Commentary: Financial innovation and a *new economics* of banking: Lessons from the financial crisis

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Llewellyn's paper gives a good framework for analysing and discussing the financial crisis. It gives a non-technical explanation of how the various factors have combined to produce the worst event since the 1930s. His main contention is that the creation and use of complex financial products have been central to this crisis and distinguish it from previous episodes, but he also gives a comprehensive summary of other contributing causes. In addition, he suggests that there will be a major rethink of the current banking model, with a move back to more traditional models or a back-to-basics framework.

I am not going to dwell on the technical descriptions of the new structures, instruments and derivatives or the detail of financial innovation, which Llewellyn describes well. Instead, I will focus on the key assertions of the paper noted above.

The split of the causes of the crisis into the different categories – proximate, ultimate, environmental, incentive structures and supervisory failures – may give the impression to the uninitiated that these were independent and that the accident was the result of many factors unexpectedly combining to produce the crisis. I am sure that this is not what Llewellyn is suggesting. In my view, what makes this event so intriguing is the self-reinforcing nature of the various factors and the build-up of the underlying problems over many years.

Strong liquidity almost always leads to overexuberant lending by banks, with new innovations in every cycle that extend credit boundaries and are meant to reduce risks. In this case, the recycling of Asian and petrodollar surpluses into global financial markets and the massive leveraging supported by off-balance-sheet lending helped push asset prices up. This made the underlying collateral look even more enticing and further boosted the banks' collective ability to lend by boosting capital and the ability to raise more capital cheaply. This virtuous cycle extended well over a decade in various forms, but the final stage was encouraged by the monetary and fiscal boosts post the 1997/98 emerging-market crisis and the recession in the United States (US) in 2001. After the dot-com bubble had burst in 2001, liquidity migrated to property and then later to commodities. While house prices continued to rise, higher debt levels were easy to justify, but once the bubble burst, it exposed significant excesses in the household sector.

For much of that period central banks largely ignored the growing risks and kept interest rates low, comforted by low consumer inflation. However, the long period of controlled consumer prices was only partly due to lower inflationary expectations stemming from earlier central bank behaviour. Much had to do with massive productivity improvements and economies of scale in China and an undervalued renmimbi, which kept the prices of imported manufactured and consumer prices in developed countries in check. When commodity prices finally started to rise strongly from late 2004 to 2006, this attitude changed and monetary policies tightened (the Greenspan 'normalisation' of the federal funds (fed funds) rate started in June 2004). Unfortunately, by then debt levels had increased dramatically and the combination of rising interest rates and – later in the cycle – higher consumer inflation started to affect consumers. The subprime twist was that many lower-income households in the US were persuaded to take out flexible interest mortgage bonds that often included a short period of a favourable fixed rate before onerous resets applied (so-called adjustable-rate mortgages (ARMs)). By 2005 the housing boom in the US was over and in 2006 house prices started to falter. The virtuous cycle had started to unravel and a vicious cycle was starting.

So who was to blame? Many would point to this episode as being a 'Minsky moment', after Hyman Minsky's (1975, 1992) analysis of financial market behaviour. The basic assertion is that capitalism inevitably creates excesses and sows the seeds of its own destruction through ever-increasing speculative financial activity. Minsky (1992: 8) also held that "over periods of prolonged prosperity, the economy transits from financial relations that make for a stable system to financial relations that make for an unstable system". Proponents of this view would look at deregulation (particularly the partial repeal in 1999 of the 1933 Glass–Steagal Act that separated commercial and investment banking) as playing a key part in the crisis. This is not the place to examine the hypothesis in any detail, although parts of it look almost prophetic today. In particular, some of the complicated derivatives that Llewellyn refers to appear – unintentionally – to have had highly speculative characteristics, with bets being placed on bets. However, there is nothing inherent in actors acting in their own self-interest, causing mutual self-destruction. Neither is deregulation by itself to blame. Rather, it was the implicit collusion of confidence over logic between the various players (i.e., banks, governments, central banks, regulators, rating agencies, investors and borrowers) that combined to produce a crisis that will have far-reaching and very damaging implications for the global economy.

