The global financial crisis and the implications for corporate governance and regulation

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- *Crisis originated by deregulated financial markets in the US, releasing a flood of toxic financial products*
- *As increased financialisation of the world economy took hold, regulation was considerably lightened*
- *Likely that global regulation of international business and market oversight will be increasingly accepted*

The prolonged systemic crisis in international financial markets which commenced in mid-2007 and continues to develop, is also a crisis in corporate governance and regulation. The most severe financial disaster since the Great Depression has exposed the dangers of unregulated financial markets and nominal corporate governance. This financial crisis is larger in scale than any crisis since the 1930s involving losses estimated by the IMF in October 2008 as potentially US$1,400 billion, eclipsing earlier crises in Asia, Japan and the US (see Figure 1).

The market capitalisation of the stock markets of the world peaked at US$62 trillion at the end of 2007, but were by October 2008 in freefall, having lost US$33 trillion dollars, over half of their value, in 12 months of unrelenting financial and corporate failures. A debate has continued for some time about the costs and benefits of the financialisation of advanced industrial economies. The long progression of financial crises around the world served as a reminder that the global financial system is neither self-regulating nor particularly robust. The explanation of why investment banks and other financial institutions took such spectacular risks with extremely leveraged positions on many securities and derivatives, and the risk management, governance and ethical environment that allowed such conduct to take place demands detailed analysis.

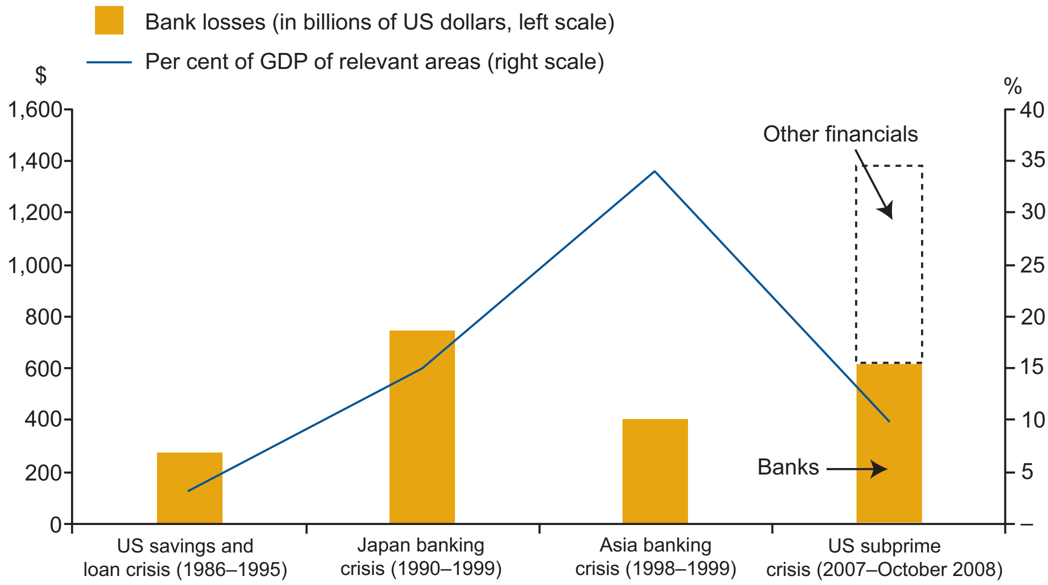
Origins of the crisis

In the cyclical way markets work, the historical origins of the 2008 financial crisis may be found in the solutions to the previous market crisis. The US Federal Reserve under the sage Alan Greenspan responded to the collapse of confidence caused by the dotcom disaster and Enron failures in 2001–2002 by reducing US interest rates to one per cent, their lowest in 45 years, flooding the market with cheap credit to jumpstart the economy back into life. US business did recover faster than expected, but the cheap credit washed into the financial services and housing sectors producing the largest speculative bubbles ever witnessed in the American economy.

The scene was set by the 1999 dismantling of the 1932 Glass-Steagall Act which had separated commercial banking from investment banking and insurance services, opening the way for a consolidation of the vastly expanding and increasingly competitive US financial services industry. Kevin Phillips described this as a 'burgeoning debt and credit complex'.[1]

The current crisis originated on Wall Street where deregulation unleashed highly incentivised investment banks to flood world markets with toxic financial products. As a stunning series of banks and investment companies collapsed in the United States and in Europe, a frightening dimension of the global economy became fully apparent: a new world disorder of violently volatile markets and deep financial insecurity.

Figure 1: Comparison of international financial crises[2]



Sources: World Bank; and IMF staff estimates
Note: US subprime costs represent staff estimates of losses on banks and other financial institutions.
All costs are in real 2007 dollars. Asia includes Indonesia, Malaysia, Korea, the Philippines, and Thailand.

