LEVY ECONOMICS INSTITUTE
OF BARD COLLEGE

Hyman P. Minsky Conference on Financial Instability

Debt, Deficits, and Unstable Markets

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Using Minsky to Think Beyond Dodd-Frank

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Minsky’s 15 Minutes of Fame: The Minsky Moment

- Minsky was ubiquitous in analyses of the crisis
- And then his 15 minutes were over
- But, there is more to Minsky than Financial Instability and collapsing Ponzi Schemes
- Most of his work was in Financial Regulation
- Still provides a framework of analysis of the Financial System

Using Minsky to Analyse Three Problems Facing the Recovery of the Financial System

1. Scarcity of High Quality Collateral
    1. Reduces lending and liquidity
2. Innovation in Payments and Lending
    1. Electronic transfers and lending
3. Transmission Mechanism for Monetary Policy
    1. Fed ZIRP and QE Zero Bounds

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1. Collateral Scarcity

- Credit Suisse: “A globalised economy has large liquidity needs which can only be met by a collateral-based financial system”
- “Efficiency advantages of a collateral-based financial system include adaptability and reduced need for costly relationship-based lending”
- But, tends to be “pro-cyclical” and “foster over optimistic expectations about future returns leading to asset price bubbles”
- Collateral Scarcity threatens the functioning of the financial system

Who Needs Collateral? Shadow Banking System

- Repo transactions are collateralised lending/deposit markets
- Exchange-traded derivatives markets require collateral for margin accounts
- Fully collateralised Commodity Index Funds
- Money Market Mutual Funds require risk free short-term liquid assets

What produced Collateral “Scarcity”

- Where does liquidity come from?
- Minsky: “Banking is not money lending; to lend, a money lender must have money.
- The fundamental banking activity is accepting, that is, guaranteeing that some party is creditworthy. A bank, by accepting a debt instrument, agrees to make specified payments if the debtor will not or cannot. ...A bank loan is equivalent to a bank's buying a note that it has accepted.
- Bankers create “good collateral” by accepting borrowers' liabilities
- **There is a scarcity of “good collateral” if banks are no longer doing credit assessment required to guarantee the illiquid liabilities of borrowers**

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Shift from Originate and Hold to “Pump and Dump” caused “Scarcity” of good collateral

- Shadow banking system depends on “fictitious liquidity” of collateral
- QE hurts the system because it drains “good collateral” from the system
- But no collateral is inherently liquid unless someone will lend means of payment against it
- Where do means of payment come from?
  - Banks acceptances
  - Banks discounting accepted assets with the Central Bank

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Minsky on Collateralized lending

- **In cases such as a collateralized security or land loans, the income the pledged asset earns, while it is held, is not enough for the interest on the loan.**
- **Such loans impart a Ponzi flavor to the financial structure.**
- **Thus, the overall fragility-robustness of the financial structure, upon which the cyclical stability of the economy depends, emerges out of loans made by bankers.**
- **A cash-flow orientation by bankers is conducive to sustaining a robust financial structure. An emphasis by bankers on the collateral value and the expected values of assets is conducive to the emergence of a fragile financial structure.**

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How to Solve the “Scarcity” of good collateral

- Restore Bank Due Diligence Acceptance based Lending
- This is the major source of “Good Collateral”
- Government Deficit Spending also produces Good Collateral
- Scarcity of Good Collateral only threatens the "Shadow" banking system – Control it!

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2. Bank Creation of Good Collateral Depends on the Payments System

- Banks can Accept only if their own deposit liabilities are accepted as means of payment
- They do this by accepting sight deposits of currency
  - That have parity with the sight deposits used to purchase the loans they have accepted
  - These provide “reserves” for possible “deposit drain”
  - They serve to create the illusion of liquidity
- Capital is held to meet possibility of bad loans

Liquidity Creation also Depends on bank provision of the Payments System

- Banks can only make illiquid client liabilities liquid by accepting them if their own liabilities are liquid
- This means they have to constitute the main means of payment
- It also means that it is impossible to separate the insurance of deposits created by loans from deposits created by accepting currency
- And that a 100% reserve system would mean elimination of banks as creators of liquidity

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Deposits are Clearing Credits

In our system payments banks make for customers become deposits, usually at some other bank. If the payments for a customer were made because of a loan agreement, the customer now owes the bank money; he now has to operate in the economy or in financial markets so that he is able to fulfill his obligations to the bank at the due dates.

