ANALYSIS OF THE FINANCIAL CRISIS INQUIRY REPORT

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ABSTRACT

As a result of the devastating domestic and global effects of the last financial crisis, known by some authors (Abadia, 2009) as the "Ninja" Crisis, the U.S. Government created a special Commission to examine its causes. After one and a half year of research, in January 2011 the National Commission on the Causes of the Financial and Economic Crisis, produced a really exhaustive inform named "The Financial Crisis Inquiry Report", where they present to the President of the United States, the Congress and the American people the results of their study. Although this report represents the official diagnosis about the situations and reasons that took the entire world economy to experience one of the greatest crises over history, it has not been object of an extensive analysis yet. The present paper tries to make a first approach to this issue by on one hand presenting the main conclusions and parts of the Report in a synthesized way, and on the other hand starting a discussion about its contents proposing an interpretation and a suggestion to get better understanding of this developments.

Key words: financial crisis, national commission on the costs of the financial and economical crisis, financial crisis inquiry report.

1. INTRODUCTION

The Financial Crisis Inquiry Commission (FCIC) was created by the Congress of the United States to examine the causes of the recent financial and economic crisis (2007-2008) in the United States, which eventually spread its effects to the entire world. The Commission was established as part of the Fraud Enforcement and Recovery Act (Public Law 111-21) passed by the Congress of the United States and firmed by the President Barak Obama in May 2009. It was integrated by ten private citizens with experience in the fields of housing, economics, finance, market regulation, banking, and consumer protection. Six members were proposed by the Democratic party[1] of the Congress and four members by the Republican one[2].

1 Phil Angelides, Brooksley Born, Byron Georgiou, Bob Graham, Heather H. Murren and John W. Thompson.

2 Keith Hennessey, Douglas Holtz-Eakin, Bill Thomas and Peter J. Wallison.

Drawing an analogy, this Commission functioned as the National Transportation Safety Board, which investigates the causes of aviation accidents in order to avoid future accidents, considering in this case the financial crisis as a colossal accident.

After one and a half year of exhaustive research, consisting of revisions of millions of pages of documents[3], interviews of more than 700 witnesses, 19 days of public hearings in New York, Washington, D.C. and communities across the country, case study investigations of specific financial firms[4], and a deep examination of the roles of policy makers and regulators[5]; the FCIC elaborated an official report to explain to the President of the United States, the Congress and the American people, the results of this investigation and the conclusions about the causes of the crisis. The main objective of the report of the FCIC was to provide a historical accounting of what brought to the financial system and the economy to the collapse and to help policymaker and people in general to understand how this terrible catastrophe came to be. The Democratic Commissioners voted to adopt the report while the Republican Commissioners dissented from it.

This report consists of 633 pages and is structured in five parts. The first part covers the background of the crisis; the second, the regulation and operations that set the stage that allow the boom and bust of the bubble explained in the third part; the fourth part unravel the fall and disruption of the banking and financial system; and finally the fifth part expose the aftershocks of this crisis.

3 Existing work about the crisis developed by congressional committees, government agencies, academics, journalists, legal investigators, etc.

4 American Internationa Group (AIG), Bearn Sterns, Citigroup, Countrywide Financial, Fannie Mae, Goldman Sachs, Lehman Brothers, Merryl Lynch, Moody´s and Wachovia.

5 The Federal Deposit Insurance Corporation, the Federal Reserve Board, the Federal Reserve Bank of New York, the Department of Housing and Urban Development, the Office of the Comptroller of the Currency, the Office of Federal Housing Enterprise Oversight (and its successor, the Federal Housing Finance Agency), the Office of Thrift Supervision, the Securities and Exchange Commission and the Treasury Department.

The Commission´s statutory instructions set out 22 specific topics for inquiry and ask for the examination of the collapse of the major financial institutions implied in this crisis. In addition, the Commission was instructed to refer to the attorney general or to any other legal instance any person that had violated the laws of the United States in relation with the crisis.

