

# FINANCIAL CRISES: A CULTURE OF COMPLACENCY

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# Financial Crises: A Culture of Complacency

## **Abstract**

The aim of this paper is to consider the role of complacency in financial crises over the last two decades, with a closer look at the ongoing Subprime Mortgage Financial Crisis. The theme of complacency and the concept of financial crisis are both explored. Financial crises are better understood by explaining their economic drivers and the fundamental role of complacency in the various transmission mechanisms involved. These drivers are then illustrated by means of recent selected financial crises including the Crash of 1987, the East Asian Financial Crisis of 1997, the Long Term Capital Management Crisis of 1998, the Dot.Com Crash of 2000, and the current Subprime Mortgage Financial Crisis. The paper concludes that complacency not only underlies but plays a pivotal role in recent financial crises. Complacency increases during periods of economic stability, leading to some departure from rational investment decisions, an effect which is then compounded by herding behaviour. Further, with regard to the governance of markets, complacency is both institutional and institutionalised. Finally, adding to this culture of complacency is the irrational belief that crises are unique and therefore cannot be spotted in advance or even in their early stages. To address this culture of complacency, remedies lie in the re-education of key players and the provision of better financial information, a rethink of market governance structures, and some recognition that the transmission mechanisms are both recurring and predictable.

**Keywords:** financial crises, transmission mechanisms, subprime mortgages, contagion, complacency

# Financial Crises: A Culture of Complacency

## 1. Introduction

The aim of this paper is to consider the role of complacency in financial crises over the last two decades, with a closer look at the ongoing Subprime Mortgage Financial Crisis. Financial crises can be extremely destructive, leading to the collapse of governments, severe economic contraction, mass unemployment and individual economic hardship, a decimation of the business sector, and so on. On the other hand, financial crises are perhaps an inevitable feature of any capitalist economy, periodically clearing out ‘dead-wood’ governments, businesses and institutional structures. In stable economies with predictable growth, complacency gnaws away at established economic thinking and erodes the rationality of economic man.

The structure of this paper is as follows. Section 2 defines the key concepts of complacency, crises in general and financial crises in particular. Section 3 then sets in place some of the key economic drivers of financial crises and discusses their relationship with the mindset of complacency. Section 4 examines recent financial crises such as the Crash of 1987, the East Asian Financial Crisis of 1997, the Long Term Capital Management Crisis of 1998, the Dot.Com Crash of 2000, and the current Subprime Mortgage Financial Crisis. Finally, Section 5 summarises and concludes to what extent complacency plays a role in recent financial crises.

## 2. The concepts of crises and complacency

To consider the nature of complacency and its role in recent financial crises, it is necessary to define the term. The Concise Oxford Dictionary (2006) defines the term ‘complacent’ as “smug and uncritically satisfied with oneself or one’s achievements.” Complacency is at the very heart of the current Sub-prime mortgage financial crisis – the complacency not only of financial institutions, but also of investors, corporations and investors. Complacency does not equip economic actors with the correct mindset to identify impending paradigm shifts, as they take their eyes off fundamental economic relationships. Recent events in financial markets have indeed seen a paradigm shift – the re-emergence after many years of erosion of a tangible relationship between risk and return.

The term *crisis* (or “krisis”) has its origin in Greek in the word decision from “krinein” to decide (Concise Oxford Dictionary, 2006). In an intuitive sense, a *financial crisis* can be usefully defined as a situation when the demand for money quickly increases relative to the supply of money – a situation which very much characterises the recent Sub-prime mortgage crisis.

Another insightful definition which emphasises the roles of liquidity and capital flight in financial crises is provided by the Deardoff (2006): “a loss of confidence in a country’s currency or other financial assets causing international investors to withdraw their funds from the country.” Financial crisis might be considered a somewhat different phenomenon from *economic crisis*, the latter of which might be defined as a long-term economic state characterised by macroeconomic indicators such as low prices, poor levels of trade and investment, and unemployment. Thus, economic crisis definitions emphasise the pervasive impact on the real rather than financial economy.

