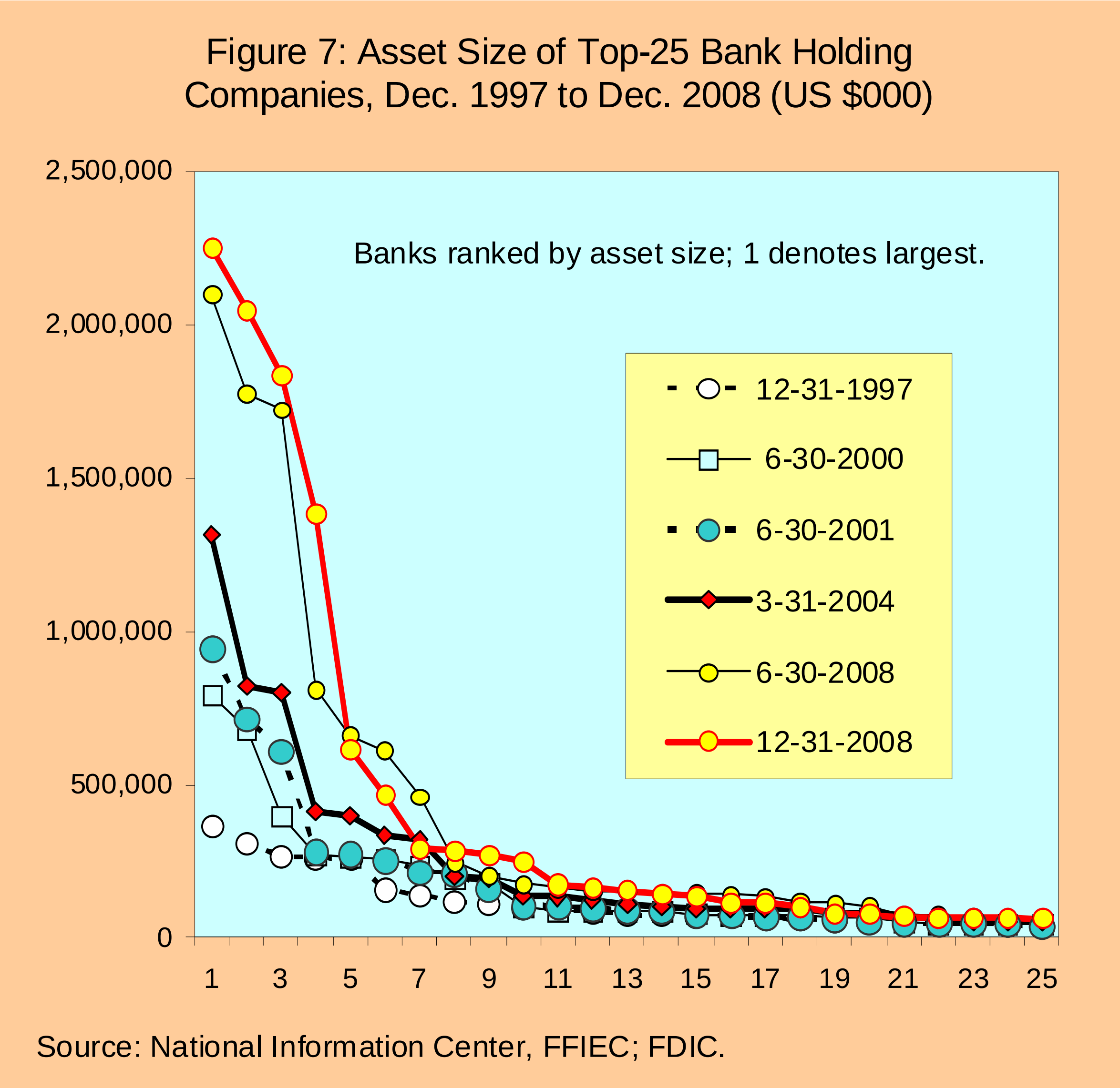


Figure 7: Asset Size of Top-25 Bank Holding Companies, Dec. 1997 to June 2008 (US $000)
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
Banks ranked by asset size; 1 denotes largest.
12-31-1997
6-30-2000
6-30-2001
3-31-2004
6-30-2008
1
3
5
7
9
11
13
15
17
19
21
23
25
Source: National Information Center, FFIEC; FDIC.



