

Financial Crisis and the Central Bank System

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Abstract: - The financial crisis that began in 2008 gradually developed into a global economic crisis and continues to this day. There is a lot of causes standing behind the creation, depth and process of the crisis, which is the deepest since the thirties of last century. One of the reasons can be found in the risky behavior of commercial banks, especially in the excessive lending of credits and mortgages. Its share on the financial crisis have central banks and their failure as the financial supervisory authority. But there is a lot of another causes of failures in the commercial banking system. And some of the causes lies outside the banking system and monetary policy. Its share of the blame has also become from state and its expenditure on the social policy. This article analyzes the role of the commercial banking system and the central banks on the financial crisis including prevention options and measures.

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1 Introduction

Financial and banking crises properly defined consist either of panics or of waves of costly bank failures. These phenomena were rare historically compared to the present. A historical analysis of the two phenomena (panics and waves of failures) reveals that they do not always coincide, are not random events, cannot be seen as the inevitable result of human nature or the liquidity transforming structure of bank balance sheets, and do not typically accompany business cycles or monetary policy errors. Rather, risk-inviting microeconomic rules of the banking game that are established by government have always been the key additional necessary condition to producing a propensity for banking distress, whether in the form of a high propensity for banking panics or a high propensity for waves of bank failures (Calomiris, 2009).

Other risk-inviting rules historically have involved government-imposed structural constraints on banks, which include entry restrictions like unit banking laws that constrain competition, prevent diversification of risk, and limit the ability to deal with shocks. Another destabilizing rule of the banking game is the absence of a properly structured central bank to act as a lender of last resort to reduce liquidity risk without spurring moral hazard.

Macroeconomists and policy makers often remind us that banking crises are nothing new, an observation sometimes used to argue that crises are inherent to the business cycle, or perhaps to human nature itself. Charles Kindleberger (1973) and Hyman Minsky (1975) were prominent and powerful advocates of the view that banking crises are part and parcel of the business cycle, and result from the propensities of market participants for irrational reactions and myopic foresight.

Some banking theorists, starting with Diamond and Dybvig (1983), have argued in a somewhat parallel vein that the structure of bank balance sheets is itself to blame for the existence of panics; in their canonical model, banks structure themselves to provide liquidity services to the market and thus create large liquidity risks for themselves, and also make themselves vulnerable to self-fulfilling market concerns about the adequacy of bank liquidity.

In fact, a central lesson of the history of banking crises is: banking crises are not an historical constant, and therefore, the propensity for banking crises cannot possibly be said to be the result of factors that have been constant over time and across countries for hundreds of years, including business cycles, human nature, or the liquidity transformation inherent in bank balance sheets. The structure of the rules governing the banking system within a country – defined by the rules that govern the location, powers, and operations of each of the banks, including government subsidies or special rights granted to favored participants in the banking system and the incentive consequences of those subsidies and rights – has been at the center of the explanation of the propensity for banking crises for the past two centuries. In times and places where politically determined microeconomic rules of the banking game have encouraged risky practices or prevented effective private measures to limit banking crisis risk, the risk of banking crises is high; conversely, the absence of such adverse political rules of the game have resulted in stable banking systems (Calomiris, 2009).

This review offers important insights for policy makers. The crisis of 2007–2009 has sharpened or redefined many public policy questions of central importance to prudential financial regulation (a means of preventing crises) and the proper role of government assistance policy (a means of mitigating the costs of crises).

2. The Banking Crisis Era Before 2008

In the past thirty years roughly 140 episodes have been documented in which banking systems experienced losses in excess of 1% of GDP, and more than 20 episodes resulted in losses in excess of 10% of GDP, more than half of which resulted in losses in excess of 20% of GDP - these extreme cases include, for example, roughly 25–30% of GDP losses in Chile in 1981–1983, Mexico in 1994–1995, Korea in 1997, and Thailand in 1997, and a greater than 50% loss in Indonesia in 1997 (Caprio & Klingebiel, 1996).

Some of empirical studies of this era of unprecedented frequency and severity of banking system losses has concluded uniformly that deposit insurance and other policies that protect banks from market discipline, intended as a cure for instability, have instead become the single greatest source of banking instability.

It is also significant that the four countries that suffered the most severe bank failure episodes of the pre-World War I era – Argentina, Australia, Norway, and Italy – had two things in common:

a) all of them suffered real estate booms and busts that exposed their financial systems to large losses,

b) prior to these crises all of them had employed unusually large government subsidies for real estate risk taking that were designed to thwart market discipline (Calomiris, 2007).

