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Crises in the financial regulation of finance-led capitalism: a Minskyan analysis

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Résumé

Financial markets are subject to more developed regulatory mechanisms than those of other sectors of the economy. This can be explained by the nature of financial transactions and by the extremely harmful consequences of financial crises for the entire economic system. The current regime of banking regulation is based on risk sensitive capital requirements and on market-based risk measurement and management, and it could be termed "supervised auto regulation". The hypothesis put forward in this article is that this regulatory framework is not suitable for capitalist economies with highly developed financial systems and very little so for our specific finance-led accumulation regime. In the current scenario of widespread crisis, it seems especially relevant to analyze financial and, more specifically, banking regulation, from a Minskyan perspective.

Entrées d'index

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Texte intégral

1. Introduction

1 Financial markets are subject to more developed regulatory mechanisms than those found in other sectors of the economy. This can be explained by the nature of financial transactions, which can produce extremely harmful effects on the whole economic system and which therefore justify the more developed regulatory and supervisory regime to which the institutions in case are subjected, with the explicit purpose of ensuring the soundness and stability of the system.

2 The current regime of banking regulation is based on risk-sensitive capital requirements and on market-based risk measurement and management, and it could be termed "supervised auto- regulation". The hypothesis put forward in this article is that this regulatory framework is not suitable for capitalist economies with highly developed financial systems and very little so for our specific, such as the current finance-led, accumulation regime[1] (Guttmann, 2008). The strength of the financial crisis that began in 2007 and which gained a systemic dimension in 2008, impacting the real side of the economy on a global scale, seems to confirm this hypothesis. Otherwise, supervised auto regulation stems from this new regime and from its logic of free-market regulation.

3 In the light of the current crisis, the purpose of this paper is to present a discussion of the financial, and especially banking, regulation from a Minskyan perspective. It is important to note that financial regulation is here understood as constituting a central element of the monetary regime[2], which is in turn regarded as one of the main institutions of capitalist economy by regulation theory. The present crisis stimulates discussion regarding the very foundations of the current framework of financial regulation. To place this discussion in its proper context, it is necessary to take a step back and analyze how financial crises are generated. This will be done from the perspective of the theoretical propositions of Hyman Minsky, who proposes that financial cycles and crises are endogenously generated. It appears to us that the Minskyan approach and the approach of regulation theory share many fundamental points. Thus, according to Boyer (2004), one particular aspect of regulation theory is that it is able to account simultaneously for the properties of a regulation mode and for the endogenous factor that can destabilize it.

4 In order to carry out this discussion, the present text is structured as follows: the next section presents the central elements of contemporary banking regulation, and the focus of the third section will be specifically devoted to the response given by current regulators to the crisis. The fourth section spells out the main ideas of Minsky's Financial Instability Hypothesis as they might be appropriately "adjusted" to finance-led capitalism. In the concluding remarks we will discuss how distant the rationale of the Basel Accords lies from the Minskyan point of view.

2. Banking Regulation and the Basel Regulatory Regime

5 As previously indicated, financial markets are subject to more developed means of regulation and supervision than other segments of the economy. This can be explained by the inherent characteristics of transactions performed in these markets. Some of these traits might be of special relevance to explain the vulnerability of financial institutions, and especially banks, to a crisis, as well as the possibility of contagion that, once a crisis has begun, can lead to systemic risk.

6 Along with the monetary authority, banking institutions are participants of the monetary system, that is to say, receivers and originators of cash deposits, which are fully liquid instruments. They resort to leverage in their operations, i.e., their liabilities are substantially larger than their capital and they are generally transformers of maturities, the maturities of liabilities operations being shorter than those of assets operations. Besides, financial contracts are transactions that involve rights and

obligations to be performed in the future and thus the value of contracts depends on the belief that they will be actually carried out.

7 Banking institutions play a central role in the credit and payments systems, and trustworthiness is crucial to them, given the high level of leverage and the difference of maturity in the transactions. A breach of trust in the agents of a certain institution might bring about adverse movements of withdrawals on the part of clients. The problems thus generated do not only affect the institution in point, but also other institutions, according to the logics of "first come first served" – which might compromise the assets/liabilities relation, even when these accounts are balanced.