Aizenman (2007) provides a very useful summary discussion of financial crises. He states that financial crisis refers to:

“A rapid financial disintermediation due to financial panic. In practice this involves a flight to quality, where savers attempt to liquidate assets in financial institutions due to a sudden increase in their perceived risk, moving their savings to safer assets.”

In open economies, he argues that such investors would shift their savings to foreign currency and bonds, whilst in a closed economy investors will shift their savings into currency, gold and domestic government bonds. He argues that the ultimate outcome of financial crises includes failing banks, stock markets crashing, and the onset of currency crises, perhaps even leading to deep recessions. Whether crises are financial or economic in nature, then, their potential impact on a country or even a region can be severe.

The pervasive culture of complacency will be explored in this paper as a key driver of the current Sub-prime financial crisis, but also as a common driver to other financial crises of the last century or so. Complacency leads to governments assuming that boom periods will continue, it leads lenders to lend more than they should prudently do to riskier borrowers, it leads investors more generally to not demand a sufficient return for the risks of an investment instrument or project, and it leads to borrowers whether corporate or individual to borrow more than they can afford to service or repay.

### **3. The relationship between complacency and the economic drivers of financial crises**

Complacency plays an important role in explaining some of the key drivers of financial crises. Financial institutions in particular are arguably to blame for believing that they could lend to increasingly risky borrowers with no commensurate increase in loan defaults. Borrowers, particularly those borrowing to purchase their own home are far from blameless, believing that they could continuously refinance and that property prices would rise continuously to enable

them to do so. The herding behaviour which underlies financial contagion is a form of complacency, though there is a debate whether herding represents rational or irrational behaviour. In the light of recent financial events, the rationality argument is probably indefensible here. Many commentators would argue that banking regulators have demonstrated complacency in their lack of rapid reaction to impending crisis, though regulatory frameworks will always tend to be cumbersome and reactive rather than timely and proactive. Certainly, the fact that banking regulators have pursued solvency as a goal rather than liquidity means that they should take some of the blame. In this section, the role of complacency is explored and demonstrated to be an important trait inherent in the institutional organisation of the western financial system in recent decades.

Minsky (1964) is probably one of the most prominent works in the field of financial crises. His financial stability hypothesis was prophetic in very clearly explaining the underlying causes of the recent Subprime Mortgage Crisis and the associated and protracted credit crunch of the last couple of years. Minsky argued that long periods of economic stability encourage investors (including financial institutions) to take on more risk. As a result they tend to borrow too much and pay too much for the range of asset classes available for investment. In many respects, then, during periods of stability investors become accustomed to asset prices continually rising and their personal balance sheets improving commensurately – this imbues them with the increased confidence to borrow further and thereby increase their risk of financial distress yet more. In short, investors become complacent and forget the relationship between risk and return which is at the core of any university ‘Finance 101’ course and a key element of professional training in any financial markets institution.

Minsky identified three main types of borrower: hedged, speculative and Ponzi. ‘Hedged’ borrowers can meet all commitments, that is, interest and capital repayment, from their cash flows and are therefore relatively safe. ‘Speculative’ borrowers can meet the interest payments on their loans with relative ease, but need to rollover their loans rather than repay them as they do not have the funds for capital repayment – these borrowers are clearly more risky than the hedged borrowers. However, more risky still are what Minsky terms ‘Ponzi’ borrowers (named after the infamous Ponzi investment scheme in the US which collapsed in the 1920s – see Zuckoff, 2005). Ponzi borrowers, then, can repay neither the interest nor the principal on their loans, relying instead on asset prices rising continuously and periodically refinancing. The longer the period of economic stability, the greater the number of Ponzi borrowers as both borrowers and financial institution lenders become complacent. An important aspect of complacency in a financial markets setting then, is that it increases through time, or more precisely increases with

each year of financial stability. Another modern term for these Ponzi borrowers which has become popular in the financial press is the NINJA borrower, the acronym standing for “No Income No Job (*and no*) Assets”. (see Kambayashi, 2007). The problem here for Ponzi borrowers is that at some point asset prices may experience corrections and/or the banking market begins to suffer increasing arrears periods and loan defaults, and the whole market experiences a credit crunch, bankruptcies, bank failures, and so on.