Demand deposits have exchange value because a multitude of debtors to banks have outstanding debts that call for the payment of demand deposits to banks. These debtors will work and sell goods or financial instruments to get demand deposits. The exchange value of deposits is determined by the demands of debtors for deposits needed to fulfill their commitments. Bank loans, while ostensibly money-today for money-later contracts, are really an exchange of debits from a bank's books today for credits to a bank's books later. 10

Fundamental Hierarchy

Loans represent payments the bank made for businesses, households, and governments in exchange for their promises to make payments to the bank at some future date. .. . Loans, unlike securities, involve a customer relation, in which banks use private knowledge willingly given by the borrowing units. An implicit commitment for continuing relations may exist for a loan customer, whereas no such continuing commitment exists for securities. Because of the private knowledge involved in bank lending, loans are presumably not transferable without the accepting a contingent liability.

Whereas business, households, and state and local governments transfer deposits on the books of commercial banks, payments among member and nonmember banks transfer credits on the books of Federal Reserve banks. Whereas the public uses bank deposits as money, banks use Federal Reserve deposits as money. This is the fundamental hierarchical property of our money and banking system.

What is happening today?

- Non-bank Payments system:
  - Pay Pal,
  - Google Wallet
  - Square
- Non-bank Lending:
  - P2P loans
  - Crowd Funding
    - supported by new JOBS bill

New Payment Systems

- PayPal
  - Lending:
    - via a Utah State Charter Industrial Bank (Web Bank) Exempt from Fed Regulation
      - Past FDIC C&D Order
  - Payments:
  - Via a Single Bank Holding Company Bancorp
    - Bancorp Bank Delaware charter, FDIC, not Fed member
      - Branchless banking
      - Private label banking
      - Affinity credit cards, prepaid debit cards
      - Developed first SPAC
- Google Wallet: Mastercard.
- Google Payment Corporation:
- "GPC is not a bank or other chartered depositary institution. Funds held by GPC or its service providers (including any bank service providers) in connection with the processing of Payment Transactions are not deposit obligations of Buyer and are not insured for the benefit of the Buyer by the FDIC or any other government agency."

Square and Starbucks

- The Square system allows the user to accept payments, including card-based payments using MasterCard and Visa. it states that "We are not a bank, and we do not offer banking services as defined by the United States Department of Treasury. We also do not offer money service business ("MSB") services as defined by the United States Department of Treasury."

- It relies on a merchant digital payment processing service offered by Chase called "paymentech".

- Square also provides a free card reader that can be attached to a smart phone, tablet or laptop as well as standard PC.

