The Crash: causes and policy responses

My hypothesis in this presentation is that the current debate about regulation as a potential response to the problems that caused the financial crash of 2008 is misplaced. The regulatory response is essentially a response to the Paul Mason/Robert Peston/BBC version of events: unregulated laissez-faire capitalism was allowed to let rip and the greed of bankers, motivated by bonus packages, led to an unprecedented degree of risk taking. Interestingly, that is almost exactly what people believed in the immediate aftermath of the 1929 Wall Street Crash. Subsequent reflection proved that view to be largely mistaken.

It is, of course, almost impossible to untangle the many factors that caused the crash. My talk is not an attempt to evaluate the empirical evidence. My real point tonight is that there was a tide here and that the US government and regulators swam strongly with the tide and encouraged it. There is nothing in their behaviour that suggests that by giving government and regulators more power one will make future such events less likely.

Loose monetary policy – boom and bust

It is now widely accepted that the boom and bust, culminating in the Great Depression of the 1930s, arose as a result of catastrophically mismanaged monetary policy. The same was true of the Japanese boom, bust and malaise of the late twentieth century. So, before we start looking at other causes of the recent financial crash, we ought to examine whether loose monetary policy was an important cause again. So it turns out to be. For six years from 2001, the US Federal Reserve sent the message to participants in financial markets that, if the markets were to fall, the Fed would underpin them. Loose monetary policy led to a financial bubble and asset-price boom, low saving and a boom in consumption. Higher asset prices raised the value of collateral against secured loans thus encouraging more lending and, combined with mark-to-market accounting, raised accounting profits. Low interest rates encouraged unsustainable borrowing, consumption and investment in the housing market and exacerbated the problem of global imbalances.

It is tempting to dismiss these issues as mere technicalities and argue that, if only bankers had behaved more ethically, the whole crash would never have happened. The problem is, however, that monetary policy, together with some other factors that I will talk about later, distorts price signals in ways that make it very difficult to discern ethical behaviour. If interest rates are held down, consumers will naturally borrow more expecting that the decrease in interest rates is permanent. If a monetary boom raises asset prices, people will borrow against those inflated asset prices believing it is entirely rational. The price system loses its coordinating function.

In this regard, some key figures worth mentioning are:

- In the US, the Fed Funds Rate was cut from 6.25% to 1.75% in 2001.
- It was then cut further and was held at 1% until mid 2004.

- The real Fed Funds Rate was negative for two and a half years in the period 2002-2004.
- A Taylor Rule would have led to the Fed Funds Rate being between 2% and 5% during the period 2001-2005.
- Money supply growth in the UK grew rapidly to 14.1% per annum in September 2007.

There were many reasons for these monetary policy mistakes that we can discuss later, but the apparent underpinning of asset markets by monetary policy was a particular problem and relates to a more general problem of the underpinning of financial risk in the US system.

Bailouts and moral hazard

In addition to this, we had the build up of moral hazard within the financial system. This is so deeply rooted within the US financial system that it is not possible to go into every aspect of this in detail. I think that the point is illustrated, though, by a number of examples.

- Fannie Mae had a commitment to spend $2trillion expanding home ownership amongst low-income earners and minorities all ultimately underwritten by the US government. 40% of loans Fannie Mae bought and securitised in 2007-2008 were sub-prime, or Alt-A loans (mainly) without documentation – again underwritten by the US government. Fannie and Freddie, at one point, were leveraged 100:1 by some estimates and it is likely that the government-backed securitisation houses will cost the US taxpayer $290billion in 2010.
- Regulation encouraged securitisation and also (as applied in the US) encouraged banks to remove all risk from their balance sheets in complex vehicles (reducing the incentives to monitor).
- There was weak personal bankruptcy law in the US and the consequent use of non-recourse mortgages. In half of US states mortgages are non-recourse so that the borrower can walk away from the property if it is worth less than the mortgage.
- There is an absence of proper risk premiums in deposit insurance systems. In theory, the US deposit insurance scheme should have involved risk-related payments but, sadly, this principle was not followed in practice.
- There had been a continual bailing out of the US financial system (savings and loans in the 1990s, LTCM, and so on).
- Excessively loose monetary policy – especially in the US – led to an asset price boom, low interest rates and excess borrowing which I have already mentioned. I think particularly important here is the way in which monetary policy seemed to underpin asset markets and how this combined with what I believe to be a mistaken approach to financial modelling which projected future returns from portfolios by using historical data. This led to an understating of risk within investment portfolios.

