© Copyright, Princeton University Press. No part of this book may be distributed, posted, or reproduced in any form by digital or mechanical means without prior written permission of the publisher.

PREFACE TO THE PAPERBACK EDITION

The fifth anniversary of the Lehman Brothers bankruptcy led many to ask whether the financial system is safe today. The answer to this question is no. The key factors that caused the subprime mortgage crisis to upset the global economy are still in place. Politicians and regulators have allowed effective reform to be stalled.

Bankers and their supporters often threaten that proposed regulation will "harm credit and economic growth." Such threats scare policymakers. Yet the explanations given for the claims, if any, are nonsensical or misleading. Actually, the sharpest downturn in lending and growth since the Great Depression occurred in the fall of 2008. This downturn was not due to regulation, but to the reckless practices and excessive fragility of banks and the financial system. The suggestion that making banks safer would be harmful for us all is simply false.

Much is wrong with banking and much can be done to make it better. Bankers may benefit from the dangerous system we have, but most others are harmed. The system is fraught with inefficiencies that harm the economy every day. Even now, the continued weakness and flawed incentives of banks dampen new lending that would help economic recovery. Financial crises, and the damage they bring to the economy, are just the most visible harm created by this unhealthy system. Yet, confusion and politics have prevented beneficial reform.

Refuting the claims made by bankers and others is not difficult. However, many people either don't understand or believe that they don't understand

For general queries, contact webmaster@press.princeton.edu

© Copyright, Princeton University Press. No part of this book may be distributed, posted, or reproduced in any form by digital or mechanical means without prior written permission of the publisher.

the issues. Many feel that they are not in a position to evaluate or challenge the banking "experts." Others don't want to engage or have reasons to avoid speaking up.

We wrote this book to inform and empower more people to participate in the debate. By explaining the issues in plain language, we wanted to create a larger constituency for effective financial reform. Enlarging this constituency is essential for bringing about change.

We have been gratified by the reception of our book. Many have told us that they found the book useful. More voices have joined ours in challenging flawed claims and urging effective reform. Some policymakers have become more aware of the issues, and some of the issues we raise are being discussed in regulatory or legislative bodies.

However, we remain alarmed by the state of the financial system. Banks continue to be unsafe and ill prepared for the risks they are taking. Many of them have not yet fully acknowledged, let alone overcome, their losses on previous investments. Institutions considered "too big to fail" are particularly reckless and dangerous.

We also remain dismayed by the fact that the policy debate continues to be muddled. The same claims we have debunked, and some new nonsensical statements, continue to be made and to impact policy. People make false assertions while ignoring, mischaracterizing, or trying to dismiss our arguments. In a document entitled "The Parade of Bankers' New Clothes Continues" (posted on the book's website bankersnewclothes.com) we outlined and briefly criticized some of the flawed arguments we came across in the first few months after the book's publication.

Someone suggested to us that there are "blind spots" within the banking community. But the blindness often appears willful—"see no evil, hear no evil." In her insightful book *Willful Blindness: Why We Ignore the Obvious at Our Peril,* Margaret Heffernan observed: "We turn a blind eye in order to feel safe, to avoid conflict, to reduce anxiety, and to protect prestige." Willful blindness helps bankers and policymakers to overlook and ignore risks they take and to deflect criticism.

Our book has clearly touched a raw nerve. Someone familiar with banking told us that our explanations are so clear that "most bankers could com-

For general queries, contact webmaster@press.princeton.edu

© Copyright, Princeton University Press. No part of this book may be distributed, posted, or reproduced in any form by digital or mechanical means without prior written permission of the publisher.

prehend" them, "but, unfortunately, would find [the conclusions] difficult to accept." Someone working for a bank said: "If I give your book to my boss, I will get fired." An executive in a major bank refused an invitation to a private dinner that one of us would be attending, saying "I can't do that."

The Bankers' New Clothes focuses mainly on bankers and lobbyists making false or misleading claims and on the politicians and regulators who listen to them and collaborate with them. Yet, flawed claims and willful blindness can also be found among academics and in the media; they too participate in the continuing parade of bankers' new clothes. For example, the 2013 edition of a best-selling textbook, written by a prominent academic and former central banker, repeats fallacious statements that have been publicly debunked in our book and in earlier writings; these statements contradict basic lessons taught in required business school courses in finance.

In our book we also took on some of the claims and narratives made in academic banking research and excluded others that seemed too esoteric. For example, some academic research claims that banks need to be fragile and borrow a lot because their depositors and other creditors monitor the banks' managers and "discipline" them if they misbehave. Readers of preliminary drafts told us that this idea was too academic, too far from the real world to be worth discussing in the book. The material became an "omitted chapter" posted on the book website.

Rather than being fallacious, some academic research consists of *myths*, theoretical constructions that claim to explain what banks do as something essential or efficient while ignoring those parts of reality that suggest entirely different explanations. An analogue would be a theory that "explained" the fact that people smoke cigarettes by claiming that it was good for their health, while ignoring the fact that smoking cigarettes is addictive and can cause significant harm. Similarly, borrowing and taking risk can be addictive and harmful, but this fact is ignored in much of the academic research about banking. The research often consists of abstract theoretical analyses with no attempt to match the theory to reality.

Many of these analyses are based on the presumption that the amount of risk in banking must be efficient because it is a result of free market activity. This presumption is convenient for lobbyists who fight regulation and for

For general queries, contact webmaster@press.princeton.edu

© Copyright, Princeton University Press. No part of this book may be distributed, posted, or reproduced in any form by digital or mechanical means without prior written permission of the publisher.

policymakers who don't want to intervene. Those who like the conclusions of theoretical or empirical studies don't care whether the conclusions are valid or whether the assumptions made in the studies have anything to do with reality.

Biases and willful blindness are also evident in the media. Reporters frequently quote bankers, policymakers, and experts without challenging the claims or asking for a balancing opinion. In attempting to explain policies or debates, media reports sometimes provide false and misleading information. For example, the debate about banks' indebtedness is often erroneously framed as if it concerned money that banks set aside as cash reserves; or the simple fact might be forgotten that deposits are part of the banks' debts.

In this paperback edition, we have clarified the writing in a few places, but we do not discuss developments after the book was completed in October 2012. Those developments, including the crisis in Cyprus, repeated scandals and investigations of large banks, the issuance of some debt by Apple, or some banks making high profits again, do not change our arguments and conclusions in any way. For example, most financial institutions, including Bear Stearns and Lehman Brothers, had record profits in 2006, only to fail or to receive massive supports in 2008 and since. If banks are profitable, such "success" often comes from their taking excessive risks that benefit few while harming others.

Our main message is that by taking simple steps to reduce excessive risks and excessive risk taking, our banking system can become safer, healthier, and better able to support the economy. For example, healthy banks can become more resilient by reinvesting their profits or by selling new shares to investors, as is routinely done by other companies.

Some banks may no longer be viable. A cleanup of such banks and of the financial system is important even if it means eliminating or shrinking some banks. Hiding from reality and providing public support to banks that cannot otherwise survive or which are too big and too complex to control, as governments all over the world are doing, is dangerous and expensive.

Once the fog of confusion is lifted, the path to effective reform can be seen clearly.

November, 2013

For general queries, contact webmaster@press.princeton.edu