

Nomi Prins

Shifting US-Japan Geo-Politics, Banking Landscape and Financial Regulations in the Trump Era

(Summary of Q&A)

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Venue: CIGS Meeting Room, Tokyo, Japan

Questioner 1: Which sector do you think the next financial crisis will come from? You think it will come from the corporate sector, not the public sector? What is your view on the risk posed by the automotive sector?

Nomi Prins: It was the mortgage system becoming a part of complex securities created and distributed by the big banks that caused the last crisis. This happened because banks always go where it is easiest to make money, and they thought, before the crisis, that it would be simplest with subprime mortgages. Banks have since stopped providing as many subprime loans. They have made it more difficult for individuals and small companies to get mortgages and loans. Yet, they have made it easier to get auto loans, in part because it's easier to repossess a car than a house. However, if auto loans default, the market and financial system will not be impacted or care as much. It is a problem that banks are selling subprime auto loans, but if something happens, it will not cause a crisis.

The same can be said for consumer debt and student loan debt. For many people student loan debt is unsustainable. And, it is more likely multiple default issues across these consumer sectors, will collectively cause problems than any single one of them.

These issues are all related to the fact that banks have had the opportunity to have a great amount of cheap capital provided for them for many years. They didn't take that capital and reduce student loan sizes or mortgage rates on existing mortgages. They used it to get more corporate clients. That is partly why there is so much corporate debt in the market. Now, banks are restructuring bonds and loans, and putting them into packaged securities. This is what happens before a crisis – banks manufacture more products to get debts off their books.

Before the next crisis, banks will take their junk corporate loans and they will repackage them to be sold globally. That is what I think will be the cause of the next major global financial crisis.

Questioner 2: Can I please ask your opinion about Japanese nuclear armament and the possession of intercontinental ballistic missiles (ICBMs), in light of what is happening right now with North Korea?

Prins: I don't profess to be an expert on armaments. However, from the standpoint of someone from the United States – right now, Trump is trying to get China, Japan, and South Korea to coordinate their responses to North Korea and limit its missile-related activities.

I think there is an economic issue here. I don't think it would make sense for North Korea to launch actual missiles from the standpoint of its own economic survival.

I think the United States is concerned. But I don't see the United States doing anything in terms of aggressive military actions in the future.

Questioner 3: My question is about the leadership changes at the Federal Reserve. Today, press reports are stating that the Trump administration is nominating Randal Quarles as the new vice chairman of banking supervision. What is your opinion on that?

Prins: Lately, new appointments at the Securities and Exchange Commission (SEC) have all been people who have advocated for deregulation of the banking sector. It is worrisome. It will be Congress that actually enacts any regulations that will happen, but these appointments still pose risks in terms of efforts for further regulations.

Questioner 4: I have two questions. Secretary of the Treasury Steven Mnuchin has said the administration plans to simplify the tax code. Can this be done by the next mid-term election? Second, what is your perspective on the new French president, Emmanuel Macron?

Prins: I will talk about Macron first. He is definitely friendly to banking and corporate interests. At the same time, he has also articulated more progressive policies. France could have elected Marine Le Pen and become a more isolationist country, but it did not. This is a positive step in terms of collaborations between France and the rest of Europe in the future. How he succeeds at positioning France in relation to Germany or the EU remains to be seen.

In terms of mid-term elections, one issue that will affect this is the amount of work Congress is doing. Congress people are only working on average 2 or 2.5 days per week, and then spending the rest of their time in their home states. As a result, the budget is still on the docket, health care is still on the docket, and the tax reform is still on the docket. I think that before Congress passes anything, they will need to write out something on what that tax reform will actually look like.

Another issue is bilateral support. The tax reform proposal ideas that have been put forward call for the cutting of corporate taxes. Most Democrats oppose that, and some Republicans do as well, because if they cut too much, it will hurt the budget.

These issues might get partially sorted out, but the reforms won't be passed before August. break If they do anything before mid-terms, it would be simplifying tax brackets, by which I mean changing some individual tax elements, and whether that's capital gains or mortgage-related gains or individual write offs, they will not create less brackets. They could agree on something, but I don't think they will agree on a 15% corporate tax, which has been proposed.

Some have made the argument that the corporate tax rate in the United States is higher than in other countries. However, we use corporate taxes to finance our budget. We need money to fund the \$53 billion extra the budget wants to spend on defense.