The concept of financial contagion is essential to a deeper understanding of the phenomenon of financial crisis. Contagion in its broadest economic sense is the likelihood of significant economic movements in one country being transmitted to other countries. The World Bank (2007) provides a more precise definition of contagion:

“Contagion is the transmission of shocks to other countries or the cross-country correlation, beyond any fundamental link among the countries and beyond common shocks. This definition is usually referred to as excess co-movement, commonly explained by herding behaviour.”

In contrast to definitions of general economic contagion, definitions of financial contagion tend to focus on asset prices. *Financial contagion*, then, refers to the phenomenon when one country's economy is negatively affected because of changes in asset prices in another country. The modern day global economic system results in a series of interdependencies which make contagion inevitable during a country's financial troubles. Therefore financial contagion is concerned with excess co-movement in asset prices, precipitated and made inevitable by the globalisation of the world financial system. Here, complacency is an issue, as financial institutions and investors fail to appreciate the extent to which international asset prices are linked, or rather they are content when asset prices are linked in bull markets, but tend to forget during periods of economic stability that assets prices are also linked in bear markets.

It is useful to examine just how highly correlated stock markets are in the western world. Figure 1 examines stock market index return correlations for European and US stocks. The figure reveals that European stock index returns are very highly correlated, with an average correlation coefficient of 0.65.

**Figure 1 Bivariate correlations between European stock market index returns February 2005 to October 2007**

	ATX	BFX	CAC 40	DAX	ISEQ	MIBTEL	AEX	PSI20	IBEX35	OMX SPI	SMI	FTSE 100	DJI
ATX	1.00												
BFX	0.68	1.00											
CAC40	0.71	0.90	1.00										
DAX	0.67	0.85	0.94	1.00									
ISEQ	0.59	0.67	0.70	0.69	1.00								
MIBTEL	0.76	0.85	0.91	0.86	0.66	1.00							
AEX	0.68	0.86	0.91	0.89	0.65	0.84	1.00						
PSI20	0.03	-0.05	-0.02	-0.04	-0.07	-0.01	-0.09	1.00					
IBEX35	0.62	0.79	0.84	0.84	0.67	0.81	0.78	-0.06	1.00				
OMX SPI	0.73	0.82	0.87	0.83	0.67	0.84	0.84	0.01	0.77	1.00			
SMI	0.66	0.83	0.87	0.84	0.65	0.83	0.83	-0.02	0.77	0.83	1.00		
FTSE100	0.73	0.83	0.89	0.84	0.68	0.86	0.86	-0.07	0.81	0.84	0.83	1.00	
DJI	0.57	0.66	0.77	0.77	0.51	0.72	0.74	0.04	0.68	0.66	0.69	0.73	1.00

Source of data: Yahoo Finance, October 2007. Indices are rebased to 100 at 1<sup>st</sup> February 2005. The stock market indices relate to the following countries: ATX = Austria; BFX = Belgium; CAC40 = France; DAX = Germany; ISEQ = Ireland; MIBTEL = Italy; AEX = Netherlands; PSI20 = Portugal; IBEX35 = Spain; OMX SPI = Sweden; SMI = Switzerland; FTSE100 = UK; DJI = US.

The relatively straightforward relationship between risk and return for stocks has been debated and developed for some decades. The Capital Asset Pricing Model of Sharpe (1964) and Lintner (1965) demonstrates that the expected risk premium on a stock equals the beta for the stock multiplied by the expected risk premium on the market. The risk-return trade-off has been developed since these seminal papers in a search for other metrics which help to capture the risk of investing in stocks. Papers such as Fama and French (1995) pick up factors additional to the market factor such as size and the book-to-market ratio. All investors in marketable financial assets such as stocks and bonds are acutely aware of the risk premium over and above the risk free asset (such as a Government Treasury Bill) which they should earn for accepting the risk implicit in that asset. The only issue with non-traded assets such as bank term loans is that they are very often held until maturity and the market does not automatically achieve equilibrium when pricing risk (as the market consists solely of the lender and the borrower). In the case of lending, then, institutions which have had a recent long run of successful lending will not adequately price the risk of default. Complacency effectively emerges when the market mechanism does not allow for the transparent pricing of risk.

