The Financial Crisis: Banking, Bankruptcy and the Origins of the Crash

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Introduction

Over half a decade since the onset of the global financial crisis (GFC), it is abundantly clear that the embedded banking crisis was the result of constellation of many parts. This essay takes seriously the role played by the Great Crash of 2008 in serving as a reminder of the extent to which bank behaviour is crucial for systemic stability, growth and development. Thus, the analysis here seeks to examine the processes which prompted many banks, especially in the United Sates (US), the United Kingdom (UK) and Europe, to adopt what we now know to be risky, high-leveraged securities trading activities in the run up to the GFC. Critically, it examines the strong market pressures that created the incentive to grow balance sheets, and dramatically elevate profits through leveraged trading at the agent-level. While many analyses have focused on structural or institutional factors in order to explain the conditions that enabled agents to adopt particular logics of appropriateness (Ciro 2012, Crotty 2009, Peláez and Peláez 2009) it will be argued here that only through tracing the contours of the complex interdependencies between agency, institution and structure, and examining the mechanisms through which they relate to one another, can the shift to aggressive and opportunistic banking in the lead up to the 'sub-prime' crisis be properly understood (Bakir 2013, Bell and Hindmoor 2015a).

In order to explain this self-reinforcing cycle, it is first necessary to assess why bank behaviour matters vis-à-vis the greater banking crisis in the US and UK, and the insights offered by an agency-centred institutional analysis. Importantly, in accounting for the shift towards high-risk leveraged trading, attention will be paid to the relevant wider macro-structural factors that both enabled and constrained agency, thereby affecting financial system resilience. Analysis will then be extended to national institutional complementaries in the form of inadequate prudential regulation that (re)enforced unprecedented levels of competition and financial market complexity via securitisation. Finally, consideration will be given to the ideational drivers that underpinned the approaches adopted by bankers, financiers and supportive state elites in the US and the UK, and the subsequent responses to the demands and opportunities embedded in institutional pressures and wider structural forces.

Why Bank Behaviour Matters

There is a far-reaching consensus that disproportionate risk-taking on the behalf of banks contributed to the 2007-08 financial crisis (Beck et al 2010, Ellis 2009, Wallenstein 2009). In assessing why bank behaviour matters in the context of the crisis, it is important to remember that agency problems are particularly relevant for banks, which carry both complexity and risk-taking at the core of their business model, thereby requiring a delegation of decision making about risk to less-senior workers by senior bank management. Further, the structure of a bank's balance sheet is within itself subject to vulnerability, requiring regulation engineered to safeguard financial stability (Diamond and Rajan 2001). Since the onset of the GFC, an increasing body of work has emerged which serves to underline the relationship between bank behaviour and financial (in)stability, building on earlier analyses by Mishkin (1999a; 1999b) who argued that the crux of financial crises lies in the vulnerabilities of the banking sector. Consequently, understanding the processes through which traditional risk-management controls are constrained and high-risk/high-return banking models based on financial innovation, misaligned incentives and leverage are enabled are crucial in

determining the genesis of the banking crisis in the US and UK.

In acknowledging the importance of agency-level dynamics embedded within bank systems, it is necessary to situate these drivers against the structures and institutions that both shape and are shaped by agents' behaviour. Thus, the approach taken here builds upon the 'agents in context' approach (Bell and Feng 2013), in tracing the mutually constitutive interactions between agents, institutions and structures. Through this, the scope for analytical dualities is recognised; structures and institutions are both independent of agency, whilst also integral to agency (Giddens 1979). In this sense, they can be viewed as both "the medium and outcome of the reproduction of practices" (Giddens 1979: 5). Importantly, the multiplicities and interdependences that shape agency-level behaviour are complex and numerous, with a long list of causal factors. This essay will extend itself only to those conditions that are seen as the key drivers in explaining the new (highly risky) banking system.

Structural Conditions: the Shift to Financialisation

Following Sewell (1992) and Bourdieu (1977: 91), structural conditions here are conceptualised as "sets of mutually sustaining schemas and resources that empower and constrain social action and that tend to be reproduced by that social action", vis-à-vis agency via social actors. In tracing the structural complementaries that affect bank behaviour, much attention has been paid to the era of liberalisation, in which the previous three decades have been described as "a period of massive growth in the scale of the profitability of the financial sector, of frenetic financial innovation, of growing global economic imbalances, of huge household borrowing and of bubbles in asset prices" (Wolf 2009). The liberalisation of finance in the US and the UK, starting the in 1970s, and the subsequent processes of financialisation, reflects an important structural shift, which is central to explaining the systemic risk of the 2000s.