Banks clearly played a major part in precipitating the crisis. They lowered their lending standards, comforted by rising collateral values and risk sharing through securitisation. Weak credit assessments played a large part in the crisis. Given the abundance of capital, it is not surprising that

spreads did not reflect the growing risks. What was also clearly not appreciated was the growing liquidity risk. Complicated off-balance-sheet structures were dependent on short-term funding. Once this dried up, banks had to step in and support their vehicles, once again, assuming the risk that they had thought had been so neatly parcelled out. This, in turn, resulted in mounting losses as the underlying collateral lost its value and, ultimately, a complete breakdown of the financial system, particularly following the Lehman Brothers collapse in mid-September.

Blame can also be apportioned to *governments*, *central banks and regulators*. In the US there was significant government pressure on banks to lend to lower-income households, starting with legislation such as the 1977 Community Reinvestment Act. The mortgage finance lenders, Freddie Mac and Fannie Mae, were also used as tools to broaden home-ownership, with a corresponding relaxing of credit or ability-to-pay requirements. Central banks played their part by largely disregarding anything but consumer inflation. This meant ignoring the growth of massive gearing in the economy and the emergence of successive asset price bubbles. Regulators were also too easily persuaded to relax lending criteria for banks. For example, in the generally euphoric mood of the time, the Securities and Exchange Commission relaxed debt-to-asset requirements on major investment banks in 2004; greatly extending the extent of leverage in the system. An associated problem was the switch in reporting standards to mark-to-market accounting. While, in principle, this makes sense, it has had the unintended consequence of encouraging further lending in boom times and greatly restricting credit in bad times. Lastly, as Llewellyn points out, there was a failure of supervision rather than a lack of regulation. The rules do not necessarily have to be changed too drastically, but in the coming years their application will.

Credit agencies have also come under significant criticism. The crisis has further revealed two fundamental flaws. The first is a potential conflict of interest: if the client is the issuer of a new exotic instrument and not the purchaser (or only indirectly), the temptation or tendency might be to rate it more favourably. The second is that it is very difficult for rating agencies to make significant downgrades as conditions worsen. By doing so they could feel that they would precipitate a crisis (making it a self-fulfilling prophecy), but by not doing so they are also failing their clients on the buy side. In any event, they collectively did little to warn of the growing underlying dangers.

The *borrowers* themselves have to assume some responsibility for continually taking on more and more debt.

Llewellyn's prediction of a back-to-basics banking model is likely to prove correct. Banks themselves will feel more comfortable with getting closer

to the client once again and regulators are likely to be very wary of any repeat of the excesses seen in the financial sector over the past few years for decades to come. My concern is that policy-makers will become too restrictive and further exacerbate the crisis in the short to medium term. For example, there have been calls for tougher capital requirements, but this seems to be shutting the stable door after the horse has bolted. In fact, the idea that such requirements play more of a countercyclical role in the future makes more sense. During periods of high bank profitabilty, capital ratios could rise, offsetting some of the self-reinforcing behaviour described above, while ratios should fall back to their minimums in more difficult times. Although this may seem counterintuitive (especially in the light of Basel II), it would provide a way of avoiding some of the major mistakes made during this cycle.

On the seriousness of the crisis for the real economy, Llewellyn stresses that this event is a major one that could result in a severe recession. My own view is similar. The deleveraging process currently under way will have a potentially devastating and long-lasting effect on the real economy. Compared with the 1930s, policy-makers are armed with prescriptions of what and what not to do, and so far have done reasonably well. These include fiscal and monetary boosts, provision of liquidity and preventing a systemic crisis by backing banks and providing comfort to deposit holders. Encouragingly, most governments also appreciate that trade barriers will serve only to worsen the crisis as occurred in the 1930s (Kindleberger 1986: 291–292). All this will help to prevent a depression. However, never before have consumers been so indebted, and never before has there been such complexity in the financial system and such a global extent of the problems. This makes predictions about the future speculative. However, deleveraging seems inevitable and the global downturn is likely to be at least as bad as anything experienced since the early 1980s.

References

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