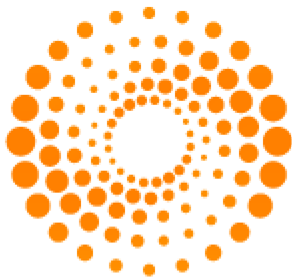

Roots of the next financial crisis: the last one's veterans give views

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There is a general consensus that the next financial crisis will follow the familiar arc of bubble, falling asset values, a run, credit/liquidity crunch, finger-pointing, new regulation, financial innovation, and unintended consequences for both regulation and innovation. There is less consensus about the where, when, how, and why.

Perceived risks range from disruptive financial technologies and shadow banking to political turmoil in Brazil and economic weakness in China.

I asked experts including policy veterans of the last crisis for their thoughts on the near-term probability of another one, including their views on sources of risk listed below. Their responses, which reflect their own views and not necessarily the views of the organizations that they work for, are set out below this list.

Sources of risk

- Liquidity – Whether enhanced capital and liquidity requirements, and the ban on proprietary trading by banks, have suppressed market maker inventories in relation to the outstanding amount of corporate bonds.
- Non-banks – Whether the next contagion will originate in asset managers and fintech companies who are subject to less prudential regulation but compete with banks in credit intermediation.
- TBTF – Whether post-crisis regulations have encouraged oligopolistic behavior by reinforcing market concentration and creating barriers to entry in banking, clearing, and ratings.
- Securitization – Whether risk retention/other regulations designed primarily to respond to the subprime mortgage crisis are optimized to reduce systemic risk without suppressing systemic benefits in other asset classes.

- Hyper-risk – The impact of quantitative easing and ultra-low interest rates on risk-pricing mechanisms, and whether these policies have encouraged excessive risk-taking by investors seeking to harvest capital gains in a low yield environment, and by banks seeking to bolster profits by lending to riskier borrowers.
- Mercantilism – Whether aggressive monetary stimulus, which tends to devalue a country's currency and make its exports more competitive, will trigger competitive currency devaluation and other trade barriers by other countries seeking to manage their trade deficits.
- Central bank divergence – Whether divergent policies (loosening in Europe/Asia versus tightening in the U.S.) will encourage speculation in the bond and currency markets.
- Dollar-denominated credit – Whether emerging market companies who have borrowed heavily in U.S. dollars can manage any credit squeeze wrought by local currency depreciation.
- "Drug-resistant" recessions – Whether central bankers have innovations, besides slashing interest rates below the "zero lower bound" and printing money, that will stimulate the economy without destroying government balance sheets.
- Zero lower bound – The consequences of negative nominal interest rates (where depositors pay rather than receive interest to maintain accounts, but borrowers pay less the longer they take to repay their loans) on perceptions of lending risk, incentives to make loans to riskier borrowers (rather than pay to hold excess cash at the central bank), and and on the stability of insurance companies, pension funds and other organizations with long- term liabilities and demographic risk.
- China – Whether the government can command a soft landing of its economy, including managing its debt crisis and dwindling reserves.
- Sovereign wealth – Whether funds run by natural resource revenue-dependent countries can manage the rapid liquidation of assets to cut budget deficits resulting from falling commodity (especially oil) prices.
- Populism – Whether populist sentiment (left or right) will trigger decisions (such as Britain's potential Brexit from the EU) that might hinder free trade.
- Non-correlated risk? – Whether insurance-linked securities, which purport to offer diversification based on low correlation to other markets, pose a contagion risk in the event of a large-scale natural catastrophe and sentiment-based volatility.
- Bailouts – Whether contingent convertible debt securities that automatically convert to equity (or are written down) when a bank crashes will obviate the need for taxpayer bailouts without inducing a panic that contaminates the entire financial system.

Expert views

H. Rodgin Cohen, Senior Chairman, Sullivan & Cromwell

The risk of another financial crisis for U.S. financial institutions has been sharply reduced — but can never be eliminated — by a variety of public and private sector initiatives. Of most importance, banking organizations' capital, liquidity, and risk management have been significantly increased — in Federal Reserve Chair (Janet) Yellen's words, by a "quantum" leap — and a comprehensive resolution framework has been implemented.

Nonetheless, there remains work to be done in identifying the actual causes of the 2008 financial crisis, as opposed to counter-factual narratives, so that the appropriate response is implemented.