The transition that began in the late 1970s represents a major development in political economy; the US government, particularly under President Reagan, began to review much of the regulatory controls and restraints over financial markets. From the 1980s onwards, the US government, with the support of international financial institutions, large corporations, banks and other elites in both developing and EU nations, pushed for a 'global neoliberalism', which carried financialisation as one of its core proponents (Gowan 2002: 50). At the heart of modern financial market theory was the belief that 'markets know best'; that is, capital markets are an effective mechanism through which risk and return are priced correctly (Crotty 2009). The theory underpinning this assumption centres on optimal equilibrium price formation in perfectly competitive markets; that is, capital markets price securities correctly, and agents use all relevant information to make optimal decisions (Crotty 2002: 45). Yet this perspective has difficulty in incorporating high levels of uncertainty; in real world financial markets, agents are unable to know the future and thus rely on market acumen to influence decisions. This latter aspect manifests itself in unpredictable ways and generally pro-cyclical patterns that further contribute to financial market infirmity and instabilities (Swamy 2012: 75).

This mainstream methodology played a pivotal ideational role in shaping bank behaviour and market structure. The idea that "financial markets are capable of being both efficient and rational" and, therefore, "self-regulatory" (FSA 2009), represented a normative commitment to a structural logic of appropriateness that resulted in the expression of informal institutions such as the 'light touch' approach within the US and the UK. Importantly, pro-market ideology did not take place in the absence of the state; rather, as Bell and Hindmoor (2015a: 27) have argued, the processes underpinning the growing scope for banking and finance both furnished agents within the market with greater power, while simultaneously reinforcing the push for continued liberalisation by governments made compliant by the prosperity associated with financial sector growth. Thus, one of the key institutional outgrowths of a decades-long structural process that propelled the entrenchment of market fundamentalist ideology was that self-regulation supplanted state authority (Keaney 2012: 64). The extraordinary faith in market forces in guiding state, market and societal relations therefore represents the main structural condition that contributed to the excessive risk-taking by the banks in the US, the UK and some European nations, and carried substantial implications for agency-enabling conditions via institutions.

Institutional Complementaries

The structural incentives for opportunistic banking behaviour both legitimated and were further reinforced by

institutional complementaries that related to market governance (Bakir 2013: 27). Institutions of market governance are critically important in informing the self-reinforcing relationship with agency-level conditions that enable and constrain bank behaviour. Informal institutions in prudential and competition regulation policy in both the United States and the United Kingdom were reinforced by the structural conditions that shaped perceptions that markets are efficient and self-regulatory, and enabled excessive risk-taking. Tracing the contours of institutional change has important implications for further illuminating the ways in which actors, institutions and agents interact in informing bank behaviour.

'Light Touch' Regulation and Competitive Markets

The regulatory regime implemented after the Great Depression in the US was designed to prevent excessive risk-taking by core financial institutions, as part of a greater drive aimed at minimising the chances of financial crises. Under the Glass-Steagall regulatory system, investment and commercial banking activities were isolated in order to inhibit use of deposits to finance abstract capital market activity (Crotty 2009: 565). However, with the structural shift towards market-based ideology and relatively stable domestic macroeconomic conditions, moves towards deregulation progressively 'wound back' the tight controls over banking and finance, culminating in the US with the repeal of the Glass-Steagall Act in 1991 and the embrace of more "market-friendly" approaches (Porter 2005: 230). This was later reflected at an international level with the amendment of Basel I in 1996 to allow large banks to use internal standards and models to calculate capital charges for market risk. The implementation of Basel II in 2004 supplemented this approach, which prompted further support from policymakers and regulators for market-based mechanisms for valuing risk (Helleiner 2011: 72). These deregulatory trends in the US were reflected in the UK, and other nations in Europe.

An important pressure linked to the regulatory emphasis on market discipline meant that fostering competition within the banking sector became a permanent feature of the institutional environment (Bell and Hindmoor 2015b: 6). Unsuppressed competition for corporate control, 'impatient capital' and short-term market indicators combined to engineer a situation in which the investment banks of Wall Street and the City of London exhibited a relentless drive to "expand balance sheets … [and] used their leverage ratio as the target to be achieved at all times rather than as an outer limit of risk to be reduced where possible by holding surplus capital" (Gowan 2009: 52). This process was enabled by institutional innovations such as derivatives, which enabled banks to drastically increase their leverage. As banking switched from the previous model, based on old-fashioned spreads on loans, towards activity based on trading income and fees via securitisation, an important institutional shift towards the 'originate-to-distribute' model occurred. However, rather than spreading risk, securitisation came to represent a process through which to drive up revenue, the return on capital and higher share prices (Garnaut 2009: 70).

