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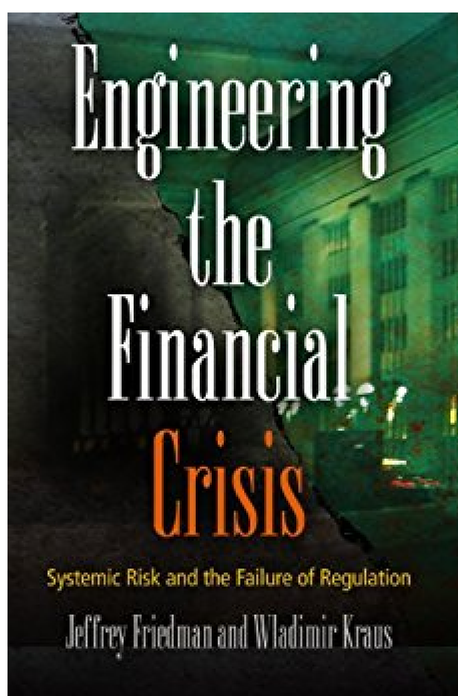
Engineering The Financial Crisis: Systemic Risk And The Failure Of Regulation



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.

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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. The authors posit instead that relative to the huge complexity of "the economy", any human or organization is likely to make mistakes, not just because of irrationality but because the complexity is such that error is going to occur even in decisions that emerge from processes thought to be entirely rational. It is a brilliant critique of what they call "economism", Hayek called "scientism" and others called "the planning fallacy" - the idea that with enough research and position papers, wise decisionmakers can create structures that eliminate problems systemically. There are several devastating sendups of exponents of the opposing camp, particularly Joseph Stiglitz, Robert Schiller and Lucian Bebchuk.The book is amazingly short - only 156 pages, and those contain an introduction and conclusion which set forth, respectively, what they are going to show and what they have shown. Appendices and endnotes add another 60 pages or so. I found it hard to go more than a few pages without dogearing one or

having to pause to absorb and reflect on the insights that emerged.If there is any flaw I see in the book, it is that it does not much address the non-commercial banks - Countrywide, Lehman, Bear Stearns and AIG - that failed or came close to failing in 2008. I would hope that the authors would do so at some point. One of the authors (Kraus) is researching the European regulatory framework and that seems quite timely and likely to lead to significant additional and similar insights (because Basel II and its implementing regulations in EU states, to my knowledge, perpetuated the bias in favor or sovereign debt and mortgage-backed debt, which have played a significant role in the crisis we see in Europe today).Also, although this is not a criticism or shortcoming of the authors, the subject of bank regulation is not one with which every reader is going to have sufficient facility to appreciate fully the arguments made in this book. If the authors could figure out way to collaborate with the likes of Michael Lewis or Andrew Sorkin, they might garner the readership their impressive analysis deserves.But if you have either some familiarity with the subject or are sufficiently intellectually gifted to jump in at a sophisticated level, you should definitely read this book.

Probably the single greatest book written on the 2008 crisis. This should be required reading for anyone looking to better understand what led to and caused the near total collapse of our financial system. Too many of the mainstream accepted theories of what caused the financial crisis are superficial and biased generally to their political agenda.These two authors have really done their homework, and they show the data to back up their logical explanation of the causes of the crises. While the explanation I believe is still incomplete- and even they recognize as such, large complex structures like our economy need to be confronted with acknowledgement of our own fallibility and imperfect knowledge- they come the closest to shedding light on the true triggers to the crisis. One can only hope that the people who make decisions are exposed to the information within this book.

Outstanding and original explanation of the 2008 financial meltdown. This is an area that I am unfamiliar with and the author presented his case with facts in an accessible manner for non-expert.

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. Mark-to-market accounting, which caused massive asset write-downs during the height of the financial crisis and may not be the best valuation methodology for assessing asset impairments in illiquid markets.4. HUD directives, starting in the mid 1990s, which paved the way to the relaxation of underwriting standards.Although their arguments are well documented, we may never know if Friedman and Kraus have found the substance of the problem over the other competing narratives. I tend to disagree with some of them, in particular, the assertion that mark-to-market accounting, which was promulgated in the early 90s, played a large role in the crisis.What sets this book apart from the others is the acknowledgement that information failures (i.e. ignorance and uncertainty) lay at the heart of the crisis. Neither the bankers nor the regulators adequately understood the nature or severity of the risks of low quality mortgage-backed securities flowing through the financial system. In hindsight, hardly anyone understood the risks or was willing to short the assertion that real estate values always rise.But, the authors make an important Hayekian distinction: information failures work very differently among regulators and market participants. While there may be heterogeneous opinions among regulators as to the correct regulations, only one theory gets codified into law. In contrast, discordant theories between market participants lead to competition and a darwinian weeding out of erroneous strategies via profits and losses. Regulations, as codified by the SEC, the Federal Reserve and various other regulatory agencies worked in perverse ways to disable important information from reaching the market and led to unintended catastrophic consequences. In the meantime, bankers did what they always do - they maximized their incomes.

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