Simone Polillo

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Book Review


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In the wake of the 2007 financial crisis, economists, and social scientists more generally, have struggled both to make sense of this catastrophic event, in an attempt to understand what it entails for knowledge in their respective disciplines; and, joining journalists writing on financial and economic matters (often from a very sophisticated perspective,) to explain the nature and main dynamics of the crisis to a larger public.

Bankers’ New Clothes – a long but clearly argued and at times even engaging book – does both things in, by all accounts, a rather successful way. In thirteen chapters grouped into three main parts, its authors Anat Admati and Martin Hellwig make a strong case that, absent a thorough and informed critique of the mystifying ideology bankers have developed in order to sustain the status quo, we will learn nothing from the current crisis, and will inevitably repeat the mistakes that led to it. The book is then both an intellectual expose of what bankers would like us to believe, and a set of prescriptions whose implementation, the authors argue, will ensure that this kind of financial crisis will not happen again.

Their assessment of the main cause that precipitated the crisis is seductively simple: unsustainable reliance on leverage. Banks, that is, borrowed excessively, funding as much as 97% of their assets with debt, when most corporations, especially successful ones, borrow 50% of their assets at most. Relying on debt as opposed to capital (by which they mean equity, and not reserves, as Admati and Hellwig go to great lengths to explain,) means dangerously magnifying one’s exposure to risk. Throughout the book, the authors rely on a simple vignette to drive this point home. Imagine someone who wants to buy a house (the name of this fictional character is Kate, and by the end of the book, you will know all there is to know about Kate’s potential accounting and financial strategies.) Kate wants a solid middle-class life and so sets her eyes on a $300,000 home. The major choice she faces is: how much should she put towards a downpayment (equity)? The less of her money she puts towards her purchase, and therefore the more she borrows, the more is her equity subject to wild economic swings. Say Kate’s initial downpayment is $30,000, and the value of her house appreciates by 5 percent: with the house now worth $315,000, once she pays off her $270,000 debt, she is left with an additional $15,000 over her original investment, a pleasing 50% return. Say, however, that Kate’s house depreciates by 5%. Now the house costs $285,000, so Kate’s initial investment, once she has paid off her debt, is a meager $15,000, or a 50% loss over her equity. Banks, argue Admati and Hellwig, are subject to the same economic forces: the more they leverage their assets, the more they are set to gain in favorable economic times, and the more they will lose when economic conditions turn sour.

Over the course of the book, the authors argue that setting strict limits on the bankers’ ability to borrow, and forcing them to raise equity instead, are crucial to a healthy economy, and then take on, one by one, any conceivable objection to this pro-
posal: for instance, that relying on equity as opposed to debt is way too expensive and therefore will have larger economic repercussions (this, they argue, only works if one conveniently ignores the externalities of excessive bank debt, the costs, that is, involved in cleaning the financial landscape up after a major crisis); that, similarly, debt-financed banks are more attractive to investors than equity-financed ones (this, they argue, is only true if one ignores the increased risk attached to debt-financing, which underlies higher returns;) that banks are different than non-financial institutions (the fallacy, the authors argue, is that banks must finance their activities just as any other capitalist firm would, therefore they are not “special” in any meaningful sense.) Why, they also ask, do bankers resist tooth and nail against proposals that would force them to deleverage their assets? The reasons, they argue, are simple enough: bankers’ compensation is based on return on equity, which can be manipulated by taking up risky investments with borrowed money; and, just like Kate can get Aunt Claire to guarantee her mortgage, therefore further decreasing her need to put in equity into her house, so can banks rely on “Uncle Sam” to underlie their own investments, therefore increasing their ability to take on more and more debt, and more and more risk through leveraging.

In sum, this is a very thorough book built around a simple but, to many, radical diagnosis of the crisis, and an apparently just as radical proposition aimed at providing a durable solution to it. As a piece of public writing, this book is by all means successful: it has not only been reviewed by dozens of journals, newspapers, and periodicals, and endorsed by some of the most influential economic writers; it also has sparked public debate, generating praise and criticism the authors have been very active in addressing directly. Yet, much debate, it seems to me, has been centered on the more technical details and the more technical claims supported in the book. This is of course desirable and even necessary, given that the policy implications flowing from this perspective require some precision. But it has come at the expense of a more systemically oriented and historically informed discussion of the role of banks in a capitalist economy, and whether subjecting them to the discipline of financial markets (as reliance on equity certainly would) is such a powerful solution to the problem of financial fragility.

On the first account, arguing that banks are not special should not lead us to ignore the ways that banks are different than nonfinancial institutions. As Schumpeter among others has argued, banks specialize in assessing the likelihood of success of entrepreneurial innovation (in this respect, the analogy between Kate’s mortgage and a bank’s balance sheet is very superficial.) This requires some attention to the long run. And the fact that contemporary banks no longer seem invested in the long run, as critics are increasingly arguing, is a problem deserving some discussion. It seems to me quite reductive to argue that a simple change in the banks’ funding sources will radically change their time horizon.

Second, and related, economic sociologists and political economists have long argued that the emphasis on shareholder value as a metric of success has very detrimental consequences for a firm’s ability to plan for the long run. So reliance on equity may in fact exacerbate some of the problems banks already face.

Third, it is disheartening to see the role of government policy to be discussed only in terms of bail-outs, for instance through the helpful-Aunt-Claire trope. It is a missed opportunity that the book does not engage in any serious discussion of how bankers and
the government can both contribute to economic development (for instance, through the setting of industrial policy.)

These are not mortal flaws, but they do lead me to question whether the book’s claim that, once we solve the problem of excessive leverage, all will be alright, is a particularly credible one.

Simone Polillo
University of Virginia