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Book Review

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Book review

Beker, Victor A. (2021): *Preventing the Next Financial Crisis*, Routledge, Abingdon, UK and New York, NY, USA (172 pages, hardcover, ISBN 978-0-367-48398-2)

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The pervading climate of financial innovation coupled with stagnant regulation of the 1990s and early 2000s led to one of the greatest financial crises on record: the 2007–2009 US financial meltdown, which quickly propagated to other financial centers and initiated what has been called the Great Recession. Between 2007 and 2009 a great many national economies experienced recession. Many issues were involved in the run-up to this highly complex phenomenon. Victor Beker's book has the virtue of analysing each of these issues in the light of the sizable amount of research undertaken before, during, and especially after the crisis. It also addresses the changes brought about since then in legislation and regulation both in the US and internationally. Furthermore, it poses the difficult question of whether such changes can give us confidence that another such great crisis and recession is not forthcoming. And the answer is negative, since '[l]egislation has not eliminated incentives to take risks that would be excessive from a social perspective' (p. 143).

The book describes the development of the financial meltdown and analyses each of the many topics that were involved in this complex crisis, including (i) the role of expectations ('irrational expectations' in the housing price bubble and panics), and the lack of appropriate regulations addressing (ii) the securitization innovation process, (iii) the actions of non-bank financial intermediaries (or the 'shadow banking system'), and (iv) the actions of credit-rating agencies. Each of these topics is addressed from different angles, among many others.

A critical issue was the growth of the sub-prime mortgage market from the early 1990s through Fannie Mae and Freddie Mac and the fact that the government sponsorship of these institutions created the belief that there was an implicit government guarantee of the loans generated. The development of securitization was the means through which the banks originating the loans could earn profits but shift the risks to the final purchasers of the securities. In this process investment banks played a critical role, purchasing the mortgages and packaging them into highly opaque securities to be sold mainly to institutional investors. Further combustion was added by the fact that rating agencies were eager to grant high ratings in order to earn more fees from the issuers of the securities, facing no meaningful downside risk if their evaluations eventually turned sour.

As Beker observes:

The interaction of these four factors – irrational expectations, securitization, shadow banking, and credit rating agencies – led to the subprime mortgage crisis. When house prices started falling most borrowers who could not afford their monthly payments had no alternative but to default their subprime mortgages; many of them found themselves holding mortgages in excess

of the market values of their homes. Subprime-related securities experienced large losses; investors learned the hard way how risky those assets were in spite their almost risk-free ratings. (p. 17)

Beker surveys the succession of moves made by the authorities as the financial crisis was evolving, the arguments invoked in each stance, and the main reforms that were implemented after the crisis. While they initially rescued Bear Stearns, which was ‘sinking under the weight of its subprime mortgage holdings’ (p. 20), driven by the fear of a succession of failures and invoking the ‘too big to fail’ argument, they subsequently refused to bail out Lehman Brothers arguing ‘moral hazard,’ only to immediately dump this scholastic argument and come to the rescue of the major insurance company AIG, which had become a major seller of credit default swaps (CDSs), a derivative that insured the interests of the assets that backed mortgages, of which Lehman held a huge amount in contracts with AIG. The next step was the institution of the Troubled Asset Relief Program (TARP), which was changed several times and evolved into a program for the Treasury purchase of preferred stock from corporations in risk of bankruptcy, eventually nationalizing a sizable part of the main financial institutions, albeit temporarily.

The reforms implemented aimed to build more resilient financial institutions (including the non-banking financial institutions and the credit-rating agencies), address the too-big-to-fail issue, and lead to safer derivatives markets. And the moral hazard issue (the risky behavior induced by the sense of being insured against losses) was given priority by invoking the need to avoid taxpayer losses. ‘For market discipline to work effectively – the argument goes – everyone needs to feel that they have their money credibly at risk and that they will experience losses if they take excessive risks, instead of being bailed out at the expense of the taxpayers’ (p. 25). The Dodd–Frank Act was thus passed in 2010, creating the Financial Stability Oversight Council (FSOC) to monitor and deal with systemically important risks in the financial system. Subsequently, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission established new confidential information reporting in order to identify potential systemic risks associated with the activities of hedge funds and other such institutions. Beker observes, however, that the repo market and the money market funds, which pose the same kind of liquidity risks as demand deposits for banks and have been shown to be systemically important, have mostly remained unregulated. Furthermore, although the Dodd–Frank Act limited banks’ proprietary trading activities (through the so-called Volcker rule that prohibits them from using their own accounts for short-term proprietary trading of securities, derivatives, etc.), hence protecting depositors, it did not restrain non-bank dealers from short-term proprietary trading (and the risks this involves).

The Dodd–Frank Act also addressed the problems generated by the ‘originate and distribute’ model by requiring security issuers to retain no less than 5 percent of the equity risk, thus inducing them to face some risk from the issuance of mortgage and other types of loans. However, some kinds of mortgages were exempted from risk retention. And though the Dodd–Frank Act intended to prevent the Federal Reserve (Fed) from bailing out non-bank financial institutions, it did preserve its ability to provide them with financial assistance through the Term Asset-Backed Securities Loan Facility (TALF) if their failure poses systemic risk. However, Beker is skeptical of such limitations to bail-outs, since ‘what may happen if a global systemically important bank needs to be resolved is still an untested issue; political costs could be deemed too high and some sort of bailout may be considered necessary in spite of the legal constraints’ (p. 29). Since the largest financial intermediaries know this, it is to be expected that they will again incur in financial innovations that allow the risky behavior that poses systemic risk.