8 It is thus important to emphasize that contagion movements might be generated even in sound institutions and then bring about problems of systemic proportions. This might in turn lead to liquidity or solvency problems in the banking system and ultimately in the entire economic system, given the role of banking in the payments system and in credit transactions.

9 The scenario might appear still more serious upon consideration of these institutions' role in mediating resources. Their impact is the result of the fact that such action moves beyond investors/savers and final borrowers. Banks also act as lenders and borrowers on the interbank market and as issuers of securities resulting from the securitization of loans. On top of this should be added their role as leveraging agents and the position of non-banking financial institutions, such as hedge funds and, more recently, structured investment vehicles (SIV).

10 All these traits justify the more developed regulatory and supervisory regime to which the institutions in case are subjected. Supervision serves the explicit purpose of ensuring the health and soundness of the system and of protecting small investors. This regime can be considered from two different points of view. On the one hand, it can be viewed as a set of instruments and mechanisms that may be activated at times when problems are already underway, as a means of softening their effects and of avoiding contagion – a safety net. Among such instruments, it is worthwhile mentioning the activity of the monetary authority as a lender of last resort and the existence of deposit insurances. On the other hand, such a regime can be deemed to act as a set of rules and regulations constituting a regime of prudential regulation and supervision, which reinforces the system's ability to avoid or absorb the abovementioned impacts.

11 Prudential regulation implies the establishment of specific rules concerning the behavior of agents and, more recently, also regarding the disclosure of information, which must be accompanied by norms of monitoring and supervision. Such rules are generally preventive, i.e., they are thought of as means of averting potential problems. For decades, prudential regulation, as it was adopted in various countries, attempted to minimize potential problems through mechanisms that restricted the action of institutions[3]and it was fundamentally based on the regulation and control of balance sheets. The freedom of action of institutions was restricted by the definition of limits to the structure of their assets and liabilities portfolios.

12 Among the issues dealt with by this sort of regulatory regime, one must underline the (lack of) liquidity of the institutions' assets as compared to their liabilities. In this manner, ensuring the liquidity of deposits by defining limits to the nature of assets and by stimulating the build-up of reserves to meet potential withdrawals always appeared as the central element of these regimes. Some of the instruments or mechanisms these regimes developed were: i) limits of indebtedness and leverage ; ii) liquidity ratios[4] ; iii) limits to a bank's exposure to single borrowers ; iv) limits regarding the composition of assets and the line of activity that each institution could develop.[5]

13 Major transformations in the financial markets during the 1970s and 1980s, however, rendered a significant portion of these rules useless. These transformations resulted from a set of three interrelated, but nonetheless different, factors: financial innovations, deregulation and liberalization. Institutional innovations developed by agents that were active on the financial market, coupled with an intense process of financial liberalization and of market deregulation, resulted in the softening, or even neutralization, of rules and norms that restrict the action of financial institutions in their never-ending search for profitability and also, in some cases, liquidity. As far as financial innovations are concerned, the following are especially relevant: i) the

expansion and dissemination of derivative instruments ; ii) the intensification of the process of securitization that contributed to banking disintermediation and to rendering institutions' assets portfolio more flexible ; iii) the strategies for diversifying income sources. The last point concerns the development of liabilities management processes, which resulted in the diminished importance of deposits as a liability instrument, thus rendering regulation by means of deposit-related ratios less effective.

14 Deregulation, on its turn, expanded the scope of action of financial institutions by softening or even eliminating barriers between banking and non-banking institutions[6]. The liberalization of capital flows across borders allowed an improvement in the integration of different domestic markets as well as the creation of international ones.

15 A reorganization of the regulatory and supervisory regime began to take place as the perception of its inadequacy to the new situation grew. In spite of the fact that a few instruments and mechanisms were maintained, the fundamental logics of prudential regulation came to lie on the risks posed by an institution's assets. This change was founded upon the assumption that threat to financial institutions – and thus to the system of payments – would be the consequence of risks assumed through a bank's transactions. Therefore, regulatory concern should no longer focus on a bank's liability profile, but move to its assets instead.

16 The demand that banks should maintain a minimum capital coefficient is a crucial element of this new format of prudential regulation, and some authors present it as a process of financial re-regulation. By means of these elements, the regulatory authority imposes on banks the need to maintain a minimum ratio between its own capital and the assets on its portfolio.

