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TOMORROW'S CHALLENGES

# FINANCIAL CRISIS TEN YEARS ON: ARE WE ANY BETTER OFF?

## 7 LESSONS LEARNED SINCE 2008

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On September 7th, 2008, the United States Treasury announced that the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, popularly known as Fannie Mae and Freddie Mac, were place into conservatorship. In short, both institutions were unable to fulfil their obligations and were therefore technically in default. One week later on September 15th, one of the largest and most successful investment banks in the world, Lehman Brothers, filed for bankruptcy in the Southern District Bankruptcy Court of New York.

It is now ten years since those events, which triggered the most profound financial and economic crisis ever. At the time I was a relatively experienced finance professor and had probably educated some of the culprits, and certainly many of the victims, of the crises that ensued. Ten years later, our world has changed: investment banks do not exist in the form they used to; there is more, and better, regulation; the financial market landscape has changed dramatically, in terms of both players and behaviors; a few countries have defaulted.

**What have I learned during the last 10 years?**

1. **The next crisis will be different.** My colleague the late Professor Stewart Hamilton used to say, even before 2008, that “I have seen too many crises in my life, and this will not be the last one”. In fact, crises happen, and we will have another one some day. However, crises do not repeat themselves and the next collapse will be different. Will it be caused by China? By geopolitical events? By increasing corporate leverage in some countries? Because we all suffer from a confirmation bias, once the next crisis happen we will say that we saw it coming. But almost nobody, very few people, saw the Lehman Brothers collapse and its aftermath coming.

2. **The 2008 crisis was a financial crisis, not a Crisis of Finance.** Today, more than ever, executives need to know financial principles and master finance tools. In the last 10 years, we have significant changes in the skill set of senior executives; in the curriculum of MBA programs, in the demand for leadership vs. functional training. We think that this is a mistake. In 2008 it was people who failed, not the tools we use. It was the lack of knowledge by the leaders with respect to financial products and risk management that was lacking, not the power of finance theory to value securities and optimize portfolios.

3. **Macroeconomics and finance matter.** Until 2008, most models of the economy ignored the financial sector; and most financial models ignored the macroeconomic underpinnings of interest rates and risk premia. That was a mistake. The financial sector is not like the oil & gas, consumer goods, or technology sectors. It has profound implications on the way the overall economy works, and financial imbalances can have multiplying effects on the real economy. Over the last 10 years academic research has made a lot of progress to understand these relationships. Now we recognize that that the financial sector can be a mechanism to transfer shocks from one country to another, as it happened when a real estate bubble in the United States triggered a banking crisis in Europe.

4. **Regulation helps preventing previous crises, not the next ones.** Many of us agree that, before 2008, we should have had not more, but certainly

better regulation. Unfortunately, the aftermath of the Lehman collapse has brought about a plethora of new rules: Basel III, the Dodd-Frank act in the USA, several European Directives; rules affecting rating agencies, compensation, derivatives, financial markets, payment systems and so on... We now know that, if had we had these rules in 2000, the world would have been different. But because markets move faster than regulators, we also know that our new set of rules will not be able to prevent the next crisis.

5. **If you do not understand a product/business/technology, it is probably your fault.** Warren Buffett is famously quoted as saying: “when I do not understand a business, I do not invest in it”. Applied to 2008, this statement allows many to justify the excesses caused by financial innovations such as Credit Default Swaps, Collateralized Debt Obligations, Repos and so on. We did not understand them and at some point they controlled us more than the opposite. I disagree. Executives have the obligation to learn, understand, and question when new products and technologies are not clear to them. Complexity cannot be an excuse. In the coming years complex technologies (blockchain, artificial intelligence) are going to drive new business models. Leaders better make the effort to master them.

6. **The crisis of 2008 was a crisis of values.** And values are only restored through education. As we often say in class: “there are many bad people out there”. The role of risk management and corporate governance is to prevent those ill-intentioned individuals to contaminate whole organizations. But the task is almost impossible unless we educate individuals with a value system from the beginning. The best tool against corruption is education.

7. **Believe in your instincts.** This is a very personal observation. Our mindset has changed in recent last decades and now we pay more attention to our instincts. It is not easy to identify a rogue executive or an ineffective leader individually. But it is very visible when organizations are dysfunctional, and risks are not managed well. We have learned to speak out in the presence of overconfidence, arrogance and hubris.

We can’t predict the future, but we have definitely become better at managing what the future will bring.

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