Forum: The Financial Crisis and Its Legacies

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The global financial crisis and banking regulation: Another turn of the wheel?

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The global financial crisis of 2008 raised the spectre of the avaricious banker undermining the stability of the real economy through imprudent lending, fancy tricks, and collusion with regulators. This is a common trope through history from the German 'swindlers' of 1873 and the New York 'bankers trust' of 1907, to the 'gnomes of Zurich' of the 1960s and the 'greed is good' Wall Street traders of the 1980s. Populist calls to reign in banking and financial markets often follow financial crises, although the effectiveness of these measures is sometimes limited and/or brief.

The 2008 global financial crisis similarly generated widespread calls for radical reform, and it is clear that there have been significant advances on both a national and an international level including new models for supervision and new benchmark standards for prudent banking. Nevertheless, there is also a sense of business as usual: few bankers were tried or convicted in the collapse, nor did they pay for the evaporation of trillions of dollars in assets. The transfer of these costs to the taxpayer in the United Kingdom and Europe enhanced the onus on regulators to mitigate the effects of future crises, but the importance of the banking and financial system to the recovery after the crash meant that the system could not be completely rehauled. This is a fundamental paradox: the banking and financial sector may have been responsible for the crisis, but it was also viewed as the key to recovery.

The lessons from the Great Depression

This paradox was a lesson already learned from the 1930s when the neglect of monetary and banking stability was deemed responsible for the world's deepest depression before 2020.[1] In the United

1. M. Friedman / A. Schwartz, *Monetary History of the United States 1867-1960*, Princeton, NJ 1963.

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States, this diagnosis prompted a dramatic reshaping of the banking and financial system through a combination of deposit insurance to protect the public and sustain confidence, and requiring banks to decide whether they were going to provide *either* retail services *or* engage in investment banking, thereby insulating the riskier financial activities from the core of commercial banking (Glass–Steagall Act 1933). There was a somewhat different complexion to reforms in Europe, where banking systems were often more robust because of less competition, larger size, and broader branch networks.[2] After the 1930s, European universal banking continued alongside state-supported savings banks aimed at the retail market. The risk of a contagious effect of the Credit-Anstalt's failure in 1931, however, prompted a novel attempt to coordinate an international response, partly through the newly founded Bank for International Settlements.[3] The effort to broker transnational support in this case ultimately failed, but it highlighted the importance of international central bank cooperation in bank resolutions that had cross-border implications—an issue that is still unresolved.

The second main lesson from the 1930s was the importance of loose monetary policy at a time of major banking crisis and the need for fiscal expansion to promote recovery. The ability to use the past as a model for policy-making was enhanced by the role of historians in powerful positions in the United States; Christina Romer as head of Obama's Council of Economic Advisers and Ben Bernanke as Chair of the Federal Reserve. The memoirs of Bernanke, US Treasury Secretary Geithner, and UK Chancellor of the Exchequer Darling all make explicit how they were influenced in 2008 by histories of the Great Depression.[4] In the end, expansionary monetary policy driven by independent central banks had the greatest impact over the longer term, while the enthusiasm for fiscal expansion evaporated relatively quickly as governments feared a growing debt burden.[5] The result was a rather prolonged period of recovery in many countries, characterised by austerity and greater inequality, while the period of extraordinarily low interest rates was extended for more than a decade after the crisis with no end in sight.

A third, but sometimes neglected, lesson from the 1930s was the recognition of the link between the international monetary system and financial stability. The spectre of 'currency wars' in the 1930s, as countries devalued their currencies to gain competitive advantage, was believed to have fractured the global trade and payments system, spreading financial instability through hot money flows across borders. The response then was the Bretton Woods system, devised in the 1940s to stabilise exchange rates in a comprehensive international system with capital controls governed by the International Monetary Fund (IMF). Similar claims of currency wars arose in 2010 as many emerging market economies blamed US monetary policy for destabilising their exchange rates and prompting volatile global capital flows. While adherence to floating exchange rates has not been challenged, there have been policy innovations (discussed below) to provide a safety net for the international monetary system. The IMF's 2012 'Institutional View on Capital Flows' acknowledged that managing capital flows might be advisable to 'support macroeconomic adjustment and safeguard financial stability'.[6] This marked an important turn-around from the IMF's free and open markets agenda that had prevailed since the 1980s.

