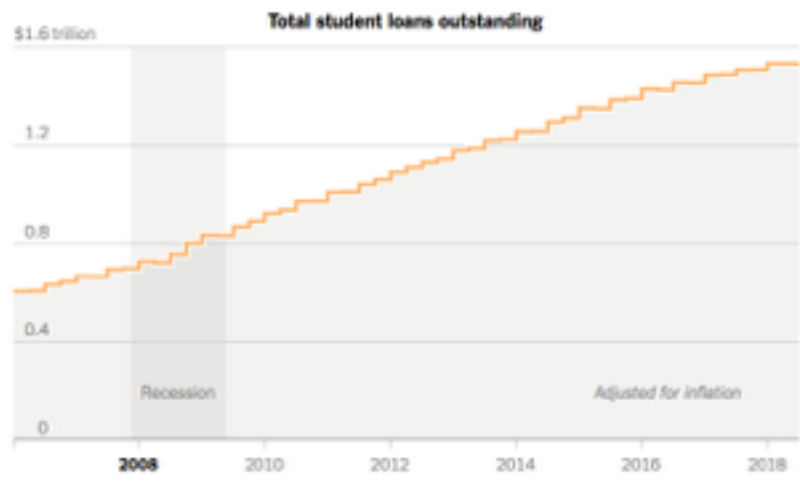
The Next Financial Calamity Is
Coming. Here's What to Watch.

The global financial crisis is fading into history. But the roots of the next one might already be taking hold. Financial crises strike rich countries every 28 years on average. Often, the break between busts is much shorter.

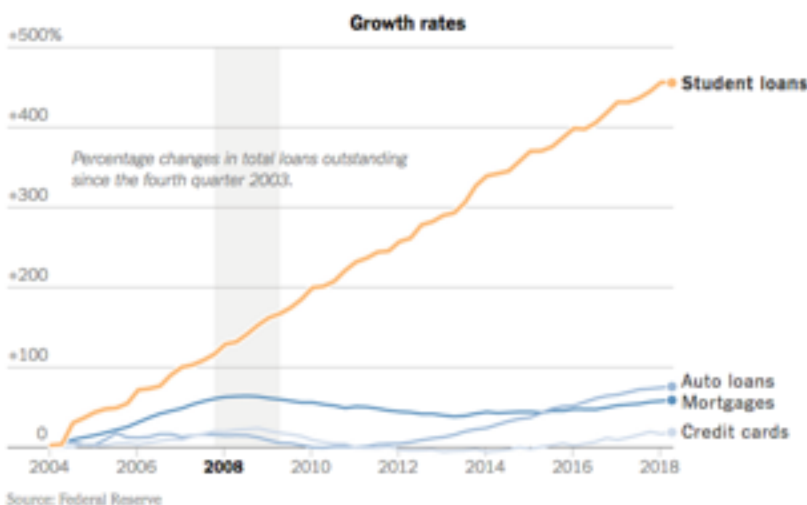
Fast-growing pockets of debt, as in the last time around, look like potential sources of problems. They're nowhere near as big as the mortgage bubble, and no blow-ups appear imminent. "But what we saw last time around is that things can creep up on you," said Wesley Phoa, a bond-fund manager at the Capital Group. "You can turn around and in three years' time you can go from not much of a problem to a pretty big problem."

The amount of American student debt — roughly $1.5 trillion — has more than doubled since the financial crisis. It is now the second-largest category of consumer debt outstanding, after mortgages.

