



THE FINANCIAL MELTDOWN

What went wrong and how do we move forward?

By Professors Arturo Bris, Didier Cossin and Stewart Hamilton - October, 2008

IMD

Chemin de Bellerive 23
PO Box 915,
CH-1001 Lausanne
Switzerland

Tel: +41 21 618 01 11

Fax: +41 21 618 07 07

info@imd.ch

<http://www.imd.ch>

With financial institutions all over the world in meltdown, IMD Finance Professors Arturo Bris, Didier Cossin and Stewart Hamilton discuss how we got to this point, the impact of today's crisis and what lessons can be learned going forward – including how IMD can help companies to assess the risks and be better placed financially in the future.

Following the move by the US Government to inject billions of dollars into its banks, the take over of mortgage giants Fannie Mae and Freddie Mac, the collapse of Lehmann Brothers, the biggest drop in the FTSE since 1987 and the failures in Icelandic banks, our financial future is anything but certain.

But how did we get here? How did we reach crisis point?

Prof Hamilton: In financial terms we have witnessed something close to the “perfect storm”. A decade of excess credit, excessive leverage of private equity transactions and uncontrolled expansion by some banks. This kind of excess inevitably leads to a downturn or a collapse.

Could we have predicted this and could anything have been done to avoid it?

Prof Hamilton: Yes, this was foreseeable and there are things we could have done. Two years ago I warned in my book that the excessive leverage, in private equity and hedge funds in particular, would lead to problems.

We have seen supervision failures at all levels – company boards, regulators, auditors and rating agencies all have a lot to answer for. Not to mention the misaligned incentives that have encouraged excessive risk taking.

Prof Cossin: In some cases it was foreseen and there are some winners in this situation, such as those who have been “playing cash”. Sophisticated players like Crédit Suisse and Deutsche Bank have also done better than other banks. Lawyers too will do well out of this.

Prof Bris: I agree there were people who could foresee the crisis. But the regulators did not see it coming and that is the root of the problem.

If it was foreseeable, why haven't we learned from past mistakes?

Prof Hamilton: Today there are very few people in the marketplace who have been through a previous crisis. Banks have been de-layering middle management and removing the "corporate experience" – the people who would mentor others and talk about the past. So there is a knowledge gap.

What are the short-term consequences and what does this mean for business?

Prof Cossin: The consequences will be lasting. The borrowing costs of corporations around the world are going to be higher and this will be the case for some time. Companies will find it more difficult to invest and it will cost them more money.

You will see more differentiation between the cash-rich companies and those that borrow. Less investment will mean less work, fewer jobs. Proper risk assessment will also need to be priced into the market.

The remuneration of bankers will also need to change, but as yet this is not happening. We need to address this "moral hazard", the bankers who piled up millions of dollars but have not been touched by the crisis.

Are we already in a recession or are we heading in that direction?

Prof Bris: Technically speaking we are not in a recession. There are countries in Europe and Asia that are close to recession, but we are not in a global recession.

The fundamentals in the economy are fine. Industrial companies are doing OK. But there is a severe restriction on credit and this will affect the economy. Financial institutions need money, investors need dividends, economies need savings, and money is not going to flow any more. Soon enough we will experience problems.

What is your take on the bailout in the US?

Prof Hamilton: In my view this was not the smartest way of dealing with things. The bailout did not re-engage confidence. While the US Government effectively took over Fannie

Mae and Freddie Mac and bailed out another bank, it allowed Lehmann Brothers to fall. So you have mixed signals, and the marketplace doesn't like uncertainty.

Prof Cossin: Another problem is that the bailout helps the institutions but, because of securitization, it is not helping people struggling with their loans – people's houses are still being seized.

Prof Bris: For me, this bailout has broken the market rules and when you disrupt the market there are consequences. In Asia in the 1990s, regulators bailed out the economy by devaluing it, allowing the market to adjust itself. This would have been a better alternative.

What impact do you see the US bailout having beyond its borders?

Prof Cossin: The US is a role model for the rest of the world and this gives license to everyone else to ignore free financial markets and do the same thing. In April 2007 Paulson was in China advocating the importance of free markets, so his actions are again sending mixed messages.

Prof Hamilton: But some regulation and constraint was necessary. Some first time house buyers have taken on sub prime mortgages that leave no room for any short-term interruptions such as unemployment or ill health. A return to prudential lending makes sense.

Finally, what message you would like to leave with our readers?

Prof Hamilton: In the short term we are going to see more focus on business history and what happened in the past. Institutions like IMD can help the educational process by focusing as much on success stories as on situations where things have gone wrong. This "post-mortem" approach is an effective way to learn and schools like ours can make a big contribution here.

Prof Cossin: I would urge people to focus on risks. We all underestimate risks. The important thing is to be aware of this and to work on it, prepare for and, as much as is possible, manage risks.

Prof Bris: Finance education has become extremely relevant. The media, regulators and customers need to understand that the financial world is complex. Education in financial concepts and techniques is perhaps more important than ever.

Professor Arturo Bris is the Program Director of Strategic Finance. He also teaches on the following programs: Advanced Strategic Management, High Performance Boards, Investment and Risk Management in Shipping and Orchestrating Winning Performance.

Professor Didier Cossin teaches on the following programs: High Performance Boards, Advanced Strategic Management, Breakthrough Program for Senior Executives and Orchestrating Winning Performance.

Professor Stewart Hamilton teaches on the following programs: High Performance Boards, Strategic Finance and Orchestrating Winning Performance.

RELATED PROGRAMS



HIGH PERFORMANCE BOARDS - <http://www.imd.ch/hpb>

A Forum for Excellent Practice

Program Director Paul Strebel

- Identify your board's power structure and decision-making freedom
- Develop insights into dealing with critical challenges in today's volatile environment
- Develop an action plan for improving your impact as a board member



ADVANCED STRATEGIC MANAGEMENT - <http://www.imd.ch/asm>

Driving Sustainable Business Results

Program Director Thomas W. Malnight

- Prepare to boost performance at individual, team and business-unit levels
- Ensure that your organization is keeping ahead in a constantly changing business environment