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The Financial Crisis: One Year Later

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Partenaire financier

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Résumé / Abstract

Cette publication se veut un retour actualisé sur les événements de la dernière année concernant l'évolution de la crise financière et de la récession économique. Poursuivant et mettant à jour l'analyse d'il y a un an, l'auteur offre une évaluation des trois scénarios potentiels qu'aurait pu suivre la crise. Ce retour sur la crise se fait à travers une réflexion, et parfois une critique, concernant le rôle des joueurs clés qui sont impliqués autant dans les causes que dans les solutions. Il s'agit des gouvernements, des banques centrales, des autorités de régulation, des institutions financières ainsi que des dirigeants de celles-ci. C'est à partir de cette analyse rétrospective que l'auteur peut conclure en partageant son impression quant aux développements futurs de l'économie et du secteur financier.

Mots clés : crise financière, récession, intervention gouvernementale, régulation financière, histoire financière, prévision financière.

This paper is meant to provide a fresh retrospective on the events shaping the evolution of the financial crisis and economic recession since last year. While continuing and updating last year's analysis, the author offers an assessment of the three potential scenarios through which the crisis could have evolved. This update on the crisis derives from a reflection, sometimes a criticism, of the key players' role in both the causes and the solutions. Those are the governments, central banks, regulators, financial institutions, and their directors. It is from this retrospective analysis that the author can conclude by sharing his impression regarding future developments of the economy and the financial sector.

Keywords: *financial crisis, recession, government intervention, financial regulation, financial history, financial forecasting*

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The financial crisis that erupted in 2008 and quickly turned into the worst recession since the great depression is now one year old.

The analysis of this event a year ago pointed to three very different possible scenarios depending on market behaviour as well as measures and decisions taken by governments, central banks, regulators financial institutions and directors.

It is now time to consider what happened in the past months and try to identify which outcome has been favoured by recent events.

1 - The three possible outcome of the crisis as they appeared to me last year

In the turbulent environment of the last months of 2008, it was very difficult to ascertain a single future course of events. The best solution was then to describe three scenarios without choosing the most likely.

The first scenario considered a quick and painless rebound. Based on the huge amount of liquidity injected by the authorities, a rapid recovery in equities followed by other markets (but not the real estate market considered too seriously hit to be able to recover in such short time) takes place. As confidence returns, governments recoup some of the bail out money and pressure on politicians lessens. All participants: banks, hedge funds but also central banks, lawyers, accountants, rating agencies and regulators, are eager to revert to previous conditions before structural damage is done to their usual way of conducting their affairs. As no significant corrective measures have been taken, the scenario leads to new bubbles and subsequent crisis.

The second scenario explored the possibility of a deepening recession and serious market weakness. As a consequence, governments get further involved in supporting, regulating and even running the financial system to the point where they put themselves at risk. The

resulting dirigiste intervention into the financial world stifles innovation, entrepreneurship and ultimately the economy creating a further downward spiral.

The third scenario put forward a balanced approach where a reasonable short term recovery leaves enough leeway for the main actors to coordinate the appropriate measures addressing the real causes of the crisis.

In this course of events, a long lasting recovery is possible provided:

Governments adopt a calm attitude to reassure the public and avoid interfering in areas outside their competence. Equally important is their capacity to resist the temptation to use borrowed funds for political purposes and thereby preserve their limited financial firepower and apply it to critical bail outs and support of the economy in a way that stimulate future growth, innovation and entrepreneurship.

Central banks improve their capacity to identify financial bubbles and act early to restrain them.

Regulators fulfill their pivotal responsibilities by:

- ◆ Revising the current failed risk models that relied too much on historical data and introducing behavioural factors into the models as well as more stringent stress tests.
- ◆ Curbing excessive, short term based remuneration of bank traders and key executives
- ◆ Promoting reliance on traditional bank risk departments, staffed with high quality, experienced personnel.