In Argentina, that subsidy took the form of special mortgage guarantees issued by the government, which guaranteed holders of the mortgages repayment. Banks were licensed to originate these guaranteed mortgages, and then resold them as guaranteed liabilities in the London market, where they were traded as Argentine sovereign debts. The less dramatic banking system losses during the Norwegian and Italian land busts reflected less aggressive, more regionally-focused government policies promoting land development. In Norway, that was achieved through government-sponsored lending and accommodative monetary policy. The Norwegian banks' losses amounted to roughly three percent of GDP, and the Italian banks' losses (which largely reflected exposures to the Roman land market) were roughly one percent of GDP (Calomiris, 2007).

3 The Crisis After 2008

The crisis, like the episodes of historical banking crises described above, was not just a bad accident. On an ex ante basis, subprime default risk was excessive and substantially underestimated during 2003–2007. Reasonable, forwardlooking estimates of risk were ignored, and compensation for asset managers created incentives to undertake underestimated risks. Those risk-taking errors reflected a policy environment that strongly encouraged financial managers to underestimate risk in the subprime mortgage market. Four categories of policy distortions were most important in producing that result.

1. Lax monetary policy, especially from 2002 through 2005, promoted easy credit and kept interest rates low for a protracted period.

The history of postwar monetary policy has seen only two episodes in which the real federal funds rate remained negative for several consecutive years: the high-inflation episode of 1975–1978 (which was reversed by the rate hikes of 1979–1982) and the accommodative period of 2002–2005. The Fed deviated sharply from the “Taylor Rule” in setting interest rates during 2002–2005; the federal funds rates remained substantially and persistently below levels that would have been consistent with that rule. Not only were short-term real rates held at persistent historic lows, but unusually high demand for longer term Treasuries related to global imbalances and Asian absorption of U.S. Treasuries flattened the Treasury yield curve during the 2002–2005 period, resulting in extremely low interest rates across the yield curve. Accommodative monetary policy and a flat yield curve meant that credit was excessively available to support expansion in the housing market at abnormally low interest rates, which encouraged the overpricing of houses and subprime mortgages.

2. Numerous housing policies promoted subprime risk taking by financial institutions by effectively subsidizing the inexpensive use of leveraged finance in housing.

Those policies included:

- a) political pressures from Congress on the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, to promote “affordable housing” by investing in high-risk subprime mortgages,
- b) lending subsidies for housing finance via the Federal Home Loan Bank System to its member institutions,
- c) Federal Housing Administration (FHA) subsidization of extremely high mortgage leverage and risk,
- d) government and GSE mortgage foreclosure mitigation protocols that were developed in the late 1990s and early 2000s to reduce the costs to borrowers of failing to meet debt service requirements on mortgages, which further promoted risky mortgages, and – almost unbelievably,
- e) 2006 legislation that encouraged ratings agencies to relax standards for subprime securitizations.

All these policies encouraged the underestimation of subprime risk, but the behavior of members of Congress toward Fannie Mae and Freddie Mac, which encouraged reckless lending by the GSEs in the name of affordable housing, were arguably the most damaging actions leading up to the crisis. For Fannie and Freddie to maintain lucrative implicit (now explicit) government guarantees on their debts, they had to commit growing resources to risky subprime loans (Calomiris, 2008, Wallison & Calomiris, 2009). Due to political pressures, which were discussed openly in emails between management and risk managers in 2004, Fannie and Freddie purposely put aside their own risk managers’ objections to making the market in no-docs subprime mortgages in 2004. The risk managers correctly predicted, based on their experience with no-docs in the 1980s, that their imprudent plunge into no-docs would produce adverse selection in mortgage origination, cause a boom in lending to low-quality borrowers, and harm their own stockholders and mortgage borrowers alike. In 2004, in the wake of Fannie and Freddie’s decision to aggressively enter no-docs subprime lending, total subprime originations tripled. In late 2006 and early 2007, after many lenders had withdrawn from the subprime market in response to stalling home prices, Fannie and Freddie continued to accumulate subprime risk at peak levels. Fannie and Freddie ended up holding \$1.6 trillion in exposures to those toxic mortgages, half the total of non-FHA outstanding amounts of toxic mortgages (Pinto, 2008).

3. Government regulations limiting the concentration of stock ownership and the identity of who can buy controlling interests in banks have made effective corporate governance within large banks extremely challenging.

Lax corporate governance allowed some bank management (for example, at Citibank, UBS, Merrill, Lehman, and Bear, but not at Bank of America, JPMorgan Chase, Goldman, Morgan Stanley, and Deutsche Bank) to pursue subprime investments aggressively, even though they were unprofitable for stockholders in the long run. When stockholder discipline is absent, managers can set up the management of risk to benefit themselves at the expense of stockholders. An asset bubble (like the subprime bubble of 2003– 2007) offers an ideal opportunity; if senior managers establish compensation systems that reward subordinates based on total assets managed or total revenues collected, without regard to risk or future potential loss, then subordinates have the incentive to expand portfolios rapidly during the bubble without regard to risk. Senior managers then reward themselves for having overseen “successful” expansion with large short-term bonuses and cash out their stock options quickly so that a large portion of their money is invested elsewhere when the bubble bursts.

