The Global Financial Crisis;
Lessons to Learn in Governance and Regulation:

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Introduction

A Global economic crisis is developing rapidly. Its implications are progressively becoming more evident and serious, although its ultimate dimensions and impact remain uncertain.
For most the crisis emerged suddenly and unexpectedly in mid 2008 in financial markets but for some, with specialist knowledge or a particular perspective, its origins are earlier, even many years earlier, in the finance and property sectors in the USA.

So, how could such a serious situation develop, less than a decade after Enron, WorldCom, Tyco and co crashed so spectacularly and ignominiously and Sarbanes Oxley was introduced, at great cost and disruption, to increase transparency and accountability and ensure there was never a repetition?

For those interested in business and the workings of markets, there are already serious lessons to be learned (or relearned!), including about the effectiveness and limitations of boards of directors and the roles and responsibilities of regulations, regulators and their political masters.

The lessons are directly relevant to New Zealand, particularly given the recent systemic failures in its the non-bank financial sector.

Nature and Origins of the Crisis

The origins of the crisis were in the USA.
Firstly, various US administrations and government agencies pushed for greater housing funding for lower income and minority groups. Goals were set and lower lending standards and practices promoted (eg: Community Reinvestment Act, 1977; Federal Housing Enterprises Financial Safety and Soundness Act, 1992; New Community Reinvestment Act, 1995; President GW Bush in 2002 further increased the goals; then HUD increased the goals in 2004 – Fannie Mae & Freddie Mac were to increase from 50% to 56% their share of lending to low/middle income families; and so on)

Then the regulation of financial institutions and instruments was relaxed (eg: Reigle-Neal Interstate Banking and Branch Efficiency Act, 1994; Gramm-Leach-Bliley Act – Financial Services Modernisation Act,1999; Commodity Futures Modernisation Act, 2000; then the SEC in 2004 suspended the "net capital rule for major investment banks which effectively removed any limit on their debt/leverage; and the Federal Reserve (2003 – 2007) abandoned loan standards supervision, emphasizing lenders ability to securitize & repackage subprime etc loans (ie obfuscate and pass on the problem?) etc.)

Through the Long Term Capital Management debacle (1999), the Asian Financial crisis, the Dot-Com bust and other periods of weak economic performance there was a general regulatory stance favouring high liquidity/credit growth and low interest rates, which reflected the politically attractive short term goal of stimulating economic activity, with little regard for the economic fundamentals and the possible/likely longer term consequences.
Between 2000 and 2001 the US Federal Reserve lowered its funds rate 11 times from 6.5% to 1.75% and in 2003 lowered it to 1%, the lowest in 45 years.

In this much more permissive environment a number of major financial institutions, but not all, particularly investment banks, responded to the relaxation of regulatory standards and constraints and the more buoyant credit markets by changing their business policies and practices. They increased their targets and incentives and innovated aggressively and ultimately recklessly, leveraging off a high level of technical skill in complex financial instruments and market strategies, their superior knowledge and, generally, their reputations as being trustworthy and responsible.

Importantly, the ability to on-sell rather than hold the assets, in part exploiting their superior knowledge and reputations, passed the problem to someone else. Having been allowed to develop this "pigs in clover" model, greed became a driving motivation in many instances.

In this model the rating agencies had an omnipotent position and critical role, but they failed miserably, abusing their positions of responsibility and demonstrating a lack of competence to deal with increasing complexity and capability to deal with growing volume, particularly as information became less reliable (eg LIAR or NINJA loans). Internal emails released by a US Congress enquiry are insightful (amazing! – www.irishtimes.com – Agencies Discredited by Questionable Ratings Face Investigation, 26.10.2008). Committee Chairman Henry Waxman said "The ratings agencies broke the bond of trust, and federal regulators ignored the warning signs and did nothing to protect the public…..putting our entire financial system at risk". Reportedly, the focus had changed from protecting investors to maximizing revenue and revenues of the three main ratings firms increased from $3bn in 2002 to $6bn in 2007. Note Waxman's reference to "regulators". A Wall Street Journal headline was insightful –"Rating Agencies Deceived by Hookers in Six Inch Heels" and Bill Goss of PIMCO was spot-on with his highly critical comments; and a SEC report details many specific examples of serious failures of rating agencies to fulfill their responsibilities.