- ◆ Extending their reach to establish adequate ethical rules for key service providers such as rating agencies, auditing firms and legal firms, who played a role in the crisis.

The dosage of their intervention needs be delicate as regulators should avoid a heavy handed approach that would dampen the risk appetite of financial institutions and snuff out innovation.

Financial institutions address the risk management shortcomings that were highlighted by the crisis (for example, by reconsidering their models and reconstituting proper credit risk departments relying less on rating agencies) and approach market risk and credit risk differently.

They would also be responsible for taming the short term culture promoted across their organizations through bonuses/and stock option awards based on short term performance, replacing them with deferred compensation that rewards long term performance, while being generous enough to attract innovative talent.

Finally, Non executive directors improve their understanding of new, sophisticated financial products, something that does not come necessarily with experience, but requires appropriate formal training programs.

2 - **Certainly a momentous year**

The first reaction to the exploding crisis has been a coordinated, fast and massive intervention by central banks and treasuries aimed at preventing a catastrophic collapse of the world financial system.

Then, as the financial system recovered from the initial shock, a series of measures some with long term implications, were taken with the stated intention to improve markets and support the economy.

It is important to analyse these two phases within the framework of the above scenarios in order to discern the possible course of events going forward.

Markets rebound quickly (surprisingly so)

At the height of the crisis a year ago, the financial system was practically in a state of cardiac arrest. It was obvious that emergency measures to get it back on track were urgently needed.

It is now clear that treasuries around the world rose to the challenge and acted with the appropriate speed, decisiveness and coordination on a global scale.

Almost bypassing legislative institutions shocked by unfolding events, they demanded the discretionary use of vast sums of money and set up their course of action with great efficiency.

The massive cash infusions into the banking system have been instrumental in restoring some degree of confidence. In fact, the huge amounts (700 billions in the case of the US TARP) made available by financial authorities around the world to purchase toxic assets, in many cases shore up the banks' capital and engineer mergers, demonstrated the ability of the authorities around the world to control and support their financial system in times of hardship.

When the crisis extended to the broader economy, governments stepped in again with more emergency support directed at selected industries (automobile, construction) or even companies (GM, AIG, Northern Rock). Many bankruptcies were successfully avoided, but at the cost of huge monetary outlays.

Beyond a crucial psychological lift and indispensable short term rescue that they provided, the longer term results of these measures seem however hardly commensurate with the vast amounts laid out.

Indeed, to this day, many of the major recipients of this considerable and unprecedented support have not fully recovered. They remain on the watch list of investors and regulators and more importantly are in no position to pay back soon the amounts provided to them.

Even though politicians were quick to announce that their wise use of tax payer's money was part of a global solution to the crisis, the long term efficiency of these measures are questionable.

From the beginning, Central banks have also taken vigorous and unprecedented measures.

In the US and Europe a flood of liquidity was injected into the banking system through the usual instruments as witnessed by the rapid rise in the M1 monetary aggregates. More importantly, central banks have been willing to take vastly increased risks. As such, the fed has purchased mortgage backed paper, and with its TALF program, extended the scope of its intervention to commercial paper, student loans, credit cards and car loans. It also acted to save some organizations, arranging the takeover of Bear Sterns and Merrill

Lynch and providing huge cash injections to AIG as did the Bank of England in the UK in order to save large banks such as RBS

This course of action by and large managed to break the interbank market paralysis and allow a more fluid flow of funds. Central banks were not able, however, to completely revive the vital securitization market, and thereby alleviate commercial banks balance sheets, one of the keys to stimulating new lending and a more vigorous recovery.

Although governments and central banks acted swiftly and in a coordinated way, the wall of liquidity that they created as early as the end of 2008 did not seem to slow the economic downward spiral, stop rising unemployment or slow the fall in the stock market. Indeed the DJIA reached its low on the 10th of March 2009.

Then the stock markets started rising almost without interruption and have retraced 50% - 60% of their declines. The interbank markets have regained liquidity and the confidence in banks has been for the most part restored. Property prices also stabilised and even bankers bonuses are now on their way back up to pre crisis levels in many institutions.

