Risk Management during the Financial Crisis

Sorin Cristian NITA [1]

Abstract

The 2008 financial crisis has made a lot of waves in both the political and economic environment. Actors on both scenes have argued on the reasons for which the financial crisis has started. The crisis was not generated by one, but my a multitude of factors, one of them being excessive risk taking behaviour exhibited by the managers in order to obtain short term profits. This behaviour was actually encouraged by various factors which will be discussed during in this working paper together with an analysis of the phenomenon that generated the financial crisis which spread panic in the financial sector.

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1. Introduction

The effects of the financial crisis that debuted in 2008 has made a serious impact in the economies worldwide, the effects being well felt even today. The GDP of the world`s greatest economies have suffered an abrupt downfall and only after years of efforts and a lot of state intervention was the trust in the system restored to a level that allowed the economy to flourish once more. The objective of this paper is the analysis of the financial crisis and the reactions of the private environment to the adverse effects of it.

Starting with 2007, the financial crisis quickly transformed, from a housing bubble originating in the United States to one of the deepest recession the world has seen since the great depression up until the present. Contrary to the widely held perception during the economic boom state in which the global economy was, the business environment was by no means as healthy and as stable as suggested. Also there were interlinked and complex factors behind the crisis, factors such as loose monetary policy, global imbalances, misperception of risk and weak financial and fiscal regulation.

Also beyond the aggregate picture of GDP collapse and increasing unemployment, the impact of the crisis was rather diverse, reflecting differences in initial conditions, transmission channels and vulnerabilities of economies, along with the role of government policy in mitigating the downturn.

[1] Nita Sorin Cristian, Bucharest University of Economic Studies, Email: nitasorincristian@gmail.com

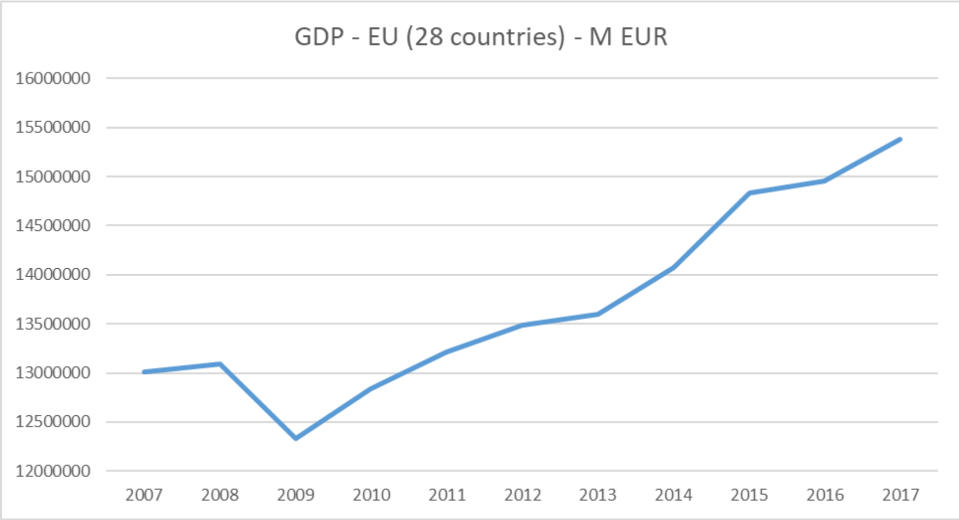

Figure 1: EU 28 GDP Evolution, Source: Eurostat

One of the main indicators that mark the gravity of the financial crisis is the GDP. In fig. 1, the GDP has a clear downward evolution starting with the end of the year 2008, the moment in which the effects of the financial crisis that originated from the United States started to make it`s effects to be felt in the EU. The European Union was severely hit the US crisis, especially through the banking sector. Due to the fact that the EU banks had assets and loans in the US, when the crisis hit and those loans were called, the entire system was in the situation of a liquidity freeze. Nobody actually had the possibility to make the required payments without having serious cash-flow issues.

