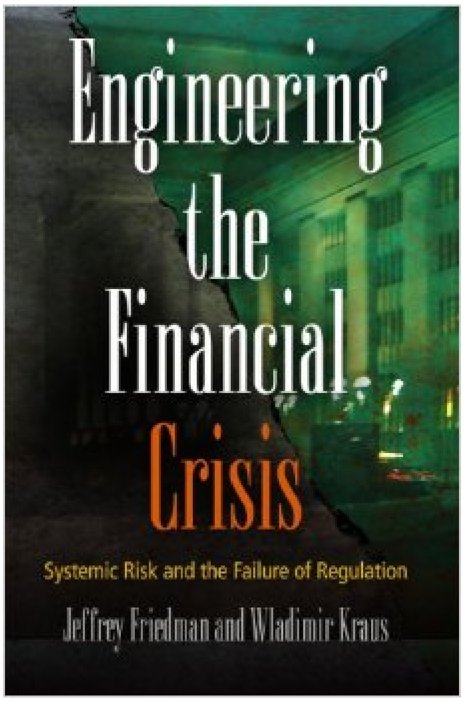
Engineering The Financial Crisis: Systemic Risk And The Failure Of Regulation



Synopsis

The financial crisis has been blamed on reckless bankers, irrational exuberance, government support of mortgages for the poor, financial deregulation, and expansionary monetary policy. Specialists in banking, however, tell a story with less emotional resonance but a better correspondence to the evidence: the crisis was sparked by the international regulatory accords on bank capital levels, the Basel Accords.In one of the first studies critically to examine the Basel Accords, Engineering the Financial Crisis reveals the crucial role that bank capital requirements and other government regulations played in the recent financial crisis. Jeffrey Friedman and Wladimir Kraus argue that by encouraging banks to invest in highly rated mortgage-backed bonds, the Basel Accords created an overconcentration of risk in the banking industry. In addition, accounting regulations required banks to reduce lending if the temporary market value of these bonds declined, as they did in 2007 and 2008 during the panic over subprime mortgage defaults.The book begins by assessing leading theories about the crisisâ ”deregulation, bank compensation practices, excessive leverage, "too big to fail," and Fannie Mae and Freddie Macâ ”and, through careful evidentiary scrutiny, debunks much of the conventional wisdom about what went wrong. It then discusses the Basel Accords and how they contributed to systemic risk. Finally, it presents an analysis of social-science expertise and the fallibility of economists and regulators. Engagingly written, theoretically inventive, yet empirically grounded, Engineering the Financial Crisis is a timely examination of the unintendedâ ”and sometimes disastrousâ ”effects of regulation on complex economies.

Book Information

Hardcover: 224 pages

Publisher: University of Pennsylvania Press (September 26, 2011)

Language: English

ISBN-10: 0812243579

ISBN-13: 978-0812243574

Product Dimensions: 6.4 x 1 x 9.1 inches

Shipping Weight: 1.1 pounds (View shipping rates and policies)

Average Customer Review: 4.1 out of 5 starsÂ Â See all reviewsÂ (8 customer reviews)

Best Sellers Rank: #635,373 in Books (See Top 100 in Books)   #32 inÂ Books > Law > Business > Banking   #508 inÂ Books > Business & Money > Processes & Infrastructure > Government & Business   #651 inÂ Books > Business & Money > Economics > Banks & Banking

Customer Reviews

This is a spectacularly intelligent work about a systemic risk they aptly call "cognitive hazard", which manifested itself in several regulatory edicts that, the authors cogently demonstrate, "engineered the financial crisis. Specifically, those edicts included not only regulations designed to expand mortgage availability to persons at high risk of default, but more systemically, bank capital regulations that assigned lower risk capital weights to mortgages, mortgage - backed securities, and sovereign debt --- the very classes of debt that have been driving the financial crisis the past four years -- which incentivized such banks to hold and demand more of them (3X what the market in general was holding, according to the appendix). As well, they specify regulatory endorsement of rating agency output among the affirmative directives that steered commercial banks into the portfolio of loans that they held at the inception of the financial crisis, and how mark-to-market regulations, adopted toward the end of the pre-crisis period, acted as an accelerant to fuel the collapse of asset prices, thereby deepening the invasion of bank capital, and the need for central bank intervention.This is an incisive counter to the MSM and political class's narrative of under-regulation, of regulators being captured and failing to do their job, which is defined to be being tough on greedy bankers. But it differs significantly from the simplistic myth that completely free markets, left alone, always produce optimal results.

