Some Lessons of the Global Financial Crisis

The roots of the global financial crisis can be traced back to the US subprime debacle, which occurred in 2007-08. First, bad loans were incurred by banks, resulting in excessive credit expansion. In general, these loans were financed by huge leverage based on short-term borrowings. Second, poor corporate governance and lack of transparency among major financial conglomerates had intensified the financial meltdown. Risks management of major US banks broke down, while compensation structures of financial executives were merely based on short-term performances. Third, little global coordination between national regulators has also prolonged the financial turmoil. This was probably due to rising protectionism policies of each country to uphold her citizens' welfare first.

To confront this ongoing issue, monetary authorities and governments implemented complex policy actions to prevent the crisis from spreading further. Restoration of market confidence in the global financial system and recapitalization of banks were common actions across countries. At this stage, it is important to ask what the lessons from the current financial crisis are. Specifically, it is useful for policymakers in preventing future occurrences or minimizing the adverse impacts.

It is ideal for every country to have a stable financial sector. However, financial stability does not necessarily entail a riskless environment. A competitive financial system will consist of some idiosyncratic risk, which cannot be diversified away and this risk may collapse periodically. Consequently, the financial authority should not focus exclusively on measures to prevent the collapse of this risk, but rather on having sufficient measures to confront the problem.

Policymakers should recognize that each domestic financial sector is integrated with the rest of the world. As such, policy actions in a financial system may positively or adversely affect the entire global financial system. For example, rising bond yields in the US due to deteriorating budget deficit and sovereign debt rating may perturb not only the financial sector in the US, but also throw the world financial sector into chaos. Accordingly, national regulators should adopt prudent financial policies consistent with financial stability, long-term economic growth, and welfare improvement.

Often regulators were at the wrong places, at the wrong time during the current global financial crisis. For instance, large impediments were imposed by numerous financial authorities on the operation of hedge funds. Hedge funds were identified as the cause of huge price swings in listed securities around the world. In contrast, prominent hedge funds were relatively well-managed with good incentive systems. Large hedge funds also adopt reasonably good risk management tools.

Instead, regulators should promulgate proper procedures for the listing, trading, and rating of various securities. Market participants should be given thorough understanding of hybrid securities and their associated risks. In general, the degree of risk varies between different types of securities. Rating agencies should be regulated and not just function as profit-making entities. A certain element of social responsibility must be introduced into the functioning of rating firms.

Both traditional and investment banks must be subjected to regulations. It is routine that conventional money banks are regulated with access to deposit insurance and other emergency borrowing facilities in each country. However, this may not be true for investment banks. The scope of existing laws and regulations should be enlarged to encompass the operations of all types of financial intermediaries. By doing so, regulators can monitor the activities of the entire financial system more effectively and thereby minimize the effects of any financial contagion.

There is an increasing trend towards the imposition of much higher capital requirements for banks as part of greater regulation of the financial sector. More capital is set aside to cover risky investments and loans by banks. However, this becomes part of the issue. By imposing large capital requirements, banking activity increasing flow from the regulated segment to the unrelated part. In order to bypass this large capital requirement, financial intermediaries use innovative products, such as structured investment vehicles to perform their daily operations. These eventually turn out to be banking risks because they came back on their balance sheets. Over a long time period, large capital requirements may lead to financial disintermediation. This additional capital would otherwise be channeled into other much needed sectors, especially for capital starved economies.

It is usually assumed that management of listed companies act on behalf of investors to uphold their benefits in the long-run. However, management need not have absolute control or even care about the long term. This is a governance issue, which entails correction through removal of certain board members or a complete change of management. Having numerous institutions also mitigate this problem via more rigorous exertion of corporate control. Different institutions may require the management to comply with different aspects of accounting procedures, domestically and internationally, from time to time.

Financial authorities commonly believe that capital injected into large banks will somehow find its way into the rest of the under-capitalized banking system. However, this may not necessarily be the case since large financial conglomerates may exert their market power over smaller, less influential banks. This may be happening in the US now. Despite efforts by the US Federal Reserve and US Treasury to pump in money into the clogged credit market, smaller banks continued to suffer from effects of the financial crisis. The remaining banks that the US regulator is not willing to capitalize will remain in difficulty. Accordingly, huge intervention may be required to either close down these banks or to keep them alive through capital infusion.

Finally, it is crucial that whenever a financial crisis emerges, the private sector does not recourse to the public sector to resolve the problem. Preferably, the private sector should create a mechanism to confront the issue as well as to bear the full cost of the financial turmoil. In addition, taxpayers also should not be required to bear any cost of a financial meltdown. Some researchers have suggested that both enterprises and financial intermediaries subscribe to some form of capital insurance. By paying regular premiums, firms and banks can fall back on this insurance whenever a financial crisis evolves. Funds from the capital insurance can be used to ameliorate the repercussions of the financial turbulence.

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