The partial repeal of Glass-Steagall in 1999 was not a significant contributor to the financial crisis. The significant contributor was imprudent real estate loans and investments. Contagion, rather than inter-connectedness, was the principal reason why the failure of some institutions led to financial pressure on other institutions. The principal antidote to contagion is enhanced transparency, which is little more than referred to in Dodd-Frank.

The bad mortgage virus was incubated in a number of insufficiently regulated mortgage banks and thrifts. Although there were also insufficiently regulated large institutions that failed (e.g., AIG), FSOC should focus on classes of financial institutions as well as large individual institutions.

Dan Gallagher, President of Patomak Global Partners, LLC, SEC commissioner (2011 – 2015)

When President Obama signed the Dodd-Frank Act into law in 2010, he told the American people that they "will never again be asked to foot the bill for Wall Street's mistakes."

However, Dodd-Frank's false narrative that the financial crisis resulted from a lack of regulation and Wall Street greed continues to distract us from the fact that the primary driver of the financial crisis – faulty federal housing policy – still threatens our economy today. When the government focuses on issues like conflict mineral disclosure, CEO pay ratios, and proprietary trading – none of which caused the crisis – it ignores the fact that mortgage underwriting standards are again on the decline and taxpayers still face potentially massive exposure to housing zombies Fannie Mae and Freddie Mac, which (along with other federal agencies) currently guarantee 90 percent percent of U.S. mortgage loans.

Apparently forgotten are the years of extraordinary quantitative easing and near zero interest rates following the crisis which have fueled new and potentially dangerous asset bubbles while doing little to improve real economic growth. And emboldened by new authority in the ill-fated Dodd-Frank Act, the Fed is using its supervisory power to control and neuter swaths of the economy to the detriment of every American. The unfortunate truth is that Americans have paid, and future generations likely will continue to pay, for flawed governmental policy.

Dr. Robert Hockett, Edward Cornell Professor of Law at Cornell Law School

The most likely source of another major financial crisis (and worse) is China. The dominos that I see falling would fall as follows: First, as China's real estate and securities market bubbles continue to deflate, waves of bankruptcy ensue thanks to the unprecedented levels of private debt taken on by those investors who fueled the bubbles in the first place. A classic domestic debt deflation follows. Little of the resultant slack, in turn, will be taken up by renewed export

activity, for other nations are enduring slumps of their own – many of them ultimately rooted at least partly in protracted trade imbalances in the first place – and will accordingly not be receptive to growing Chinese imports. As China's debt-deflation in consequence worsens, its government, whose legitimacy rests critically upon its capacity to continue delivering prosperity, will see two compelling reasons to become even more bellicose in the South China Sea and elsewhere than it has been to date: (a) to deflect public anger from the domestic government to foreign adversaries; and (b) to stimulate the domestic economy through heightened military expenditure. I worry that this, in turn, could ultimately lead us to wish that the crisis were only financial in character.

Dr. Douglas Holtz-Eakin, President, American Action Forum; Member of the Financial Crisis Inquiry Commission (2009-2011)

I see little near-term chance of a serious financial crisis. There will doubtless be some volatility associated with Fed normalization – especially because of the ultra-loose stance of other monetary authorities – and liquidity stresses emanating from the Dodd-Frank law. But I do not expect significant fallout to the real economy.

Over the next decade, the primary risks emanate from sovereigns. The nearer-term risk is a sharp falloff in real economic activity in China that endangers its financial stability. Over the medium-term, there are continued issues in European sovereign debt and interconnections with European banks. Finally, the U.S. needs to be on that list toward the end of the decade. Left unaltered, the federal budget will enter an unsustainable debt spiral, making it the single largest source of systemic financial sector risk.

In the private sector, in this era of innovation, traditional financial services are being disrupted by new technologies that may very well trigger a wave of panic over the future of the institutions of yesteryear. The fallout will be dictated by the degree of interconnectedness and the nimbleness of the regulatory response.

Dr. Gary Hufbauer, Senior Fellow, Peterson Institute for International Economics; formerly Wallenberg Professor of International Financial Diplomacy at Georgetown University

The next crisis will more likely be triggered by one or more political eruptions than by quakes in debt or swap markets. Three political eruptions lie on the horizon, though today all rate as low-probability events. The first is a complete political and economic meltdown in Brazil. The cartoonish attempt by President (Dilma) Rousseff and former President (Luiz Inacio Lula) da Silva to avoid jail could provoke violence in the streets of Sao Paulo, Rio and Brasilia, a sharp fall in Brazilian equities and sympathetic declines in other emerging markets.