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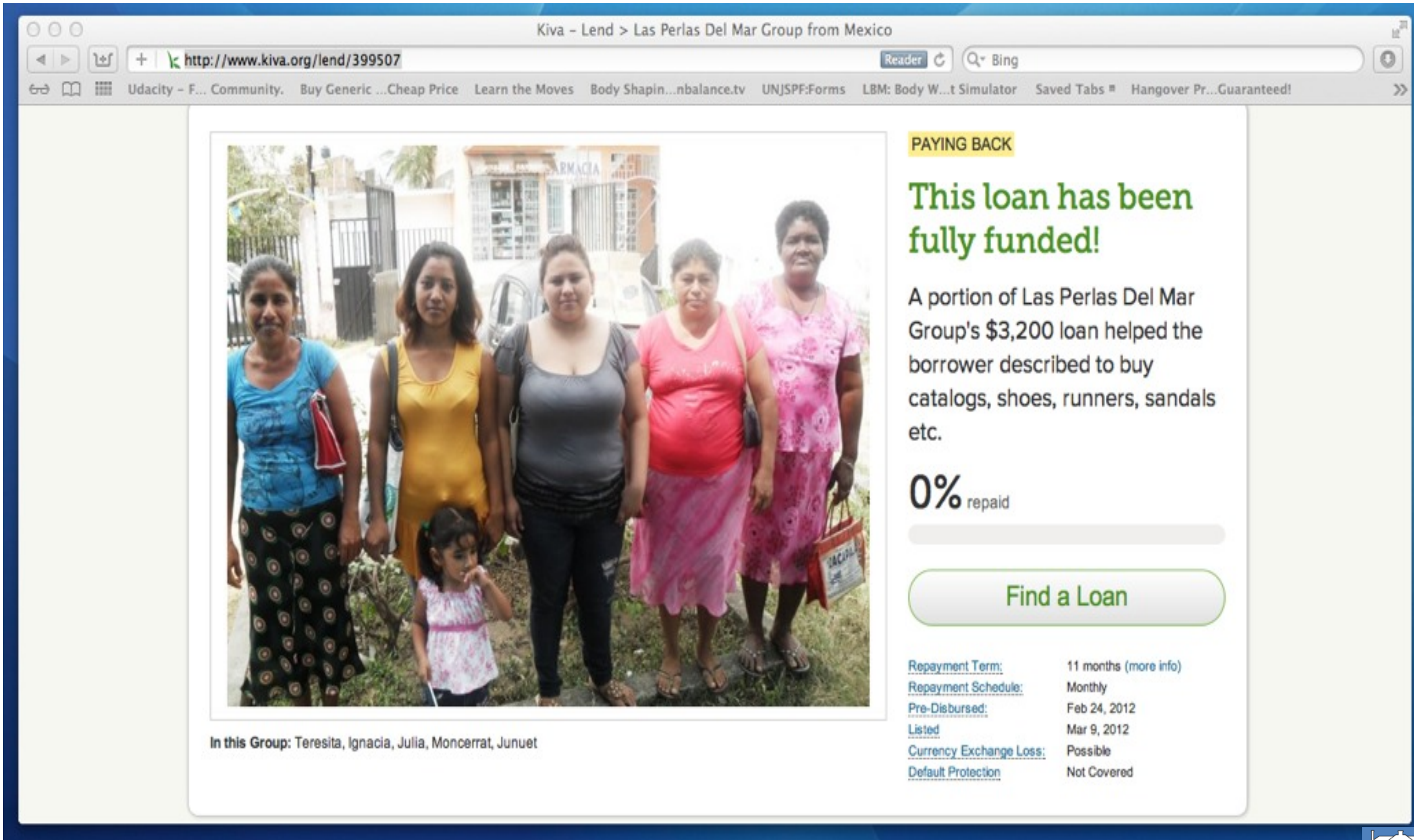
p2p Lending


Kiva – Lend > Las Perlas Del Mar Group from Mexico
http://www.kiva.org/lend/399507
Reader
Bing
Udacity – F... Community.
Buy Generic ...Cheap Price
Learn the Moves
Body Shapin...nbalance.tv
UNJSPF:Forms
LBM: Body W...t Simulator
Saved Tabs
Hangover Pr...Guaranteed!
PAYING BACK
This loan has been fully funded!
A portion of Las Perlas Del Mar Group's $3,200 loan helped the borrower described to buy catalogs, shoes, runners, sandals etc.
0% repaid
Find a Loan
Repayment Term: 11 months (more info)
Repayment Schedule: Monthly
Pre-Disbursed: Feb 24, 2012
Listed Mar 9, 2012
Currency Exchange Loss: Possible
Default Protection Not Covered
In this Group: Teresita, Ignacia, Julia, Moncerrat, Junuet

Las Perlas del Mar

- This group chose the name Perlas del Mar (Pearls of the Sea) because they are good, honest woman and consider themselves to be as beautiful as pearls.