2. C. W. Calomiris / S. H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit*, Princeton, NJ 2014.
3. N. Marcus, *Austrian Reconstruction and the Collapse of Global Finance 1921-1931*, Cambridge, MA 2018, 301–310, 318–320.
4. B. Bernanke, *The Courage to Act: A Memoir of a Crisis and its Aftermath*, New York 2015; A. Darling, *Back from the Brink: 1000 Days at Number 11*, New York 2011; T. Geithner / B. Bernanke / H. Paulson, *Firefighting: The Financial Crisis and its Lessons*, New York 2019.
5. B. Eichengreen, *Hall of Mirrors: The Great Depression, the Great Recession and the Uses—and Misuses—of History*, Oxford 2015.
6. IMF, *The IMF's Institutional View on Capital Flows in Practice*, prepared by IMF Staff for the G20, Washington, DC, 2018, 5.

The structure of global banking and finance

To leap from the 1930s to 2008, however, neglects the many regulatory reforms and changes in the structure of global banking and finance that occurred in the twentieth century. Although they have not attracted as much academic or public attention in the twenty-first century as the 1930s, it is important to note the contribution of these developments to the evolution of regulation and international cooperation. Three innovations stand out on an international level: central bank swaps in the 1960s, international cooperation on cross-border banking in the 1970s, and the erosion of barriers between retail and investment banking in the 1980s.

In 1962, concerns about the stability of the international monetary system prompted Charlie Coombs at the Federal Reserve Bank of New York's foreign exchange department to propose to a range of European central banks a system of facilities for currency swaps that could be easily and quickly accessed by either party. At first, the European central banks were reluctant to engage with what they viewed as a gimmick, but they eventually acquiesced, mainly to placate the Fed. Very quickly, however, the system became central to the stabilisation of the Bretton Woods system. Less well known is that the central bank swaps were also used by the Fed to stabilise the offshore Eurodollar market in the 1960s.[7] By providing dollar liquidity to European banks outside the United States, they hoped to ease pressure on the markets in New York. In 2007, central bank swaps were reactivated, both to provide dollar liquidity to European banks and to demonstrate the common commitment to central bank cooperation in the wake of the crisis. The facilities expanded rapidly, were extended beyond the G10 central banks to monetary authorities in regional financial centres, and finally were made unlimited for the core G10 central banks. Although the swaps were not used much after 2012, they remained on the books and were reactivated and extended in response to the COVID-19 crisis in March 2020.

The long and unfinished journey to devise cross-border supervision and resolution of banking crises took its first major institutional turn in 1975 after a series of tremors in foreign exchange markets prompted the collapse of several banks in Europe and the United States and many hidden losses and scandals.[8] The Basel Committee hosted at the Bank for International Settlements started off quite slowly, building on foundations of sharing best practice among European central bankers.[9] It took several years to reach the point of agreeing a framework of minimum capital adequacy benchmarks, which were due to be implemented just as the developing country sovereign debt crisis struck in 1982. The more capital a bank has to hold against its loans and other assets, the less profitable is its use of funds. Banks thus have incentives to minimise the capital they hold in reserve in case of default and this draws regulators in to try to set minimum capital adequacy. The pattern of taking many years to devise standards, consulting closely and at length with banks themselves and responding to a crisis rather than anticipating the causes of crises was set in these early years. Thus, in the first Basel Accord of 1988, non-OECD (Organisation for Economic Co-operation and Development) sovereign debt on a bank's balance sheet required banks to hold more capital buffers, while inter-bank loans were more lightly backed. Just after the adapted Basel Accord was being implemented, the Asian financial crisis of 1997 showed the vulnerability of the international economy to cross-border bank loans and exchange risk, and the capital adequacy

7. R. N. McCauley / C. R. Schenk, 'Central Banks Swaps Then and Now: Swaps and Dollar Liquidity in the 1960s', *BIS Working Papers* 851, 2020.
8. C. R. Schenk, 'Summer in the City: Banking Scandals of 1974 and the Development of International Banking Supervision', in: *English Historical Review* 129 (2014) 540, 1129–1156.
9. C. P. Goodhart, *The Basel Committee on Banking Supervision: A History of the Early Years 1974-1997*, Cambridge 2011.