In common with many other phenomena in finance and economics, the market failure of information asymmetry is at the heart of recent financial crises. Why does information asymmetry exist in the market for financial assets? The answer lies in both human nature and in complacency. As gathering information across different country financial markets is costly, investors tend to remain uninformed about asset prices and their underlying risk. As a result they instead infer price changes on the basis of how the rest of the market is reacting. Thus, the “uninformed” tend to follow the “informed” (such as well resourced large financial institutions) – this causes the whole market to move together. However, once such investors observe foreign crises occurring, they tend to reassess the risks of investing in other countries and withdraw their funds from foreign asset markets. This is often termed “herding behaviour” which gives rise to panics in financial markets. An alternative term for this behaviour is “irrational exuberance”, implying an irrational approach used to enter and exit the international market for financial assets. An interesting debate amongst economists is whether this behaviour is indeed irrational – it could be argued that such behaviour is rational after all because complete information on financial assets is too costly and the investor can therefore benefit from observing the market reaction and making decisions accordingly. However, whilst at a private level this proposition is defensible, at a public level contagion is indeed very costly and therefore a bad thing. Countries with otherwise very sound macroeconomic fundamentals can find themselves with balance of payments and banking crises through little fault of their own as a result of the contagion associated with financial crises. Arguably, herding is a form of complacency. If investors wished to precisely capture risk in the returns that they demand for investing in an asset then they would ‘price the risk’ themselves and not merely ‘follow the crowd’. Complacency is the easy way out, whether rational or otherwise, which determines the extent to which investors engage in herding behaviour. For example, if all other banks are investing in subprime debt instruments then surely we should too as the market cannot be wrong!

The inherent focus of the banking industry on solvency rather than liquidity lies at the centre of recent financial crises. A schematic diagram is given in Figure 2 to help explain this issue. Bank regulation and therefore strategy has traditionally focused on solvency, that is, banks must demonstrate their ability to remain balance sheet solvent. Given the reverse-image of a bank’s balance sheet, this essentially means that assets must remain easily covered by liabilities and capital. To clarify, a bank must be able to cover its loans to customers (assets) from its deposits from customers (in their many forms of liability) and from capital. This has been the focus of banking regulation to date, and will remain so under Basel II regulation (Basel Committee on Banking Supervision, 2004). There is a permanent maturity mismatch between



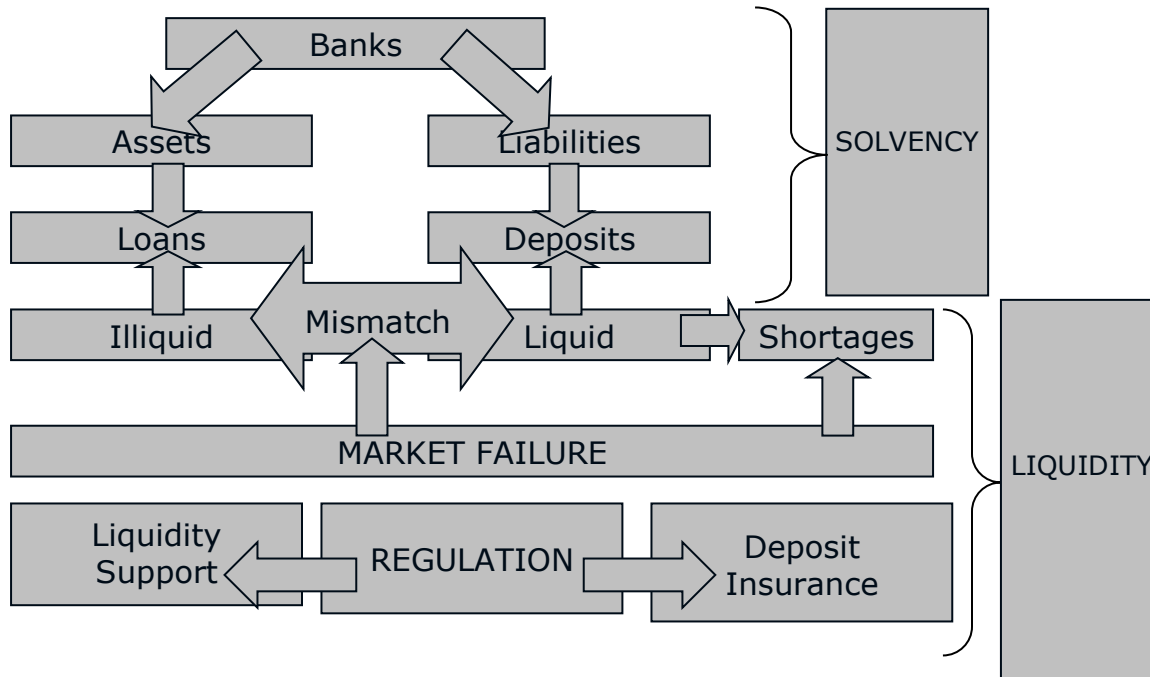
bank assets and liabilities, unsurprisingly, as this is the prevailing business model of all banks – they borrow short-term and lend long-term – and as long as the flow of depositor money (or other short-term sources) is continuous and large enough to support their lending business then the model works well. However, in recent years the emerging issue is one not of bank solvency but of bank liquidity. In times of financial crises, then, the maturity mismatch becomes a significant issue as depositors withdraw on mass their funds from banks and short-term inter-bank funds tend to dry up as banks hoard funds and prohibitive interest rates emerge to compensate for the higher perceived risk of operation. This is a liquidity problem and is an important form of market failure. Complacency for banks is observed here in two forms: (i) complacency that because no liquidity problems have occurred in the banking system for many years then there are unlikely to be liquidity problems over the life of an investment, and (ii) if liquidity problems do occur then either depositors will not withdraw their funds or the banking regulator and the government will intervene to restore banking confidence and prevent a ‘credit crunch’.