This is a Group Loan: each member of the group receives an individual loan but is part of a larger group of individuals. The group is there to provide support to the members and to provide a system of peer pressure, but groups may or may not be formally bound by a group guarantee. In cases where there is a group guarantee, members of the group are responsible for paying back the loans of their fellow group members in the case of delinquency or default

Señorita Moncerrat as she is the group representative. She is 19 years old, single, and has been selling shoes from a catalog for close to three months. She will use the loan to buy catalogs, shoes, runners, sandals etc. so she can better stock her business.

The other group members have a variety of businesses:

Teresita--butcher

Ignacia--fruit seller

Julia--fruit seller

Moncerrat--shoe seller

Junuet--clothes seller

Germany: Smava starts p2p lending

Startup Smava.de starts offering p2p lending in Germany. Anybody can lend or request a loan online. Borrowers, after registering will by checked for identity and credit grade by smava. Smava uses PostIdent (a service offered by German postal service Deutsche Post) to verify the identity of the borrower and relies on credit report information from Schufa, a leading German credit bureau. Smava is only open to borrowers with credit grades A to F (which smava says leads to expected default rates between 1.4% and 7.2%).

After validation the borrower can post his request which can range from 500 to 10000 Euro and state the interest rate he is willing to pay. Lenders can bid in intervals of 500 (minimum) Euros.

If the loan request is fully funded the loan is payed to the borrower which will repay it in monthly rates for a period of 36 months. The borrower has the right to payoff early anytime (without any additional fees).

Smava does not take fees from the lenders. Smava charges 1% fee of the loan amount from the borrower.

UK: Funding Circle

British p2c lending marketplace Funding Circle announced that they have raised 10 million GBP (approx 16M US$) from Index Ventures and Union Square Ventures. Funding Circle enables individual lenders to lend to establishes businesses in the UK. Since its launch a loan volume of 28.6 million GBP has been funded. According to numbers published by Funding Circle so far only 5 out of 686 loans have defaulted giving lenders an average gross yield (annualised, compounded return lenders are earning before fees or any bad debts) of 8.4%.

Samir Desai, co-founder of Funding Circle, said: “This deal represents the next step in the growth of Funding Circle **and will help us to create a lasting alternative to banks for small business loans.** Index has been a prominent supporter and advocate of what the business is trying to achieve, and we are delighted to continue our partnership together. We are also excited to welcome Union Square Ventures as co-investors. They bring with them a wealth of expertise and experience …”.

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US: Lending Club

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US: Lending Club

- ## Former Morgan Stanley chief Mack joins peer-to-peer lender

By Tracy Alloway in New York and Sharlene Goff in London

John Mack, the former chairman and chief executive of Morgan Stanley, is to join the board of a peer-to-peer lending company that aims to bypass banks and extend credit directly to borrowers through the internet.

Mr Mack, dubbed "Mack the Knife" for slashing costs during his time at the investment bank, will add a position on the board of Lending Club to his growing portfolio of non-executive appointments. He joined buyout group KKR last month and acts as senior adviser to China Investment Corp.

Lending Club is one of a crop of fast-growing peer-to-peer companies which seek to match lenders directly to borrowers. The web-based club says it has lent $589m since it opened in 2007 with a Facebook-based lending platform, and generated $51m of interest for investors.

US bank lending remains sluggish after the financial crisis, which led to the failure of numerous smaller lenders and the bailout of Wall Street groups, including Morgan Stanley.

Mr Mack said in an interview that he learnt of Lending Club through Mary Meeker, the former Morgan Stanley internet analyst who now works at a venture capital firm. "Technology is something I want to get more involved in," he said.

The nascent peer-to-peer lending sector seeks to exploit two emerging trends in the finance industry: bank disintermediation and the growing importance of technology. Traditional banks are also seeking to harness technology by rolling out mobile and tablet platforms.

