

Risks grow as reform resolve disappears

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The 2008 subprime crisis in the US grew into a global financial crisis. After the Lehman Brothers bankruptcy, markets froze and many institutions came close to failure. It took massive interventions by governments and central banks to stop the panic.

At the time, politicians, central bankers and regulators expressed firm resolve to reform regulation so such a crisis could not happen again. By now, this resolve has disappeared.

Even without a crisis, the financial system remains unhealthy and distorted. New regulations brought in after the crisis are poorly designed, often inadequate and sometimes undermine their own objectives by exacerbating distortions. These rules do not address the conflicts of interest between those who control the financial sector in private and government institutions and society's interest in a safe and healthy system.

The crises of the past decade, in the US and in Europe, were caused by reckless lending, by bankers fooling themselves and others about risks, and using derivatives and flawed accounting to hide risks and pass them on with help from credit rating agencies, auditors and even supervisors. Governance failed at all levels, internal and external. Banks were eager to buy assets that were declared safe, but were in fact toxic. Because of extreme leverage, losses on these assets quickly caused concerns about solvency and led to a breakdown of funding. The Lehman bankruptcy triggered a run by customers on money market funds and a run by money market funds on banks. The resulting money market freeze caused banks to scramble for cash.

Most of the mechanisms at work in the crisis are still around today. Leverage is somewhat lower, but most large banks still fund more than 94% of their assets by borrowing. The claim that equity requirements have tripled applies only to equity relative to so-called risk-weighted assets. As Martin Wolf, the Financial Times columnist, remarked, 'tripling almost nothing does not give one very much'.

Important risks, such as those from sovereign bonds, are not taken into account properly. Large banks still depend on wholesale money markets. New requirements are supposed to protect banks from another breakdown of liquidity, but these rules treat

assets such as mortgage-backed securities, whose markets froze in August 2007, as liquid. Moreover, the rules do not prevent runs when institutions are insolvent.

Equity requirements

The key to proper regulatory reform would have been a much more substantial increase in equity requirements. Financial institutions persist with dangerously low equity levels and opaque risk exposures because their creditors are passive, supported by deposit insurance, the use of collateral for non-deposit borrowing, and expectations of support from central banks and governments. With more equity, some other regulations that are costlier would be unnecessary.

Although there have been some improvements in bank resolution, a liquidation procedure that is an alternative to bankruptcy, it is still not possible to subject global institutions to such procedures without causing damage to the overall system. These institutions have systemically important operations in multiple jurisdictions, which are likely to suffer when different countries' authorities intervene. Single point of entry, where only the authorities in charge of the parent company intervene, is politically improbable. In Europe there is also no workable arrangement for providing liquidity to a bank in resolution.

Instead of serious analysis of what had actually happened, what ails the system, and what measures would be most effective in improving it, regulatory reform has been led astray by opportunistic attempts to promote other agendas. Many institutions, especially in Europe, have not yet cleaned up their balance sheets, and new systemic risks are building up.

In 2008 and since, massive public support for the financial system and the overall economy succeeded in preventing a recurrence of the great depression. Along with this success, however, the industry and its sycophants retained their hold over public discourse. Society continues to bear large and unnecessary risks and costs. ●

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