

Financial and economic crisis as a mirror of the existing economy

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Economic cycles occur partly because the predictive ability of economic actors, including regulators, investors, debtors, producers, consumers and intermediaries, is not accurate, leading to decisions which, on aggregate, cause temporary imbalances. These tend to be self-correcting over the long run, resulting in an organic cyclicality. John Maynard Keynes advocated for government intervention to act as a stabilizer, but interventions through monetary and fiscal policy can affect the economy also by augmenting the cyclicality. Exogenous and unpredictable factors, such as floods, droughts or wars can, of course, also have dramatic influence on economic conditions and development.

The recent economic crisis was the result of factors which accentuated this cyclicality both on the upside as well as on the down side. We would like to discuss 6 interconnected factors that were particularly influential.

(A) Factors that lead to the crisis:

1. Political intervention

A root cause of the crisis can be found in the political push to increase American homeownership. Fanny Mae’s Chairman, James A. Johnson wrote a book in 1996 titled “Showing America a New Way Home, Expanded Opportunities for Home Ownership”. On June 15, 2000 the House Banking Subcommittee on Capital Markets Securities and Government Sponsored Enterprises heard testimony by William Michael Cunningham ¹ urging the regulators to encourage the three GSEs - Fanny Mae, Freddy Mac and Ginny Mae, to support lending to low to moderate income families, minorities and women. This commendable objective was shared by a wide public and was fully aligned with the new trend of “socially responsible investment”.

Accommodating policies were implemented towards the GSEs to further homeownership. Regulators traditionally allowed the GSEs to hold significantly less equity capital against their loan portfolio than commercial banks, thereby encouraging them to expand mortgage lending. This same weak government supervision facilitated wide-spread accounting errors at Fanny Mae and Freddy Mac that were discovered in 2004, and which had allowed top managers to collect substantial bonuses. In February 2008, near the peak of the economic crisis, and shortly

after Fannie Mae announced \$2.05 billion losses for 2007 and actually predicted a continuing fall of house prices, the Office of Federal Housing Enterprise Oversight further reduced the capital requirements of the GSEs to encourage lending.²A significant portion of these loans were also re-packaged and sold to investors.

Creeping deregulation of the US financial industry and particularly the repeal of the Glass-Steagall Act in 1999 removed constraints on inter-state banking in the US, encouraged banking mergers and the creation of financial conglomerates spanning the previously prohibited mixing of investment and commercial banking and insurance. This unleashed a generally unhealthy and cut-throat competition in an industry that forgot its important social role as blood vessels of the economy.

2. Greedy Investors

The creation of deeper financial markets provided fertile ground for, but was also the result of a fundamental shift in the intermediation of savings and of the basic characteristics of the financial industry. Investors assumed a greater and more direct role in channelling capital. Driven by optimism, wishful thinking, easy monetary conditions and risk-free rates that did not meet their expectations, investors extrapolated the recent past's higher returns, including rising real-estate values that were partly driven by the above described factors and, like lemmings, chased risks that they either did not understand, were oblivious to or simply ignored. Perverting the rule that profitable opportunities require the taking of risk by formulating an implicit link between risk level and positive return, investors were enticed, rather than discouraged, by the lengthy and detailed boiler plate risk warnings contained in prospectuses. Even commonly used terms such as "liars loans", for mortgages that required no verification of the borrower's financial condition, did not discourage investors.

3. Leverage

The expansion and access to financial markets and the creation of tradable financial products allowed the public and the growing number of financial institutions to invest in risk assets that were previously not available to them. To aim at "adequate returns" in such an environment, where the risk-less rate of return was near historical lows, easy and cheap credit was utilized and leverage was created also through increasingly abstract derivatives.

