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Why Banking Crises *Happen*

BY HANS-WERNER SINN

The role of bad accounting and moral hazard missteps.

After the 1982 debt crisis, the savings and loan crisis in the United States in the late 1980s, and the Asian financial crisis of 1997, the subprime mortgage crisis is the fourth major banking crisis since World War II, and by far the biggest. According to the International Monetary Fund, the total loss in terms of balance sheet write-offs will be nearly $1 trillion worldwide, of which the lion's share probably will be borne by U.S. financial institutions. Given that the combined equity capital stock of all U.S. financial institutions is roughly $1.2 trillion, this is a breathtaking sum.

Why do banking crises happen? Are bank managers ignorant? Why do they underwrite risks that drive their banks to the brink of bankruptcy? The answer lies in a combination of a bad accounting system and various moral-hazard effects that were not contained by existing regulatory systems.

The bad accounting system is the International Financial Reporting Standards (IFRS), which is now used by big companies throughout the world. The deficiency of IFRS is that it does not mitigate systemic contagion resulting from asset price movements. When asset prices move, firms that own these assets are forced to revalue them on their balance sheets quarter by quarter. The timely reporting of non-realized capital gains and losses makes the shares of the company that holds them volatile, sending shockwaves through the financial system.

An alternative would be a precautionary accounting system, like the one that all German companies used before the transition to IFRS began. In Germany's traditional system, a company's assets were evaluated according to the "lowest value principle": the lower of an asset's historical price and its current market price must be used for accounting purposes. This allowed managers to pursue more long-term goals and proved effective in blocking contagion

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Hans-Werner Sinn is Professor of Economics and Public Finance at the University of Munich and President of the Ifo Institute.

effects. Indeed, it was a major reason for the German financial system's stability.

In the current crisis, three moral hazard effects are particularly important. First, management pay depends too much on short-term share price performance, probably owing to the excessive influence of investment banks on commercial banks' policies. Given that investment banks can only attain high rates of return in a world with volatile asset prices and short-term performance goals, companies pressure their managers to follow suit.

Second, banks' assumption of excessive investment risks reflects their expectation that governments will bail them out if necessary. This was the case in the savings and loan crisis, where the government explicitly served as a deposit insurer. Banks could take on overly risky projects without scaring off investors because the government would step in as the lender of last resort.

In the subprime crisis, a similar phenomenon was implicitly at work, with banks speculating that they were too big for governments to let them fail. The fact that the Bank of England bailed out Northern Rock and the U.S. Federal Reserve saved Bear Stearns with $30 billion suggests that they were right.

The third, and probably most important, moral hazard results from asymmetric information between banks and their lenders. Banks issue securities with attractive nominal interest rates but unknown repayment probability. Often, securities are created that are backed by sophisticated portfolios containing good and bad assets whose true risk cannot easily be assessed. In the current crisis, even the private rating agencies dramatically underestimated the risks involved, which helped lure international financial investors into purchasing mortgage-backed securities at exaggerated prices.

So nothing stopped the banks from selling "lemon" bonds. Like used cars that break down right after they are sold, tomatoes and apples that look good but taste like water, or suits that quickly become threadbare, the seller could reduce the quality of the product and cut costs without the buyer's knowledge. As low-quality products sell at the same price as high-quality products, the latter disappear from the market.

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In capital markets, the information asymmetry between buyers and sellers of securities is even more extreme, making it hugely tempting for banks to issue securities that increase their expected profits by reducing the repayment probability below what buyers expect. To do so, they develop complicated legal claim structures that hardly anyone can fully understand and operate with too little equity capital to cover the risks. This destroys the market for sound financial instruments, undermining the viability of the capitalist system.

To address this problem, stricter banking regulation is needed in order to increase the probability of repayment, and hence the quality of securities. Financial products must be made transparent, off-balance sheet operations must be limited, and, above all, the scope of leveraged operations must be reduced by requiring higher equity-asset ratios. Banks often oppose higher equity-asset ratios, because equity capital is more expensive than debt capital. But this is precisely because of the lemon effect.

The International Monetary Fund, the G7, or a joint U.S.-European body could be the right forum for determining new rules for financial markets aimed at enhancing the efficiency and stability of the world economy. By contrast, setting rules unilaterally would be a recipe for global disaster, because competition between governments to create advantages for their own banking sectors would merely reproduce the inadequate regulations that resulted in lemon banking in the first place. ◆