Former Lehman Brothers chief economist warns 'risk incentives' could cause new crisis

By Adam Creighton, The Australian, 22 October 2018

The former chief economist of failed US investment bank Lehman Brothers has warned that conditions for a financial crisis are "serious and intensifying", scolding regulators for leaving the financial system vulnerable to "doom loops" more than a decade after the GFC began.

In a private note to clients titled "the next global crisis", John Llewellyn, chief economist at Lehman until the bank collapsed a decade ago, told investors the combination of irrational exuberance, greed, explosive debt and ultra-low interest rates were creating an economic tinderbox.

"While greed cannot be eradicated, it can be discouraged. Few financiers have been fined, and almost no one has been jailed; incentives remain unduly skewed towards risk-taking," he said, in a note based on comments made at a closed OECD forum in September, which included former ECB governor Jean Claude Trichet.

"It has become common place to say that considerable progress has been made in financial regulation (globally)," Dr Llewellyn said.

Dr Llewellyn, now a consultant, said banks could lend to sovereign governments without maintaining any equity — in effect a zero per cent risk weight. "Banks still have too much latitude to use internal models to set their own risk-asset provisioning," he says.

Risk weights, based on the perceived level of risk set by regulators, permit banks to ignore shares of their assets when calculating their minimum equity requirements. In 2016 the Australian Prudential Regulation Authority increased the average risk weight for residential mortgages from 16 per cent to 25 per cent, which allows each dollar of equity to support $50 of lending.

"White-collar crime is generally treated far more leniently than its blue-collar counterpart," he said.

Dr. John Llewellyn, managing director and former chief economist for Lehman Brothers. Picture: Bloomberg News.

The comments come at a delicate time for financial services after a damning report by the royal commission into the integrity of the financial service sector and the quality of its regulation.

Speaking at a parliamentary inquiry last week, officials at ASIC, which has come under heavy criticism for lack of vigilance in enforcing the law, said the corporate regulator would toughen its stance.

But ASIC chairman James Shipton also cast doubt over the government's "industry funding model" for the watchdog, telling parliament he faced a cash shortfall to fund the expected 50 criminal and civil prosecutions to be launched against rogue executives and corporations over the next two years.

In numerous speeches since taking over as ASIC chairman in February, Mr Shipton has stressed the need to improve ethics and integrity in financial services to mitigate misconduct.

Lehman Brothers collapsed in October 2008, ushering in months of near unprecedented global financial turmoil, which prompted regulators to redraft prudential regulations.

Finalised last year, the revamped Basel bank regulations capped bank leverage at about 33 times their shareholders' funds, and curbed banks' ability to set their own equity requirements.

Since 2007 the major banks' capital ratios — equity as a share of their total assets — has increased from 4.4 per cent to about 5.7 per cent.

Mr Llewellyn said economists were under "considerable pressure" to play down concerns. "Investment bank economists and most analysts have an employer … with a vested interest in the status quo: few are genuinely independent, and those who are generally have only limited access to the media," he added.

Higher capital ratios reduce "return on equity" and curb the implicit subsidy from government to financial institutions. "Honest analysts are therefore hesitant to shout when they see crisis as imminent," he said.

Ratings agencies were "less dysfunctional", Dr Llewellyn said.

"But still no fundamental change has taken place in the incentives facing them — it is still the 'ratee' who pays," he said.

Ratings giant S&P puts the major Australian banks in the bottom half of its global rankings for "risk adjusted capital", noting they experienced among the "steepest declines" globally in 2017.

"Following unwarranted fiscal stimulus, the equity market is near an all-time high, and valuations are stretched," Dr Llewellyn said.