How is the market failure of liquidity addressed in the real-world? The role of the central bank is pivotal here. Central banks will intervene in the financial economy (i) to provide liquidity to banks when required to, and (ii) to provide deposit insurance to reassure depositors. Knowing this critical linchpin of banking tends to make banks complacent. When central banks intervene on both of these fronts then a liquidity crisis can be mitigated as banks do not run out of the liquidity required to continue in business, and depositors do not engage in ‘bank runs’. Authors such as Diamond and Rajan (2002) from Chicago Business School advocate a renewed focus on liquidity in banking, adding that, due to the impact of business cycles on bank balance sheets, liquidity must be monitored by central banks and others over the cycle.

Dornbusch and Fischer (2003) provide some important insights into the subject of international financial crises, particularly their distinction between “old crises” and “new crises”. They argue that old crises were characterised by a world with little capital mobility, and where a government had reserves plus some World Bank funds. However, poor government policy tended to lead to a budget deficit due to government over-spending, and an overvalued fixed currency. Such spending led to inflation, an influx of imports and a current account deficit. The deficit in turn tended to lead to a diminution of reserves as the currency is bolstered, and ultimately led to a desperate need for policy change. However, policy change often came from tariffs, quotas, export subsidies, and so on, which are merely a temporary fix and just delay the onset of financial crisis. The result would ultimately be a significant currency devaluation,

resulting in competitiveness gains, monetary expansion (again), and the whole transmission mechanism would repeat itself.

**Figure 2 The issue of banking solvency versus liquidity**



New crises, they argue, are very different phenomena. Such crises involve huge and rapid flows of short-term money around the world. Countries become very highly geared in a globalised financial market. They are highly geared because governments are seeking to prop up weak currencies, and industry is expanding dramatically in a rush for economic modernisation. This is all fine until at some moment in time a country needs to borrow huge amounts of cash, but the world financial system decides that it will no longer lend. In globalised financial markets, the IMF and others cannot respond to such a crisis rapidly enough. As a result there is massive currency speculation, widespread bankruptcy, and the effects quickly spread to the next country, and perhaps even the region.

