Global Economic Meltdown: Greenspan's Legacy

Samir K Barua and Mahendra R Gujarathi

In the event of statedly the deepest global crisis ever since the Great Depression, with the world economy mired in a severe economic meltdown, Samir K Barua and Mahendra R Gujarathi identify the factors and the players that incubated and nurtured the meltdown. The policies of deregulation, monetary expansion, and fair value accounting are specifically addressed in a historical perspective. The authors offer an insight into how sequentially the lawmakers first created the potent environment for risk-taking through unrestrained deregulation, the Federal Reserve then set the stage for the crisis with a policy of unbridled monetary expansion, and the accounting standard-setter finally relaxed norms to provide support for hiding the losses incurred—thus together fuelling the crisis. Although several trillions of dollars have been pumped into the market to maintain the credit flow, it is yet uncertain as to how the crisis will impact in the long run, the authors conclude on a cautionary note.

"He who sows the wind,
shall reap a whirlwind"

— A well known proverb

The Global Credit Crisis that began like a small fire in the US housing finance market in 2007, spread and became a forest fire that first engulfed the US, then the Western economies, and eventually the rest of the world. The crisis is clearly the deepest and the most widespread economic meltdown that the world has faced since the Great Depression. Volumes have been written on how the unrestrained individual greed and perverse managerial incentives created the monstrous crisis. What has not been adequately addressed in the discussions is the regulatory 'reforms' that incubated the crisis. This paper documents the policies of unrestrained deregulation, unbridled monetary expansion, and changes in fair value accounting rule that spawned and nurtured the economic meltdown.

DEREGULATION

In the wake of the Great Depression, investigations by the lawmakers in the US revealed irrefutable evidence of subterfuge and fraud arising from the conflict of interest between the commercial banking activities and the activities related to the securities markets. Chinese walls were therefore created by lawmakers in the form of the Glass-Steagall Act of 1933 that prohibited any organization from undertaking a combination of commercial banking, investment banking, and insurance activities.

By the early nineteen eighties, pressure had started mounting from the banking industry to repeal the Glass-Steagall Act as the US banks started losing out to European banks that faced no such restrictions. The latter, operating on the principle of 'universal banking,' could provide the entire range of financial services under one roof.

The Gramm-Leach-Bliley Act, also known as the Financial Services Modernization Act of 1999, repealed the Glass-Steagall Act of 1933. The Gramm-Leach-Bliley Act legalized a financial services company to engage in a combination of commercial banking, investment banking, and insurance activities. Almost two years before the Act was passed, Citicorp, a retail banking giant, was merged with Travelers Group, another giant in the field of securities and insurance, in anticipation of regulatory clearance. This indicates the possibility of regulatory capture by the parties involved in the merger. Be that as it may, the repeal enabled commercial banks such as Citigroup to underwrite mortgage-backed securities and collateralized debt obligations – instruments intimately associated with the housing finance sector. It also allowed commercial banks to create and deal in the structured financial products with poorly understood risk-reward relationship.

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While the repeal of the Glass-Steagall Act might have made the US banks more competitive, and led to the creation of banking behemoths such as Citigroup, it also resulted in exposing them to much bigger risks that the Act aimed to contain. The unbridled expansion of banks, their extreme financial leverage, and the possible conflict of interest between research departments (that issued stock recommendations) and investment banking divisions (that benefited from IPOs) of these firms did a great disservice to the investors. A huge parallel financial system developed without the traditional regulatory supervision applicable to commercial banks or insurance companies. In April 2004, capital requirement of investment banks was also loosened. The federal government also pressured financial institutions to lower lending standards which led to the heightened use of mortgage backed securities by financial institutions. The new environment of lax regulations forced financial institutions to compete with each other and chase higher risk clients by offering loans with lesser and lesser scrutiny.