Students are borrowing at record levels



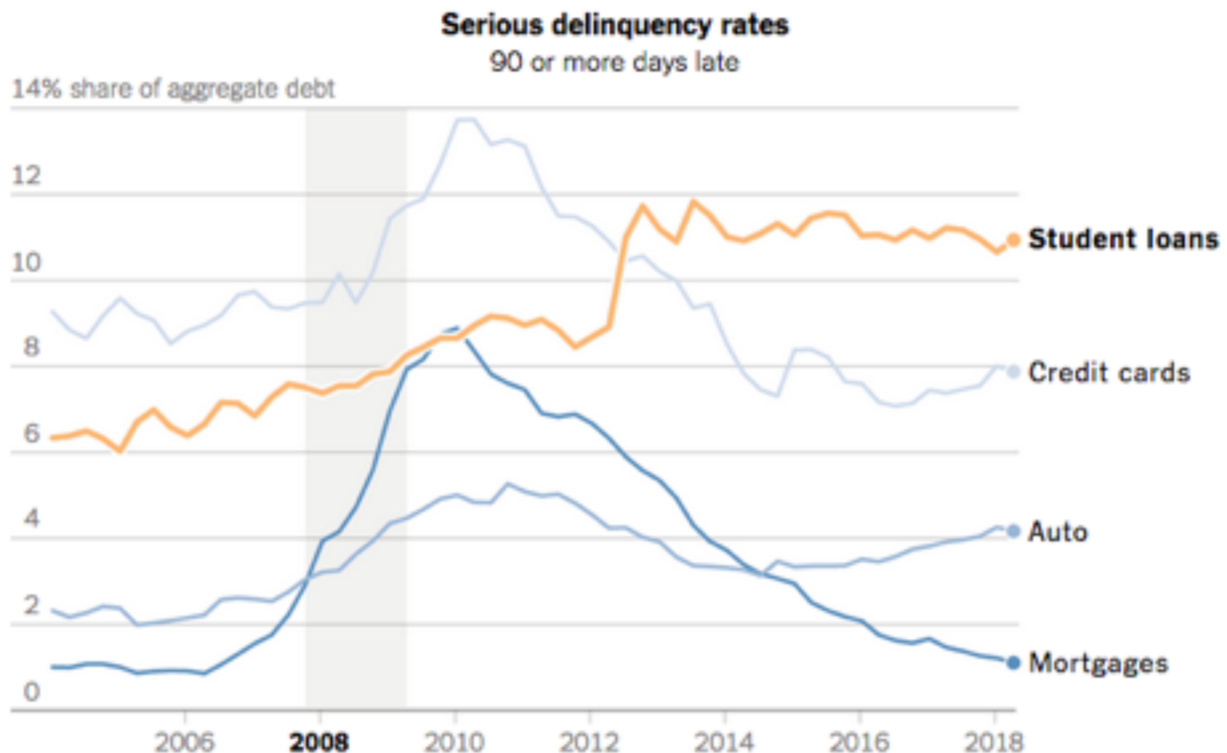
Public colleges and universities, hurt by state budget cuts, increased tuition. The drop in house values also made it harder for families to tap into their home equity to pay for tuition. As a result, the financial burden shifted to students, who took on heavier debt loads to pay for school.



Many borrowers are already falling behind. During the second quarter of 2018, more than 10 percent of student loans were at least 90 days past due. That was down slightly from a couple of years ago, but higher than the peak for mortgage delinquencies during the last crisis.

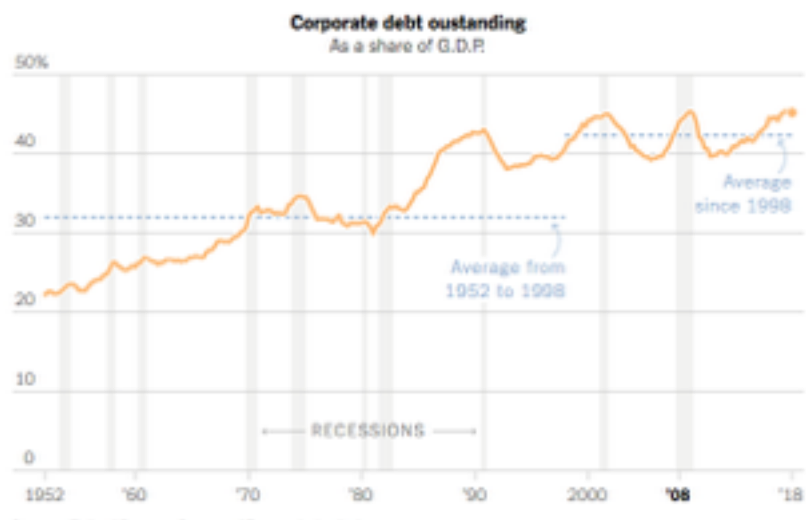
Could this spark a new crisis, with student loans playing the role that mortgages played a decade ago? Probably not.

The student loan market is much smaller than the mortgage market. And the main lender is the federal government, so even a surge of defaults would barely touch the banking system, unlike the mortgage meltdown. The bigger issue is whether growing amounts of student debt may be a drag on consumers. Some think it could be playing a role in the decline of homeownership over the last decade, an important driver of spending in the consumption-led American economy.



Companies are also loading up on debt

After the crisis, central banks slashed their interest rates. Investors moved their money out of government bonds, which were paying essentially nothing. And they piled into corporate bonds, which typically pay slightly higher rates.