The second is a failure by British Prime Minister (David) Cameron to deliver a majority vote against Brexit. That would hit the FTSE index hard, with consequences in Frankfurt and Paris. Finally, in the United States, the election of Donald Trump to the White House would create enormous uncertainty, given his belligerent and volatile nature, and his unrelenting opposition to international trade pacts. If anything could kill the bull market and ensure the next recession, that would be President Trump.

Dr. Jeffrey Miron, Director of Economic Studies, Cato Institute

Economies around the world have suffered financial crises for centuries. Afterwards, politicians and pundits often claim that newly adopted regulation has minimized the risk of future crises, but such claims are typically dashed by subsequent experience.

The latest crisis is likely a case in point. President Barack Obama, for example, has suggested that "Wall Street reform now allows us to crack down on some of the worst types of recklessness that brought our economy to its knees, from big banks making huge, risky bets using borrowed money, to paying executives in a way that rewarded irresponsible behavior."

Similarly, Paul Krugman claims that "financial reform is working a lot better than anyone listening to the news media would imagine… Did reform go far enough? No. [But] for all its limitations, financial reform is a success story."

Krugman is right that, other things equal, forcing banks to issue more capital should reduce the risk of crises.

But other things are not equal. According to Liz Marshall, Sabrina Pellerin, and John Walter of the Richmond Federal Reserve Bank, the federal government now protects a much higher share of private financial sector liabilities than pre- crisis: 60.7 versus 44.8 percent.

If more private liabilities are explicitly or implicitly guaranteed, private parties will (at some point) take even greater risks than before. And the 2008 crisis suggests that government will always bailout major financial intermediaries when risky bets turn south.

So, new regulation may have reduced the risk of financial crises; but other government actions have done the opposite. Time will tell which effect dominates.

Anu Munshi, Managing Partner, B&B Financial Markets, JPMorgan (Structured Finance) (1997- 2005)

The next financial crisis could result from a combination of lower liquidity in corporate bonds and the rise in shadow banking.

Regulatory capital requirements have driven banks to significantly reduce their corporate bond inventories. According to the New York Federal Reserve Bank, dealer inventories of corporate bonds are at their lowest levels in the last 12 years. This has had the effect of reducing liquidity in the U.S. corporate bond market. At the same time, U.S. corporate bond issuance is at its highest levels, driven by low interest rates from quantitative easing.

Regulatory capital requirements have also driven banks to reduce their risks in lending and credit intermediation. Other institutions, such as hedge funds and family offices, have filled the gap, which is referred to as the shadow banking industry. However, in most cases these institutions are subject to less prudential regulation than banks, so it is hard to know how well their risk is managed or how well capitalised they are.

An extraneous shock to financial markets, say from geopolitical risk, could lead to a sudden and sharp drop in bond prices, which could lead to contagion in other markets. Only chance and time will tell how well the shadow banking industry is poised to cope with that shock.

Akshat Tewary, Attorney, a co-founder of Occupy the SEC

The next financial crisis will be precipitated by Too Big to Fail (TBTF) banks. Despite the 2008 crisis, the top banks are today larger, with greater risk concentration, than ever before. Dodd-Frank (DFA) will not preclude the next TBTF-induced crisis.

TBTF institutions still have incentives to undertake outsized risk because of implicit bailout guarantees. Title II of DFA prohibits taxpayer bailouts, but it can be undone by an act of Congress. TARP, we must remember, was just such an act of Congress. In the throes of economic turmoil Title II will not prevent emergency government action. Similarly, Title XI of DFA placed limits on intervention by the Federal Reserve, but Title XI would not have prevented the nearly $16 trillion in near-zero percent handouts made by the Fed to the banking sector during the last financial crisis.

DFA attempts to address TBTF via Title II 0rderly liquidation, but that process is woefully inadequate. For one thing, government regulators will face stiff political opposition to designating a troubled company as worthy of government liquidation. And even if political will exists, orderly resolution will probably occur too late to be of use. Lehman's demise caught everyone by surprise – even if Title II existed at the time, Lehman's assets would have been unwound under fire sale conditions, after the damage to the markets had already been done.