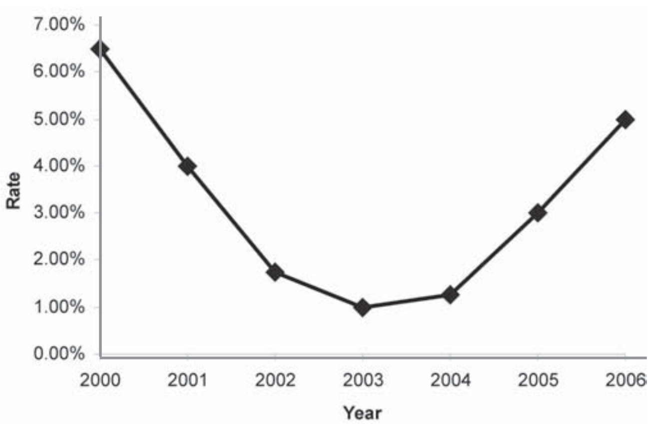
A striking parallel exists between the widening scope of US financial institutions and the lax regulations that prevailed in Japan in the late 1980s. The Japanese banks had at that time taken on loan portfolios that were far too risky; and, Japan has lost since then over two decades of growth. The same errors have been committed by banks and institutions in the US two decades later.

MONETARY EASING

On December 5, 1996, commenting on the booming stock market, Alan Greenspan, Chairman of the Federal Reserve, had observed, 'But how do we know when **irrational exuberance** has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?' Greenspan threw this caution to the wind when faced with a slowing US economy. He followed a policy of monetary expansion that perhaps set the stage for the crisis.

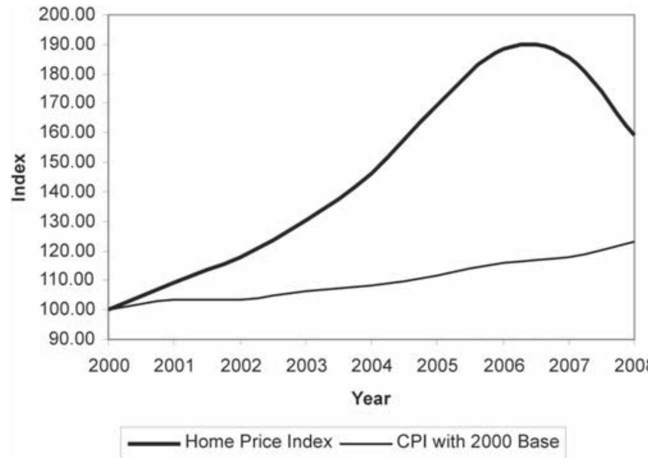
Between 2000 and 2003, Federal Reserve brought down the Fed Funds Rate from 6.5 per cent to just 1 per cent (Figure 1). The steep decline in interest rates resulted in rise in asset prices and flow of foreign money into the US. In the years leading up to the crisis, significant amounts of foreign money flowed into the US from fast-growing economies in Asia and oil-producing countries. The resulting monetary expansion coupled with low interest rates created a situation whereby almost anyone could afford his/her dream home. The Fed created a perfect setting for fuelling both housing and credit bubbles.

Figure 1: Fed Funds Rate



Note: The rates plotted are mid-year rates sourced from http://www.newyorkfed.org/markets/omo/dmm/fedfundsdata.cfm

Figure 2: Home Price Index *vs* Consumer Price Index



Note: The data on the Home Price Index (HPI) has been sourced from http://www2.standardandpoors.com/spf/pdf/index/csnational_value_052619.xls; the data on Consumer Price Index (CPI) has been sourced from http://data.bls.gov/cgi-bin/srgate.

The euphoria or recklessness spilled over into the real estate sector. Between 2000 and 2006, the rise in prices of residential properties in the US was far in excess of the rise in consumer price index (Figure 2). The rising demand and prices of property fed each other in a virtuous cycle of increasing demand and escalating prices.