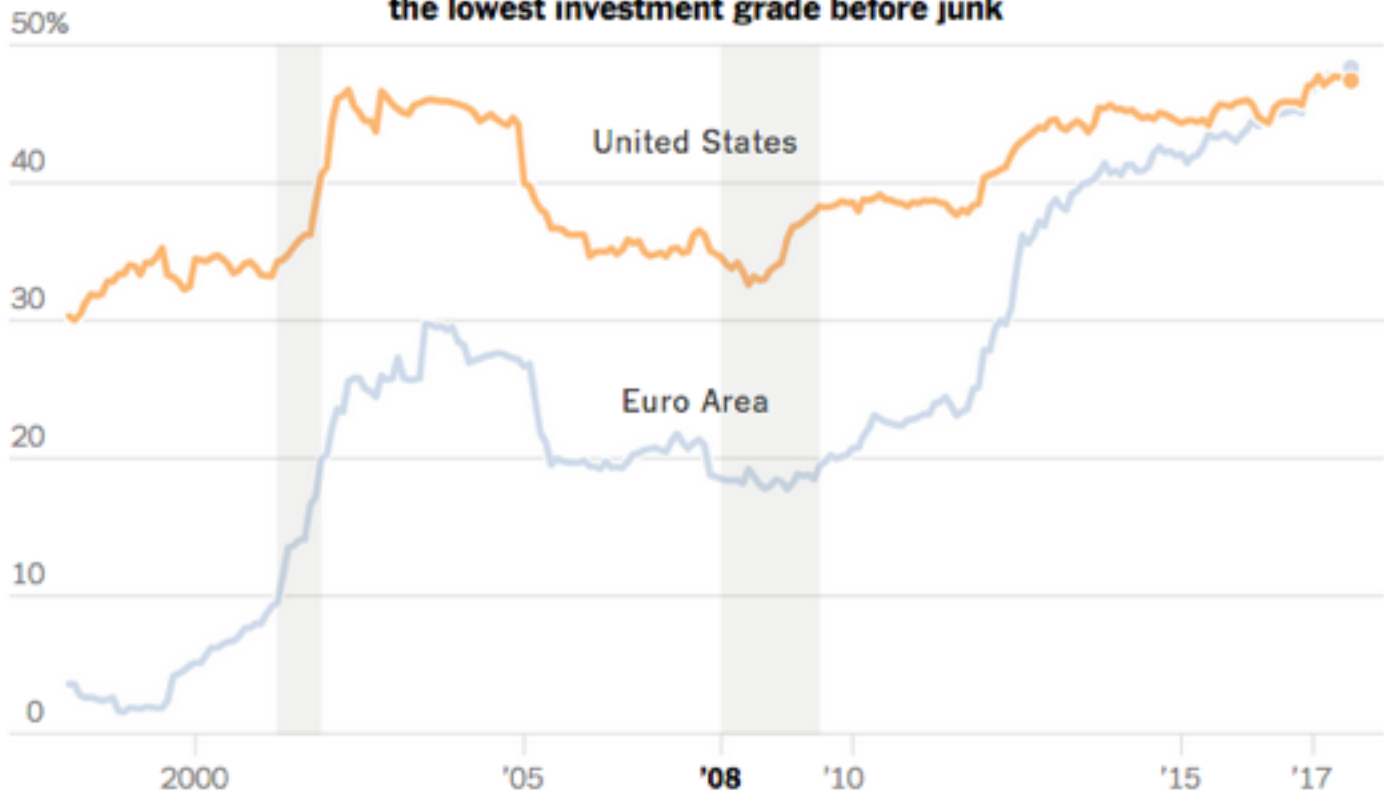
American companies were more than happy to satisfy investors' ravenous appetites — and they did so by selling gobs of debt.

There are signs that the borrowing binge may have gone too far. Debt issued by non-financial companies is near its highest levels, as a share of the United States economy, since World War II. In the past, such indebtedness has been followed by a rise in defaults.