Risks in "old style" securities were unbundled, ostensibly to allow investors to focus on the specific type of exposure that they wanted to "play". For example: coupons were stripped from principal repayment of bonds, the inherent credit and interest risks were packaged separately, derivatives on volatility, correlation, and other variables were created and traded. Many new acronyms were coined (CDO, MBS, CLO, CDS, etc.) and Greek letters were used (α , β , γ , etc.) to produce a bewildering alphabet soup of financial terminology. In short, financial investment

products became always more abstract and removed from the underlying, productive economical activity. In fact, the size of outstanding derivatives positions vastly exceeds that of many underlying markets, including credit default, foreign exchange, etc. Soon, the size mismatch between the real economy and the financial markets was equalled by the mismatch of many investors' level of sophistication and that of their investment portfolios.

4. Faulty risk assessment

Securitization allowed investment banks to earn commissions for buying and selling risks, with the anticipation of not holding on to those risks over the medium to long term. This incentivized banks to be less stringent in the analysis of the risks they were temporarily underwriting. Just as with the GSE's, banks' risk assessment standards on products securitized for resale became ever laxer. In turn, investors were falsely comforted by the huge real-estate exposure that the US Government guaranteed through the GSEs into believing that the sector had little downside risk.

In the quest for objectivity and the application of a scientific process, bankers and so called sophisticated investors began to apply and rely on a mathematical risk measure called "Value at Risk". The basic flaws of this system were known, including that the real world does not conform to the probability distributions assumed by the model (exhibiting so called fat tails, kurtosis and other incompatible characteristics) and that correlations and other assumed inputs are not stable. Nevertheless, VaR had sufficient basis in theory and seemed to exhibit an impressive level of mathematical complexity and sophistication. Conveniently, its results could be used, in many cases, to justify taking more risk for a given amount of bank capital, thereby increasing the bank's profitability - for as long as all went well. For bankers and other risk takers that were motivated by asymmetrical compensation packages that incentivized them to ignore potential risks, VaR was therefore a very opportune tool. VaR soon assumed an almost religious authority for viewing financial risks, and banking regulators were also converted and gave absolute credence to the VaR model.

Furthermore, under the Basel II Framework of the Bank for International Settlements, regulators essentially allowed banks to outsource their credit risk assessment to approved third party credit rating agencies. This created a principal/agent issue similar to that of the banks and brokers that created and sold on mortgages or other loans. It also made risk assessment, and therefore portfolios, more homogeneous across banks. As the same credit ratings were used in similar VaR models by different banks, the risks of one bank resembled more closely that of the others, resulting in an increase of the systematic banking risk.

5. Conflicts of interest

The securitization and sales process contains potential conflicts of interest, and it has been alleged that many investment banks have exploited these to their own benefit. The informational

asymmetry between packager and buyer is an obvious one. This was basically ignored by investors that were relying on the good faith of the banking sector and the ostensible protection of the regulators. The regulators were slowly working on improving rules to protect the retail investor, known in the industry as investor of “dumb money”. The plethora of suits by investors who claim that they had been “mis-sold” investments, also by blue chip banks and asset managers, is a testimony to the conflict.

While bankers were creating new products, rating agencies diversified from evaluating the probability of bankruptcy and insolvency of corporations, to developing theoretical models to predict default probabilities of complex structures created out of novel instruments. These instruments had existed only in times of positive economic growth and generally positively trending markets, making the job difficult. Sailing in uncharted waters, the model inputs reflected the recent positive historical values. That rating agencies continued to be paid for their services by the seller of the risk asset would indicate that their interests were aligned with the investor only on a secondary level.