These are particular examples of a big issue that policy makers seem to have shelved in their response to the crash – especially in the US. The underwriting of risk through monetary policy was noted as long ago as 2000. The Times said eight years before the crash that Greenspan encouraged a "Destructive tendency towards excessive risky investment supported by hopes that the Fed will help if things go bad." This all has many effects, none of which are desirable: incentives to monitor are reduced significantly when markets expect bailouts; guarantees also mean that markets do not send price signals in terms of widened bond spreads so crucial information is lost; the too-big-to-fail problem is then self-fulfilling as government-backed institutions will find it easier to raise capital and will expand more than other institutions.

If we underpin the financial system with guarantees, people are insulated from the consequences of their own actions and so take actions that are more risky – because the risks are socialised. Prudence then has public good qualities and public goods are under-provided. In the nineteenth century, banks competed with each other to demonstrate how sound they were and they often had double shareholder liability – now depositors get the benefits of more risk taking through higher interest rates but do not bear the costs of risk taking because of deposit insurance. Before the US deposit insurance scheme began, US banks usually had equity capital of 20-30% of total assets: during the rest of the 20th century this figure never reached more than 10%.

Ultimately, a credible policy has to be developed to ensure that banks can fail to which I shall return later. However, we need more than that. We need to ensure that, right through the financial system, individuals are not insulated from the consequences of the risks that they take.

Regulation, taxation and unintended consequences

Many have also blamed the fancy complex securitisation instruments for the crash. They certainly played a part but this line of argument is a bit like blaming a rifle for a murder. Why was so much lending obscured by securitisation? Securitisation itself – rather like a gun – is not in itself a bad thing – indeed it can be very helpful in making risk less systemic and diversifying risk.

As well as the actions of the Federal backed mortgage agencies, international regulation played its part. The Basel Banking Accord in 1988 and its successor, Basel II, led to two consequences. They radically distorted the activities of banks, encouraging them to take on gearing in more and more complex ways – and to give the impression that they had offloaded risk through securitisation. The regulatory capital ratios of banks could be reduced by securitising loans even if risk was kept on the balance sheet. Indeed, if a bank securitised a tranche of loans and bought securities backed by a set of loans similar to those that they had previously securitised, they could reduce their capital requirements significantly as long as the securities they bought were AAA securities. This then encouraged the rating agencies to over-rate securities. This gap was plugged in the US by requiring penal capital if banks kept risk exposure when they undertook securitisations so banks then responded by moving the risk off the balance sheets altogether and lost the incentive to monitor loans. The activities of rating agencies have been seriously distorted by the fact that banks gain regulatory advantage from holding better-rated securities and, of course, a ratings agency oligopoly was created by US Federal regulators.

Secondly, international regulators, through Basel II, strongly encouraged the adoption of similar types of risk models throughout the banking system. When those risk models turned out to be flawed, it affected the whole system at the same time. These models were intended to reduce the probability of failure of individual banks – which in the classical analysis of banking regulation is not really the job of the regulator – but encouraged banks to have similar business models thus raising the probability of the whole system failing. The further moves towards international regulation are surely a recipe for increasing the probability of system-wide failure.

Government policy across the western world has also provided strong tax incentives for companies – including banks - to gear their balance sheets and become more risky. This arises as a result of the way in which different forms of investment are taxed. Almost without exception, when a company raises capital by issuing equity, its tax burden is considerably higher than when it raises capital by borrowing. This does not explain why financial institutions lent out too much with insufficient capital but it does help explain the explosion in debt markets in general and the increased gearing in financial sector balance sheets. The tax system is a significant factor in making equity capital more expensive than debt capital.

Too little regulation?

I do not think that the problems in financial markets were caused by deregulation. Financial markets are heavily and closely regulated – which is not to say that they were sensibly regulated. Take a look at the FSA prudential regulation handbook at the time of the crash. The full handbook contained ten sections. The section entitled “Prudential Standards” was divided into 11 sub-sections. The sub-section “Prudential Sourcebook for Banks, Building Societies and Investment Firms” was made up of 14 sub-sub-sections. The sub-sub section “Market Risk” was divided into 11 sub-sub-sub sections. The sub-sub-sub-section on “Interest Rate PRR” had 66 paragraphs. This detailed, bureaucratic approach to regulation encourages a box-ticking approach whereby management believes it has fulfilled its prudential and ethical responsibilities by fulfilling the letter of the regulation. Regulators justify their jobs by writing rules yet cannot see the wood from the trees and miss the big picture. I do not blame them: essentially regulators are trying to do a job that cannot be done – and this is why, under Basel II, banks were allowed to use their own models.

