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Leverage, System Risk and Financial System Health: How Do We Develop a Healthy Financial System?

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2.1 Introduction

The subprime crisis of 2007–2009 was the most devastating financial crisis since the Great Depression, cost the US economy trillions of dollars (see Atkinson, Luttrell and Rosenblum, 2013) and caused significant economic stress worldwide. In response, new financial-market regulations were adopted in many countries, including the Dodd-Frank Act in the US, which is a massively complex piece of legislation that touches most financial intermediaries in significant ways and imposes a host of new proscriptions and requirements on all sorts of intermediaries. Moreover, the crisis also required unprecedented government intervention in the financial market and the real economy, with the issuance of ex post guarantees against failure to a multitude of a priori uninsured investors and institutions, in order to stave off a complete collapse of the financial system. While there is much debate over whether the regulatory interventions were the appropriate ones (see Lo (2012), and Thakor (2013b) for detailed discussions), these interventions raise concerns about potential moral hazard insofar as expectations of future bailouts may influence present behaviour, and greater political involvement in the functioning of credit markets (see Song and Thakor, 2012).

Now that the dust has settled, it is time to reflect on two important questions: (1) what caused this crisis? And (2) what does a healthy financial system – one not prone to periodic bouts of systemic crises – look like?
In this chapter, I briefly discuss my views on these two issues. Since a large number of papers and books have been written on this crisis, my response to the first question will be somewhat brief, and I will refer the reader to some review papers on the subject. On the second question, my thoughts are somewhat preliminary and are intended to provide stimulus for future research.

The rest is organized as follows. Section 2.2 addresses the question of what caused this crisis. Section 2.3 proposes some simple steps that could be taken to build a healthy financial system. Section 2.4 concludes.

2.2 What caused this crisis?

The standard view is that this crisis, like many before it, was caused by misaligned incentives at many levels. Financial intermediaries took excessive risks due to *de jure* and *de facto* safety nets (e.g., Bebchuk and Fried, 2010; Farhi and Tirole, 2012), regulators were lax and permitted this due to incentive misalignment with taxpayers (e.g., Barth, Caprio and Levine, 2012; Kane, 1990), and politicians blocked ‘sensible’ regulation (e.g., Stiglitz, 2010). The US government *Financial Crisis Inquiry Commission* (FCIC) report also noted that, similarly, regulators saw warning signs but chose to ignore them, and that the Federal Reserve was ‘too supportive’ of banking industry growth.

However, many doubt the validity of this viewpoint. In his excellent review of 21 books written on the crisis, Lo (2012:173) writes:

> There are several observations to be made from the number and variety of narratives that the authors in this review have proffered. The most obvious is that there is still significant disagreement as to what the underlying causes of the crisis were, and even less agreement as to what to do about it. But what may be more disconcerting for most economists is the fact that we can’t even agree on all the facts. Did CEOs take too much risk, or were they acting as they were incentivized to act? Was there too much leverage in the system? Did regulators do their jobs or was forbearance a significant factor? Was the Fed’s low interest-rate policy responsible for the housing bubble, or did other factors cause housing prices to skyrocket? Was liquidity the issue with respect to the run on the repo market, or was it more of a solvency issue among a handful of ‘problem’ banks?

In a recent paper (Thakor, 2013a), I argue that, while there is quite a bit of empirical evidence that misaligned incentives had a role to