What sparked off this outstanding recovery in the spring of 2009 was the realization that banks' results were going to be much better than expectations, indicating that the financial system was in much less danger than previously thought.

The remarkable return to profitability in such short time can be traced directly to the bold decision of central banks to lower interest rates close to 0%. This drastic measure, which in fact did not cost anything to the taxpayer, had translated into a huge transfer of revenues to the financial system at the expense of private savings as banks did not drop their lending rates to the same extent as their cost of funds declined. This stealth tax on savings directly benefited financial institutions' profits and as a consequence, their share prices.

As the stock market started recovering, fund managers, who held large cash positions, were compelled to participate in the developing rally in order to match the market performance. Then investment bankers and traders jumped in, lifting further the whole market.

It is therefore possible to conclude that while the measures involving large cash outlays avoided a short term collapse of the financial system, it was the unprecedented, coordinated drop in interest rates that caused the spectacular sustained recovery of the equity markets and the unfreezing of bond and money markets.

In the meantime however, economic indicators still remain weak, unemployment high, consumption sluggish and real estate prices lethargic. Clearly the crisis seems to be lingering. Can we attribute the contrast between the rise in the stock market and the poor state of the economy to the usual gap between forward and lagging indicators or are we still in the throws of this unusual crisis?

The answer requires an analysis of the set of events that followed the critical first phase of the crisis.

Key players adopt self-serving and somewhat misguided approach

The robust, short term support of the financial system last fall has been very costly but the rebound of the stock markets has provided an indispensable respite to initiate essential reforms.

A sensible approach called for the major players in this crisis to work together, within their own spheres of competence and adopt the proper long term measures even if they did not produce immediate effects or are unpopular. Although a rational approach has

often been advocated particularly by regulators, the most prevalent behaviours we have witnessed to date has ranged from blaming others, settling old scores, pushing individual agendas, grabbing power at the expense of other parties or protecting one's own field and hoping the problem will eventually go away.

Governments

Depending on how hard they were hit, governments have reacted with various degrees of invasive policies. Countries such as Australia, Canada or Israel have had to commit fewer resources in support of their economies and indeed, have also emerged faster from the slowdown. However, these are not major economies on the world scene and it is more meaningful to concentrate on the larger and more influential ones.

After recovering from the initial shock, politicians in large countries predominantly chose to take advantage of the power vacuum left by the once dominant but now wounded financial industry in order to advance their political agenda.

First they decided to settle old scores with the financial industry, essentially in areas that previously escaped their control.

Backed by a frustrated public, governments targeted off shore tax heavens and hedge funds although both targets bore little responsibility for the crisis. Similarly, they launched an assault on bonuses, linking the crisis to the extravagant amount paid to bankers. This narrow focus on bonuses, shows only a partial understanding of the wider issues that caused the crisis but a real determination to escape political damage

Likewise, the recent measures proposed by President Obama illustrate this point very well. They first exclude banks from hedge fund, proprietary trading and private equity activity, none of them being at the root of the crisis. Then they limit their size so that no too big to fail organization could operate (a clear attempt to protect the government

finances without any regard to preserving the international competitiveness of these organizations) and finally impose a fee on the 50 largest banks whether they still owed Tarp money or not (although conveniently excluding Fannie Mae and Freddy Mac now owned by the government) in order to recoup 117 billions in Tarp funds deemed irrecoverable introducing therefore a penalty on success and good behaviour.

The net result has been to create an antagonistic atmosphere – to the point where the US treasury secretary described it as “a just war “ – and induce in the financial sector a defiant and suspicious attitude precisely when cooperation was needed.

Then most governments launched massive stimulus plans. As the consumer retrenched, there was ample justification for such initiatives. However, the vast deficits created by shoring up the financial system coupled with reduced tax revenues in time of economic crisis demanded a very prudent use of these funds.