Since the bursting of the real estate bubble in 2008, a slew of books have been published claiming to provide the definitive narrative of what caused the financial crisis and resulting economic malaise. Some blame irrational exuberance while others have attributed the blame to deregulation or poorly aligned economic incentives between bank executives and their principals. Given the irreducible complexity of our global economy, it is quite possible that we will never know the correct narrative - assuming that one exists - and that the whole debate is more ideological posturing than anything else.Of the books that I have read, "Engineering the Financial Crisis" is the best so far, not because I think that Friedman and Kraus have necessarily identified the correct culprits, but rather they are able to see beyond the economic blinders that cause so many other authors to focus on incentives over information failures. In short, the authors are able to get to the heart of the crisis better than anyone else.Friedman and Kraus argue that the following elements significantly contributed to the financial crisis by disabling important market information and providing the wrong incentives:1. The SEC conferred monopoly status on three credit rating agencies, which severely disrupted competition and the dissemination of dissenting information related to the quality of mortgage-backed securities.2. Bank capital requirements (e.g. the Recourse Rule), as promulgated by various regulatory agencies in the U.S., which provided a large capital subsidy for purchasing mortgage-backed securities over other securities.3.

In my opinion Engineering the Banking Crisis would have been a more descriptive title. It has little to say about the housing bubble and burst that led to the crisis at commercial banks. Absent knowing the authors' narrower meaning of "financial crisis", one would find the alternative explanations that they "find no evidence for" on page 1 very questionable. I haven't read What Caused the Financial Crisis, which was co-edited by Friedman, but it appears to be about the financial crisis with the wider, usual meaning.I still thought the book covered the territory it did pretty well. The authors say the primary cause of the financial crisis -- reduced lending by commercial banks to non-financial companies or consumers in the "real economy" -- was Basel I and the Recourse Rule (an adoption in the U.S. of part of what later became Basel II), which specify capital requirements for commercial banks. These set low capital requirements for mortgage-backed securities compared to much higher capital requirements for loans to non-financial companies and consumers. A secondary cause is mark-to-market accounting, which affected capital adequacy. Another cause was the bond rating agencies. They make a strong case for these. I've read quite a bit about the financial crisis, and this was the first source that addressed the capital requirements and their effect.A major thesis of the book is ignorance--of both regulators and bankers. Regulators acted lacking understanding of the full range of regulations that apply to the regulated and unintended consequences. It appeals to the difference between "uncertainty" and "risk" ala Frank Knight and Keynes. They don't do so mainly to cast blame, since they regard economic uncertainty as inevitable.

Middle East Modeling Risk, + DVD: Applying Monte Carlo Risk Simulation, Strategic Real Options, Stochastic Forecasting, and Portfolio Optimization Shadow Banking in China: Risk, Regulation and Policy Zondervan 2016 Minister's Tax and Financial Guide: For 2015 Tax Returns (Zondervan Minister's Tax and Financial Guide) Cyclic Nucleotide Phosphodiesterases: Structure, Regulation and Drug Action (Wiley Series in Molecular Pharmacology of Cell Regulation) Lectures on BSDEs, Stochastic Control, and Stochastic Differential Games with Financial Applications (SIAM Series on Financial Mathematics) Financial Regulation: Law and Policy (University Casebook Series) Banking Law Manual: Federal Regulation of Financial Holding Companies, Banks and Thrifts Regulation of Bank Financial Service Activities: Cases and Materials (American Casebook Series) Regulation of Bank Financial Service Activities 4th: Selected Statutes and Regulations (2012) (American Casebook Series) AIFMD Quick Guide: Introduction to rules and concepts (International Financial Market Regulation) (Volume 2) Consumer Financial Services (Financial Services Series) Principles of Financial Regulation