The securitisation of mortgages created a new source of supply for investors and a new source of demand for bankers, as previously illiquid forms of debt were packaged into tradable securities and 'tranched' into complex structures that could be either sold or held on bank balance sheets to generate growing returns (Bell and Hindmoor 2015b: 7). This latter purpose of securitisation represented a sub-optimally functioning market involving highly complex and opaque assets, in which systemic risk was concentrated in the financial institutions because of the market opportunities and over-leveraging that it allowed. The net result was that bankers and financiers had "created a fragile asset and debt structure whose ultimate ramifications they did not understand and could not control" (Bell and Hindmoor 2015b: 15). Yet in order to expand markets and derive methods with which to extract more profits from the assets on their balance sheets, banks utilised increasing leverage and trading volumes. As Bell and Hindmoor (2015b: 9) demonstrate, UK banks recorded an average leverage in 2006 that exceeded 40:1; or, otherwise translated, "high leverage sustained high profits." In addition to these competitive pressures and market opportunities, institutional incentives also play an important role in explaining banker behaviour.

Misaligned Incentives

Against this backdrop of the growth of securitisation, spectacular profit opportunities came embedded with perverse incentives that enabled agent-level banking personnel to take increasingly excessive risk. Examples of such misalignments in the run-up to the financial crisis included bank managers' incentives to boost short-term profits, and

top investment bank traders receiving giant bonuses linked to performances that generated high revenue and profits. In the aftermath of the crisis, reports showed that Wall Street's top traders received bonuses of up to US$50 million in 2006, while Goldman Sachs' bonus pool amounted to a total of US$16 billion (White 2009). These bonuses and pay schemes reinforced the incentive to maximise the flow of loans and packaged securities through the system, irrespective of loan quality. Indeed, subprime mortgages came to be viewed as lucrative given the subsequent demand from investment banks, hedge funds, and insurance companies (Crotty 2009: 564).

Central to misaligned incentives is the problematic nature of the structural conditions inherent to the pro-cyclical, micro dynamics of uncertainty and instability associated with financial markets. Both profits and bonuses are maximised in boom conditions by augmenting leverage, which has a parallel impact on generating risk (Crotty 2009: 565). In financial systems, the duration of the boom translates into increasing incentives for bankers to continue to take risks, given that investors chase higher-return securities as a sound strategy. This behaviour channels back into institutional competition; numerous companies were making high returns in derivatives markets, and even bank managers in the US and the UK who perceived that the bubble was soon to deflate had little choice but to remain in the game (Helleiner 2011: 70). When the bubble burst, it was presumable that all firms would suffer losses, and thus no one would lose competitive advantage. Thus, an institutional feedback loop was created in which the agents "had every incentive to increase the quantity of CDOs on the balance sheet as much as possible, since their own bonuses were tied to instant profits with no recognition of any risk" (Acharya and Richardson 2009: 207). The sum of market opportunities, increased institutional competition and misaligned incentives was the creation of an environment in which employees at highly-leveraged banks were ideationally and financially encouraged to employ increasingly risky behaviour in order to generate bigger short-term profits.

Conclusion: Crisis in the Heartland

Interactions between various structures, institutions and agents affect bank behaviour. In seeking to explain why many banks in the US and the UK adopted what we now know to be risky, high-leveraged securities trading activities in the run up to the GFC, it is necessary to examine the ways in which financial system fragility is facilitated when structural and institutional complementaries, and enabling conditions experienced at the agency-level mutually reinforce risk-taking behaviour. The latter played a pivotal role in mediating responses to the market opportunities and enhanced institutional competition vis-à-vis lax regulatory conditions, while further encouraged by misaligned incentives to adopt opportunistic behaviour.

However one important dynamic of the banking crisis is the recognition that its impacts were not homogenous. While most banks within the US and the UK adopted high-risk strategies, some did not. Likewise, many nations outside of the 'financial heartland', such as Australia or Canada, exhibited resilience and continuation in terms of conservative bank behaviour (Bakir 2013: 158). This divergence demonstrates the necessity of incorporating agency-level analysis in order to explain within system variation, as a causal variable that reinforced conservative behaviour in some banks, but not others.

Nevertheless, for most banks in the US and the UK, incentives to take excessive risks in investing in the sub-prime market in search of higher short-term profits were underpinned by strong competition in the domestic market and compounded by impatient capital. Structural and ideational factors conditioned informal institutions to favour market-based ideology over prudential regulation, which entrenched a faith perpetuated by agents in the ability of markets to correctly price risk and return, and thus self-regulate. These structural ideas both influenced and were reinforced by state-based agents over consecutive governments. As the global financial crisis demonstrated, the multiplicity of structural, institutional and agent-level processes that perpetuate risk aversion carry with them severe consequences.

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