17 The major argument put forward to justify the generalization of the capital index is the stimulus generated by using part of a bank's own capital, which would compensate for incentives for taking on excessive risk. Prudential regulation would thus stimulate the maintenance of more secure portfolios by means of minimum capital demands since in adverse situations not only savers, but also shareholders, would be affected by losses. Such point is central for the 1988 Basel Accord (Basel I).[7]

18 At the time of its creation and first revisions (1996 Amendment), Basel I was seen by regulators and supervisors as a major step progress towards a regulatory framework based on capital risk sensitivity. However, some weaknesses of the simple risk-bucking approach of Basel I came to the fore. It was seen as unsuitable to deal with the rapid andextensive evolution of the market, such as repurchase agreements, securities borrowing and lending, margin loans and over-the-counter derivatives. The Accord also stimulated regulatory capital arbitrage (Kroszner, 2007a ; Kroszner, 2007b).

19 In mid-2004, the Basel Committee of Banking Supervision (BCBS) launched Basel II and it is currently being adapted and implemented in many countries. The central idea has been kept, i.e., the need to maintain minimum ratios between risk-weighted assets and capital, just as its fundamental goal, which is "...to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital regulation will not be a significant source of competitive inequality among internationally active banks." (BCBS, 2004). However, the new structure is much more complex than the previous one. It aims at making progress in the process of risk measurement by integrating into the regulatory framework the allegedly more accurate methods of risk measurement developed by the market's institutions themselves. Furthermore, it introduces treatment of operational risk, alongside credit and market risks, which were already present in Basel I. The focus of regulation and supervision would apparently become increasingly centered on the quality of risk management and on the adequacy of its measurement. The expected result was a sounder and more stable international banking system, based not only on a more risk-sensitive system, but also on the private sector's understanding of risk, given that Basel II integrates the practice of the market into regulation.

20 From our point of view, however, the relevant question is whether this regulatory regime based on risk sensitive capital requirements and on market-based risk measurement and management is adequate for capitalist economies with extremely developed financial systems. In order to address this point we will resort to Hyman Minsky's perception that contemporary capitalist economies are inherently fragile from

the point of view of the financial structures they generate. Based on this assessment, we intend to propose a criticism of the current model of banking regulation. However, before the criticism is formulated, we turn, in the next section, to the approaches taken by current regulators to handle the fragilities of the regulatory regime that they had identified.

3. The response of current regulators

21 At the beginning of 2008, even before financial systems had suffered the recrudescence of the crisis, the BCBS announced the need to strengthen the Basel regime by means of improvements and through the prompt implementation of the Basel II, these being understood as fundamental steps to enhance the resilience of the banking system. According to the BCBS chairman, "...the key building blocks to core bank resiliency are strong capital cushions, robust liquidity buffers, strong risk management and supervision, and better market discipline through transparency." (Wellink, 2008b, p. 1) The initial proposal highlighted the following measures: i) enhancing the capital treatment of complex instruments and credit exposures held in the trading book ; ii) furthering global sound practice standards for liquidity risk management and supervision ; iii) strengthening banks' risk management practices and supervision[8] ; and iv) improving market discipline through better disclosure and valuation practices. In other words, according to the BCBS it would be necessary to strengthen capital and liquidity buffers, enhance risk management and market transparency and also enforce sound risk management practices.

22 After a round of discussion and the deterioration of the world economy in the third quarter of 2008, the BCBS developed a more precise evaluation of the crisis as well as a better sense of what the possible and necessary changes should be. According to the Committee,[9] the turmoil revealed significant weaknesses in the risk management of banking institutions. As in almost all financial crises, extremely high leverage and the concentration of risk played a fundamental role. The evaluation was that, in some cases, risk concentration resulted from poor risk management. The Committee also concluded that the "originate and distribute" model may have implied that banking institutions were not entirely aware of major risk exposure and concentration. According to the BCBS, one of the main lessons that regulators and supervisors should learn from the crisis is that they should pay attention to the "big picture" and to the longer-term horizon. In other words, they should not focus strictly on isolated indicators – such as excessive leverage, risk concentration and maturity mismatches, on and off-balance exposures, etc. – but rather on the combination of all these forces, which has been proved to be extremely disrupting.

