

Genesis of the Financial Crisis

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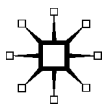
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Preface and Acknowledgements

This book began as a chapter of another book. The other book was an explanation of business for people with a humanities or science background. I had hoped to explain the impact of macroeconomics on businesses with a chapter on the case of the financial crisis. That chapter grew into something too extensive for the original project, and I decided to turn it into the volume you hold. It retains the ambitions of the original work: to make complicated issues accessible to the uninitiated and to offer the initiated a coherent and synthetic purview of the basics. The reader must judge the degree of my success.

This book attempts to gather *all* of the factors contributing to the crisis brought to the public eye on 15 September 2008. It is not meant to provide a simplified explanation that the capitalist system is broken or that our system is one in which the rich, powerful and initiated appropriate the dwindling wealth of the poor and the middle class, or that what we need is better regulation of the financial sector. It has been written without any ideological agenda. However, the best way to defuse any bias in this exposition is to declare my opinion at the outset. This opinion is that the financial sector shares a management problem with much of business in the Anglo-American world: incentives. The problem usually manifests itself at the level of CEOs and top management, where the unscrupulous may pillage a firm's resources or weaken its mid-term strategic position in the pursuit of short-term performance goals which either directly trigger bonuses or else increase the value of shares and thus that of the options that form part of their compensation. The case of the financial sector is far more dramatic in its consequences and displaced to other echelons of the firm, because in the financial sector it is the traders – the blue-collar workers of the financial world – who pocketed huge bonuses based on falsely valued performance, although top management also benefited from this misperception of performance.

However, many, many factors and influences had to be in place for this defective management tool spawned by agency theory to have the devastating effect it had. To explain the 2007–2010 financial crisis by poor employee evaluation techniques alone would be to misunderstand the crisis.

The first draft of this book was completed as the National Commission on the Causes of the Financial and Economic Crisis in the United States published its final report. The ten-person commission had a staff of 80, powers to obtain documents and testimony under oath and seven months to acquire data. I was eager both to fill in any lacunae in my own work and to see how badly I had been scooped.

The final report was in fact a 'majority report'. Four of the ten commissioners dissented from the final report, and two brief dissenting statements (one by three commissioners) are included in the published book. The majority report provides a reasonably complete catalogue of the various factors contributing in some way to the crisis, but fails to give much insight into the relationship between the different factors. There is no evident discernment between context, causes, catalysts and motives, nor does the report give a sense of the weight of the various causes. Further, the vast powers of the commission to obtain and analyse data seemed to have remained untapped. For example, both majority and dissenting commissioners take for granted conventional wisdom that subprime mortgages are what made so many securities perform poorly. Given the considerable manpower and coercive powers of the commission, many real estate and other researchers must have hoped that the staff would have been directed to do the dog work of breaking down a statistically useful sample of mortgage-backed securities to find out whether the prime loans indeed contributed little or nothing to the non-performance. The report refers to a website (<http://fcic.law.stanford.edu/>) where the commission had archived extensive resources, but unfortunately only a single 'story' of a mortgage-backed security is related, with information about aggregate performance of the bundle of mortgages. The data for the security is provided, including the FICO rating and delinquency status for each loan, so it is technically possible to drill down for the information. (The meaning of the technical terms used in this paragraph will become clear later in this book.)

The critiques of the dissenting reports are partly valid, but underestimate the moral and financial influence of the US economy. The conclusion of this book will discuss the first and more substantial of the two dissenting statements, although the body of this book does not benefit from the report of the commission.

Tiurlan Sihaloho and Jonathan Deraiche helped finalize the typescript for submission to the publisher. Lisa von Fircks, my editor, provided patient moral support and humour as well as technical guidance. Marc Stern, Raymond Théoret and Yong Lee answered my technical questions in finance; Jean Canonne and Unsal Ozdilek provided expertise

in real estate. John Singleton read a couple of chapters and offered critiques from the economist's and economic historian's viewpoints. Marc Stern read the entire book and corrected my English as well as my Finance. Terry Ryan, former economic secretary of the Kenyan Ministry of Finance, initiated me into the mysteries of economic policy long before I undertook this project. The Waikato School of Management provided New Zealand hospitality and encouragement that transformed a chapter into a book. The School of Economics and Finance – Victoria University of Wellington, across the street from the parliament of New Zealand, also provided one week of intensive consultation with several researchers as well as new friendships. Numerous students and professors in Canada, Indonesia, New Zealand and Vietnam have been subjected to the ideas contained in these pages.

In the final vetting of the manuscript, Vidhya Jayaprakash, Will De Rooy and the entire team at Newgen Publishing & Data Services saved me from many mistakes and helped make the final work more elegant. I wish to thank them as well as all readers who advise me of any errors I have overlooked.