"Alongside the disintermediation of lending, which we can see across banking, peer-to-peer lending is definitely growing in importance," said David Renz, a director at Sungard financial systems, which provides software for banks.

"The great attraction of using the internet is that someone at one end of the country can lend to someone at the other end of the country without having to meet them."

First launched in the UK in 2005, peer-to-peer lending has grown as individuals and small businesses seek alternative sources of finance to big banks.

The US market opened up in 2006 with the launch of Prosper. Lending Club followed in 2007. Together these companies have lent a total of almost $1bn in the past six years. The peer-to-peer model is also gaining traction in Germany and China, which has an estimated 100 lending sites.

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State of selected P2P Lending Companies

created by P2P-Banking.com March 16th, 2011

Company	Cou.	New loans/ month [mio. US$]	Brand/ Press	Growth/ Mar-keting	Sustain-ability	User satis-faction
Auxmoney		0.8	--	-	-	-
CommunityLend				+	+	
FundingCircle		3.5	+	++	+	
Isepankur		0.1	+	+	+	
Lending Club		15.0	++	++	+	+
MYC4		0.2	o	-	-	-
Prosper		3.8	+	o	o	-
Quakle		0.0		-		o
Ratesetter		0.8	+	+		
Smava		2.2	++	o	o	+
Yes-Secure		0.0		-	-	-
Zopa		8.0	++	++	++	++

Crowd Funding (JOBS Act)

- Jumpstart Our Business Startups (JOBS) Act provides a tax exemption for individuals to investor up to $10,000 or 10 percent of an investor’s annual income, whichever is smaller.
- Startups can raise up to $1 million this way without having to do a public offering.
- "Emerging growth companies" with annual gross revenues under $1B can go public under reduced SEC regulations.

Who Needs Banks?

- Crowdfunding websites can help you find a community of small investors to fund your business, without the risks of traditional financing.
- Don't let access to capital hold you back — let the crowd fund you.
- 33needs, appbackr, ChipIn, Cofundos, FansNextdoor, IndieGoGo, Kickstarter, ProFounder

- http://www.practicalecommerce.com/articles/2853-13-Crowdfunding-Websites-to-Fund-Your-Business

- **Self Regulation**
- The Crowdfunding Accreditation for Platform Standards (CAPS) program is an initiative by Crowdsourcing.org to promote the adoption of best practices for the operation of crowdfunding platforms globally. Designed to protect both crowdfunders (people pledging or investing capital) and fundraisers (people raising capital).
- http://www.crowdsourcing.org/caps

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Who Needs Shadow Banks?

- Innovation is leading to non-regulated payments systems
  - that may evolve into liquidity creators that may challenge regulated financial institutions and even non-regulated shadow banks
  - And can create an additional source of instability
  - You can leave money "on deposit" with Pay Pal or Google Wallet
- What is the most efficient payments system?
- A single bank clearing system
- Currently payment systems are competing
  - Just as different bank notes competed under wildcat banking
- Will one emerge as the monopoly payments system?
- Or is it time for the government to extend its monopoly on coin and currency to the payments system?

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Henry Kaufman at 2012 Minsky Conference:

- “ in the future the entire deposit function will be handled by some giant cloud computer facility controlled and guaranteed by the government.”
  - Checks will disappear
  - Bank branches will disappear
  - Financial advisers will disappear!!
- “The financial future will be one in which credit is socialized and our major financial institutions are financial public utilities.”
- Or will the public sector allow private institutions to capture control of liquidity creation again as in GLB?

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3. Threats to the Implementation of Monetary Policy

- Securitisation
  - If banks do not hold assets on their balance sheets monetary policy that seeks to influence the size and composition of balance sheets ceases to be functional
  - Policy can only work by influencing capital markets
    - Interest rate expectations
    - This means that QE and announcements of policy intentions becomes permanent features of policy

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Threats to the Implementation of Monetary Policy

- Non-Bank Payment Systems
- p2p Loan Systems
- The Fed currently has only direct control over these systems

Thank You
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