23 This perception may explain the format given to the proposal the BCBS presented for changing the regulatory regime in November 2008 (BCBS, 2008b). They once again pointed to the need to strengthen the already established system of risk-sensitive capital buffers, of risk management and of better governance, through a broaden evaluation of risk. Some new elements were, however, added, such as the necessity of measures to contain excessive leverage and to stimulate banks to strengthen their liquidity buffers.[10] As far as liquidity is concerned, the BCBS also expects that more solid capital buffers will mitigate the banks' exposure to liquidity risk:

> While liquidity risk cannot be mitigated with capital, capital is itself a form of liquidity since, unlike other liabilities ; it does not have to be repaid. Furthermore, a strong capital buffer enhances a bank's creditworthiness and, from the market's perspective, reduces its counterpart risk. This helps to ensure continued access to funding. (Wellink, 2008b)

24 One may notice that, even if there is no fundamental change of direction, the possible introduction of measures to contain leverage and to manage liquidity into the Basel II framework is in itself innovative. This is because the logic of Basel II is centered on the assets portfolio, and liquidity risk is barely mentioned in the original document of Basel II.

25 The acknowledged urge of promptly implementing the Basel II regime can be better understood if we bear in mind two ideas: first that, according to the BCBS, this regulatory regime is sufficiently efficient to ensure the soundness and stability of financial systems ; second, that Basel II has now been adopted by several banking systems, but with different schedules of implementation.[11]

26 According to supporters of the Basel II regulatory regime, differences in the adoption and implementation schedule may have affected the course of the current crisis. Although it is not clear how much difference Basel II would have made to the current crisis had it already been fully in force, the Committee presents some technical arguments in support of the idea that it actually would. For instance, under Basel I banks are not required to keep capital for the exposure of off-balance sheet vehicles. Differently, Basel II requires capital for such exposures, which were in fundamental in the production of the current crisis.[12]

27 The announcement of the intention to strengthen Basel II and to stimulate its prompt implementation is based on the analysis produced by the central banks represented by the BCBS. According to these analyses, the regulatory regime of Basel II, based on the private sector's approach to risk measurement and management through market prices, is an appropriate and efficient means of addressing the fragilities of financial markets and of ensuring the existence of a sound and stable financial banking system[13]. Thus, the recent crisis does not put at stake the essence of the regulatory regime. It simply spells out the need for improvements.

4. Endogenous Financial Instability according to Minsky

28 In order to build his hypothesis of the cyclical and unstable performance of economy, Minsky typifies each economic unit according to its portfolio. A distinctive feature of Minsky´s portfolio is the introduction of a significant maintenance or carrying cost for all assets, understood as the payment commitment required for the liabilities that "carry", or fund, any asset. By introducing liabilities in his theoretical structure, Minsky is laying the foundations for an endogenous theory of cycles and crises. In an economy in which there is historical (instead of logical) time and the future is unknown, uncertainty is pervasive, rendering the portfolios speculative, since only the future will validate, or not, the positions that were taken.

29 According to Minsky, when an agent decides to purchase a long-lasting asset and to borrow, and other decides to finance its acquisition, both borrower and lender alike are speculating on the future cash flows of the buyer, as these are the primary source for the fulfillment of debt obligations.[14] The agents are also speculating on the future price of the asset that is now being financed and on the future behavior of the financial market, since they may have to refinance their debts.

> When a financial contract is created, both the buyer (lender) and the seller (borrower) have scenarios in mind by which the seller acquires the cash needed to fulfill the terms of the contract. In a typical situation there is a primary and some secondary or fallback sources of cash. For example, in an ordinary home mortgage the primary source of cash needed to fulfill the contract is the income of the homeowner. The secondary or fallback source of cash is the market value of the mortgaged property. (Minsky, 1982b, p. 19-20)

30 According to Minsky, economic units can assume three different behaviors as far as the relation between expected income and financial commitments is concerned. A unit is "hedge-financing" when its income[15] is more than sufficient to cover all of the unit's financial commitments and in all periods in which they have to be met, with no mismatches regarding terms or the amounts of assets and liabilities.

31 When financial commitments are larger than the expected income for certain periods, this unit is "speculative-financing". Speculative structures are generated when the maturity of the asset exceeds that of the liability, thus requiring a refunding of the

latter – and the agents are speculating on this possibility – as well as when the funding profile is such that it implies variations in the value of the commitments.

