GLOBAL BANKING &
FINANCE REVIEW

COMMENTARY

A Gresham's Law of Bank Management Engendered the Financial Crisis

By David B. Moore
24 January 2012

Gresham's Law, according to Wikipedia, is an economic principle which states that: "When a government compulsorily overvalues one money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation." It is more commonly stated as: "Bad money drives out good".

A classic example of Gresham's Law at work is the case of silver coins that were widely circulated in Canada (until 1968) and in the United States (until 1965 for dimes and quarters, and 1971 for half-dollars). As Wikipedia further explains: "These countries debased their coins by switching to cheaper metals as the market value of silver rose above that of the face value. The silver coins largely disappeared from circulation as citizens retained them to capture the higher current or perceived future intrinsic value of the metal content over their face value, using only the newer coins, comprised of cheaper metals, in daily transactions."

Any informed post-mortem of the recent global banking crisis must conclude that a Gresham's Law of management permeated the banking industry's executive suites between the mid-1990s and mid-2000s; that is, bad management drove out good. More specifically, most bank executives who were deemed excessively cautious ("appropriately" cautious, in hindsight) during the late-1990s and early-2000s were either demoted or their influence reduced as the credit/housing bubble made excessive risk-taking, among other bad management practices, look prudent. By 2007 most overly (again, "appropriately") cautious bankers no longer had a voice at the table.

To wit, among the myriad damning passages buried inside the Federal Deposit Insurance Corp.'s complaint against former executives of Washington Mutual, Inc. ("Wamu," a $330-billion asset savings bank holding company that failed in 2008) is the following:

"Wamu's compensation structure for loan officers was based on the volume of loans originated, and thus loan originators were incentivized to push as many loans through the system as possible, creating additional risk to Wamu. For instance, Wamu's 2006 compensation plan for loan originators stated: 'Rewards will be based on the dollar volume of loans funded each month.' Wamu's compensation policy for underwriters similarly created strong incentives to increase the volume of loans."

Now, imagine the reaction of Wamu's senior management to the executive who suggested in, say 2004, that maybe, just maybe, basing compensation solely on the volume of loans originated might lead to lax underwriting standards (and in some cases – gasp! – fraud), thus potentially "creating additional risk to Wamu". The reaction was likely to resemble closely that of someone being either demoted or fired. Thus, because caution in the banking industry for so many years failed to remunerate, extreme risk takers all too often were the last executives standing among the ranks of senior management as the financial crisis unfolded. In too many cases, bad management and poor practices had driven out good management and sound practices because the former had been more profitable than the latter for too many years.

The case of Dirk Röthig, a former executive with Germany's IKB, is instructive as a specific case in point. Röthig had in the early-2000s set up an offshore vehicle for IKB called Rhineland Funding that borrowed in the (short-term) commercial paper market and invested that money in longer-term structured credit products such as US subprime bonds. By 2004 Rhineland seemed like such a good idea that other German banks were setting up their own versions of Rhineland in order to acquire subprime-mortgage bonds for themselves. Röthig had created Rhineland at a time when the company was being paid well for the risk it was taking. By the end of 2005, however, Mr. Market was extremely optimistic and the price of risk had collapsed.

As author Michael Lewis explains (in a recent issue of *Vanity Fair*): "Röthig says he went to his superiors and argued that IKB should look elsewhere for profits. 'But they had a profit target and they wanted to meet it. To make the same profit with a lower risk spread they simply had to buy more,' he says. The management, Röthig adds, did not want to hear his message. 'I showed them the market was turning,' he says. 'I was taking the candy away from the baby. So, I became the enemy.' When he left [in 2005], others left with him, and the investment staff was reduced, but the investment activity boomed. 'One half the number of people with one-third the experience made twice the number of investments,' he says. 'They were ordered to buy.'"

And buy they did. After Röthig left, the IKB portfolio went from $10 billion in 2005 to well over $20 billion by the time the market crashed in 2007. Having lost over $15 billion against $4 billion in capital, IKB had to be rescued by a state-owned bank in July 2007. Gresham's Law had proved out again: bad management had driven out good.

In hindsight, it is clear that the Greenspan-era Fed's interest rate policies – specifically, to reduce interest rates anytime even a hint of economic weakness was in the air (the so-called "Greenspan Put") – artificially extended the U.S. economy's expansion, thus playing an unintentionally important role in keeping reckless financial executives in place. Had the Fed allowed a more normal business cycle to transpire, perhaps we would have witnessed a garden-variety recession during the early-2000s – accompanied by modest financial stress and related management cleansing – and avoided the disastrous credit bubble-cum-financial collapse that transpired instead.

Unfortunately, there is no simple solution for this Gresham-related predicament. After all, as Upton Sinclair noted sagely, "It is difficult to get a man to understand something when his salary depends on his not understanding it." Nevertheless, it remains the principal role of bank boards and regulators to ensure that a Gresham's Law of management doesn't permeate the institutions under their purview. That board members and regulators have done such a pitiable job over the past decade doesn't change this fact. All we are left with after the dust has (seemingly) settled is the hope that the past will not be prologue.

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