All this helped certain sectors of the banking sector to produce extraordinary and probably long-term unsustainable returns on equity. Whereas US Bank’s average return on equity had generally trended from about 6% in 1940 to hit an interim peak of 14% in 1980, before seeing a substantial dip during the following decade, it was above 14% in all years from 1990 to the recent crisis except for in 2001.³ The diversified financial sector sub-index of the S&P 500, which includes investment banks, asset managers, insurance companies, and also a rating agency, produced average returns on equity of between 15% and 27% from 1993 through 2007!⁴

In addition, the importance of the financial sector ballooned, and it started to represent an excessive percentage of US economical activity. Measured as a percentage of the US GDP, profits from finance doubled between 1960 to 2006 (from 1.5% to over 3%), whereas those from manufacturing more than halved (from over 5% to 2%).⁵

6. Globalization

Over the past century, the economy and society have shifted from being local and agrarian to being international and industrial, and then to being global and “knowledge based”. Technology and substitution of labour with capital caused return on capital to rise faster than on labour, leading to rising but unequal distribution of wealth and education.

Since the 1980’s, there has been a general wave of corporate consolidation, which created ever larger entities in order to compete on a global basis. In a merger of two equally valued family enterprises, each family changes from being the 100% owner of its family business to being a 50% owner of the combined entity. The wave of mergers resulted in an ever larger portion of

the economy no longer firmly controlled by any shareholder. The shareholding in many of the largest companies is so fractured, that a power shift has occurred between owner and management, particularly the board of directors. Cross board memberships can bestow onto individual Directors of several important corporations and perhaps also of a bank, powers that are greater than those of the largest of those entities' shareholders. The majority of shareholders of publically listed companies, as well as many large financial investors such as pension funds, neglected to apply even their reduced power and fail to exercise their voting rights at AGMs, thereby augmenting the unbalance. This has again created a large principal/agent problem, allowing management to grant themselves excessive and asymmetrical compensation packages. Ironically, it has also lead to many mergers that were unfruitful for shareholders, but caused management of the merged entity to extract higher compensation, which was presumably justified by their enlarged responsibilities.

Globalization of the financial world, regulations requiring transparency and marked-to-market accounting, instant and ubiquitous access to information, and the purported liquidity of financial instruments, as well as a belief in an incorrect interpretation of the Efficient Markets Hypothesis which basically assumed that there is almost no knowledge advantage, encouraged investors to buy instruments whose underlying economical activity was geographically located in places or activities with which they had limited familiarity: European banks loaded up on US mortgages, German banks became the largest lenders to Greek shipowners, etc. This made a problem that seemed to be confined to a particular sector (mortgage lending) of a particular country (the USA) become a global financial crisis. The first domino quickly felling a series of further dominos that had been standing and supported by similar mechanisms and or were directly inter-connected.

7. Summary

In fact, the mortgage crisis was not the problem. It was merely the first, violent symptom of a damned combination of the factors that were mentioned before: well meaning but incorrectly applied political pressure to allocate capital to high risk borrowers, a banking industry that had not found its equilibrium following the removal of artificial constraints, regulation that allowed risk assessment to be outsourced to agents rather than be performed by the principal, blind trust in imperfect models, highly skewed incentive systems that encouraged risk taking, and outright conflicts of interest.

Investment bankers, asset managers, economists, rating agencies, corporate management, the financial press, and last, but not least, the central banks all acted as willing accomplices in encouraging reckless investing. The "Greenspan put" created moral hazard by making investors believe that the US central bank would and could bail out the economy and thereby reduced sensitivity to risk. It was generally forgotten that "there is no such thing as a free lunch". Through their actions and words, these parties generated a type of self fulfilling virtuous cycle,

until it became clear that the market and the economy was not actually dressed in the emperor's wonderful new clothes, but was in fact naked and beset by deformities.

(B) Relevant characteristics of the existing economy and lessons:

The previous section identified some of the prime forces or mechanisms that lead to the recent crisis. Each one, by itself, or in economic jargon, *ceteris paribus*, would not have been able to create a crisis. There are always at least two counterparties in a transaction: the borrower needs an investor or lender and vice versa. The drivers were different in previous economic crises or troughs, and will surely be different in future ones. So, when we want to look at the crisis as a mirror of our economy, we must become more introspective and reach to a more fundamental level.