32 In an extreme situation, when it becomes necessary to increase indebtedness in order to face previously undertaken financial commitments, the expected income being insufficient even to serve the debt, the economic unit is said to have a very speculative structure, which the author called Ponzi.[16] Borrower and lender are both speculating that it will be possible to refinance the debt in the future. They are also speculating – and this is a situation that applies only to certain kinds of assets – with the possibility of an appreciation of the price of the asset, so that the income that can be made by selling the asset will allow fulfillment of the debt.

33 In case the asset is, for example, a capital asset, the capitalist is expecting that the future cash flow generated by its acquisition will be higher than the total cost of acquisition – including financial costs. In case the asset is acquired by households – like real estate – the rationale is slightly different because the asset does not generate cash flow. So the point is that the agents will either have an ordinary income – such as wages – which will allow them tofulfill the commitments or they will be able to refinance the debt in the future or even sell the asset for a higher price.In the context of an expanding economy, however, the increasingly optimistic expectations of borrowers and lenders are rational in the sense that they keep being fulfilled. According to Minsky: "The performance of our economy at any date is closely related to the current success of debtors in fulfilling their commitments and to the current view of the ability of today's borrowers to fulfill commitments." (Minsky, 1982b, p. 17)

34 It should be noted that the decisions of borrowers – non financial agents – to undertake debt will only be effective if lenders – financial agents – agree with it. In fact, the financial agents themselves, looking for larger profits, will also undertake riskier decisions for as long as stability and prosperity goes on. So it is necessary to emphasize that, in Minsky's view, the decision of buying assets, as well as the decision of financing their acquisitions, become ever more speculative. Kregel points this out:

> An endogenous evolutionary process leading to a reduction in the safety margins must be based on something more than euphoria or excessively optimistic expectations. Since bankers can have no better knowledge of future conditions than anyone else, the basic decision is based on the… rule of 'trust' and the creditworthiness of the borrower… Further, since the bank is an ongoing enterprise, the banker not only wants to know how the borrower will repay the loan but also, more importantly, whether the bank can lend to this client again. The decision will be based on the client's history as much as on expectations of future cash flows. (Kregel, 2008b, p. 1)

35 To a large extent, it is the combination of the different financial structures within the entire system that will determine its degree of fragility and, thus, its potential instability. An economy in which speculative and Ponzi units predominate will display a high degree of fragility, and this is bound to happen as long as there is a lasting upturn.

36 The sanctioning of additional funding required to undertake positions of growing indebtedness is, in turn, determined by the portfolio decisions of the financial market agents. They will fund new positions in assets and will be able to do so – within certain limits, but under pressure from competitors – whenever the decision seems profitable, which will lead to a reevaluation of their expectations and to the acceptance of a higher level of indebtedness on the part of debtors. In order to support this situation, new instruments, new financial practices, new institutions and new arrangements between such institutions are generated. Indeed, for Minsky, financial innovation is one of the defining features of the expansionist stages of modern capitalist economies. Thus, during the upturn, a significant change in the portfolio of the economic agents will occur, which will tend to become more speculative.

> In contrast to the orthodox Quantity Theory of Money, the financial instability hypothesis takes banking seriously as a profit-seeking activity. Banks seek profits by financing activity and bankers. Like all entrepreneurs in a capitalist economy, bankers are aware that innovation assures profits. Thus, bankers (using the term generically for all intermediaries in finance), whether they be brokers or dealers,

> are merchants of debt who strive to innovate in the assets they acquire and the liabilities they market. (Minsky, 1992b, p. 7)

37 As a consequence of these developments in the financial markets, a new macroeconomic financial framework comes into existence, with a higher degree of fragility. This is so because debtors and creditors, by adopting more “aggressive”, but nevertheless rational, structures, reduced the safety margins previously adopted, thus allowing for the progressive deterioration of the liabilities of non-financial agents as well as of the assets of the financial agents. This growing financial fragility sows the seeds of the next downturn. Minsky notes, however, that the process that converts a solid financial standard into a fragile financial structure is not carried out overnight and with no controls being exerted. The limitations on the speed and on the virulence of this process, which represents nothing but the search for opportunities of growing valuation, are determined by the intensity and speed with which creditors and debtors take more fragile approaches.

