Anniversary of Lehman's collapse reminds us – booms are often followed by busts

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Christie's auctions off a Lehman Brothers sign in 2010. Reuters/Andrew Winning

Only a decade has passed since the collapse of Lehman Brothers, and it seems the mortgage crisis and subsequent Great Recession are already ancient history in the minds of many investors, bankers and regulators.

All it took was a few short years of low default rates and good loan growth to re-create the kind of heady atmosphere of irrational exuberance that transforms staid bankers into high-wire risk takers.

For those who have forgotten, such risk takers are the the ones who caused the 2008 crisis, which resulted in the collapse of investment bank Lehman Brothers on Sept. 15 and the worst recession since the 1930s.

With their hubris restored, bankers once again have convinced themselves and others that they are the "masters of the universe," with superhero risk management skills.

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Disclosure statement

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At the same time, regulators are beginning to loosen their reins, in part on the belief that the booming economy, flush with the gains from tax breaks and deregulation, no longer needs such restraints.

But, as my research into past financial crises has shown, the seeds of the next bust tend to be sown during the boom times.

Boom foreshadows doom

A psychological bias known as the availability heuristic helps explain why this happens.

This is sort of a mental shortcut in which people rely on only the most readily available information, such as from the very recent past, to arrive at inferences about the current and future state of affairs. In other words, if things are going well, it's easy to convince yourself that they'll continue that way indefinitely.

And this bias becomes very prevalent on Wall Street when times are good, leading to the kind of reckless behavior that sparks crises.

Research into the conditions that existed prior to the major financial crises of the past eight centuries shows that virtually every one was preceded by an asset price bubble in the economy – which makes it appear like it's booming – and an excessive amount of debt held by banks, conditions that suggest an environment tolerant of high risk.

My own research into the conditions and causes of the last two major financial crises – in the 1980s and 2008 – reveals that the longer a lending boom lasts, the more trouble it foreshadows. More generally, during booms, any aspects of risk management in financial institutions get corrupted by a kind of overconfidence in the skills of bankers.

And that's exactly the environment we have now. A decade of ultra-low interest rates across the world have led to ever-rising debt loads for every type of borrower in most countries and have created incentives for increased risk-taking among investors and traders in the pursuit of high yields.

I believe this is putting the global financial system at risk of another collapse if regulators don't act soon.

The author explains how booms can turn into crises.

Stemming the cycle

So is there something we can do to break this cycle and avert another crisis?

In my view, it primarily comes down to capital requirements, which are rules meant to ensure banks have enough equity – and not too much debt as percentage of total assets – to absorb the risk they're taking with their investments.

In short, the current requirements are just not high enough to protect banks and the financial system. Furthermore, regulators tend to loosen them and other lending requirements when the economic picture is improving – the precise time when they should be raising them.

Asking banks to hold more capital in good times, like now, will put in place the right incentives to prevent the kind of behavior that puts entire economies at risk. That's because the more capital banks have, the more circumspect they'll be in terms of how much risk they take, thus making a bust caused by the kinds of investments they made in the run-up to the last financial crisis much less likely.

Beefing up Basel III

One way regulators could do this is by beefing up Basel III, a voluntary, global regulatory framework on bank capital adequacy, stress-testing and market liquidity risk.

Basel III set banks' so-called leverage ratio – a measure of how much capital a lender has relative to debt – at 3 percent. U.S. regulators have gone a bit further, requiring 5 percent. But that's far too low for a healthy banking system.

Regulators should be aiming for 15 percent because research has shown that such a ratio will reduce the systemic risk of the banking sector significantly. With that much equity capital on their balance sheets, banks will resist the temptation to take undue risks that jeopardize the safety net taxpayers provide them through deposit insurance and occasional bailouts.

The greater cushion will also give them more time to adjust when the next crisis comes, as it inevitably will. And the more capital a bank has, the more time it has to take protective actions before going belly-up as losses start wiping out its equity.

Just imagine, would a bank ever give you a reasonably priced home mortgage if you only put 5 percent down and wanted to borrow the other 95 percent?

Some bankers complain this will hurt shareholders because being required to hold more equity as a share of total assets will lead to lower returns.

A paper I co-authored in 2009, however, found that higher bank capital levels are actually associated with greater bank values, not to mention a safer and sounder banking system.

Preventing the next big one

I'm not suggesting that regulators and banks do this overnight, but I think when the economy is doing well, lenders are doing well and profits are high, it's relatively easy to build up capital over a period of three to five years.

And it's the most effective means of preventing a financial crisis.

What regulators often do instead is focus on restricting banking activities and driving up the costs of complying with regulations. Rather than creating systemic protection, this simply leads banks to move their riskier activities to areas of the industry where regulators aren't looking.

Regulators can only do so much to keep these firms from taking excessive risks. What they can do is ensure banks have enough capital to absorb future shocks so that the global financial system isn't once again brought to the brink of collapse.

This is an updated version of an article published on May 27, 2015.

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