The book also addresses many other changes in the US regulatory framework as well as changes in the international institutions and regulations, for example the Financial Stability Board (FSB) established after the 2009 G20 meeting, the Basel III increases in capital requirements for counterparty risks in the OTC derivatives transactions, etc.

The author deals with the role played by non-bank financial intermediaries during the financial crisis and the subsequent regulatory reforms aimed to address it. He reminds us that the 'shadow banking system grew ... because large commercial banks found it advantageous to shift increasing amounts of their activities off their balance sheets as it allowed them to conduct lending with less capital' (p. 36), for which they created special purpose entities that used various short-term funding instruments to finance the purchase of mortgage and other types of long-term loans that were then securitized. Investment banks were created by large commercial banks to deal with derivatives generally and, in particular, the highly opaque collateralized debt obligations (CDOs) that played such an important role in the meltdown. Beker holds that the Dodd–Frank Act 'fails to bring the shadow banking component of the financial system under the regulatory umbrella in a systematic way' (p. 44).

The issue of systemic risk and the financial system's vulnerability to runs are topics also discussed in the book. Three different channels of transmission of shocks to the rest of the financial system are considered: interconnectedness, contagion, and panic. Lehman Brothers was highly interconnected both to AIG and to the Reserve Primary Fund, an important money market mutual fund (MMF) that 'broke the buck' immediately after Lehman went bankrupt, thus generating fear of greater losses by investors in this fund and they quickly redeemed their funds, as depositors would from a bank. This created contagion effects and these quickly turned into a panic, as the opaqueness of the interconnections in the various institutions induced investor prudence through their hoarding of cash, making all asset prices fall.

Beker evaluates how information economics has tried to escape from the fetters of neo-classical theory, 'built under the assumption that information is complete, perfect and symmetric' (p. 53). He surveys how such issues as interconnectedness, contagion, and panics have been modeled since the 1983 Diamond–Dybvig model of multiple equilibria. But although there have been advances in the theoretical understanding of the issues involved, the changes in legislation in the US, the eurozone, and Japan since the financial meltdown have mainly focused on rather conventional tools such as minimum capital and liquidity requirements and insolvent bank resolution procedures. To address banks' concerns on their reputation when asking for liquidity funding, the Fed has also created 'new anonymous lending programs' (p. 59) like the Term Securities Lending Facility and the Primary Dealer Credit Facility and the Term Auction Facility, designed to use auctions in making loans without making public who the borrowers are.

The author is skeptical about the extent to which the increased capital requirements that have been implemented 'may function to prevent or moderate the effects of financial dislocations' (p. 58). In the US 'the role of the Fed as lender of last resort has been restricted by the regulatory reform in the hope that private liquidity might be a close substitute for the public one' (p. 59). As evidence of this, he mentions that collateral requirements for emergency lending have been strengthened. The focus has been once more on the moral hazard argument. But how credible is this argument when we have seen in the 2007–2009 meltdown how quickly it can be discarded when push comes to shove?

Beker points out the need for avoiding excessive concentration of loans in any one sector, region or kind of asset of the economy. He argues that ceilings for exposures to funding sources are equally necessary.

To tackle the too-big-to-fail issue, the new legislation created an Orderly Liquidation Authority (OLA), which gives the Federal Deposit Insurance Corporation (FDIC) and the

Fed tools to help in the resolution of failing companies outside normal bankruptcy proceedings. If a financial company is designated as posing systemic risk in the event of default, it can be placed into receivership under the OLA and provided with a resolution mechanism that ensures the 'continuation of essential business lines, with minimum disruption and the preservation of franchise value and low cost to the public' (p. 61). This allows the operating subsidiaries, such as the banks and brokers and dealers underneath the parent, to continue operating. However, the author is skeptical that good resolution procedures can by themselves prevent contagion if the lender-of-last-resort (LLR) faculty is restricted.

Another important issue is the role of 'dealer of last resort' that the Fed had during the crisis, where it intervened as market-maker in the money market (serving as a central counterparty between borrowers and lenders) and in the market for mortgage-backed securities (where it got to purchase 90 percent of all new issues). This was a necessary complement to its LLR function. Since there was no trust in the securities serving as collateral, the Fed supplied its own liabilities as a substitute for those suspicious assets, seeking to maintain a 'fair price' for bank assets based on long-run fundamentals by setting price floors for key assets.

In conclusion, this is a very useful book, especially for the non-specialist reader, since it defines the many financial concepts and institutions that were involved in the greatest financial meltdown in modern times in a way that is easily understandable. Furthermore, it analyses the issues related to the evolution and handling of the crisis by the authorities in light of recent developments in economic theory by referring to a vast amount of economic and financial literature.