As the new financial instruments were developed and marketed, the securities markets grew massively in the 2000s dwarfing the growth of the real economy. For example, according to the Bank of International Settlements the global derivatives markets grew at the rate of 32 per cent per annum from 1990, and the notional amount of derivatives reached US$106 trillion by 2002, US$477 trillion by 2006, and exceeded US$531 trillion by 2008 (though gross market value is a small fraction of this).[3]

The supposed purpose of this increasingly massive exercise was to hedge risk and add liquidity to the financial system. Derivatives allow financial institutions and corporations to take greater and more complex risks such as issuing more mortgages and corporate debt, because they may protect debt holders against losses. Since derivatives contracts are widely traded, risk may be further limited, though this increases the number of parties exposed if defaults occur.

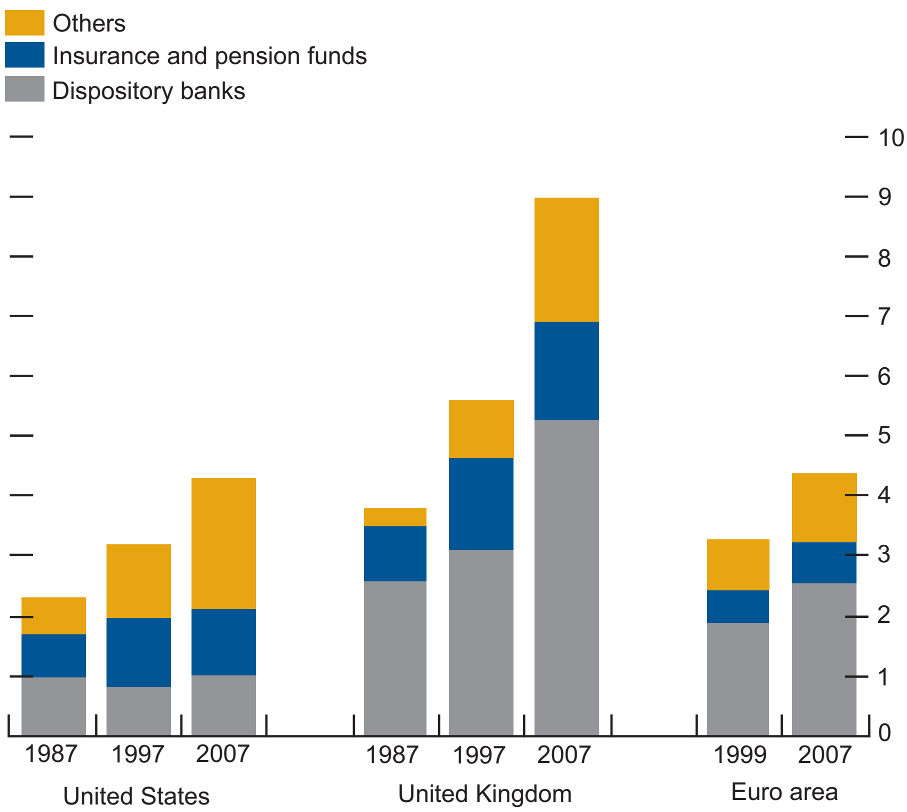
As Nobel Prize winner in Economics Joseph Stiglitz argued 'America's financial institutions have not managed risk; they have created it'.[4] Innovative Wall Street investment bank securities originally conceived to insulate against risk, metastasised through immense misuse into the wide distribution of acutely dangerous and uncontrollable risks. Instead of risk being hedged, it has become interconnected and international, and unknown.

Financialisation

Understanding financial markets, let alone coordinating or regulating them, is now a great deal more difficult since they have become much larger, inter-connected and internationalised. Relative to gross domestic product, the financial sector in all of the industrial countries grew considerably in the last two decades of financial deregulation, innovation and globalisation. The size of financial assets in both the US and UK has more than doubled in 20 years. The massive growth of the UK finance sector and also the sustained growth of the European finance sectors involved the adoption of similar financial innovation and exotic instruments as in the United States. British and European financial institutions have also succumbed to the temptations of high leverage (in some cases higher than the Wall Street investment banks), minimal risk management, and a fascination with the returns that new financial securities and speculative industries — most notably the property sector — might deliver.

In the UK the financial sector became gargantuan, with assets around nine times GDP, a multiple more than double that of the US finance sector (see Figure 2). A concentration on financial services is considered in the US and UK as an essential part of the new economy, and was associated with rapid market growth, high profits and very high salaries for a privileged few dealing in the most exotic financial securities.

Figure 2: Scale of financial assets in multiples of gross domestic product[5]



Sources: US Board of Governors of the Federal Reserve System; UK Office of National Statistics; European Central Bank; and IMF staff estimates.

