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Book Review

Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation

Jeffrey Friedman and Wladimir Kraus
Philadelphia, Pennsylvania: University of Pennsylvania Press, 2011, 212 pp.

David Howden

Enough reasons for the crisis are trumped around that even the well-read professional is at a loss for a consistent explanation of the facts at hand. Jeffrey Friedman and Wladamir Kraus attempt to separate the wheat from the chaff by sizing up these theories next to some hard facts. The result is enlightening. In what is one of the most anticipated books on the crisis, the authors are able to give a logically coherent story and put some tired theories to rest.

Consider six conventionally accepted causes of the crisis: 1) low interest rates spurred a nationwide housing bubble, 2) government sponsored enterprises (think, Fannie Mae and Freddie Mac)

David Howden (dhowden@slu.edu) is chairman of the department of business and social sciences, and professor of economics at St. Louis University—Madrid Campus.

loosened lending standards, 3) financial deregulation allowed a "shadow" banking sector to originate and securitize subprime loans, 4) bank bonuses incentivized short-term profit taking, 5) the risk premia on banks were artificially low because they were too big to fail, and 6) irrational exuberance fed the hysteria. Each of these theories has appeal, but the authors cast them aside by reviewing the facts. (All except for the role of low interest rates, which they allow for with some caveats, as we will see below.)

Did banker compensation packages incentivize risk taking during the crisis? Conventional wisdom says yes, and it in part explains the ire directed at the banking establishment today. Friedman and Kraus say no. Cash incentives may have incentivized some short-term decisions, but the bulk of compensation beyond salaries was through equity-based bonuses. These bonuses generally had a vesting period of three to five years, meaning that the time horizon of the recipient was constantly moving out as they accumulated equity. By the end of the boom, few individuals had a larger stake in financial companies than their own employees did. In the aftermath, bankers lost more than anyone did, in some cases more than they made during the boom. Couple this with the fact that banks were not leveraged as highly as the law permitted and the evidence that bankers were incentivized and knowingly took on undue risks begins to diminish.

What of irrational exuberance—perhaps investors and borrowers just got optimistically ahead of themselves. This cause has much appeal among both laypeople (it is plausible, and casts away most of the complexities of the crisis) and academics (who also like to cast away complexities, though they do so under the auspices of assumptions, but more because a presumption of irrational exuberance fixes one perceived problem with modern economics—an overly rational *homo economicus*). Yet categorizing behavior under the rubric of "irrational exuberance" and relegating causal explanations to the dustbin seems a little unscientific, or, as Friedman and Kraus claim, "calling people crazy merely explains their behavior away." In a bid to rid humans of the unrealistic assumption of perfect foresight and infallible judgment, economists citing irrationality as a causal factor impose a new unrealism on them—humans are deigned to act without reason. While behaviorists provide specific situations when the assumption of strict rationality is unwarranted, an appeal to a general breakout of animal spirits muddies more than it reveals.

In identifying the causal factor at play, Friedman and Kraus point to the perverse incentives of the regulatory requirements imposed on the financial industry. In chapters 2 and 3 the authors spell out how banks could partake in "regulatory arbitrage" by holding increasing amount of their assets in the form of what the regulators deemed "safe" assets, which would in turn free up capital to fund further operations. By way of example, an American bank originating a $100,000 mortgage would be required to hold $4,000 in capital. If it sold its mortgage to Fannie Mae or Freddie Mac for securitization, and then bought it back as an agency bond, that capital requirement would be reduced by 60 percent, down to $1,600. In this way banks were incentivized to securitize loans and make use of government agencies to increase their lending capacity.

The authors do well to note the distinction between regulatory capital requirements and a usable capital cushion. Most banks in the U.S. were more highly capitalized and liquid than the regulators deemed necessary. This does not mean that they were highly capitalized or liquid, as events over the past four years have demonstrated. Indeed, capital ratios become strictly limited when one starts to question what qualifies as an asset or a liability on a bank's balance sheet.