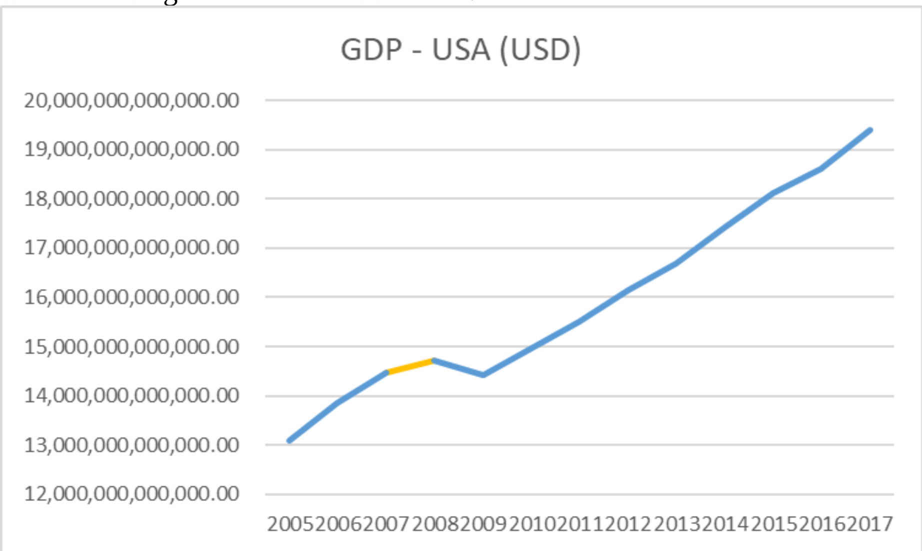

Figure 2. US GDP Evolution, Source: Eurostat

Looking at figure 2, it is noticeable that the beginning of the downshift in GDP growth starts a few months earlier, with the fall of Lehman Brothers in September 2008. Lehman borrowed significant amounts to fund its investing in the years leading to its bankruptcy in 2008, the bank being one of the first Wall Street companies to move towards the business of mortgage origination, since 1997 with the purchase of Aurora Loan Services.

There were companies that failed in respecting their own risk procedures, and also managers, that failed at restraining themselves in taking excessive risks. An example of such a company is the investment bank mentioned above, yet many more were in the same boat. Following this behavior, a bubble formed in the housing market, bubble that was fueled with increases in prices from day to day. As any traditional bubble, fueling it through more and more credits, lead to an eventual burst

2. The 2007 crisis phenomenon

As mentioned earlier, the financial crisis has undergone a very quick transformation from a bursting housing bubble, fueled by mortgages to the worst economic downturn of our time. The increase in the number of loans offered by financial institutions to people at the time located at the subprime level, helped the increase of the bubble, just like adding gas on an already burning fire. Before the year 2000, subprime mortgages were negligible, yet while time has been passing, these mortgages had seen an impressive growth.

The price increases in the housing market as well with innovations on the finance sector, managed to transform clients formerly classified as subprime, that were invisible to the mortgage market, into attractive and most importantly, eligible customers towards a mortgage loan. Thus, products appeared, known as ARM`s. In such products, a payment in advance was rarely required, and sometimes, clients were even allowed to postpone an instalment. Nevertheless, mortgage securitization, or pooling mortgages together in order to sell them to investors ready to receive pro-rata payments out of the principal and interest was what guaranteed success. This is how, the Wall Street investors managed to finance a large number of clients wishing for a mortgage and could not afford it. In this way, new solutions to pack subprime loans were discovered, such as CDO`s in order to be able to share the cash flow to different classes of investors, depending on their appetite for risk

These financial innovations, allowed Wall Street to view subprime clients at the same level as conforming clients. Thus, through the decision of redirecting a large amount of investor funds towards this sector, lots of non-conforming people managed to obtain a mortgage. These policies practiced in the market, prospered under an expansionist monetary policy and also weak market and fiscal legislation. In 2010, Joseph Stiglitz started discussing the recipe for a successful financial disaster: Weak regulations, lots of liquidity with low interest rates, a speculative bubble and policies that support subprime borrowing. With low interest rates and with regulators that weren`t able to observe potential market problems, the financial institutions kept borrowing until they were indebted many times above the percentage that they were able to repay that debt being in other words, over indebted.

Ever more, SIV`s (structured investment vehicles) were created by the banks in order to acquire mortgage assets that weren`t subdued to the capital requirements, entities held in the off balance sheet.

As more loans were granted, the prices increased and the debts were rolled over and over. The fact that credits were granted without real coverage is underline by the non-performing loan indicator, in the US, the place where it all started.

