Project Syndicate

Five Years of Financial Non-Reform

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STANFORD – Five years after the collapse of Lehman Brothers triggered the largest global financial crisis since the Great Depression, outsize banking sectors have left economies shattered in Ireland, Iceland, and Cyprus. Banks in Italy, Spain, and elsewhere are not lending enough. China's credit binge is turning into a bust. In short, the world's financial system remains dangerous and dysfunctional.
Worse, despite years of debate, no consensus about the nature of the financial system's problems – much less how to fix them – has emerged. And that appears to reflect the banks' political power.

For example, Vince Cable, the United Kingdom's business secretary, recently accused Bank of England regulators – whom he called "capital Taliban" – of holding back the country's economic recovery by imposing excessive burdens on banks. Cable appears to believe the banks' lobbyists when they claim that lending and growth would suffer if banks were forced to "hold more capital."

Such claims by senior policymakers are hardly unique to the UK; but they are false and misleading. Bank capital is not cash reserves that must be "set aside"; it is unborrowed money that can be used to make loans.

Simply put, lending and economic growth have suffered since 2007 because highly indebted financial institutions could not absorb their losses, not because of regulations that sought to reduce their indebtedness. The regulations in place when the crisis erupted were both inadequate and inadequately enforced, and the reforms proposed since then do little better. The proposed Basel III reforms, for example, would allow banks to fund up to 97% of their assets with borrowed money; some investments could be made entirely by borrowed funds.

The perils of this approach should be obvious by now. When homeowners cannot pay their mortgages, they may lose their house, blighting the entire neighborhood.

The same is true of financial institutions, as the Lehman bankruptcy showed. Moreover, the effects of heavy borrowing are felt before borrowers default. Distressed or "underwater" homeowners do not invest much in maintenance or improvements. Similarly, weak banks with overhanging debts that prevent them from funding worthy investments are a drag on the economy.

Flawed regulations further distort weak banks' behavior – for example, by biasing them in favor of making loans to governments or investing in marketable securities over lending to businesses. Regulators too often tolerate, and sometimes support, weak banks, denying the reality of their dire condition. This is counterproductive.

Instead, regulators must take forceful steps to unwind zombie banks and compel viable banks to rely more on equity markets, where risk is traded and priced, to become stronger. Banning payouts to shareholders and requiring banks to raise funds by selling new shares would bolster them without restricting their ability to lend. Banks that cannot sell their shares at any price may be too weak to survive without subsidies. Such banks are dysfunctional and must be unwound.

If we want safer and healthier banks, there can be no substitute for requiring banks to reduce their reliance on borrowing. As lenders, banks lose when borrowers default. Banks themselves, however, are the heaviest borrowers, routinely funding more than 90% – and sometimes more than 95% – of their investments by taking on debt. (By contrast, non-financial corporations rarely borrow more than 70% of their assets, and often much less, despite the absence of any regulation of their leverage ratios.)

Cyprus illustrates the problem. Beginning in 2010, Cypriot banks invested some of their deposits in Greek government bonds, which promised interest rates of more than 10% – sometimes even 15% or 20%. As long as Greece paid these high rates, Cypriot banks could pay their depositors attractive rates, such as 4.5%, and thrive.

Cypriot banks passed stress tests in July 2011. Yet, in early 2012, their Greek bonds lost 75% of their value. Because the banks made their investments with too little unborrowed money, they became insolvent. After being kept afloat for a year with help from the European Central Bank, the Cypriot banks were forced to face their losses. One was shut. Deposits over €100,000 ($133,000) incurred losses. Eurozone taxpayers provided €10 billion in bailout funds.

Remarkably, regulators had allowed Cypriot banks to engage in the practices that led to their troubles. Although investing in Greek bonds was risky – reflected in the high rates the bonds promised – the regulations ignored the possibility of a loss. While the upside of the risks played out, the banks' profits benefited their shareholders and managers, politicians were happy, and the banks grew enormously relative to the economy.

The proposed Basel III regulations set wholly insufficient minimum capital requirements and maintain a failed approach to adjusting the requirements to risk. Within the eurozone, for example, banks can extend loans to any government using exclusively borrowed money. The French-Belgian bank Dexia, like Cypriot banks and many others since 2008, failed or were bailed out from losses on risky investments that regulators had considered safe.

Regulations everywhere appear to be based on the false notion that banks should have “just enough” equity. Equity is not scarce for viable banks, and the “science” of complex risk weights and stress tests is a harmful illusion. Instead, regulation should seek to force banks’ investors to bear much more of their own risk, and thus to care much more about managing it, in order to limit the collateral damage of their excessive borrowing.

Some say that banks are inherently special, because they allocate society’s savings and create liquidity. In fact, banks have *become* special mainly in their ability to get away with so much gambling at others’ expense. Nothing about financial intermediation justifies allowing banks to distort the economy and endanger the public as much as they do.

Unfortunately, despite the enormous harm from the financial crisis, little has changed in the politics of banking. Too many politicians and regulators put their own interests and those of “their” banks ahead of their duty to protect taxpayers and citizens. We must demand better.

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