Fuelling the whole process of financialisation were volcanic eruptions of debt. When Alan Greenspan became Chairman of the Federal Reserve in 1987 public and private debt in the US totalled US$10.5 trillion, but after his departure in 2006 it had quadruped to US$43 trillion. Meanwhile financial services including finance, insurance and real estate now account for over 20 per cent of the US GDP, with manufacturing shrinking to 12 per cent. In Australia similar processes of largely private debt accumulation have grown the finance sector to 19.4 per cent of GNP while manufacturing has fallen to 10.1 per cent.

A debate has continued for some time about the costs and benefits of the financialisation of advanced industrial economies. The increasing role of financial markets, financial institutions, financial managers, and financial motives in the basic operation of both domestic and international economies is a continuing concern. What happened to the *real* economy where people produced goods and services that other people enjoyed?

As the Archbishop of Canterbury argued recently:

> Trading the debts of others without accountability has been the motor of astronomical financial gain for many in recent years…The crisis exposes the element of basic unreality in the situation — the truth that almost unimaginable wealth has been generated by equally unimaginable levels of fiction, paper transactions with no concrete outcome beyond profit for traders. The biggest challenge in the present crisis is whether we can recover some sense of the connection between money and material reality – the production of specific things, the achievement of recognisable human goals that have something to do with a shared sense of what is good for the human community in the widest sense.[6]

Regulation

Financial institutions that deliver an efficient and liquid supply of finance and credit are critical to the operation of any economy, and traditionally are subject to a framework of firm regulation.

However, as the financialisation of the US and international economy proceeded, paradoxically the regulatory touch lightened considerably. In the words of one US finance expert, in the years before the crisis:

> We were developing a system of very large, highly levered, undercapitalised financial institutions — including the investment banks, some large money centre banks, the insurance companies with large derivative books and the government-sponsored entities… Regulators believe that all of these are too big to fail and would bail them out if necessary. The owners, employees and creditors of these institutions are rewarded when they succeed, but it is all of us — the taxpayers — who are left on the hook if they fail. This is called private profits and socialised risk. Heads I win. Tails, you lose. It is a reverse Robin Hood system.[7]

The regulatory authorities, ratings agencies, and risk management of the financial institutions themselves all failed spectacularly. In the US the Securities and Exchange Commission in 2004 introduced a new rule essentially allowing large broker-dealers to use their own risk management practices for regulatory purposes enabling a lowering of their capital adequacy requirements (the core capital which a financial institution is required to hold to support its risk-taking activities). The problem was that many of these risk-management practices were ineffective or non-operating in the context of the frantic securities deal making of the time.

It is the job of the credit ratings agencies to assess the risk associated with particular financial institutions and financial instruments, in order to give investors a better understanding of the risks they face. Yet the question asked by everybody when the financial crisis erupted was how could asset backed securities containing subprime mortgages and other high-risk debt possibly be given AA credit ratings by Standard & Poor's or Moody's?

The answer is again that financial innovation has outpaced regulatory effectiveness. The ratings agencies instead of monitoring rigorously the growth of financial markets and instruments have become junior partners in this enterprise. Coffee in his critique of the failure of the gatekeeper professions in US corporate governance including auditors, corporate lawyers, and securities analysts, raises serious issues regarding rating agencies:

- their entrenched market duopoly
- the conflict of interest in the agencies receiving their revenue for the issuers of debt products
- their capacity to understand the underlying assets and cash flows involved in complex structured finance products and
- the fact that ratings agencies do not review how the risk profile of debt products may change in different market conditions.[8]

Risk management

In financial businesses themselves, innovation in financial products has far exceeded the capacity of risk management measurement and monitoring tools to gauge risk, with undue reliance on the VaR (value at risk) measure which does not evaluate risk in the most extreme circumstances. As the penetrating report on the reasons for the $44 billion writedowns at UBS reveals:

> The investment bank was focused on the maximization of revenue. There appears to have been a lack of challenge on the risk and reward to business area plans within the investment bank at a senior level. UBS's review suggests an asymmetric focus in [the investment bank] senior management meetings on revenue and profit and loss, especially when compared to discussion of risk issues.[9]

As with many other US, UK and European banks, UBS sailed blithely towards the iceberg of the subprime mortgage crisis in a state of profound ignorance:

> Presentations of Market Risk Control to UBS's senior governance bodies did not provide adequate granularity of subprime positions UBS held in its various businesses. No warnings were given to group senior management about the limitations of the presented numbers or the need to look at the broader contextual framework and the findings were not challenged with perseverance.[10]

Getting the incentives very wrong

The final and most critical part of the explanation of why investment banks and other financial institutions took such extreme risks with highly leveraged positions in complex securities, neglecting risk management, governance principles, and often basic business ethics, was that *they had enormous incentives to do so*. As the UBS report concludes:

> It remains the case that bonus payments for successful and senior international business fixed income traders, including those in the businesses holding subprime positions were significant. Essentially, bonuses were measured against gross revenue after personnel costs, with no formal account taken of the quality and sustainability of those earnings.[11]

Massively incentivised irresponsibility became the operating compensation norm in the financial community, as banks and fringe financial institutions chased the super profits available as global financial markets expanded exponentially.