The impact and aftershocks of this crisis persists in almost all the countries and sectors, millions of people have lost their jobs and their homes, the governments of many countries have compromised their public finance because of the different bail out programs implemented, and in general the economic activity has not been able to experience a clear recovery until now.

Considering that the report of the Financial Crisis Inquiry Commission is the official document to explain the causes of this recent crisis that have affected both the financial and real economy of the entire world, the objective of this paper is to analyze initially the main conclusions presented by the Commission in order to start a line of analysis around this issue that enable us to understand in a clearer way, the causes and effects of this crisis from different approaches. The structure of this paper is as follows: in the second section we present a discussion of the main conclusion of the FCIC, in the third we present a synthesis derived from the second section; in the fourth and fifth section we attempt to make an interpretation and some suggestions for the future, respectively; and finally in the sixth section we present the references consulted.

2. A FIRST APPROACH TO THE MAIN IDEAS OF THE FCIC.

Considering that the recent crisis known for some authors (Abadía, 2009) as the "ninja crisis"[6] has been the greatest financial crisis since the Great Depression, the tasks of the FCIC was mainly to determine what happened, how it happened and why it happened. In this section we present and analyze the main conclusions about it presented in the Financial Crisis Inquiry Report (FCIR) where the FCIC expose the facts, indentify responsibility, unravel myths and help us to understand how the crisis could have been avoided.

First of all and before we start with the explanation of each one of the conclusions of this report it is important to remark three core aspects to understand the nature of this crisis:

First, the report shows a very clear view about that this crisis was a fundamental disruption and a financial upheaval, i.e. that the events of this crisis were neither bumps in the road nor an accentuated dip in the financial and business cycles expected in a market economy. Some of the consequences of this crisis were 26 million of Americans unemployed; four million families that lost their homes; nearly $11 trillion of US dollars in household wealth vanished, including retirement accounts and life savings; and large and small business experiencing a deep recession. The collateral damage of this crisis has

6 From no income, no jobs, no assets.

been real people and real communities and it is considered that its effects will reach one generation.

Second, although there were many events and conditions that made that this crisis were formed during several years, it was the collapse of the housing bubble originated by low interest rates, easy and available credit, scant regulation and toxic mortgage, the spark that ignited a sting of events that led to the crisis of 2008. The process of securitization of trillions of dollars in risky mortgage was the vehicle of transmission of this crisis to the entire world, and when the bubble bursts hundreds of billions of dollars in mortgage and mortgage-related securities shook the all the financial markets and all the financial institution exposed to this kind of financial instruments and derivatives related to them. The failure of Leman Brothers and collapse of American International Group (AIG) with all the effects to the rest of financial institution interconnected gave catastrophic proportions to the problem made the credit market to seize up, the stock market plummeted and the economy plunged into a deep recession.

Third, the financial sector has become a much more dominant force in the economy of USA.

From 1978 to 2007 the amount of debt held by the financial sector soared from $3 to $36 trillion of U.S. dollars; the nature of the Wall Street firms changed from private partnership to publicly traded corporations taking greater and more diverse kind of risks; by 2005 the 10 largest U.S. commercial banks held 55% of the industry assets; and in 2006 financial sector profits constituted 27% of all corporate profits in U.S.

Taking in consideration the three aspects stated above, now we can proceed to the analysis of the conclusions of the FCIC.

1. **This financial crisis was avoidable.**

The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. There were many warning signs that both financial institution and regulators of the financial system ignored such as: the explosion of in risky subprime lending and securitization, an unsustainable rise in housing prices, widespread reports of predatory lending practices, dramatic increases in household mortgage debt, an exponential growth in firms' trading activities, unregulated derivatives, and short-term "repo" lending markets, among others. In addition, both financial institutions and regulators authorities failed in understanding, measuring and managing the evolving risks within a system basic for the well-being of the people. For example the Federal Reserve, is suppose to be the entity that should have prevented the failure and stopped the flow of toxic mortgage or at least to have set and supervised some prudent mortgage-lending standards, however it did not. Although many people from financial and political spheres say that the crisis could not have been foreseen, the warning signs stated above point the contrary.