In the housing finance markets, perverse incentives existed for each participant. Securitization played an important role in spreading the crisis throughout the financial system. In the decade ending 2006, securitization had grown from about $50 billion to over $2 trillion. All institutions with significant investments in MBS (Mortgage Backed Securities) faced the brunt of rising defaults. Between 2001 and 2006, credit default swaps, derivative instruments for the transfer of risk arising from decline in creditworthiness of assets, increased from $632 billion to over $63 trillion. The institutions that had sold these derivatives started incurring huge losses as creditworthiness of the real estate sector went into a tail spin.

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The defaults may not have had such a drastic and cascading impact on the financial sector, had it not been for another serious imprudence by the institutions. The institutions financed their asset positions through high leverage. A recent paper by Acharya, Gujral and Shin* notes that during 2000 to 2007, the debt/equity ratio for commercial banks increased from around 5.0 to 6.5, whereas for investment banks, it increased from 11.0 to 19.0. Not only were the banks getting increasingly levered, they were placing higher reliance on short-term financing mechanisms. Commercial banks, for instance, doubled their reliance on commercial paper between 2000 and 2007. Short-term financing mechanisms resulted in the need of financial institutions to refinance their positions frequently. As the prices of the assets fell and the losses mounted,

* Acharya, Viral V, Gujral, Irvind and Shin, Hyun Song (2009). "Dividends and Bank Capital in the Financial Crisis of 2007-2009," (available at http://ssrn.com/abstract= 1362299)

such refinancing became increasingly difficult. Not only did the cost of funding start going up but a point was reached when funding was simply not available. As happens in such situations, the liquidity in the asset market too dried up and even fire sale of assets became impossible. It was also not possible for these institutions to deleverage by raising risk capital in the jittery market from institutions that had the capital to spare but were unwilling to oblige. The 'happenings' finally led to spectacular failures of a variety of institutions. The contagion that began in the US spread to Europe and soon engulfed the rest of the world.

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Compensation packages of the senior management of financial institutions also resulted in deepening the crisis. Whereas they had every possibility of fattening their pay package by taking on risky loans, they did not have commensurate penalty for undertaking excessive risks. By the second half of 2006, the property prices started stagnating and then started declining by the beginning of 2007; the decline continued in 2008 (Figure 2). The virtuous cycle of rising values turned into a vicious cycle of declining demand and lower prices. The defaults started occurring when the loan amounts started exceeding the property prices.

FAIR VALUE ACCOUNTING

The accounting standard, SFAS 157 (Statement of Financial Accounting Standard 157), requires portfolios of financial institutions to be valued using fair value for the assets in the portfolio. This requires assets to be valued at market prices (that is, they should be marked-to-market) and not at the (historical) cost of acquisition. The standard is based on the reasoning that accounting must reflect the current financial reality of a company.

The principle of marking the asset prices to market faced heavy criticism by several commentators on the ground that it exacerbated the credit crisis. These commentators argued that since market prices can and often are exceptionally volatile, they ought not to be used to value assets. Such pricing could be particularly misleading if the firm holding the assets had no intention of liquidating those assets.

The decline in the prices of securities based on the lending to the real estate sector created a situation where the financial institutions exposed to these securities needed increasing amounts of risk capital to meet their capital adequacy ratio to be able to hold on to their assets. In a market with plummeting prices and shrinking volumes, these firms were neither able to raise the required risk capital nor were they able to sell their assets. As the panic spread, with increasing number of financial institutions going belly up, the credit markets finally came to a standstill.

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Loss of competitiveness, lower asset values, and lower profits are the results of business decisions of firms and not of the accounting standard that mandates presenting the relevant numbers in an unbiased manner. Enhancing financial stability is not the purpose of accounting; depicting true financial condition is. If at all, the mark-to-market rule may have had the unintended effect of 'exposing' the risks associated with unduly leveraged balance sheets. The solution, therefore, lies in de-leveraging the balance sheets rather than in questioning the relevance of the mark-to-market rule. After reviewing three years of financial data for

22 failed banks, the SEC (Securities Exchange Commission) concluded that the current financial crisis was not caused by the application of SFAS 157. The review concluded that to get the system back on a solid footing, these losses needed to be recognized. Not doing so may prolong the crisis as has happened in the case of Japan.