targets were adapted to include market risks, such as foreign exchange markets. Basel II, launched in 2004, was a more elaborate framework that relied heavily on rating agencies and internal risk assessment by banks themselves to determine capital buffers, but had a concessionary rate for assets backed by residential property.[10] As Basel II was being implemented, the financial crisis of 2007/2008 demonstrated the inaccuracies in rating agency assessment and the devastating risk that retail mortgages in the United States posed for the global financial system. Basel III developed from 2009 to 2017 recognised that Basel II 'acutely miscalibrated' some of the credit and market risks and aimed to make a yet more robust framework by adding macro-prudential elements to guide supervisors.[11] The interaction between the detailed regulations on capital adequacy and the strategy of international banks to innovate to minimise the costs of these regulations in ways that increase risk is an unresolved aspect of global prudential supervision.

Finally, the air lock between retail and investment banking introduced in the United States in 1933 was fundamental for the evolution of the architecture of international banking. The persistence of national banking frameworks and structures despite globalisation of financial services speaks to the importance of national regulatory frameworks.[12] But for global finance, what happens in the United States as the largest economy in the world and the issuer of the world's dominant currency still matters. In the 1960s, domestic US regulations pushed dollar markets overseas to London and other offshore centres. US banks found they could use the ability to combine investment and retail banking in financial centres in Europe to enhance their operations and there was a rapid internationalisation of American banks. Conversely, European banks were restricted in their operations in the United States by the Glass–Steagall Act. During the 1970s and 1980s, financial innovation and advances in information technology shifted the banking business model from generating income from loans to fees-based services like under-writing, asset management, securities trading, and mergers and acquisitions. This was hastened by deregulation of stock markets in New York in 1974 and in London in 1986.[13] The opportunity cost of segregated commercial and investment banking increased.

By the 1980s, the Fed was driving the campaign to overturn Glass–Steagall. A month after the October 1987 global stock market crash had required the Fed to support a range of securities companies, the Chair of the Federal Reserve Board, Alan Greenspan called for the repeal of Glass–Steagall to allow bank holding companies to be able to engage in a wider range of securities trading through subsidiaries to enhance their competitiveness.[14] In December 1987, he described 'the artificial separation of commercial and investment banking' as 'perhaps the single most important anomaly that now plagues our financial system'.[15] The chair of the Senate Banking Committee, William Proxmire, supported him, but they faced opposition from the House of Representatives and the securities industry.[16] Over the next decade, the Fed allowed a series of loopholes to open up until the Glass–Steagall Act was ended by the Gramm–Leach–Bliley Act of 1999. Meanwhile

10. The weighting was 35% for all assets backed by residential property compared to 100% for corporate real estate or 50% for A+ rated corporate loans.
11. Basel Committee on Banking Supervision, *High Level Summary of Basel III Reforms*, December 2017.
12. P. Molyneux / D. M. Lloyd-Williams / J. Thornton, 'Competitive Conditions in European Banking', in: *Journal of Banking and Finance* 18 (1994) 3, 445–459.
13. C. R. Schenk, 'Regulatory Foundations of Financialisation: May Day, Big Bang and International Banking 1975-1990', in: *Financial History Review*, 27 (2000) 3, 1–34.
14. Greenspan testimony before the Committee on Financial Institutions Supervision, Regulation & Insurance, US House of Representatives, 18 November 1987.
15. Greenspan testimony before Committee on Banking, Housing and Urban Affairs, US Senate, 1 December 1987.
16. Nathanial C. Nash, 'Let Banks Enter Securities Field, Greenspan Says', *New York Times*, 19 November 1987.

in Europe, the Second Banking Directive implemented in 1993 spread the universal banking model across the European Union (EU) and encouraged national regulators to allow the combination of investment and commercial banking. The deregulation of the US market also allowed the largest European banks like Deutsche Bank and UBS to enter and compete in the New York financial markets through mergers and acquisitions.[17] The battle for the bulge bracket of huge universal investment banking was launched.

In 1997, Greenspan warned against excessive optimism about global financial stability:

> Markets may have become more efficient, competition is more global, and information technology has doubtless enhanced the stability of business operations. But, regrettably, history is strewn with visions of such 'new eras' that, in the end, have proven to be a mirage. In short, history counsels caution.[18]

Ten years later, the hugely lucrative securitisation boom eventually culminated in the collapse of the mortgage-backed securities market in 2007/2008.