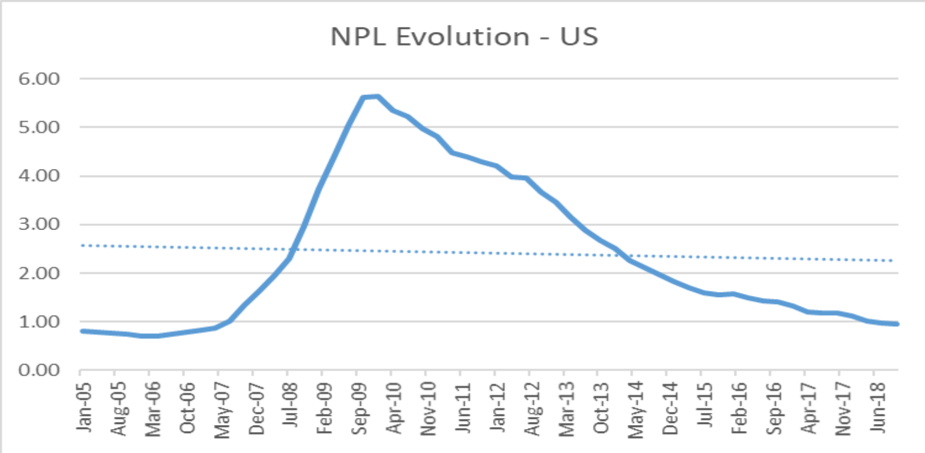

Figure 3. NPL Evolution – US, Source: World Bank

The indicator started to climb since 2007, reaching it`s peak in 209 where is started to descend, but much slowly that the speed at which it climbed. One of the reasons for which the NPL indicator evolved the way it had, was exactly what we were mentioning earlier, the financial inovations that allowed the viewing of sub-prime clients, by financial institutions as solvable clients.

Looking backwards, there were many telltale signs that the crisis will take place. Even more intriguing is the fact that the vast majority of investors, academies and officials were actually aware of the signs but chose to ignore them. More so, the trend was to make profuse claims about a new prosperous era. There was a general euphoria about the conditions in the new economy with many voices claiming the usual saying: “This time is different”.

3. Risk management – what did we learn?

The term risk management, is a board term used for the business discipline that protects the assets and profits of a company by reducing the potential of loss before it occurs or mitigating the impact of an already occurred loss. It involves a series of steps that include risk identification, the measurement and evaluation of exposures, exposure reduction or elimination, risk reporting, and risk transfer and/or financing for losses that may occur. The financial crisis has taught us a number of lessons from the risk management point of view.

One of those lessons is the fact that financial innovation can hide underneath multiple risks. For example, the use of credit derivatives for hedging or speculative purpose implies numerous risks, such as: credit risk, counterparty risk, model risk, rating agency risk, and settlement risk (Gibson, 2007). As earlier mentioned, the process of financial innovation on the financial markets has determined a reduction of transparency and an increase of the markets interconnectivity, fact that automatically generated uncertainty. Due to the lack of transparency on the markets for financial innovations and to the complexity of these instruments, investors couldn't identify and asses properly the risks implied by their investments.

Another lesson of high importance is represented by the standard quantitative models for risk management evaluation and the fact that the analysts using these models underestimated the systematic nature of these risks. Models are not well-suited to handle such new instruments. Financial innovation has introduced complex instruments that have limited historical data and require assumptions regarding risk and correlations with other instruments, reducing the effectiveness of quantitative risk models.

The incentives and compensation policies promoted by the industry have not been appropriately correlated with the risk management. Due to the fact that compensation culture has been very oriented towards short term gains, managers have assumed risks which they disregarded. Also, compensation structures encouraged excessive risk taking. Many financial institutions used to incentivize risk-seeking behavior through short-term, asymmetric compensation structures. These structures tend to have limited downside associated with underperformance, but tremendous upside for strong performance, often being based entirely on the most recent calendar year, not taking into account future performances.

According to Larcker & amp; Tayan (2013), a reward system based on legal mechanisms, as well as reputation and credibility is associated with a greater degree of dedication, motivation and coordination within a company

4. Conclusion

The biggest danger with regard to risk management is actually given by human behavior. According to Adam Smith, man is economically driven by the personal interest, the so-called invisible hand that intervenes in the economy. In other words, man is guided by gain, and risk management, in a sense, has the intention to temper this gain. It is often extremely difficult to assess what one means by sustainable earnings. It can be measured over short periods one year, two years, four for example. Who can anticipate what will happen within four years of the time present? Especially when the ones to assess the risks are directly involved and benefit directly from those earnings? At the same time, the personal interest mentioned by Adam Smith in "The Wealth of the Nations" is also the key to explaining the "principal agent" problem. Basically, the principal agent problem is the key to the bonus scheme that has caused so many problems for corporate governance and risk management.

Why did traditional risk management fail? To argue that the issue at hand is the result of only one factor would be incomplete. Rather a combination of factors favored this failure. Traditional risk management methods are rooted in history – and history doesn't always repeat itself exactly. In managing risk during the financial crisis, it is likely that a number of risk managers only considered past events, rather than future possible scenarios. By taking this into account, one can draw the conclusion that the greatest risks are those that have not yet been experienced, making measuring very difficult.

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