The economy is the aggregate of all its participants' activities related to production, consumption and investment. Behind each and every one of its large or small structures (including: private corporations, government agencies and controlled corporations, regulators, unions, etc.) lies one or more persons. Therefore, the economy is motivated and driven by basic human characteristics and crisis results from their failings. Three of these are worth mention.

1. The human race has a tendency toward optimism. Optimism is nothing but a bias to underestimate risk. Regulators who encouraged lending to a part of the public that had previously been eschewed for risk considerations and also investors were predicting more benevolent future conditions than actually occurred.
2. We have ingrained in our DNA both a primary survival instinct and a sophisticated striving for social hierarchy, which in the animal world is also known as the "pecking order". This drives our ego and wish for self-fulfillment. The result includes competition and egotistic behavior. And it motivates many individuals to behave in ways that are in or over the grey zone between ethical and unethical. To these aspects one can attribute: using bargaining power to create and exploit conflicts of interest, principal/agent abuses which allowed excessive and asymmetrical compensation for corporate management, incorrect analysis of risk to be borne by others, and even pushing populist economic/social policies that, from a fundamental economic perspective, were perhaps untenable.
3. The last characteristic we would look to is our tremendous diversity, not only culturally, but of how we perceive the world and form our opinion. It forces us to make subjective valuations and therefore allows for errors of judgment and irrational behavior. Diversity means that actors have different and sometimes inconsistent or opposing objectives and motivations. Diversity is necessary for markets to exist – the seller needs liquidity or fears a fall in value while the buyer has liquidity and expects an increase in value. It

means that policy decisions are based on compromise. Unfortunately, it also means that there is no universal agreement on what is ethical or fair behavior. Can the common pay-as-you-go pension system, whereby benefits to retirees are paid out of contributions of workers still be considered fair, now that demographics have shifted?

(C) Conclusions:

The above noted characteristics of optimism, self interest and diversity are fundamentally positive and constructive human traits. They are not erasable. As the human race will never achieve perfection, negative collateral consequences of these traits cannot be avoided. The conclusion of the above, is that market volatility and economic cycles are here to stay. Attempts by governments to regulate, control, or to influence economical behavior in any other way will, at best, have the desired effect only over the short term because Newton's third law of motion is not fully applicable to the multi-dimensional, interconnected system that is the economy. It is only applicable in the sense that for every benefit, there will also be a cost.

On the other hand, human nature also includes a strong drive to action, and so an effort should and will be made to correct flaws. In doing so, we must try to aim at the root causes and not at the symptoms.

Policies that increase the level of ethics, fairness and transparency need to be strengthened, implemented and enforced. There are a number of noteworthy positive initiatives in the financial industry which are, however, only applied in isolation. Among these are:

- The EU MiFID Directive, which is partly aimed at reducing conflicts of interest in the securities business;
- World Bank and IFC guidelines to further social and environmental policies in the borrowing countries;
- The Equator Principles, which are voluntarily applied by certain banks in their international project financing and are based on World Bank and IFC guidelines;
- Truth in advertising standards that apply to consumer products but which must be more rigorously implemented also to financial markets. The recent investigations of Goldman Sachs by the SEC and UK regulators are sending a strong signal in this respect.

The determining element of any crisis is the human element. Therefore regulatory and governmental intervention should implement stricter rules and standards of acceptable conduct. However, these institutions have limited powers in this respect if acting alone. And it should be noted that well meaning regulation can have unexpected negative consequences. There is, therefore, an important role to be played by NGOs and organizations such as the World Public Forum "Dialog of Civilization" to forcefully propagate and instill in each citizen:

- The fundamental element of ethics, which is the respect of the other and

- The taking of responsibility for the harm, and not only for the good, that one has caused. Application of these principles on a grass roots basis by all would hinder the exploitation of conflicts of interest and taking of excessive risks that were partly responsible for the crisis.

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