Questioner 5: I would like to ask for your insights on the roll back of the Department of Labor (DOL) Fiduciary Rule, the possible repeal of the Volcker Rule, and the reinstatement of Glass-Steagall.

Prins: Two weeks ago, the House passed the Financial Choice Act to reduce the power of the Volcker Rule, but I don't think it will get passed by the Senate.

The Financial Choice Act would allow banks to sell complex securities to customers, for instance, when they open checking accounts. Currently, banks have an obligation not to sell products that will put their customers at risk. The Financial Choice Act would allow major institutions to, for example, sell customers securities that they know are toxic but say to the customers that they would be good for that customer's portfolio. They wouldn't have a duty to warn the customer about those products substantively.

The banks poured a lot of money into the House to get that act drawn up and passed. On the Volcker Rule, we are seeing the same thing. There is a push to get rid of it. The Volcker Rule isn't perfect. It was part of the 2010 Dodd-Frank Act, and drawn up as a compromise when the Obama administration couldn't get Glass-Steagall re-implemented, or even get agreement amongst the Democratic party to consider pushing it. It prohibits banks from investing with their own accounts. During the financial crisis, we had banks like Goldman Sachs that were selling mortgage securities on the market themselves while at the same time trying to get private customers to buy mortgage securities. They were trying to get their customers to take on that risk at the same time they were trying to free themselves of the risk. The Volcker Rule is supposed to prevent this.

A criticism of the Volker Rule by people like Treasury Secretary Steven Mnuchin is that it has reduced liquidity in the market by regulating market making. Of course, it is important for banks to create liquidity, or nothing can happen in the market. But there is a loophole in the rule to allow banks to buy and sell whatever they want anyway, and there is no regulation on how long they hold their purchases. In the end, it is not a very useful rule. That said, the Financial Choice Act would get rid of it.

There has been a lot of opposition from Wall Street over the Volker Rule even though there is that loophole in it allowing banks to make markets. Opposition has also been promoted by Gary Cohn, and economic advisor to President Trump, and Jamie Dimon from JPMorgan Chase. They are on the Economic Advisory Council, which meets with Congress to advise them about these issues. This Council does not support the reinstatement of the Glass-Steagall Act for the same reasons it opposes the Volker Rule.

All of that said, there are still a lot of individuals and groups in Washington DC, from both sides of the aisle, that want to mitigate the risk of future crises, and that are considering bringing back Glass-Steagall through left-right coalition building.

Questioner 6: Could you talk about the currency policy of United States? Mr. Trump has insisted that China should be named a currency manipulator but it has not happened. Can you explain the delay?

Prins: The idea of China as a currency manipulator actually came up before the last election. Hillary Clinton discussed it, not against Trump, but when she ran against Barack Obama. She also talked about it as Secretary of State. It was also brought up by Jack Lew and Tim Geithner, who were both the Treasury Secretaries under Barack Obama.

This issue tends to be something that the United States mentions when it needs international focus to be off of US economic problems. It is more of a political issue than an economic one.

In terms of Trump, when he was running, he did call out China on trade. However, since the election, he has stepped back from attacking China.

Treasury Secretary Steven Mnuchin hasn't talked about it to the extent Tim Geithner or Jack Lew did. I don't think it will come up again, because people like Steven Mnuchin

and Gary Cohn want more open markets, while Trump seems to want more isolationism and protectionism. The market side and political side of the administration are at odds, which could create a standstill with respect to how it views China's currency policy.

Questioner 7: President Trump has in the past promised to increase investments into infrastructure, but has cut infrastructure investments in his budget. Could you talk about why you think that has happened?

Prins: I think when Trump promised that he would increase infrastructure spending by a trillion dollars over the next 10 years and create jobs; that were a good promise. I think that swayed a number of his voters.

However, this issue goes back to Congress. A lot of the members of Congress understand infrastructure. They travel a lot. But if you ask them about building more infrastructures, they will ask where they can get the money from to do that. Money for infrastructure can come from taxes or debt. If you are considering cutting taxes or lowering debt, where do you then get construction money?

There is a disconnect on this issue between the ideal policy and what laws are actually being passed for the budget. One option to remedy that is to look more at public-private partnerships, where the private sector would be more involved in funding, and the Government would give tax breaks. I can see how that could move projects forward, although not to the extent of a trillion dollars over the next ten years. This method would also limit larger projects. We won't get a train across the United States through these partnerships. Another way is by public or development bank funding, but we don't have a public bank in the US, just in one state.