Thus governments enjoyed the political fruits of more buoyant economic activity and actively facilitated and encouraged lower lending standards and more accommodating regulatory arrangements.

Regulators were complicit, negligent, incompetent and/ or simply wrong and effectively ceased to exercise independent prudential judgment and oversight and the perceived benefits of economic buoyancy and personal wealth creation swamped any prudential judgment about heightened risks.

Cautionary or dissenting voices – and there were more than a few, were simply lost in the roar of irrational exuberance. They included commentators, insiders – former Federal Reserve governors, senior officials, employees of investment banks and rating agencies and others. Some identified that the model being used was broken - key parts were not working. Others were fearful of the consequences of the rapid growth in poor quality lending – to people who could not afford it; and of soaring house and other asset prices into a fragile bubble. Some investment banks were more cautious than others about participating, or withdrew earlier, and some insiders recognized the impending wreck and positioned to be beneficiaries of it.

Banks bundled the mortgages collateralized and securitized them and then on sold them, after they were highly rated, in the USA and around the World. A lot of the buyers were naïve or misled. Bundles were further aggregated, divided, repackaged and further leveraged, with increasing use of complex and, for many, opaque derivatives.
Now there are many billions of dollars of this stuff, in many forms, in many hands, but how much and where is simply not known.
The house price bubble has burst, and as mortgagors fail, values fall,and ratings, and the asset position of whoever owns the mortgage. Hence collapsing balance sheets and capital, the failure of some investment banks and other organizations and the recapitalization of others, the effective closure of many financial markets, the drying up of credit and the emergence of a global economic crisis.

Accountability and Performance

How did such a large and disastrous problem develop in the developed, sophisticated economy and regulatory environment of the USA.
I am particularly interested in the performance of directors but first - the role of “managers”.

Managers

Managers do most of the work in a business, within the framework of the board approved strategy, operating plan/budget, policies and delegated authorities.

The CEO is the top manager and there are a hierarchy of managers below that role, down through the organization.
So, in the financial firms/investment banks in the US what were the managers doing as sub prime lending and so on boomed? Where was the leadership, supervision and prudential oversight, the identification of unacceptable risk and decisions not to participate or to scale back or withdraw?

Some did, or never engaged, but many were fuelling the flames, doing the business – it was a great chance to make money, big upside and little perceived downside.
But the critical question is - where were the policies, the extensive risk, credit, lending, market, new product etc policies, processes and analytical tools that characterize large, and most other, financial organizations. And where were the numerous accountable people in related roles, in risk and audit in particular, people in review and oversight functions, that constitute the lines of defence against mistakes or failure.

One way or another many managers and firms failed to act to prevent the disastrous situation developing and the lines of defence and checks and balances also failed.

Directors

The board is ultimately accountable for a business, management operates under its guidance and control and in large US financial organizations the boards are "Blue Chip" and prestigious.
So, why did they allow the position to deteriorate? Why didn't they react to the numerous warning signs externally, or to the logical implications of what should have been evident internally.

A few actually did, but most didn't and the evidence of this is clear in the current wreckage.
Then there are the directors of the rating agencies, which played such a critical role. What were they thinking and doing?

To me the answer lies in a fundamental weakness of the "board of directors" model – and this view is not new, it's simply reinforced by the current debacle.
A board is not a machine or a mathematical model. It is a group of people selected by what is often a rather ad hoc process. The ultimate appointment power lies with the shareholders but existing directors typically manage the process, under the chairman's leadership. The objective should be a strong and effective team but many factors can

frustrate this outcome – particular shareholder views, social and cultural attitudes (diversity?), personal and business relationships and so on.

