What Did We Learn from the Financial Crisis of 2008?

by Shibashish Mukherjee

Its two years since the fall of 2008 during which, ironically enough, the world witnessed with both shock and awe the fall of Lehman Brothers. What did we really learn from that economically devastating episode that led to the bankruptcy of one of the biggest investment banks of Wall Street and created a domino effect that led to the credit crunch? That chain of events started much before the fall of Lehman Brothers. The real story began in China.

The emergence of the Chinese economy since its economic liberalization was mainly based on export of manufactured goods for the consumption of the western consumers. Post two decades of high growth China amassed huge wealth of foreign reserves. They did invest a lot of money in their infrastructure but still they were left with a sizable amount of liquidity for investments. U.S. treasury bonds have had the reputation of being risk free therefore the Chinese started investing in them essentially making the cost of money cheaper for the U.S. banks to borrow from. As a result of some aggressive lobbying and the resultant low interest rates regime and favourable policy decisions on regulations by the U.S. congress played a crucial role in making the borrowing cheaper for the big banks of Wall Street. This cheap money prompted these banks to look for avenues to invest and they found the realty market especially lucrative. With access to cheap money the big investment banks together with other financial institutions like mortgage banks etc. started giving discounted mortgage loans to prime then eventually sub-prime borrowers. The basic assumption was that the price of property such as a house does not and will not go down.

It turned out to be a great business model for the first half of the 2000s. Banks gave loans to the sub-prime borrower, then made a portfolio of these loans tagging along with prime loans and sell it in the secondary market to the investment banks. These investment banks then re-package these loans and name it *Collateralized Debt Obligations* (CDO) which they insure with Credit Default Swaps (CDS) (as insurance) and sell them to the overseas lender, such as the cash-rich Chinese investors who were looking for avenues to invest in apart from the low-yielding treasury bonds of the U.S. government. When the sub-prime borrower could not afford to pay back their loans, they would file bankruptcy and the property goes to foreclosure and finally sale. The demand for home mortgages created an artificial high demand in the property market resulting in the quick appreciation of the property prices. Post foreclosure these banks will still come out with a healthy profit at the end of the cycle. This went on for some time making everyone from investment bankers, retail and mortgage bankers, and realty agents on the way wealthier with an exception of the poor borrowers. Soon other players also joined in the bandwagon like the British banks, German banks, and Japanese banks etc.

What everyone missed in this whole process was the rise of systematic risk of the entire financial system. Markowitz's Portfolio Theory (MPT) gave rise to the concept of diversification. Essentially it means that the idiosyncratic[1] risks that investors face can be diversified away. If we accept this argument then China, Britain, Germany, etc. did the right thing in investing in U.S. treasury bonds and CDOs. That way they thought to be diversified. At the height of this lucrative business hundreds of billions of dollars entered the U.S. market from all major economies around the world. The real factor that changed the systematic risk dynamics was the scale of investments being made by both national

[1] Sharpe, W. E. (1963); A Simplified Model for Portfolio Analysis, Management Science, Vol. 9, No. 2 (Jan., 1963), pp. 277-293

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and international investors in the CDOs. The benefit of diversification was being eroded with the massive scale of investments and from the same five or six big players in the market. This phenomenon gave rise to the Endogenous Risk[2] that can be constituted as a systematic risk inherent in the market but invisible unless something to the scale and scope of investments in the CDOs and CDSs happens. As Danielsson and Shin described it Endogenous Risk refers to the risk from shocks that are generated and amplified within the system. The rise in the foreclosure rates prompted a fall in demand for homes thereby decreasing the home prices in the U.S. home mortgage market. That created a domino effect in terms of confidence in the CDO and CDS markets thereby giving rise to the latent Endogenous Risk that immediately gripped the market by freezing the flow of credit. At one point banks were not ready to lend to other banks[3] for fear of uncertainly of their exposure to mortgage backed securities. This further increased the problems of the banks as they were unable to meet the demands of their lending operation or for that matter regular banking operations giving rise to further rounds of uncertainty until the Federal Reserve had to pitch in to ensure liquidity flow to the cash-strapped banks. While all this was going on there was hardly any information available in the market about these fancy new financial derivatives. Even the investors who were investing into these products were unaware of the true nature of these derivatives. This created a huge information asymmetry[4] but the returns generated by these derivatives were far too good to let go, giving rise to a herd mentality of the investors with billions of dollars. Rational decision-making ability was thrown out of the window and everyone bought into the illusion of a safe investment as claimed by the Wall Street banks and confirmed by the rating agencies that showered these derivatives with their best ratings possible essentially making them risk free but with high returns. The result of all that hype was the Great Financial Crisis of 2008.

So what did we learn from this Great Financial Crisis? The main lessons that we should draw from this crisis are as follows: (i) the importance of voluntary and involuntary disclosures on financial products, or the lack of both, (ii) the importance of regulators and how important it is for them to regulate and have an oversight of the macroeconomic indicators, (iii) existing risk management practises especially for the big banks and rating agencies, (iv) the most important of all, it is the exercise of rationality while making large investment decisions by the investors.

From a policy-making perspective the crisis has been a wakeup call for the regulators who have until now ignored the Keynesian economic model that speaks about free market economy along with strong oversight. In fact the accounting regulation body such as the Financial Accounting Standards Board (FASB) have completely failed to keep up with the pace at which firms have evolved in the recent years. There are some legitimate concerns such as the fair value accounting of non-tradable assets, etc. However, the big picture is still that the market value of the banking firms far exceeds in their intangible assets value than their tangible assets and still the accounting regulations do not require these firms to disclose sufficiently on their intangible assets especially when it comes to exotic derivatives such as the

[2] Danielsson, J., Shin, H. S. (Sep 2002); Endogenous Risk, London School of Economics (*www.riskresearch.org*)
[3] Samuelson, R. J. (2010); Was the Great Panic of 2008 preventable?, *Washington Post*
[4] Healy, P. M., Palepu, K. G. (2001); Information Asymmetry, corporate disclosure, and the Capital Markets: a review of the empirical disclosure literature, Journal of Accounting and Economics 31 (2001) 405–440

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CDO and CDS. This is the leading factor that creates a huge information asymmetry in the market where the investors have a limited knowledge about the instruments in which they are making large investments, and definitely before the crisis the scale was unprecedented. There are some who might argue that a little information asymmetry is good for the market as complete or absolute information will make banking firms highly correlated, thus eroding the benefits of diversification. However, the scope information asymmetry is plenty in the banking sector that starts from processes, culture, human capital and the capacity for the bank to be innovative. These asymmetries are constructive asymmetry and can benefit the investors from the diversification perspective. What is not recommended is that investors are deliberately kept in the dark because of lack of reporting standard about derivatives such as CDOs and CDSs, which can be lucrative investment vehicles and banks are able to sell these instruments in enormous quantities creating a shift in the systematic risk quotient of the market.

Therefore, it is absolutely essential for the U.S. banks in order to remain globally competitive regulators have to fix the shortcomings of the financial reporting standards and market oversight policies. This should motivate banks to formulate their risk management and disclosure strategies rather carefully. With more information and understanding about seemingly complicated derivative products perhaps investors will also make better choices and informed decisions.

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