2. **Widespread failures in financial regulation and supervision proved devastating to the stability of the nation´s financial markets.**

The faith in the self correcting nature of the markets and the ability of financial institutions to effectively police themselves made that the sentries were not in their posts. The deregulation and reliance on the self-regulation of financial institution in the last 30 years have eliminated the key safeguards which could have helped avoid this catastrophe. The Federal Reserve last administration along with several consecutive Congresses and Federal Administrations have set the conditions to let financial institutions act with almost all the freedom and without regulation in many aspects. The economic power of this institutions and the big contributions to political campaigns can me us to think the strong influence that they have exerted into the regulators. From 1999 to 2008, the financial sector expended $2.7 billion U.S. dollars in lobbying expenses and more than $1 billion in campaign contributions. This situation have let gaps in critical areas without supervision where trillions of dollars were at risk, such as the over the counter derivatives markets.

In addition, although regulators justified themselves arguing the lack of power to protect the financial system, there are many areas where they have ample power but they decided not to use it. For example, the Securities and Exchange Commission could have required more capital and stopped the risky practices in the big investment banks, but it did not. The Federal Reserve Bank of New York could have enforced stricter measures against Citigroup excesses at the beginning of the crisis, but it did not either. In general, regulators continued giving safe ratings to the institution even when they face many troubles. Changes in the regulatory system never occurred even when the financial markets evolved which made that the nation was deprived of the necessary strength and independence to ensure the financial stability of the system.

3. **Dramatic failures of corporate governance and risk management at many systematically important financial institutions were a key cause of this crisis.**

The belief that the self-preservation instinct of the financial institution will not allow them to take excessive risks creates the illusion that they do not need any regulatory supervisor; however, the reality was very different. Too many of these institutions acted recklessly taking too much risk, with too little capital, and with too much dependence on short-term funding. They increase their activities on risky trading activities, that obviously generated very big profits, but that expose them to very high risk positions. The main exposure was given by the acquisition and supporting of subprime lenders, the securitization process of the mortgage-related securities including a large variety of synthetic financial derivatives that increase the profits for some time but also boost the exposure to risks exponentially. In addition, the proportions of the business grow exponentially as well making the management of all the risks relates very difficult or impossible to measure and deal. Consequently, financial institutions let the mathematical models all this responsibility considering their results as reliable predictors replacing judgment in many instances. In general the conditions of cheap money, intense competition and light regulation take all the

system to reward more the short-term gains encouraging the big bets than the long-term consequences of this kind of business.

4. **A combination of excessive borrowing, risky investments, and lack of transparency put the financial system on a collision course with crisis.**

In the last years too many financial institutions borrowed to the hilt, leaving them very vulnerable to the ruin or financial distress even with a modest undervaluation of their investment. For example in 2007 the five biggest investment banks[7] presented leverage ratios as high as 40 to 1 i.e. that for every $40 U.S. dollars in assets, there was only $1 U.S. dollar to cover losses. In addition, much of their borrowing was short-term, in the overnight market, i.e. the borrowing had to be renewed every day. For example, at the end 2007, Bear Stearns had $11.8 billion U.S. dollars in equity and $ 383.6 billion U.S. dollars in liabilities and was borrowing as much as $ 70 billion in the overnight market.

7Bearn Sterns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley.

The main problem was that not only investment banks were doing these practices; other financial institution such as the giant Government-Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac presented in 2007 combined leverage ratios of 75 to 1. In addition, all these leverage in the different financial institution was often hidden in derivatives positions or in off-balance sheet entities. On the other hand the financial institutions were not the only borrowers, the national mortgage debt in U.S.A. from 2001 to 2007 almost double, and the amount of mortgage debt per house-hold rose more than 63% from $91,500 to $149,500 even when wages remained almost at the same level.

