CHASM | Centre on Household Assets and Savings Management

Briefing Paper

Misconceptions of the Financial Crisis

One of the main purposes of the FinCris project[1], is to investigate different accounts of responsibility for the financial crisis. Understanding responsibility helps ground proposals for change, for example in how banks are taxed, and in approaches to promoting financial inclusion. Determining which individuals and institutions were responsible involves understanding what caused the crisis, but it also involves understanding more qualitative detail that helps determine who may be held accountable for the crisis and on what basis. For this reason, narrative accounts of the crisis are important. Not only are they an effective way of organising a causal chain; they also help bring the story of the crisis to life. Most narratives are written from a certain perspective – be it the global macroeconomy and the actions of international institutions; or the behaviour of a Wall Street financial elite and their capture of US regulators; or the culture of credit amongst western businesses and consumers. Whilst each is often presented in isolation they are, typically, complementary and together capture a complex network of causes and accountability. Simplifying the narrative around one theme, e.g. 'greedy bankers,' is one-sided.

We focus on some of the most common features that appear in popular narratives, and provide a more nuanced perspective on them. Sometimes this involves exposing popular misconceptions. Below are some examples.

- The process of securitisation, whereby banks packaged loans to form securities and then sold them on investors, has been portrayed as a highly dangerous innovation that should be strictly controlled. Securitisation did indeed play a significant role in the crisis. Very high volumes of such securities were issued. They were often highly complex and opaque so investors were unclear how they were exposed to defaults

[1] http://fincris.net/

of the underlying loans; and by passing on risk to investors they incentivised banks to neglect their job of vetting the underlying loans. The securities also employed leverage, which increased risk. This means they were structured so that their value would change more than proportionally to any change in the value of underlying assets. One way leverage was achieved was through 'tranching'. This involved issuing different 'seniorities' of securities from the same loan pool, with the junior tranches being the first to take losses, but also paying higher returns. Junior securities were thus leveraged compared to the underlying loan pool. However, in principle securitisation need not have these features. Moreover, securitisation provides an important alternative to bank lending as intermediation between lenders and borrowers. At times, such as now, when banks are either unable or unwilling to lend, securitisation offers an alternative mechanism for stimulating the flow of money to consumers and businesses[2].

- Credit rating agencies are routinely held responsible for failing to rate securities properly, giving triple-A ratings to products that did not deserve them. This accusation is reasonable in some cases, notably for securities based on US sub-prime loans, and it is also true that doubts about such securities precipitated the panic which brought about the crisis. These failings are made worse by the fact that agencies failed to resolve a conflict of interest which saw them paid for their work by the banks which designed the mis-rated products. However, for the majority of securities, particularly in Europe, default rates have been in line with the agencies' ratings. The crisis occurred because market liquidity disappeared when investors panicked. But rating agencies are not expected to assess liquidity risk, only credit risk[3], and in the majority of cases they got this right.

- Hedge funds are another class of financial institution that have been in the firing line. They have at times been portrayed as shadowy institutions manipulating the world's financial markets, causing global chaos in pursuit of astronomical profits. Notorious

[2] Atkins, R (19 February 2013) 'Packaged loans to fill EU banking void'. *The Financial Times*. http://www.ft.com/cms/s/0/43b72ace-7a71-11e2-9cc2-00144feabdc0.html#axzz2NnP1qHZN
[3] Standard & Poors 'Credit Ratings Definitions and FAQs'. Retrieved 18 March 2013 from http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us

cases, such as the hedge fund Paulson's deal with Goldman Sachs[4], in which Goldman allowed Paulson to select assets that would be used to create new securities, with the intention of betting against those securities, have not helped. While some maintain that hedge funds did play a significant role[5] in precipitating the crisis, others disagree[6]. Doubt about the role of hedge funds was also expressed by the Turner Review[7] in the UK. At any rate, a better understanding of, and more nuanced approach to, hedge funds is warranted.

The general lesson is this: treat any simple stories of what caused the crisis or which individuals or institutions should be held accountable with caution. Not only are such accounts likely to miss out significant detail, but one sided or polemic approaches are unlikely to generate the kind of consensus necessary to take much needed action to reform the financial sector.

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[4] The BBC (16 April 2010) 'Goldman Sachs accused of fraud by US regulator SEC'. http://news.bbc.co.uk/1/hi/8625931.stm

[5] Lysandrou, P (April 1 2012) 'The real role of hedge funds in the crisis'. *The Financial Times*. http://www.ft.com/cms/s/0/e83f9c52-6910-11e1-9931-00144feabdc0.html#axzz2NnP1qHZN

[6] RAND Corporation (September 19 2012) 'Hedge Funds Not a Primary Cause of the Financial Crisis, but Could Contribute to Systemic Risk'. http://www.rand.org/news/press/2012/09/19.html

[7] Financial Services Authority (March 2009) 'The Turner Review: A regulatory response to the global banking crisis'. Available at: http://www.fsa.gov.uk/pubs/other/turner_review.pdf