I think we should invest in infrastructure, but there is a lot of push-back in Washington DC. Trump hasn't made the alliances to get around that. He has just talked about infrastructure in the campaign and a little after, but he hasn't put in the political work.

I was just in Thailand, where people are talking about building a broad canal that could reduce the costs of shipping over the routes that now go through Singapore. This kind of large project could change the world. The United States will not be taking a leadership role on these kinds of projects.

Questioner 8: My question is about the low number of politically appointed positions that have been filled. What is your view on that?

Prins: One thing that I have been seeing is a move away from getting policy work done via senior Trump appointees or political appointments and more towards work at the ground level. Every time a new person comes in, people in Washington have to look at them to see how they are going to work together with Congress or federal agencies to get things done. At some point, people have to make the assessment that they are going to be helpful, or that we will have to work around them if we want to get anything done.

What is happening in Washington right now, particularly within Congress, is more people working around the administration simply to get things done. On the other hand, people are still required to think about and interpret what the executive branch wants, because they fear doing the wrong thing in the eyes of senior leadership. It is a balancing act.

Questioner 9: Could you please expand on your comments related to new financial crises in the future? Do you think that the expansion of monetary policy could lead to another crisis? How so?

Prins: There was a limited extent in the past to which providing more liquidity through quantitative easing made sense. If banks would have received the money they did and put that money toward loans or development projects, it could have led to real productive growth, but that didn't happen.

Rather than taking the liquidity they have received over the past few years and restructuring mortgages or commercial loans or using it for productive lending, banks have used the money to speculate. There has been no requirement to do anything else.

The money produced by quantitative easing has gone to the place where it was easiest for the banks to put it, which is into the financial markets. That is a problem.

Quantitative easing has led to a lack of real growth in the economy, which has in turn caused dissatisfaction among the public. There hasn't been regulation to fix the problems behind the last financial crisis. The market has merely been subsidized by quantitative easing and cheap money policy, so another crisis could happen at any time.

Questioner 10: How do you think republicans will fair during the mid-term elections?

Prins: I don't know for sure, but over the last six months, I don't think that the concerns that caused people to elect Trump and put Republicans and in the House and Senate have gone away.

I think this issue will be decided by what the Democrats do. Because what happened in the main elections was, to a large extent, that the Democrats didn't listen to the economic concerns of their constituents. I think that really hurt them.

Right now, it's not clear that Democrats fully understand that either. The old leadership of the Democratic Party is still in existence. Nancy Pelosi, who is the minority leader of the House Representatives, is still around. There has been a call to younger, newer, or more active leadership to come to power, but the party seems to embrace its old guard.

I don't think the Democratic Party has the ability to do very well in the mid-term elections. If it doesn't actually become more progressive and more in touch with what its voters are concerned about, then it is not going to win back the House.

Questioner 11: Almost 1 year ago, the International Monetary Fund (IMF) surprisingly put out a message which said that Deutsche Bank is the largest risk of the world financial system. I think this is because of their huge number of derivatives. Is this issue unique to Deutsch Bank, and has this issue been resolved, or is it still a problem?

Prins: Yes, that issue still exists. Some leadership has changed at Deutsche Bank since then, but the issue still exists. Derivatives are not an isolated thing. There are high co-dependencies between all of the international banks. If the credit of a derivative plummets, it can affect a number of different banks. Since the message by the IMF, both Deutsch Bank and JPMorgan Chase and others have tried to sell off some of their derivatives.

As we saw during the crisis though, with derivatives, what matters is not the quantity that a bank holds, but the quality of those derivatives. Banks can sell off their derivatives, but that doesn't necessarily reduce the risk they hold.

Banks will say that the risk of selling a derivative equals the risk that the counterparty buying it faces, so everything cancels out. If that were true, no one would make money. Derivatives are risky.

Deutsche Bank was one of the recipients of the initial bailout provided by US Congress after the financial crisis. It received \$12 billion because of its exposure to AIG, the US insurance company, which had insured derivatives for US banks.

Nothing has changed in the way that Deutsche Bank does its business or in terms of the actual quality of its derivatives. Regulators don't necessarily understand that. For that reason, Deutsch continues to work the way it does, as does JPMorgan Chase, Citigroup, and Bank of America. These banks are selling their derivatives, but that doesn't mean they have reduced their actual dependencies or the risk they face.