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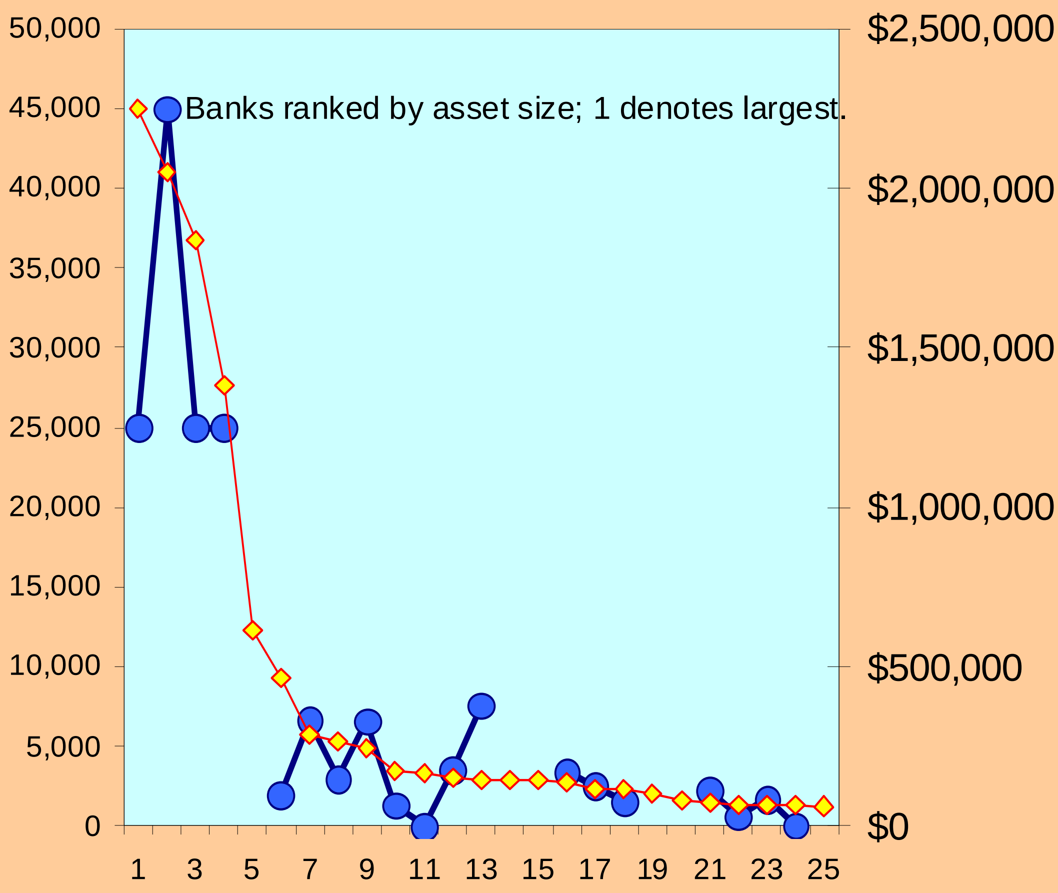
2,500,000
2,000,000
1,500,000
1,000,000
500,000
0
Banks ranked by asset size; 1 denotes largest.
12-31-1997
6-30-2000
6-30-2001
3-31-2004
6-30-2008
12-31-2008
1
3
5
7
9
11
13
15
17
19
21
23
25
Source: National Information Center, FFIEC; FDIC.

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