

The Economist

It's fire season for finance, writes Ken Miller

A former top banker predicts that an unreformed pay system and the gutting of regulation will accelerate the next financial crisis

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IT IS NOW just over 17 years since the financial crash triggered by the Lehman Brothers bankruptcy, and American stockmarkets are again at or near all-time highs. The two main drivers of investor optimism are artificial intelligence and a substantially loosened regulatory environment. These factors, combined with a Wall Street compensation system essentially unchanged since 2008, have now converged to tee up the next financial debacle.

After the crash of 2008, the Dodd-Frank legislation that President Barack Obama signed in 2010 strengthened the big banks by increasing their capital requirements and imposing other constraints on risk-taking. But Section 956 of that law—the provision directing regulators to curb incentive-based pay that encourages excessive risk—was, in effect, shelved during the first Trump administration and today exists only on paper. The most important reform of incentives on Wall Street never took effect.

Bonuses are the beating heart of the modern financial system. Whereas most Americans think of a bonus as a small percentage of base pay, on Wall Street bonuses are typically multiples of a salary that itself may be several hundred thousand dollars. There was talk of “clawbacks” for bad deals, meant to align dealmakers’ incentives with the long-term health of their employers. But clawbacks remain rare and largely symbolic. Traders, investment bankers and

asset managers continue to be rewarded for adding to the bottom line in the current year, even when the transactions they push through generate losses later on.

This culture of outsize, short-term incentives is no longer confined to the traditional banks Dodd-Frank sought to regulate. Pay at non-bank institutions—now vital engines of finance—is just as skewed towards short-termism. Talent has migrated to small, lightly regulated trading shops built around automated models, statistical arbitrage and ultra-high-speed execution. Partners take a share of annual profits. No deferrals. No clawbacks. Most trade with borrowed funds and face no prudential supervisor.

Dodd-Frank never anticipated a world in which the bulk of market-making and intraday liquidity would be handled by automated systems overseen by financial engineers whose bonuses are tied to model profitability, not market stability.

Private credit—now a multi-trillion-dollar shadow-banking sector—compensates its dealmakers on an even more asymmetrical basis than the pre-2008 banks. Executives and originators at these firms earn enormous carried-interest payouts tied to loan-origination volume and fund returns in the early years of a strategy, even though the true performance of these illiquid loans may not be known for a decade. Today's private-credit industry has recreated the incentive structure that fuelled the subprime-mortgage boom—only on steroids and with less oversight.

Mortgage and consumer-lending shops operate under similar incentives, retaining no long-term exposure to the risks they create. This is precisely the dynamic that produced the last crash, reborn through new channels. All this is taking place in an era of extreme deregulation. Early in his first term, Donald Trump mandated that for every new regulation issued, two existing regulations had to be eliminated. Major parts of Dodd-Frank were rolled back, releasing all but the biggest banks from heightened oversight and shifting regulators' focus from rules to “innovation” and growth.

In Mr Trump's second term, his approach has shifted from changing the rules to replacing the enforcers. Senior positions across the regulatory architecture have been filled with anti-regulators—agency heads drawn from the industries

they now oversee, enforcement chiefs whose careers were built on antipathy towards the very rules they are charged with applying, and supervisory officers who openly oppose the concept of supervision. The rules remain; the referees vanish.

As Russell Vought, director of Mr Trump's Office of Management and Budget and one of the architects of this administrative strategy, put it: "Personnel is policy." In February, after firing the director of the Consumer Financial Protection Bureau, Mr Trump designated Mr Vought acting director of the agency. Immediately, Mr Vought ordered a sweeping pause in its activities—suspending investigations, enforcement, rulemaking and even the drawing of additional funding. Entire categories of predatory lending were treated as, in effect, non-actionable.

At the Securities and Exchange Commission, cases against big crypto and fintech firms have been dropped or indefinitely paused. The supervisory arms of the Office of the Comptroller of the Currency and the Federal Reserve have reassigned or sidelined career examiners who once scrutinised liquidity mismatches and operational risks. This gives financial institutions leeway to acquire hard-to-sell, higher-yielding long-term assets and finance them with cheaper short-term liabilities, thus increasing profits through a risky "mismatched book".

Meanwhile, politically connected financial offenders get pardoned. White-collar crime has become negotiable.

When Lehman went bust, its failure caused some \$10trn in global equity losses within weeks. It's impossible to know what will be the spark that sets off the next conflagration. A sudden consensus that AI won't live up to expectations? A massive corporate fraud? Something else entirely? What's clear is that, once the blaze begins, plenty of kindling will help it spread—thanks to Wall Street's obsession with bonuses, hidden illiquidity, mismatched books and unregulated markets. ■