The key arguments: public choice economics

I think that the main problem in the post-crash analysis is that we have been over-confident in what regulators can achieve in looking for a new regulatory framework. Many of the problems that led up to the crash were caused by well-meaning responses to previous financial crises. This is true, for example, of the creation of the US mortgage securitisation warehouses as well as the development of international bank regulation. There are several reasons not to put trust in regulation to resolve the crash many of which are suggested by public choice economics:

- Regulation will tend to be diverted away from its proper economic objectives by incentives within bureaus. This leads to a number of effects:
    - Regulators will tend to discharge their duties by writing rules
    - Politicians, who ultimately control regulators, will often follow the interventionist's fallacy: "something must be done, this is something, therefore it must be done".
    - Regulators will be risk averse, trying to reduce the number of failures on their watch
    - If a failure does happen, the regulator may be slow to act in the hope that the failed institution will recover.
- Regulators will be captured by those whom they are trying to regulate. It is obvious that this happened in the US case – though we should beware simply of drawing lessons from the fact that so many bankers were in the Bush administration.

There are also lessons from Austrian economics. It is simply not possible for regulators to gather all the information that is necessary to regulate the market effectively. Indeed, that is precisely what they were trying to do in the run up to the current crisis. The regulatory system before the crash was extensive but it failed. Indeed, in many senses it encouraged the behaviours that led to the crash. Whatever regulators try to do, there will be unintended consequences – and these unintended consequences might be very grave.

Some regulators have also criticised the unethical behaviour of market participants. However, ethics and virtue need to be practised and in financial markets underpinned by prudence. I do think that the conduct of monetary policy and the particular regulatory systems that we had distorted price signals, rewarded imprudent behaviour and made it very difficult for market practitioners to discern the difference between ethical and unethical behaviour. This is not to excuse behaviour that was clearly unethical, but the regulatory system – and other aspects of government intervention – should run with and not against the grain of human nature.

What should we do?

In my view, we cannot resolve the problems of the financial system by trying to regulate more. Public choice and Austrian economics tells us this loudly and clearly. Regulators can always stop the last crisis happening again but that is not very helpful. The discourse in the wake of the crash – especially in the US – is all wrong.

Financial institutions need to be made financially responsible for the decisions they take. Decisions to ensure this would be a "win-win" response to the crash. They might be opposed by corporatists but they would be welcomed by free-market economists and other interventionists. Such moves will have a dramatic effect on risk-taking behaviour – we know this from the study of the financial system in the past. Yes, individual banks will fail, but the system will be more stable. Banks will be more careful themselves and counterparties who provide credit or capital will also have an incentive to monitor more effectively. There are several ways of achieving a restoration of market discipline that have been proposed. I don't agree with all of them but I throw a number out for discussion:

- There should be risk-based deposit insurance – organised either by the market or by the central bank.
- We could have a system of narrow banking whereby some banks only take deposits and are more or less risk-free - I do not approve of this.
- Depositors could be made senior creditors whilst we ensured all other creditors can lose their capital if a bank fails.
- Living wills and other legal mechanisms could be used to ensure that banks can be wound up easily in the event of a failure – one of the most unsavoury aspects of the present crisis was that providers of capital (other than share capital) retained most or all of their money.
- Banks should publish more detail of their exposures *to the market* – currently their key relationships are with regulators.
- Banks should have contingent debt capital that can be converted into equity capital (of course, this is what a preference share is but the preference share has, in effect, been made obsolete by our dysfunctional tax system).
- There could be regulation only of retail banks by the Bank of England on a contractual basis in return for a promise of lender of last resort facilities.
- There should be a complete revision of the way in which equity capital is taxed to ensure that gearing is not penalised.

It is not necessary to extend regulation further out into the financial system as the EU has proposed on the grounds that any institution could be systemic if it contracts with a bank (as AIG was). This would, in any case, be an impossible task. If retail banks have their capital regulated then their capital requirements can depend upon the counterparties with which they are connected. It is not necessary to regulate the counterparties themselves.

In summary, there are many ways in which governments and regulators are at fault for the crash. There are many ways in which private sector actors are at fault too. It is not possible to perfect regulatory systems. However, it is possible to ensure that private sector actors are held responsible for the decisions that they take. If that is done, many other beneficial things follow. I think this issue has been given some attention in the UK. However, there is still too much focus on fine-tuning regulation and not enough on ensuring that all failed financial institutions can be wound up; that there is greatly increased transparency; that the tax bias against equity in the financial system is addressed; and that we have a proper risk-based deposit insurance system. The proposed enhanced regulation of mortgages is a huge red herring. In the

US, entirely the wrong approach has been taken – but then this is merely an extension of a process that began in 1933 and shows no sign of reversing. We could learn many lessons from the way in which we dealt with financial crises in the nineteenth century – but then politicians are not fond of economic history any more than they are fond of public choice economics or Austrian economics.