Dornbusch and Fischer identify some of the drivers of new financial crises. Emerging market countries have very short-term liabilities which in itself encourages runs on financial institutions in times of crisis. These liabilities are often foreign exchange-denominated which is very dangerous in itself as such governments have no influence on the ultimate value of these liabilities. Therefore, country balance sheets have high levels of Value at Risk due to large

balances of foreign exchange liabilities, as well as investments in foreign stocks. They argue that under such circumstances national credit risk can deteriorate very quickly, causing sudden short-term fund capital flight. This outflow of liquidity is particularly serious if the one remaining tool to support an ailing currency, that is, interest rates, cannot for some reason be employed successfully. Indeed many countries, particularly emerging countries, cannot raise interest rates given the weakness of their banking industry. Banks are often weak as indigenous companies are highly geared and on the verge of financial distress at any time. Interest rates cannot be raised to stop funds being withdrawn from the country, and the country may also have small reserves and a lack of transparency regarding the size of those reserves in an attempt to prevent currency speculation. There is no warning of impending crises due to this lack of transparency – the timing of such crises thus becomes very difficult to predict. Further, the depth of the crisis is also difficult to establish, as it depends on bank gearing, the ability of foreign investors to liquidate collateral associated with debt investments, and the political environment, particularly the tendency of troubled governments to print more and more cash in a vain attempt to address the problem. Complacency is inherent here in the design and acceptance of a financial system which is implicitly unstable. Short-term capital flight is not a new phenomenon, nor is macroeconomic mismanagement. A complacent government attempts to bet against a truly international financial system, even when the country's currency is in the process of collapsing.

#### **4. Financial crises over the last two decades**

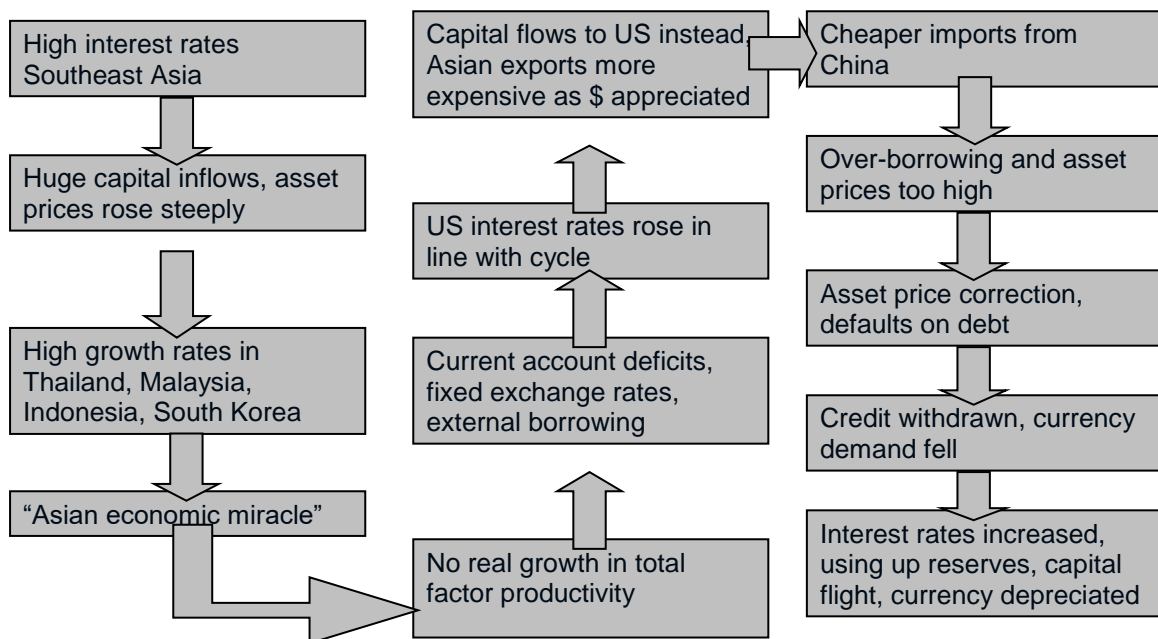
In this section, we review a number of financial crises which occurred in recent years to better understand the underlying causes and implications of financial crises, and in particular to understand the role of complacency. An excellent review of recent financial crises is provided by Steve Schifferes and this paper draws upon some of the insights of this review (see BBC, 2007).