4. The prudential regulation of commercial banks and investment banks has proven to be ineffective.

That failure reflects:

a) fundamental problems in measuring bank risk resulting from regulation’s ill-considered reliance on inaccurate rules of thumb, credit rating agencies’ assessments, and internal bank models to measure risk,

b) the too-big-to-fail problem (Stern & Feldman 2004), which makes it difficult to credibly enforce effective discipline on large, complex financial institutions (such as Citibank, Bear Stearns, AIG, and Lehman) even if regulators detect large losses or imprudently large risks.

The risk measurement problem has been the primary failure of banking regulation and a subject of constant academic criticism for more than two decades. Regulators use different means to assess risk, depending on the size of the bank. Under the simplest version of regulatory measurement of risk, subprime mortgages (like all mortgages) have a low asset risk weight (50 percent) relative to commercial loans, although they are riskier than those loans. More complex measurements of risk (applicable to larger U.S. banks) rely on the opinions of ratings agencies or the internal assessments of banks, neither of which is independent of bank management.

Rating agencies, after all, cater to buy-side market participants (i.e., banks, pensions, mutual funds, and insurance companies that maintained subprime-related asset exposures). When ratings are used for regulatory purposes, buy-side participants reward rating agencies for underestimating risk because that helps the buy-side clients reduce the costs associated with regulation. Many observers wrongly believe that the problem with rating agency inflation of securitized debts is that sellers (sponsors of securitizations) pay for the ratings; on the contrary, the problem is that the buyers of the debts want inflated ratings because of the regulatory benefits they receive from such ratings.

The too-big-to-fail problem involves the lack of credible regulatory discipline for large, complex banks. The prospect of their failing is considered so potentially disruptive that regulators have an incentive to avoid intervention. That ex post “forbearance” makes it hard to ensure compliance ex ante. The too-big-to-fail problem magnifies incentives to take excessive risks; banks that expect to be protected by deposit insurance, Fed lending, and Treasury-Fed bailouts and believe that they are beyond discipline will tend to take on excessive risk because taxpayers share the downside costs.

The too-big-to-fail problem was clearly visible in the behavior of large investment banks in 2008. After Bear Stearns was rescued in March, Lehman, Merrill Lynch, Morgan Stanley, and Goldman Sachs sat on their hands for six months awaiting further developments (i.e., either an improvement in the market environment or a handout from Uncle Sam). In particular, Lehman did little to raise capital or shore up its position. But when conditions deteriorated and the anticipated bailout failed to materialize for Lehman in September 2008 (showing that there were limits to Treasury-Fed generosity), the other major investment banks immediately either were acquired or transformed themselves into bank holding companies to increase their access to government support.

4 Conclusion

Banking crises properly defined consist either of panics or of waves of costly bank failures. These phenomena were rare historically compared to the present. A historical analysis of the two phenomena (panics and waves of failures) reveals that they do not always coincide, are not random events, cannot be seen as the inevitable result of human nature or the liquidity transforming structure of bank balance sheets, and do not typically accompany business cycles or monetary policy errors. Rather, risk-inviting microeconomic rules of the banking game that are established by government have always been the key additional necessary condition to producing a propensity for banking distress, whether in the form of a high propensity for banking panics or a high propensity for waves of bank failures.

Some risk-inviting rules took the form of visible subsidies for risk taking, as in the historical state level deposit insurance systems in the U.S., Argentina's government guarantees for mortgages in the 1880s, Australia's government subsidization of real estate development prior to 1893, the Bank of England's discounting of paper at low interest rates prior to 1858, and the expansion of government-sponsored deposit insurance and other bank safety net programs throughout the world in the past three decades, including the generous government subsidization of subprime mortgage risk taking in the U.S. leading up to the recent crisis.

Other risk-inviting rules historically have involved government-imposed structural constraints on banks, which include entry restrictions like unit banking laws that constrain competition, prevent diversification of risk, and limit the ability to deal with shocks. The most important example of these structural constraints was the U.S. historical system of unit banking, which limited competition and diversification of loan risk by preventing branching, and by effectively preventing collective action by banks in the management of crises once adverse shocks had hit.

More recent banking system experience worldwide indicates a dramatic upward shift in the costs of banking system distress – an unprecedented high frequency of banking crises, many bank failures during crises, and large losses by failing banks, sometimes with disastrous consequences for taxpayers, who end up footing the bill of bank loss. This pandemic of bank failures has been traced empirically to the expanded role of the government safety net, as well as government involvement in directed credit. Government protection of banks and government direction of credit flows has encouraged excessive risk taking by banks and created greater tolerance for incompetent risk management (as distinct from purposeful increases in risk). The government safety net, which was designed to forestall the (overestimated) risks of contagion, ironically has become the primary source of systemic instability in banking.

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