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## POLICY SPOTLIGHT

# Banking Crises: 50 Years of Lessons for Policymakers

Policy discipline, capital strength, and simpler, clearer rules are essential for financial stability

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**T**he history of banking crises is more than a chronicle of bank-management errors and failures; it is a recurring narrative of systemic vulnerabilities shaped by repeated policy errors. These crises collectively underscore a central truth: Banking stability hinges not on predicting the unpredictable, but on addressing the causes of instability rooted in policy, regulation, and market incentives.<sup>1</sup>

### The Roots of Financial Instability

Banking crises often originate in the corridors of power, not just in the boardrooms of individual institutions. Crises have followed a familiar, persistent pattern of distorted risk perception driven by macroeconomic policy missteps, while regulatory responses have addressed industry misconduct rather than underlying policy flaws:

- **1970s:** Loose fiscal policy and accommodative monetary regimes fueled lending against inflated collateral, creating an inflationary spiral.
- **Early 1980s:** The Fed's 20-percent rate hikes exposed overextended banks, triggering mass failures.
- **Post-2000s:** Monetary easing incentivized excessive mortgage leverage.
- **Post-pandemic:** Stimulus spurred risky bank bets on long-term bonds, again distorting risk perception.

Policymakers have also weakened the system by turning their focus on liquidity rather than capital as the source of systemic instability. Policymakers have framed liquidity and capital as distinct challenges, but these two pillars of bank stability are intertwined. A bank becomes illiquid precisely when stakeholders doubt its

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<sup>1</sup> See Thomas Hoenig, "Five Decades of Banking Crises: What Have We Learned?," *FinRegRag*, May 28, 2025, <https://www.finregrag.com/p/five-decades-of-banking-crises-what>. Scan the QR code below for the full analysis.



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solvency. Modern safety nets focused on liquidity backstops have provided short-term stability but weakened banks' accountability to depositors. Deposit insurance and bailouts have substituted for market discipline, as depositors look more to the safety net and less to bank capital for protection. Liquidity demands confidence, and under stress, confidence demands strong and transparent equity capital.

### Framework Flaws

The importance of strong capital exposes deeper flaws in modern regulatory frameworks. The Basel Accords, conceived to harmonize global capital standards, have become a case study in unintended consequences:

- Risk-weighted capital rules, allowing supervisors to employ complex models to align capital buffers to risk, were gamed by banks to minimize those very buffers.
- In 2008, for example, Lehman Brothers reported a moderate risk-weighted leverage ratio under Basel capital rules, but it effectively operated with an unweighted, extreme leverage ratio, almost guaranteeing failure under stress.
- Post-crisis reforms led to more rules and complexity without addressing the core issue: Banks still manipulate the rules to increase leverage and maximize returns, not resilience.

**The lesson is clear: Unnecessary complexity breeds fragility.** A straightforward leverage ratio—equity against total assets—would offer a more reliable gauge of health than risk-weighted calculus does.

### The Too-Big-to-Fail (TBTF) Dilemma

Compounding the systemic flaws outlined above is the corrosive effect of TBTF subsidies. Failure among the largest banks would destabilize the financial system, and rather than allow them to fail, the government bails them out. By protecting the largest banks, policymakers have created distortion in market discipline. The implicit guarantee of protection creates a perverse equilibrium: Profits are privatized, losses are socialized, and competition is stifled. Lacking protection, smaller banks face disproportionate scrutiny despite posing less systemic risk. The result is a bifurcated industry in which ultimate accountability is illusory for the most consequential players.

### Regulation Without Accountability

In place of market accountability and strong capital, banks now face a maze of regulations. Since the 1970s, the number of rules governing bank operations has increased by the thousands. While this regulatory environment raises costs for all banks, it inadvertently favors the largest and more powerful institutions. **Regulatory burdens create artificial barriers to entry and promote consolidation, as larger institutions can spread their costs over more assets, reducing relative unit costs.**

### A Path Forward

The stakes extend beyond banking: In an era of fintech disruption and digital currencies, the system's credibility hinges on learning from past mistakes. The frequency and ferocity of future crises depend on choices made today. To strengthen the financial system, policymakers can do the following:

- Rein in fiscal and monetary excesses.
- Emphasize strong capital and robust leverage ratios as the bedrock of resilience—with no exceptions.
- Simplify rules to reduce gaming and fragility.
- End implicit guarantees by allowing failing institutions to exit the system.
- Prioritize transparency and accountability over regulatory bloat.

The lessons of 50 years can serve not just as a complaint, but as a blueprint for the future.