5. **The government was ill prepared for the crisis, and its inconsistent response added to the uncertainty and panic in the financial markets.**

Key policy makers[8] as well as other related agencies were bad prepared to deal with the events of 2007 and 2008. They did not have a clear idea about the financial system they were suppose to oversee in one part for the lack of transparency of the markets and on the other hand for the misunderstanding of the risk management of the whole system.

8 The Treasury Department, the Federal Reserve Board, and the Federal Reserve Bank of New York.

As a matter of fact, the authorities thought that the risks were diversified where actually they were extremely concentrated. Since regulators did not understand the risks and interconnections in the financial markets when the turmoil engulfed the system the authorities did not show a comprehensive and clear strategic plan to contain the contagion, which increase the panic and uncertainty in the markets boosting the collapse.

Additionally, the ignorance of the underlying situation in the financial markets made regulators not to recognize that a bursting in the housing bubble could threaten the entire financial system.

3. A SYNTHESIS.

The Financial Crisis Inquiry Commission (FCIC) Majority Report (Democratic) centers itself in the following independent factors that acted as links in a circle that finally turned out, vicious:[9]

- Subprime Mortgages, (non optima).
- Liquidity Excesses.
- Financial Deregulation.
- Banking Innovation.
- Community Reinvestment Act (CRA).
- Innovative Mortgages.
- Government Policy of Housing.
- Excessive Leverage.
- Extreme Securitizations (Collateralized Debt Obligations and Credit Default Swaps).
- Excess use of Derivatives and Repos (Short Financing).
- Supervision Failures.
- Light Granting of Investment Grades.
- Inconsistent Policy of Financial Bail Outs.

These were all weaved in the FCIC Report as factors leading to the Crisis, a very complete report in which there are three parts, one by the majority, and two by the dissenting minority party: The majority Report in the FCIC (Democratic) synthesized these developments in a causality based on three factors: capital availability and excess liquidity, the role of Fannie Mae and Freddie Mac (the GSEs), and government housing policy (page xxv).

Nevertheless, the Republican fraction of the FCIC presents two different versions: one that centers itself in ten essential causes of the Crisis: 1.- Credit bubble 2.- Housing bubble 3.- Nontraditional mortgages 4.- Credit ratings and securitization 5.- How Financial institutions concentrated correlated risk 6.- Leverage and liquidity risk 7.- Risk of contagion 8.- Common shock 9. Financial shock and panic 10.- Financial crisis causes economic crisis (p.417-419). While the other Republican version says that the Cause of the Crisis was only the US Government Housing Policy, which led to the creation of 27 million subprime mortgages (p. 444), that destabilized the housing and the mortgage markets.

9 The Financial Crisis Inquiry Commission; *The Financial Crisis Inquiry Report*; U.S. Government Printing Office; Official Government Edition, January 2011

4. AN INTERPRETATION.

In the first, Democratic version it is emphasized the deregulation of the financial and banking system of the US, and the lack of supervision to the activities of all those involved, as well as the greed of the bankers, and the corruption on the part of the regulators that did not act (for alleged millionaire financial support to political campaigns) or the lack of ethics by those granted the mortgages shown in the delinquency rates, meanwhile in version one of the Republicans there appears in privilege position the international comparison that shows all the factors that led to financial crisis in almost all of the developed world, about the same time, while version two focuses on the number and amount of subprime mortgages. Although these three approaches even if they are useful for understanding the Crisis and some of its features, they are also insufficient as explanations of the Origen of the Crisis ¿Why? Because one of the most renowned authors on the subject of Prosperity and Depressions, Gottfried Haberler has pointed out that to determine the cause of a depression one must signal the means by which aggregate demand or production falls[10], and in this case the problem was how the process became a bubble.

