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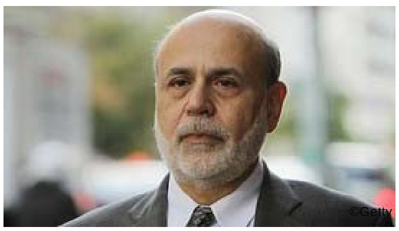
Bernanke's failed mortgage application exposes the flaw in banking

By Amir Sufi

We must stop providing bailouts based on unrealistic models, writes Amir Sufi



Banks enjoy tremendous support from governments. During the financial crisis, that assistance went well beyond protecting depositors – even long-term creditors and shareholders of banks received large taxpayer-financed bailouts. President George W Bush said in September 2008 that he understood the frustration of responsible Americans who were "reluctant to pay the costs of excesses on Wall Street" but added: "not passing a bill now would cost these Americans much more later".

So what is the justification for bailing out the shareholders of financial institutions? Stemming bank runs is not a good enough reason on its own, because it is easy to protect depositors and other short-term creditors without bestowing taxpayer gifts on bank shareholders.

Part of the rationale comes from research in 1983 by Ben Bernanke, former chairman of the Federal Reserve, who in studying the Great Depression argued that banks have a unique ability to intermediate credit, because of the valuable information they gather and hold. As he put it, "the real service performed by the banking system is the differentiation between good and bad borrowers." If we do not save the banks, the argument goes, this function will disappear, causing further misery as good firms cannot get credit.

It seems a little ironic, then, that Mr Bernanke was recently unable to refinance his mortgage, a fact he recounted to a conference earlier this month. Apparently, banks are unable to tell whether the former head of the world's most powerful central bank – someone who can earn $250,000 per speech – is a good or bad borrower. Mr Bernanke added that he thought credit conditions were too tight. The better explanation is that banks are bad at the job that is supposedly their main source of value.

The modern banking system does very little of the information gathering that many economic models have in mind. When an individual applies for a credit card or a mortgage, their characteristics are put into a computer with a score produced by a credit bureau, and the computer spits out a decision. There are few face-to-face meetings. Little additional information is collected.

Banks rely heavily on credit scoring, even though the process of scoring can be flawed. In May, the US Consumer Financial Protection Bureau released a report showing that credit scores are excessively affected by unpaid medical bills, even though these were often due to administrative glitches. The CFPB showed that unpaid medical bills do a poor job of predicting default on other debt. The main US credit scoring agency responded by lowering the weight of medical bills in their calculation of credit scores. The lesson? Researchers working for a government agency were able to distinguish good and bad borrowers better than credit scoring agencies relied on by banks.

Those who support bailouts of bank shareholders have in mind banks that make primarily business loans. But new research from Òscar Jordà, Moritz Schularick and Alan Taylor shows that today's banks are not primarily involved in business lending. Instead, they make mortgages. From 1940 to 2010, the proportion of bank lending dedicated to mortgages across 17 advanced economies (including the Germany, the UK, and the US) rose from 30 per cent to 60 per cent.

Modern banks are not savvy, information collecting business lenders. Instead, they take very leveraged bets on real estate. They borrow short with government-subsidised liabilities such as deposits, and they lend long against property assets. They do so with very little equity to cover their losses in case things go wrong. Meanwhile, the very thing that banks are meant to do well – selecting businesses to lend to, so that they can grow, invest, hire employees and boost local economies – has fallen by the wayside.

The bias toward supporting banks remains ingrained in policy makers' minds. For example, many of the European Central Bank's acrobatic measures are designed to support banks in the eurozone periphery to boost lending to businesses. The underlying rationale is that banks have a unique ability to discern good and bad business prospects, and they can therefore boost productivity and growth through lending. But research suggests the supposed value of banks' credit intermediation function is overstated.

There may be other reasons to bail out bank shareholders – maybe the government wants to raise house prices by supporting mortgage lending? But we must stop providing support based on models that do not accurately describe the world in which we live.

The writer is professor of finance at the University of Chicago Booth School of Business and the co-author of 'House of Debt'

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