Regulations after the crisis

One of the first regulatory reactions was to start to reinstate a version of Glass–Steagall to isolate risky investment banking. After exceptionally complicated drafting and amendments, the Dodd–Frank Wall Street Reform and Consumer Protection Act passed into law in 2010 with the 'Volcker Rule' isolating risky proprietary trading from standard retail and commercial banking. Under the Trump administration, since 2016 many aspects of Dodd–Frank have been watered down in a renewed round of deregulation. Conversely, in the United Kingdom, the Financial Services (Banking Reform) Act of 2013 required large banks to ring-fence their retail and commercial banking from investment banking by 2019. In Europe, as elsewhere, Systemically Important Financial Institutions (SIFIs) attract a higher level of supervisory oversight, but European Commission proposals to separate retail from investment banking ultimately failed to gain support from members like France and Germany with a long history of universal banking. Nevertheless, we can see the cyclical turn of reform agendas from regulation to deregulation and then to reregulation in the prudential control of the structure of banking in the United States.

Conclusion

Having looked back at the evolution of reforms, can we now say that the regulatory response to the crisis is over? Certainly, the capital reserves of banks have increased, so they are more secure. In the United Kingdom, for example, risk-weighted capital ratios doubled over the 10 years after the crisis. Legislation requiring banks to apply more of their own resources and those of their owners to resolution in case of insolvency may reduce the call on the taxpayer in future crises. In Europe, greater coordination of supervision through the Single Supervisory Mechanism and plans for deposit insurance and common resolution mechanisms have made the system there more robust. In the United Kingdom, a new Financial Policy Committee was tasked with identifying, monitoring, and mitigating risks to financial stability. These innovations reflect a shift to macro-prudential supervision, that is, identifying systemic risks rather than just examining the balance sheets of individual banks. On the contrary, one of the outcomes of the crisis is still with us. Low interest

17. W. Plumpe / A. Nutzenadel / C. R. Schenk, *Deutsche Bank: The Global Hausbank 1870–2000*, London 2020.
18. A. Greenspan, Testimony before the Senate Committee on Banking, Housing, and Urban Affairs, 26 February 1997.

rates (sometimes even negative) and relatively low inflation created a highly unusual financial and economic environment that has privileged borrowers over savers. In response, corporate debt issues increased as did household debt, while equity markets soared. Unconventional monetary policy has also renewed academic attention on the impact of US monetary policy on global financial flows.[19]

There is a circularity to regulation as approaches are taken up and abandoned and resurrected in response to business cycles and recurring (but distinctive) crises. When the COVID-19 crisis struck in March 2020, many of the tools of the 2008 crisis were readily available: central bank swaps, quantitative easing, fiscal spending. The scale of the crisis and its existential threat, however, meant that these tools were amplified in unprecedented ways. Central bank swaps were already unlimited for the G10 countries, but new US Treasury repo facilities were offered by the Fed to a much broader range of central banks than in 2008 or 2010. This time, the Japanese have been the largest drawers, whereas in 2008–2012 it was the European Central Bank. Quantitative easing has taken on a new shape beyond the purchase of government securities from banks to the Fed's purchase of corporate securities and even junk bonds to help support the corporate bond market. Finally, unlike in 2010 when the G20 commitment to fiscal expansion was quietly abandoned, governments have mortgaged the future on a scale unprecedented since World War II. The uncertainty over the biological trajectory of the COVID-19 virus and its phenomenal human cost casts a large shadow over the 2008 crisis, which now seems an acute but less existential threat. The regulatory response to 2008 may be open to criticism, but it did in the end forestall a permanent or long-term meltdown of the global financial system, albeit at a considerable and unequally distributed cost. This should place banks in a position to mitigate the economic consequences of the pandemic. The pandemic crisis presents even greater challenges than the financial crisis, but it also offers opportunities for innovation in how nation states, global organisations, and international financial markets respond to a collective threat. There may be more such threats on the horizon due, for example, to global warming.

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19. H. Rey, 'Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence', NBER Working Paper Series, Cambridge MA, 2018 [2015].