The origin of the Crisis can be seen in the following way: during the years after World War II there was dominance of government in the composition of GNP, i.e. defense spending, so that government demand was sustaining the growth of the U.S. economy and this was preventing the business cycle, noting that the size of the budget and/or the deficit, was limiting the growth of aggregate demand, it was called the time of Keynesian Economics, where demand by the government was known and metered *a priori* because of the need of budget approval, whereas in the years 1997-2007, after the end of the cold war, when the relative impact of the government expenditure is reduced, and so the Monetarist approach came to full utilization for purposes of economic expansion, this increased private expenditure especially in consumption, and with the abundance of credit and low interest rate, what the monetary authority wanted was to have investment in whatever field investors wanted, the so called "market making", and did not worry on the composition or destination of the investment creating or accepting sectoral booms that turned into bubbles: The rise in prices was not to be sustained because if the financing (of the mortgages) had been in other common consumer good, it would have caused plenty of supply and the immediate consequence would have been a fall in the prices of the goods, increasing sales and market shares and profitability for the producers, so we have learned to expect lower prices in markets where there is plenty of financial investment however the mortgage-housing market was not a normal case, because the subject of the mortgage finance was also the guarantee of the loans (deposit of value) and once the increase in quantities caused the price of houses and mortgages to start falling, this meant that the prices of both the houses and the mortgages started losing value, the loans and mortgages became un-payable and so the process ended abruptly.

10 Gottfried Haberler; *Prosperity and Depression*; (New York: Atheneum, 1963) p.347-349.

This stimulus caused the exposition to the risk of the Accelerator as well, as every intermediate macro economics student knows: the initial increase in demand for any product or service causes the business cycle in this way: "the structure that caused violent fluctuations in orders and inventories, involved the supply chain of multiple stages and the delays between the different stages, the limited information that was available in each stage of the system and the goals, costs, perceptions, and fears that influenced the orders"[11]

All that the Financial Crisis Inquiry Report shows can be seen as mentioned above: there was a multi staged supply chain, delays along the different stages and limited information all over the line, and the perceptions, goals, and fears of the participating public, whatever the product, either beer as in the famous textbook example or house construction or loan mortgages granting in FCIC, s: The original increase in demand for loan mortgages was transmitted along the supply chain: the financial broker- the mortgage bank-governmental agencies regulating mortgages-

11 Peter Senge; "La quinta disciplina", Buenos Aires: Ediciones Granica, 2004, page 60, translated from The Fifth Discipline, where it is illustrated a simulation done by that author, to explain the formation of the business cycle in the case of a common consumption good, beer, and adapted by the present co-author.

rating agencies-big investment banks- stock exchanges- governmental housing agencies-governmental regulators of money- government regulators of savings- government regulators of credit- government regulators of stock exchange, all of whom took the idea of a limitless growth in the demand for subprime mortgages.

The delays between the stages caused waiting gaps that caused apparent rises in the quantities demanded, in the prices of mortgages and then falling prices of houses, of mortgages and falling conditions in the quality

IMPLICATIONS FOR THE FUTURE: A SUGGESTION.

The 2007-2008 Financial Crisis was not only a matter of Excessive Deregulation, or of Light Supervision, or casino like behavior on the part of brokers, there were elements of a Structural Nature because if all the mentioned apparent factors were corrected there would be standing this structural factor as follows: like the type of good financed by the new brokers: not a consumer good, but an intermediate good and also a guarantee (eroded deposit of value), and also the formation of a vicious circle, which must be understood in its entirety, or it would repeat itself not waiting long, this is the almost forgotten concept of the Accelerator: To accept that there are Not linear isolated economic relations any more but relations conforming patterns of wholeness, there needs to be a change of approach and to learn how to model global, whole systems of economic (or social, political, organizational) interactions to learn how to deal with them.

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