Depending on their political leaning and their freedom of action, governments spent these funds in different ways. China for example put a strong emphasis in supporting innovative industries and expanding manufacturing capacity, creating the conditions for future progress. On the other hand the US plan was short on stimulus to growth sectors, but long on support to politically sensitive, mature industries with high payroll numbers.

All of them however have involved massive borrowings that will become more and more difficult to service. The Financial Times estimated recently that the world’s government refinancing needs will come to \$ 1 trillion a month in 2010. One wonders whether investors have the capacity to supply the vast sums needed and what will then be left to cover the private sector borrowing needs.

Perhaps more importantly, massive deficits may erode investor confidence in sovereign risks of which Iceland and more recently Dubai and Greece are good examples. In

addition the prospect of unending, huge budget deficits and possible inflation arising from excessive short term money markets liquidity are also draining confidence.

By their aggressive interference and some lack of long term vision, the most influential governments have created an antagonistic atmosphere and weakened the financial stability of their countries. As such, their actions have made scenario 2 more probable.

Central banks

From the beginning central banks have intervened decisively coordinating their actions worldwide to stem a complete collapse of the financial system. To achieve such commendable success, they had to:

- i) Create huge amounts of liquidity. At the height of the crisis, the Bank of England, the ECB and the Swiss central Bank went as far as offering unlimited funds at auctions.
- ii) Assume highly unusual risks by taking on their books commercial, mortgage, credit card and personal loans in an effort to offset a drained securitization markets,
- iii) BBuy paper issued by governments and most importantly drive interest rates down to zero to restore the profitability of the banking sector.

In doing so however, they put themselves in a very delicate position.

The liquidity they created has to be mopped up at some point otherwise it will lead to high inflation which could be either headline inflation, that will induce an uncontrollable rise in interest rates, or asset inflation, that will start another speculative bubble.

However, the recovery of the financial institutions has not yet taken hold. Despite some successful equity issues by good quality banks, many financial institutions remain weak and in need of more capital. Moreover, the securitization market has recovered for government guaranteed paper, but definitely not for mortgage securities. As a consequence, when central banks adopt a more restrictive liquidity policy the risks of initiating a new crisis will increase accordingly.

Even more challenging is the dilemma concerning interest rate levels.

Central banks – and investors - are conscious that the near 0% interest rate policy underpins the whole recovery of markets and mitigates the cost of extravagant levels of government debt. They also know that, in the long run, such distorting policy leads to excessive budget deficits as the Japanese example has shown or encourages speculation.

However their boards seem rather bent to fighting any economic slowdown, regardless of future cost hoping that conditions will soon return to what they were. As for speculative bubbles there is still no consensus on whether central banks have a mandate to control asset inflation. In matters relating to central banks, public perception is perhaps more important than actual action. This attitude favours scenario one.

Regulators

From the start, regulators have taken some blame for the crisis and the UK has considered returning the supervisory role to the Bank of England.

A number of regulators have reluctantly also admitted their past willingness to accommodate excessive risk taking by financial institutions as well as their incapacity to identify the causes and the magnitude of the crisis. However, in reaction to the hostile atmosphere, they have claimed that low budgets resulted in inadequate resources,

underpaid and insufficient staff that in any case lacked the necessary competence and training.

They then proceeded to deflect the attention of the public, by pursuing headline grabbing cases of insider trading or hedge fund frauds. These are worthy accomplishments, but rather distracting in the current context, where serious efforts at broad-ranging reforms are necessary.

On a more positive note, regulators have started to concentrate on the necessary long term reforms. They have progressed on the subject of disconnecting traders and senior managers remuneration from short term results, although concentrating mainly on bonuses while paying less attention to stock options and the endless quest for improved quarterly profits that they induced at top management level.

In a major effort to improve the financial stability of banks and protect the governments and the public from future crisis, regulators have been discussing the best options to increase the statutory capital of financial institutions. This idea is perfectly justified even though the protection it provides will always be insufficient if a major run on banks gets underway.