On a good board there is enough experience, judgement and courage to ensure close investigation of matters that give ground for concern, and enough upward flow of information to directors so that they are alerted to signs of possible problems. But there are many boards where this doesn't happen, there are many inadequate directors and poorly performing board teams - and there are enough poorly performing companies to underline the significance of this problem.
Inexperienced, in the broadest sense of the word, directors are a major problem, as are those who are timid, or a chairman who lacks the experience, leadership skill, judgment or courage to support enquiring directors or pursue diligent enquiry.

In my opinion, all of this means that the role of the chairman is critical. They have to be able to lead the process of forming a board as a potentially effective team and lead the board to work as an effective team, in the many circumstances that a board may be faced with.

It is clear from the corporate carnage in the USA that many boards failed to work effectively, with disastrous consequences. Yes, managements failed but the board has the overriding responsibility.

Moreover, is a system of governance satisfactory when it is so prone to major failure; and is the critical role of the board chairman given due recognition. Personally, I don't think so and too many social and other factors getting in the way of selecting the best person for the role.

Only rarely do shareholders intervene effectively although their role could be much more effective, especially the institutional shareholders.

All of these factors also underline the importance of the framework of laws and regulations that businesses operate within and the regulators that administer and enforce them.

Unfortunately, in this instance, there is compelling evidence that the regulators did not provide effective oversight and intervention, and that the politicians who set the framework for the regulators and oversee them, did not act effectively either; in fact they probably lit the fire and then added petrol.

The failure of the ratings agencies was a key element in the process, but who monitored and regulated their performance?

Consequently the current crisis not only highlights the weaknesses of the corporate/board model but also the comprehensive failure of all of the main elements of the system essential for the effective operation of the corporate model and a sound, resilient market- based system – and there really is no alternative!

The next step will be see whether there are actually consequences for those that failed, as this is a vital element in a system of checks and balances, or whether the litany of failures is comprehensive – and there are no consequences.

The New Zealand Issues

New Zealand has had its own problems - the systemic failure of some 25 non-bank financial institutions, with the loss of perhaps a billion of investors money, much of it invested on the basis of a registered prospectus. To my knowledge no other economy other than the US has had such a significant adverse experience.
Interestingly, New Zealand's growth in liquidity, household debt and house prices were also excessive, exacerbating a number of serious structural problems

Amazingly, the non – bank failures seems to have been accepted, largely with resignation and not much outrage or action. Ministers and others made limited public comment and only a small number of prosecutions have slowly emerged.

Of the failed businesses, some were probably honestly and reasonably run, caught in an unexpected, major liquidity squeeze and loss of investor confidence. But public information suggests that many engaged in questionable practices, including poor risk management, concentrated and related party lending, unreliable prospectuses and even fraud.

This raises important issues about the performance of directors and boards, and why this important sector was not subject to effective regulation and regulatory oversight and why has there not been a more effective Government and regulatory response to these serious failures.

The contrast with the main banks in New Zealand is stark. The main banks are robust, well run and well regulated; the non-banks were mainly subject to normal corporate regulation, rather than more specialized financial regulation, even though they competed for depositor funds in the retail market.

New regulations are now in place but they do not have the robustness of those applying to banks, which is unfortunate.

There are at least two serious consequences from the failures:

- New Zealand's reputation has suffered in financial markets; and
- Many people have lost a lot of money.

The community is entitled to expect a better performance from all concerned.

Conclusions:

The origins of the present financial crisis remind us that the performance of boards of directors is not necessarily reliable and effective and that effective regulation is necessary in a system dependent on markets.

To a substantial extent variation in the performance of boards reflects differences in the quality of boards. A good board is much more likely to perform well and the ability of the chairman is often a determining factor..

While business is risky, the recent failures in the USA, New Zealand and elsewhere suggest serious systemic weaknesses, rather than simply the normal visissitudes of corporate life.