38 It is relevant to ask how some aspects of the new accumulation regime, and more specifically those related to the new features of banking activity, may influence the speed and degree of this process that tends to a progressively fragile economic – and financial – system. We should here refer to the widespread process of securitization, which has been described by some analysts as one of the key changes in contemporary finance (Guttmann, 2008 ; Kregel, 2008a and 2008b ; Wray, 2008).

39 Kregel (2008b) states that:

> This system has produced a new form of bank operation now known as ‘originate and distribute’, in which the bank seeks to maximize its fee and commission income from originating assets, managing those assets in off-balance-sheet affiliate structures, underwriting the primary distribution of securities collateralized with those assets, and servicing them. (Kregel, 2008b, p. 2-3)

40 According to Kregel (2008b), the “originate and distribute” model means a radical change in the banking activity because the traditional assets of banks – loans – are not to be held in their books anymore[17]. They become securities to be sold in the market. Under this system the banker has no interest – or, at least, is less interested than they used to be – in credit evaluation since interest and principal will be repaid to the buyers of assets that generally are the so-called institutional investors (Kregel, 2008b). Credit evaluation for the institutional investors is often made by credit rating agencies.

41 Since the 1990s, credit evaluation by credit rating agencies has partially replaced evaluation formerly performed by banks, which used to be more conservative because their own very illiquid balance sheets were at stake. Credit rating agencies, instead, do not evaluate assets they will hold themselves, but for the investors whose very liquid and diversified portfolios[18] could in principle allow for riskier assets.

42 Vidotto (2008) also points to the profound change in credit evaluation in this new financial system:

> In principle, the ‘foundations’ of debts distance themselves from the intermediate and final buyers, making it more difficult for them to accurately evaluate risks... As securitization unfolds in new and successive rounds the final investor has each time an increasingly vaguer notion of this chain. (Vidotto, 2008, p. 60)

43 As a consequence of this endogenous process unfolding in a new regime of accumulation and which allows for riskier decisions, the current system is more fragile than the situation Minsky used to analyze at the end of the upturn. Accordingly, this economy tends to be even more prone to financial instability.

5. Basel Regulation in a context of endogenous financial fragility: concluding remarks

44 The Basel Accords are based on a system of minimum capital requirements and are increasingly dependent on the idea that the market is efficient in measuring and managing its risks. This idea was absorbed gradually. Basel places the minimum requirements for capital adequacy at the center of the regulatory regime, the calculation of capital rates being made through a system of fixed risk-weights defined by the regulator. As previously stated, the idea behind this mechanism is that banks should adapt their capital to the risks they take on or, to put it differently, that banks take on risks based on their ability to maintain capital.

45 By endorsing and stimulating the use of risk assessments performed by market institutions, either banks or external credit rating agencies as is more frequent since the 1990s, the arrangement proposed by the New Accord integrated the logic of market agents into the regulatory structure. In this way, the model proposed by Basel II is based on trust in the adequacy of the behavior of banks, which are the relevant market agents. They would be more qualified to evaluate and to manage their risks and to decide how much capital ought to be maintained given the risk they take on.

46 This new format of banking regulation was well suited for both the interests of financial institutions, which naturally seek greater freedom to act, and the preferences of the regulatory authorities. These preferences were based on the perception that the imposition of rules that would limit the action of institutions tends to stimulate the implementation of innovations that in turn render the rules inoperative.[19] They are also based on the perception that market agents would be apt and willing to measure risks accurately, so to speak.

47 Basel I innovated by bringing the behavior of banks to the center of the regulatory regime and by enabling the harmonization of rules at an international level. The New Accord's proposal also innovates by drawing regulation closer to market practice, thus seeking to enable the construction of a system of rules which is actually viable in the face of the ubiquitous possibilities of financial innovation and arbitration on the part of the agents. In this sense, Basel II would have more accurate mechanisms than those of its 1988 predecessor.