Despite the conclusions of the study by the SEC, under intense pressure from the industry and also perhaps from the US government, the FASB (Financial Accounting Standards Board) recently relaxed the mark-to-market rule to allow judgment in valuing assets of financial institutions. As a result, financial institutions would be able to write-up the value of assets that had earlier been written down. This relaxation in standard is unwise because although it boosts the bottom line of banks, it compromises the independence of standard-setters, a critical ingredient for proper functioning of the financial sector in the long run. Relaxation of norms for valuation can not be the answer to meeting the norms for capital adequacy of financial institutions and for prudent capital structure and business operations. Compromising the conceptual soundness of the principle for valuation of assets is a disservice to the capital markets.

The standard-setting process became hostage to the pulls and pressures arising from the crisis. The relaxations that have been made in valuing assets and liabilities of financial companies are imprudent and can have serious negative consequences in the longer term.

Another accounting standard, SFAS 159 (brought in after intense lobbying by finance companies), allows companies the option to 'fair value' their liabilities. This option is not sensible except where the liability is directly linked with the 'fair value' of the asset acquired with the liability. Otherwise, the standard creates the possibility for a firm whose creditworthiness has deteriorated to report gains through lowering of the liabilities arising from decline in the present value of liabilities due to higher discount rate arising from lower creditworthiness of the firm. For instance, SFAS 159 allowed Credit Suisse to report a gain of $1.2 billion in its 2007 income statement. Indeed, its investment banking division would have posted losses in the third and fourth quarters without FAS 159 instead of profits of $6 million in the third quarter and $328 million in the fourth quarter. Morgan Stanley and Goldman Sachs too have reported stronger earnings because of SFAS 159.

In sum, it is clear that the standard-setting process became hostage to the pulls and pressures arising from the crisis. The relaxations that have been made in valuing assets and liabilities of financial companies are imprudent and can have serious negative consequences in the longer term.

The lawmakers in the US, its Federal Reserve, and the accounting standard-setters incubated and nurtured the crisis. The lawmakers first created the potent environment for risk-taking; the Fed then obliged by providing cheap funds for investment and after the damage was done, the accounting standard-setters provided the proverbial fig leaf to hide the losses incurred.

CONCLUSION

The lawmakers in the US, its Federal Reserve, and the accounting standard-setters incubated and nurtured the crisis. The lawmakers first created the potent environment for risk-taking; the Fed then obliged by providing cheap funds for investment and after the damage was done, the accounting standard-setters provided the proverbial fig leaf to hide the losses incurred.

It is as yet unclear as to how the crisis will play out in the longer term. Central bankers all over the world, led by the US Fed, have pumped in trillions of dollars into the market to maintain flow of credit. The easy money environment that they have created is exactly what fuelled the crisis. Only time will tell whether the green shoots we notice today will not lead to a prolonged period of yellow weeds in the future.

Samir Barua, currently the Director of the Indian Institute of Management, Ahmedabad (IIMA), has been on the faculty of the Institute since 1980. Having an expertise in the areas of financial markets, decision sciences, corporate strategy, and corporate governance and wide-ranging consulting, corporate advisory and training experiences, in India and abroad, he has been associated with the Indian corporate sector for over a decade and a half through membership of Boards of several corporate entities including Fortune 500 companies. In addition, Prof Barua has been associated as a Board member of two international organizations and companies in the financial sector, besides having membership of committees of regulatory bodies. He has also contributed to public policy making in the financial and banking sector through research and policy papers and has published extensively on a variety of subjects in management in academic journals and business publications.

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Our economy is badly weakened, a consequence of greed and irresponsibility on the part of some, but also our collective failure to make hard choices and prepare the nation for a new age.-

— President Barack Obama