A review of financial models and stress tests to take into account “ black swan “ effects, and a return to more traditional approach to credit risk are only beginning to be discussed. Similarly, the important process of extending supervision to rating agencies and auditing firms in light of their significant responsibilities in the sub prime crisis is being considered in Europe but not yet in the US.

By and large, regulators have started the search for proper measures to avoid future crises. Their progress is predictably slow and will probably not make a difference in the near future, but it is a worthwhile effort that should be encouraged. Provided that their

independence is not threatened or their priorities altered by politicians, regulators are the best chance left to make progress on the path to scenario 3.

Financial institutions

As the main cause of the crisis and also the main recipient of governments rescue funds, the financial sector has been closely scrutinized by the authorities and the public. From the amount of staff bonuses to lending guidelines, risk appetite and management policies, all aspects of their operations have been examined and criticized. As a consequence, banks have retrenched in a besieged frame of mind.

So instead of instigating the necessary long term reforms in coordination with the authorities, they decided to get into a short term protective mode by rebuilding their profitability as soon as possible and if feasible, pay off any kind of constraining conditional public support, a move that according to the recent announcement of President Obama does not seem to insulate them from the anger of the authorities.

Their first priority in this uncertain climate has been to avoid any further loan losses.

The continuing weakness of their loan portfolio caused by a faltering economy, coupled with the internal rise in power of risk departments has translated into a very conservative lending policy. Despite official pressure to extend more loans, this conservative stance is not likely to change anytime soon thereby slowing down the recovery.

The second goal has been to increase revenues. Comforted by the effortless and assured profits derived from the nil interest rate policy conducted by central banks for their benefit, financial institutions were quickly emboldened to take advantage of the powerful rise in markets. Over this period, their market trading has been very successful and profitable. This allows them to now pay hefty bonuses, while they still can, and retain talent. The banks have also managed to preserve most of their advanced financial

activities that are crucial to future innovation and economic progress. The downside, however, is their continued reliance on failed risk model which could increase their vulnerability if a new bubble develops.

In the end, financial institutions, shock shelled by the crisis and under great pressure, have isolated themselves somewhat from the general economic environment and are acting as if they believed strongly that the financial world will soon revert back to pre crisis conditions. As such, they are betting on scenario one rather than promoting the more reasonable scenario three.

Directors

The role of directors has recently received some attention. In a frantic effort to find new ways to curb management power and remuneration, the authorities are considering legislation that will dissociate further, non executive directors from top management and encourage their role as defenders of shareholders' interests. Various measures have been proposed such as regulators vetting new bank directors, giving shareholders more say in directors' selection and managements' remuneration processes.

While there is merit in allowing a third party to break up relationships between management and board when they become too cosy and the directors fail to control runaway remuneration, it is more difficult to understand how this would have avoided salvaged companies and financial institutions from the dire consequences of the recent crisis. Surely, if any management or board members had seen the financial meltdown coming they would have taken measures to protect their company whatever the level of remuneration or the friendly relationship with management. The reason they did not is that they were not able to assess the risks properly, something that indeed regulators and rating agencies were not capable to do either.

Clearly the missing factor and the key to a real solution is to teach directors how to evaluate and stress test the risks attached to an ever more complex financial environment, something that their past experience seldom provides. This important pre condition for scenario three to play out has not been properly addressed so far and leaves boards hoping for scenario one to happen.

3- What does the future hold?

The past twelve months has been eventful, if somewhat hectic, in the financial world. With the benefit of a one year perspective we can try and assess how the chances of each scenario have been affected by the main participants' attitude and the many measures discussed, envisaged or taken.

The chances of scenario three, the reasonable option, have receded

Scenario three offers a comprehensive solution to the crisis provided that a cooperative, thorough and long term approach is adopted by the authorities and the financial players.