48 According to Kregel (2006), however, the major principle of the New Accord must be questioned, "since it is based upon the presupposition that the market mechanism can offer a common restriction to the activity of banks – something that financial markets are still to produce." (Kregel, 2006, p. 36) Griffith-Jones and Persaud (2006) argue in the same way and state that risk assessments made by banks are inherently pro-cyclical and that good banking regulation should therefore do exactly the opposite of Basel II. Wray (2006), adopting a markedly Minskyan approach, makes a similar point. For him, "it is the force of the market that induces participants to reduce the risk they assess at the moment of greatest danger – those that attempt to resist the speculative trend not only face smaller return rates, but also doubts concerning their administrative abilities and their capacity to generate profit." (2006, p. 152)

49 The analysis here conducted based on Minsky's discussion of the agent's behavior in a capitalist economy, including the participants of the financial market, leads us to disagree with such a hypothesis. The behavior of market agents concerning risk is inexorably cyclical and tends to the undertaking of ever greater risks. And this is so because the perception that the agents themselves have of the risks they assume, just as the decisions they make, is strongly influenced by the state of confidence, which feeds back the new decisions and conditions the evaluation of the assets and the interpretation of its risks. If we go further and therefore consider the finance-led regime as a financial system characterized by the securitization of assets, which allows a less conservative evaluation of risks either by banks or by credit rating agencies, it becomes clear that the system has become endogenously more fragile and prone to instability – in other words, it is more subject to crisis.

50 When the market is flourishing, the growing fragility which is inherent to the process itself, as presented by Minsky, is not captured by the process of risk-weighing in Basel I and tends not to be detected by the internal risk evaluation models of the financial institutions, nor by the agencies specialized in credit risk evaluation. In this way, the growing fragility is not reflected on the capital requirements demanded, the key to ensure soundness in the regime discussed above. Besides, the pro-cyclical nature

inherent to the behavior of market agents concerning risk is strengthened by the risk evaluation performed according to the rules of the market because risk goes down when the market is doing well, and goes up when the market becomes more volatile. Under Basel II, so does capital and, as a consequence, the banks' asset portfolio. When markets are doing well, the banks' asset portfolio, especially loans, can rise rapidly. During the downturn, however, the opposite may take place, as new capital requirements may force banks to cut down their lending. Thus, in finance-led capitalism, new instruments and mechanisms of the financial markets may have reinforced the cyclical tendency. In this sense, regulatory regimes based on risks, especially on the current financial environment, reinforce the pro cyclical feature that is inherent to financial markets.

51 That said, one might ask whether the Basel regulatory regime may have fulfilled its goals, i.e., "... a framework that would further strengthen the soundness and stability of the international banking system". The obvious answer is no. In defense of Basel II, it could be argued that the crisis was created in an environment marked by Basel I and that Basel II, still in the process of being adopted and implemented, would have been more adequate to face some of the characteristics of the current financial environment, such as the Agreement's determination of capital charges towards off-balance exposures and treatment to securitization.However, it is undeniable that the foundations of Basel II, such as the banking institutions risk measurement of bank risk and adequacy based on credit rating agencies and internal risk models, were already broadly disseminated before the crisis occurred. Thus, the Basel regulatory regime sustained the decisions and strategies of financial relevant agents, including non-banking institutions and did not soften the conditions that led to the crisis. Instead, the regime may have contributed to them.

52 In relation to this perception, it is necessary to point out that the current evaluation of the adequacy of "Basel-type" regulation conducted by the BCBS takes another direction, although maintaining its fundamental principles. The intention not only to strengthen Basel II but also to stimulate its prompt implementation was announced with the complement of a treatment of leverage and liquidity. This proposal is supported by the diagnosis produced by central banks represented by the BCBS, i.e., that such a regulatory regime would be suitable and efficient in order to address the fragilities of financial markets and to endorse a sound and stable financial banking system. In contrast to this diagnosis, however, we have argued in this text that such a measure is not going to enhance the solidity of the system. Much to the contrary, it could even enhance its fragilities by reinforcing the evaluation of risk by the market as a cornerstone of the regulation regime. For this reason, Basel II is much more pro-cyclical than Basel I. And, in this sense, it is much more prone to stimulating crisis.

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Notes

1 Alternatively called patrimonial capitalism (Aglietta, 1998 *apud* Guttmann, 2008), finance-led growth regime (Boyer, 2000 *apud* Guttmann, 2008) or finance dominated accumulation regime (Stockhammer, 2007 *apud* Guttmann, 2008). According to Epstein (2005, p. 3), finance-led capitalism is defined by "the increasing role of financial motives, financial markets, financial actors and financial institutions in the functioning of the domestic and international economies. This new accumulation regime is related to a very different financial system". One of the main features of this new financial system is that it is centered on typical investment banking activities, like the underwriting of securities, instead of being based on traditional commercial banking activities (Belluzzo, 2005 ; Guttmann, 2008 ; Kregel, 2008a and 2008b).