Consequences

While the accumulated cost of the global financial crisis is being realised, the commitment to establish a new international financial regulatory framework increases, culminating in the G20 meeting. The general market assistance and specific rescue

Table 1: Subprime losses by international banks, October 2008

Company	Country	Losses ($US billion)
Citigroup	US	66.6
Wachovia	US	52.7
Merrill Lynch	US	54.6
Washington Mutual	US	45.6
UBS	Switzerland	44.2
HSBC	UK	27.4
Bank of America	US	21.2
JP Morgan Chase	US	18.8
Morgan Stanley	US	15.7
IKB Deutsche	Germany	14.7
Royal Bank of Scotland	UK	16.5
Lehman Brothers	US	18.2
AIG	US	16.8
Fannie Mae	US	12.7
Deutsche Bank	Germany	11.4
Ambac	US	10.3
Wells Fargo	US	10.0
MBIA Inc	US	9.4
Barclays	UK	9.2
Credit Agricole	France	8.6
Credit Suisse	Switzerland	8.1
HBOS	UK	7.5
Canadian Imperial Bank of Commerce	Canada	7.1
Fortis	Belgium/ Netherlands	6.9
Bayerische Landesbank	Germany	6.7
Freddie Mac	US	6.7
ING	Netherlands	6.5
Societe Generale	France	6.4
Mizuho Financial Group	Japan	6.2
Dresdner Bank	Germany	5.0
Bear Sterns	US	3.4
WestLB	Germany	3.1
BNP Paribas	France	2.7
UniCredit	Italy	2.7
Lloyds TSB	UK	2.6
Nomura Holdings	Japan	2.5
DZ Bank	Germany	2.0
Natixis	France	2.0
Swiss Re	Switzerland	1.8
HSH Nordbank	Germany	1.7
LBBW	Germany	1.7
Commerzbank	Germany	1.2
Mitsubishi UFJ	Japan	1.2
Sumitomo	Japan	1.2
AXA	France	1.1
Total losses		**582.60**

packages for individual financial institutions provided by governments has amounted to almost US$10 trillion worldwide. The losses of international banks alone reached US$582 billion by October 2008, and despite successive immense investments by the US, UK and European governments have remained weak in early 2009, with the prospect that public ownership of a significant number of banks may be the only effective immediate remedy (see Table 1).

As the financial crisis impacts upon the real economy the fears of a prolonged world-wide recession grow. The International Labour Organization in Geneva estimated that up to 20 million people would lose their employment as a consequence of the financial crisis, and for the first time in a decade the total global unemployment will be above 200 million. The evidence in early February 2009 that over 20 million people will lose their jobs in China alone demonstrates the financial crisis has now become a global economic crisis. The desperate news from the US car industry illustrates how the financial crisis will further undermine already vulnerable manufacturing sectors.

There is a widespread sense that this regulatory failure of financial markets cannot not be allowed to occur again. A problem in devising a new financial regulatory architecture equivalent to Bretton Woods is that dealing with digital and interconnected global financial markets presents a much bigger challenge. The outdated rhetoric of the Bush administration about the dangers of overregulation will be dismissed by US legislators and the US public, alarmed at the potential collapse of the US economy. The new US administration is committed to reform of the financial institutions, and having invested heavily in the banks is in a position to demand change.

The proposals for reshaping international financial institutions and reforming worldwide regulatory and accounting rules agreed at the G20 summit are comprehensive and based on a sober analysis of the causes of the crisis.

> Weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.[12]

The commitments to strengthening transparency and accountability, enhancing regulation, promoting integrity in financial markets, reinforcing cooperation and reforming international financial institutions, represents an ambitious agenda. These commitments and the diplomatic process that has delivered them suggest that an important consequence of the financial crisis is a defining move towards a multi-polar world, with a new economic order in which global regulation of international business and global market oversight will be accepted as the basis for market stability and integrity, With executive incentives aligned to prevent excessive risk taking, and reward sustainable business development.

However the questions[13] are whether the deference of governments and regulators will return when financial markets recover, and whether financial institutions and markets will be free again to pursue their own self-interest.

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Notes

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12 *Declaration of the Summit on Financial Markets and the World Economy*, 15 November 2008

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