In fact, because of complex counterparty risks and interconnectedness, the next Lehman Brothers probably won't even know that it is in trouble in time to prevent market-wide contagion. Jamie Dimon famously touted JPMorgan's "fortress" balance sheet and downplayed London Whale as a "tempest in a teapot" before eventually admitting that the loss amounted to $6 billion – an amount sufficient to capsize most banks. Dodd-Frank has been of some utility in some other areas of finance but TBTF remains a vexing problem.

Dr. Harald Uhlig, Professor of Economics, The University of Chicago

A financial crisis is never off the table: the question is, is it more likely now than at other times (except, perhaps, for 2007)? I think it is, for a variety of reasons. First, central banks world-wide now seem to be stuck at or near the zero lower bound, with little maneuvering room. The time-honored recipe of quickly cutting rates, when a recession looms, is off the table. Even more dangerously perhaps, the central banks may have lost control over inflation. Inflation is stable, good, but nobody quite knows why, and that is scary.

Second, Asia was the anchor during the 2008 crisis, now it may become the problem. We see it clearly in China now, with a variety of indicators. But more broadly, we have witnessed spectacular real estate booms in a number of Asian countries: partly for the sound reasons of their spectacular economic development, sure, but one cannot shake the feeling that there might be another real estate crash cum financial crash in the making. It should be a concern, if now parents in some of these Asian countries put their life-savings together, so that their offspring can afford the down-payment on condos that would be considered expensive even in large U.S. cities.

Third, the sovereign debt situation in Europe is far from resolved. Debt-to-GDP ratios are higher now than they were, when the European crisis started in 2010, yields on Greek debts have started to climb again. And, finally and with the low rates on sovereign debt, pension systems and financial investors are desperately searching for higher yields. What makes us so confident that

the alchemists of financial engineering will not once again concoct another toxic brew, and sell it as snake oil? Vigilance is called for.

Gaurav Vasisht, Director of Financial Regulation, the Volcker Alliance; Executive Deputy Superintendent of the Banking Division of the New York State Department of Financial Services (2012 – 2013).

Eight years following the onset of the crisis the risk of runs and fire sales remains all too real. A fundamental reason why is that financial institutions without access to the bank safety net and which operate outside the strictures of prudential regulation remain heavily reliant on runnable short term funding techniques to finance their long term assets.

This funding structure introduces in the markets the risk of runs that plagued depository institutions before deposit insurance. Given the increasing interconnectedness of the markets, including through central clearing counterparties and investment vehicles, the failure or stress of a large market participant can be transmitted astonishingly rapidly throughout the system, possibly leading to cascading market-wide failures.

Compounding matters, our regulatory framework itself remains a problem. It deprives regulators of a comprehensive understanding of the risks in the system and the tools necessary to mitigate those risks. As an example, the Federal Reserve, which has a mandate for financial stability lacks reach into systemically important parts of the financial markets, while the SEC and CFTC, which may have the reach appear to not have a stability mandate. This makes implementation of financial stability policy difficult to achieve.

Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute; Author – Hidden In Plain Sight: What Caused the World's Worst Financial Crisis and Why It Can Happen Again; Member of the Financial Crisis Inquiry Commission (2009-2011).

There is of course no way to know whether another financial crisis looms in the future, but there is good reason to believe that free markets are stable when adequate information is available.

The one thing that markets cannot do is account for the disruptive effects of various government policies. Unfortunately, over the last 50 years, as additional information has become available to markets, the government's role in economic and financial policy has become pervasive, canceling out much of the benefit. The 2008 financial crisis was caused by the US government's housing policies. Everyone agrees that the crisis was caused by the prevalence of subprime and other risky mortgages in the U.S. financial system. By 2008, there were 31 million such mortgages outstanding, and 76 percent of them were on the books of government agencies, primarily Fannie Mae and Freddie Mac. So there is no question that the government created the demand for these mortgages. The steps governments around the world have been taking in reaction to the crisis have made it far more likely that another one—probably of a completely different kind—will occur.

The Dodd-Frank Act in the United States, one of those reactions, has slowed the U.S. recovery and introduced restrictions on financial activity, such as the Volcker Rule, that are now threatening the liquidity of markets. The Fed and other central banks have adopted unprecedented monetary policies, driving interest rates to zero, but without reviving robust

economic growth. We don’t have any idea how these unprecedented actions will play out. Keynesian economic policies have created unprecedented levels of sovereign debt. With extraordinary luck, we might come out of this unscathed, but it’s unlikely.