Investors are increasingly willing to lend to risky companies

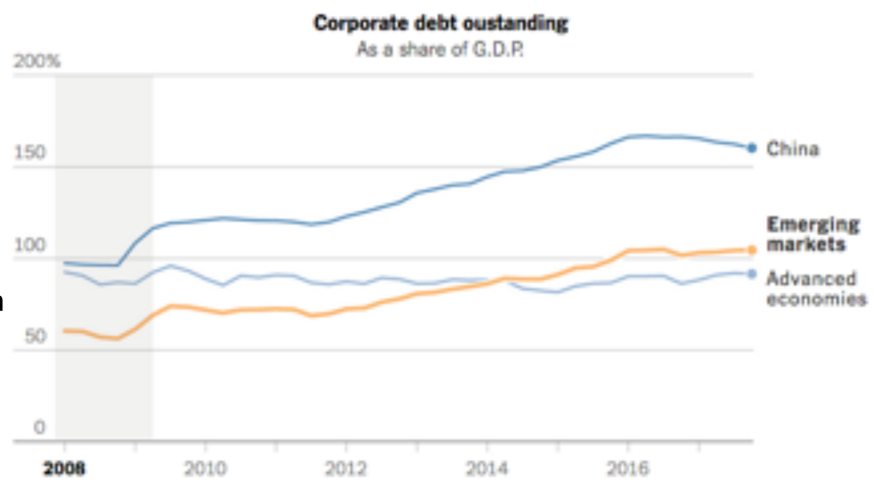
Even in the market for the safest corporate bonds, funds have been flowing to the borrowers that have some of the lowest credit ratings — the category known as BBB. Roughly $1.4 trillion of the debt is currently outstanding, making it the largest single piece of the investment-grade corporate bond market, according to Standard & Poor's.

More than $500 billion of these BBB-rated bonds are just one downgrade away from being junk, according to Fitch Ratings. A wave of downgrades could cause losses for investors, potentially scaring them from lending more. That would make it more expensive for companies to borrow and invest, weighing on the entire economy



Emerging markets, too, gorged on cheap debt

Developing economies are looking shakier — and, again, a main culprit is corporate debt. The amount outstanding in all emerging markets is now slightly greater than the size of their actual economies.



In China, the ratio of corporate debt to gross domestic product is above 150 percent, according to the Bank for International Settlements. Some Chinese companies are struggling to keep up with their loans as the world's second-largest economy faces pressure. While China has significant financial heft to deal with problems, any issues could prompt jitters in the broader markets.

A key risk for many countries is that much of the debt is denominated in American dollars, as opposed to the borrowers' local currencies. The loans are getting more expensive because the dollar has gained value in recent months relative to other currencies.

In Turkey, the lira's plunge is already expected to unleash a wave of bankruptcies, and the risk of a recession there is rising. In the past, problems in one emerging market have tended to spread elsewhere, creating concerns about the health of the global economy.

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A final concern is the repeal of Dodd-Frank. In response to the financial crisis, congress with the support on the Obama administration passed the Dod-Frank Act which created an agency to make sure banks don't overcharge for credit cards, debit cards, and loans. It requires them to explain risky mortgages and verify that borrowers have an income.

Dodd-Frank allows the government to identify banks and insurance companies that are becoming too big to fail. During the financial crisis, the government had no authority to stop financial firms from taking on too much risk. It's one reason why Lehman Brothers went bankrupt and insurance giant American International Group Inc. required a bailout.

With Dodd-Frank, the government can turn over risky banks to the Federal Reserve to supervise. It can keep better tabs on insurance companies. Dodd-Frank also prevents banks from using their depositors' cash to invest in hedge funds. The Treasury Department now has final say on any bailouts made by the Federal Reserve.

Dodd-Frank Since Trump

Many banks complained that the regulations were too harsh on small banks. On May 22, 2018, the Republican Congress passed a rollback of Dodd-Frank rules for these banks. The Economic Growth, Regulatory Relief, and Consumer Protection Act eased regulations on "small banks." These are banks with assets from $100 billion to $250 billion. They include American Express, Ally Financial, and Barclays.

The rollback means the Fed can't designate these banks as too big to fail. They no longer have to hold as much in assets to protect against a cash crunch. They also may not be subject to the Fed's "stress tests." As a result, only the 12 biggest U.S. banks have to comply with this portion of Dodd-Frank.

In addition, these smaller banks no longer have to comply with the Volcker Rule. Now banks with less than $10 billion in assets can, once again, use depositors' funds for risky investments.

The new Act does allow consumers to freeze their credit for free. Previously, they had to pay a $10 fee to each credit company.

Trump has weakened the CFPB by hiring staff who oppose it. As a result, enforcement actions have dropped by 75 percent, despite rising consumer complaints. At least 129 employees have left.

On February 3, 2017, Trump signed an executive order that asked the U.S. Treasury to propose Dodd-Frank changes. One of its proposals was to reduce the requirement for bank stress tests from annually to every two years. These tests tell the Federal Reserve whether a bank has enough capital to survive an economic crisis.

Trump's plan would allow the president to remove the CFPB director for any cause. It would switch its funding from the Federal Reserve to Congress.

Could rising debt and loosening regulation again lead to a financial crisis? History seems to repeat itself, but unfortunately we won't know until we are looking in a rear view mirror.

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