2 According to Boyer (2004) a monetary regime is defined by the set of rules intended to manage the credit and payment system.

3 A few systems, such as the North American, imposed geographical limits, limits regarding the line of products and limits concerning the association of banks with other types of companies, financial or others. The logic of segmentation prevailing in the North American regulatory structure was to avoid contagion movements between different markets.

4 Imposition of quantitative parameters to evaluate the legal operations, with a level of liquidity based on the availability of primary and secondary reserves.

5 The last one applied especially when the financial system became segmented, i.e., when there came to be many specialized institutions.

6 Banking institutions began to operate in other markets and with other instruments, which brought about important changes in the composition of their assets' and liabilities' portfolios, and

also different risks exposures.

7 The environment originally idealized for the Basel Accord was the internationally active banks from the G-10. However, Basel's rules were adopted in more than 100 countries.

8 Stress testing, off-balance sheet management and valuation practices, among others.

9 The opinions of the Committee were presented in the BCBS press release and in the speeches of the Committee's members.

10 They are: i) strengthening the risk capture of the Basel II framework, especially for trading book and off-balance sheet exposures ; ii) building additional shock absorbers into the capital framework in order to dampen pro-cyclicality in periods of stress ; iii) evaluating the need to supplement risk-based measures with simple gross measures of exposure in both prudential and risk management frameworks to help contain leverage in the banking system ; iv) strengthening supervisory frameworks to assess funding liquidity, especially in cross-border banks ; v) leveraging Basel II to strengthen risk management and governance practices in banks ; vi) strengthening counterpart credit risk capital, risk management and disclosure in banks ; and iv) promoting globally coordinated supervisory follow-up exercises to ensure implementation of supervisory and industry sound principles. (BCBS, 2008b, p. 1).

11 In Europe, the progression to the Basel II regulatory regime has been the responsibility of each national central bank or supervision agency, being marked by the adoption of the Capital Requirement Directives (CRD) in mid-2006 and by its implementation at the beginning of 2007. The period determined for the implementation of Basel II in the US is quite different and much longer, extending from April 2008 to April 2011. The adoption of Basel II in the US was delayed due to the results of one of BCBS Quantitative Impact Study (QIS4). The model of Basel II to be adopted in the US is also quite different: the advanced approaches will be mandatory for some internationally active banks, whereas the other banks will be able to choose between Basel IA and a standardized approach.

12 One could point out that the current "originate and distribute" model was stimulated by the Basel I regime, as within this framework risks were assumed to be transferred, thus implying less capital requirements.

13 It is also important to highlight that, at least since the beginning of the discussion of this regulation framework, in 1999, lots of resources, efforts and time have been spent.

14 "The primary source of cash for households is wages, for business firms it is gross profits, for government units it is taxes, and for financial institutions it is the cash flow from owned contracts." (Minsky, 1982b, p. 21-22)

15 In the original formulation, the author resorted to the notion of "quasi-income". The concept of quasi-income, or "gross income", lies close to the notion of expected gross profits after taxes, a profit needed to face the payment commitments on contracted financial debts and dividends.

16 The expression *Ponzi finance* relates to the behavior of a speculator, Charles Ponzi, who became famous in the US in the 1940's for having set up a sort of "pyramid scheme". These pyramids are based on the notion that, by offering larger revenues to depositors (members of the pyramid), one can obtain a significant amount of deposits and thus pursue endless growth. It is evident that this kind of enterprise will only remain standing for as long as the deposits it receives grow at a faster rate than the income it is bound to pay.

17 Guttmann (2008) states that the shift from loans to securities as a major form of credit is paralleled by the shift from bank deposits to funds as the main savings outlets. This process tended to benefit investment banks and their traditional activities of brokerage, dealership and underwriting. Facing this situation of potentially declining activities and profits, commercial banks reacted by also getting into this funding business.

18 Guttmann (2008) says that suppliers of funds prefer securities to loans for many reasons, one of them being that these instruments give them a way-out whereas loans do not.

19 Another hypothesis that has already been put forward by the literature (see, for example, Freitas, 1997 and2005 and Griffith-Jones and Persaud, 2006) is that of a "capture" of the regulator by the regulated, i.e. that the "pro-market" format in the New Accord would also reflect the large political influence wielded by the financial sector.

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