<u>Lessons from previous banking crises</u>

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Cyprus economy and its banking system is undoubtedly going through a rough period following the decisions taken by the Eurogroup members in March 2013. The Memorandum, among others, calls for the restructuring of the banking sector that includes better corporate governance and supervision. It seems that everyone was got by surprise by the decisions taken, however, the truth is that the problems of the banking sector go a long way back. We should have seen this coming and acted appropriately at the right time. Furthermore, there were lots of other major banking crises (and some of them are very recent ones) that we should have studied them carefully to draw important lessons of how to cope with the difficult situation. The purpose of this article is to document some of the previous, major banking crises.

The Great Depression

The Great Depression of the 1930s is obviously one such example. There are many stories regarding the causes of this crisis, ranging from demand-driven to monetary theories. Major bank failures were certainly instrumental to the stock market crash in October 1929 and the subsequent depression. The response to the crisis was the Banking Act of 1933 and the Glass-Steagall Act, which limited the activities of commercial banks (restrictions on speculative actions), the competition for interest rates on deposits through rate controls, and branch banking. The Act also provided a separation between commercial and investment banking, and limited and enforced a federal system of bank deposit insurance. The instigators of this Act claimed that big commercial banks were marketing high-risky securities to their clients, unsophisticated bank depositors ("naïve" investors) and other, smaller banks. Opponents of this Act argued that a "government-enforced" cartel was therefore formed limiting competition and producing an inefficient banking system. Supporters of this Act though argued that it was the reason for a prolonged period of stability in the US banking system.

However, the regulation of commercial banks imposed by the banking reforms of the 1930s, failed with the emergence of nonbank institutions that replaced traditional commercial banks for providing loan and deposit schemes. Multiple efforts were then made to repeal the provisions under the Glass-Steagall Act, with the successful signing of the Gramm-Leach-Bliley Act (GLBA) in 1999 by President Clinton. This Act repealed the Glass-Steagall Act and the provision for separation between commercial and investment banking.

Many argue that the above repeal was an important factor for the recent global banking crisis. It allowed commercial banks to provide the same kind of risky products similar to the capital markets, and created institutions that grew to such a large extent, that now were "too big to fail".

The Great Recession

That was the case with the collapse of Lehman Brothers in September 2008 that rocked capital markets, propagated the shock to the real economy, as well as markets around the globe. Many stories and theories have been written about the crisis and its causes – real estate bubble, lack of the necessary supervision of financial markets, failure of corporate governance, creation of highly complex but very risky securities, cheap credit, excessive leverage by institutions, deregulation of financial markets, among others. Governments around the world responded to the crisis with large fiscal stimulus packages, lowering of interest rates, and expansion of money supply through quantitative easing (QE) programmes. Furthermore, the US has proposed and passed a law known as the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 (that included the Volcker rule) that calls for much stricter regulation and increased transparency. Results of this Act thus far are mixed, and even the U.S. Fed Chairman has pointed out that the government is not capable in measuring the costs/rewards that this law has placed on the U.S. economy.

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