In assessing bank liquidity, the authors focus much attention to the unstable (or "fragile") nature of banking in light of bank assets—mostly risky mortgages and loans. Yet if banking is fragile, it is surely not the work of assets, which are fundamentally no different than in other industries: illiquid and at times of indeterminate value. A look at a bank's liabilities reveals that it is fragile mostly due to the fact that most of its liabilities are callable, that is to say, depositors can demand at any moment's notice the return of their funds. This leaves banks in a fundamentally difficult position—how best to balance and manage an asset base against these demandable liabilities. Although Friedman and Kraus do not mention it, the fragility of banking has less to do with its regulatory constraints and more to do with its asset-management technique, otherwise known as fractional-reserve banking. Holding only a fraction of deposits in reserve allows a bank to seek otherwise unobtainable profits, but also exposes it to liquidity and solvency problems under certain conditions.

While providing a more or less monocausal "regulatory" theory of the crisis, the authors do note some secondary explanations. Low interest rates might have been to blame, and a dependence on the work of John B. Taylor and his "Taylor Rule" to show that the Fed set interest rates too low (compared with what?) is apparent. This reviewer thought it strange that the authors seemed to not want to engage the "Austrian" rationale of interest rates being too low relative to some natural rate, with the ensuing disruptions in the production activities in the economy. As Friedman and Kraus give so much attention to incentives, and work so hard to cast aside non-causal theories, the lack of attention to how money and interest can alter people's incentives seems especially misplaced. This omission is especially glaring given that both authors have the advantage over others of being adequately familiar with the Austrian theory of the business cycle. At places the authors seem to imply that *no* economist saw the crisis coming, indeed, could not given the tools at his disposal. Yet examples abound in this journal's pages of just the opposite—it was just a question of what toolbox the economist had on hand. Austrian economists in pointing to these monetary factors dominate the list of economists who wrote about the bubble, its origin, and its looming bust.

This lack of monetary focus leaves some threads hanging. While much attention is afforded to the credit supply—how securitization expanded banks' ability to lend, how mark-to-market accounting created a more elastic credit supply, or how changing collateral rules for banks affected (and will affect) their ability to lend—the demand for money receives little attention. While Friedman and Kraus do the reader a great service by explaining why business investment was pulled in by bank lending starting in 2007:Q1, alternative rationales exist. What if business investment declined not because of constrained bank lending, but because businesses saw their expected profits decline in the face of increasing inflation? What if business investment declined because consumer spending was being reined in with the onslaught of deteriorating private balance sheets? The supply of credit is important, and the reader is given a flood of facts to this point, but there are two sides to every market—demand matters, too.

Friedman and Kraus provide a general theory of the crisis based on faulty regulation by ably disproving many of the specific causes commonly paraded around. Their explanation is also largely an "incentives story," which lacks the drawback of being too narrowly focused, as is the case in other similar exposés.

Who, in the end, is to blame? Friedman and Kraus tread lightly here. To err is to be human; a reality the authors continually remind the reader. This point is where the crisis gets most controversial, and also where the authors make some of their most important contributions.

Homeowners wanted low-cost mortgages, which banks provided as best they could. This simple fact has led to much finger wagging directed at bankers who, knowingly or not (though the authors think not), imperiled their depositors' funds on overly risky bets. But there is another story buried in here. In making these loans, banks were required by law to maintain certain capital and liquidity requirements. One way to satisfy the regulators was to securitize mortgages to mitigate risk. In this way lending institutions killed three birds with one stone—borrowers were given access to affordable funding, perhaps more affordable than they deserved, banks took on only a seemingly small portion of the undeserving borrowers' risk through securitized loans, and the regulators were happy because capital requirements were maintained.

No one book seems adequate at putting all the complex debates surrounding the crisis and its causes to rest. Friedman and Kraus' effort, though valiant, is no different. Although this reviewer cannot help but feel that some issues are overshadowed by others, the authors do realize their shortcomings (indeed, they dedicate a section of their conclusion to address some of them) and should be lauded for their effort. New nuggets of wisdom abound, and from a regulatory point of view, the authors tell a consistent and coherent story. In this sense, the book is exemplary, and one of the best on the crisis yet.