With politicians mainly influenced by public opinion and the next election; central banks eager to recover as soon as possible the huge and risky amounts lent in support of financial institutions; regulators under pressure to “do something “; banks under siege trying to survive and rebuild their balance sheet as fast as they can, it would have been difficult in the past year to draw together the parties involved and devise long term measures to avoid future crisis.

Of course, there is always the possibility that a change of attitude, most probably led by regulators, takes place in support of a more stable long term future of the world financial system. The US and the EU are indeed considering new regulatory rules but they seem mostly focused on avoiding the detrimental consequences of the crisis rather than the

causes. Overall a comprehensive and timely solution remains doubtful if we consider the general lack of enthusiasm for such approach (the head of the IMF recently declared that asset bubbles were the cost worth paying for reviving growth through loose monetary policy), the reduced influence of regulators.

Also the window of opportunity could be closing either because conditions continue to improve and the topic becomes largely out of fashion or they deteriorate and immediate action is politically demanded at the expense of comprehensive longer term approach.

Therefore the chances of scenario three are now reduced.

Scenario two: still possible in a modified form

The original scenario two envisaged a straight downward spiral. Clearly this has been averted by the rise in markets. Nevertheless, it does not mean that this possibility should be discarded as conditions might deteriorate again in after a short respite.

Indeed the world economy is still struggling despite the various stimulus plans and high unemployment continues to threaten consumption. Even though domestic deficits are growing at an alarming rate and deficit imbalances between countries continue to grow, governments feel compelled to support economic activity and talks of further stimulus plans abound leading to more governments' borrowings.

Meanwhile, the banking systems remain weak and are now clearly perceived as government's responsibility.

As a consequence the probability of a new credit crisis remains significant. This time around it would not be linked to the real estate market, which has for the most part stabilized, but would involve the only sector which indebtedness is presently growing out

of control: sovereign debt. The warning shot of the Dubai liquidity crisis in December 2009 and the current difficulties of several Euro zone countries such as Spain, Portugal or Greece could be a precursor of a new crisis and if confidence in larger countries debt or currency starts to erode, a real downward spiral could develop.

In this modified version, scenario two seems more probable at this point in time than scenario three.

Scenario one: the temptation of short term mind-set

Among the causes of the financial crisis identified in last year analysis, the most important is arguably the rise of “short- termism”. Recent events show that the emphasis on immediate action based on the most recent news and trends is still widely prevalent. Moreover several partakers would like conditions to revert back to pre crisis order.

If markets continue to rise and the world financial system regains its footing, banks will be happy to repay their emergency loans and regain their independence. Central banks will clean their balance sheet. Governments, after taking the best political advantage of recent events, will recover their loans and welcome the return of economic growth often a pre condition to re election. This leaves only regulators with the task of making sure it does not happen again but in such euphoric atmosphere, chances are that only light reform will pass.

The problem is, as we know from recent experience, that such conditions are conducive to new speculative bubbles. This time however the massive liquidity hanging around means that their magnitude and related crashes would be considerable particularly in view of the fact that Central Banks do not have efficient tools to detect new bubbles and have not even decided if they should intervene in cases of asset inflation.

Speculative movements involving such massive liquidity can only take place in markets large enough to accommodate them.

In last year's paper, we argued that the real estate market will not return into speculative mode soon and recent statistics confirm this point. So we are left with equities, commodities (including precious metals) and foreign exchange as possible candidates for the next bubble. While central banks seem to have foreign exchange under reasonable control, equities (especially emerging markets equities) and commodities are showing the first signs of speculative behaviour.

Overall, scenario one, while still far from being certain, seems at this stage more probable than the two others.

And so ...

It is not yet possible to decide how the current financial crisis will play out. Many questions still need to be answered. However in the last twelve months, the measures taken and the attitude of the major partakers seem to favour a return to pre crisis conditions. The world economy could still slip into another downward spiral particularly if some sovereign debt problem emerges and panic sets in but this seems somewhat less likely. Finally the chances of a long term and more stable solution have not disappeared but have definitely receded.

In any case, what can be safely expected is that volatility will remain high in the near future.