The Crash of 1987 was precipitated by the introduction of rapid trading technologies, a spate of highly-g geared takeovers, a belief that insider-trading was endemic, the US economy experiencing a slow-down with a depreciating dollar, and at the same time German interest rates were rising. The result was that the Dow Jones experienced its largest one day fall in history, falling by 22% on 19<sup>th</sup> October 1987. The US government tackled the crisis head-on by dropping interest rates, encouraging other central banks to follow suit, and introducing stock trading circuit breakers and suspensions in trading. The effects were therefore contained and there was little effect on the real economy in the US. However, as a prime example of the 'ripple effects' of financial crises, in the US, the lower interest rates ultimately gave rise to a housing market

bubble in the UK which ultimately burst, and, more significantly, the UK's exit from the Exchange Rate Mechanism as sterling could no longer be supported through open market operations at the same time. Thus, international contagion was brought into sharp focus. Complacency was apparent on the part of both the UK Government and home buyers. The UK Government effectively attempted to prop up sterling against the currency speculators of the world who all knew that eventually the UK would exit the ERM and the value of the pound sterling would be allowed to fall. Home buyers lost track of the fundamental value of the asset of their property, relying upon an 'up market' with little contingency for a 'down market' (and hence problems with strongly correcting house prices, defaulting loans, negative equity, and so on).

The East Asian Financial Crisis of 1997 is probably the best documented crisis this century in the financial press and the most analysed crisis in the academic literature, deservedly so given the extent of its effects and the breadth of its associated contagion. A particularly useful summary of the crisis can be found in the article, "1997 Asian Financial Crisis" (Wikipedia, 2007), an article on which the discussion below is based. Another interesting discussion of the crisis is provided by Paul Krugman on his MIT website (Krugman, 2007). The transmission mechanism in Figure 3 helps us to explain how the crisis evolved.

**Figure 3 The transmission mechanism of the East Asian Financial Crisis of 1997**



Note: Figure based on author's discussion of article: "1997 Asian Financial Crisis", Wikipedia (2008)

Let's commence with the prevailing high interest rates at that time in Southeast Asia, giving rise to huge capital inflows and a large rise in asset prices. The whole region appeared to be growing very strongly, particularly Thailand, Malaysia, Indonesia and South Korea, with many commentators referring to the phenomenon as the "Asian Economic Miracle". However, there was no real growth in total factor productivity (the increase in output not explained by increases in labour, capital or technology). In each country, a similar pattern emerged of current account deficits, whilst governments maintained a fixed exchange rate system (their currencies were pegged to the dollar) and borrowed huge sums on external markets to finance the high rate of growth. When interest rates rose in the US, consistent with the economy's point in the business cycle, this led to capital flows to the US instead of Asia. The US dollar appreciated as a result, and therefore, implicitly, the value of the pegged Asian currencies did so as well, leading to Asian exports appearing suddenly more expensive. At the same time, China with its new-found market-based socialism was emerging as an economic power to contend with and East Asian countries' former export customers began to switch to imports from China, particularly as value of the Chinese currency was purposefully kept artificially low. Thus, the East Asian countries borrowed further to maintain their growth paths and fill the funding gaps which appeared when export incomes declined. The mix of excessive gearing and inflated asset market prices eventually led to some sharp market corrections and Asian companies began to default on their debt obligations. Credit was withdrawn from both countries and their indigenous companies, leading to a sharp fall in currency demand. To maintain liquidity, East Asian countries were prepared to pay increasingly unsustainable interest rates, using up their reserves very rapidly. There was significant capital flight from the region and currencies collapsed in value. The ultimate impact was widespread recession across the region, leading in turn to political crises, government changes, and the rise of religious fundamentalism. Worldwide financial institutions such as the IMF and the World Bank were considered by many as partly to blame and the crisis led to the emergence of anti-globalisation movements across the world. Since the crisis, East Asia has engaged in foreign exchange reserve building and economic restructuring. The sharp fall in demand and economic stagnation also led to collapsing Russian oil prices, with the attendant political and economic problems this caused in that region. Further afield in the US and UK, the flight of capital into these "less risky" markets gave rise to a sustained period of low interest rates, extremely high liquidity and easy financing – ultimately this resulted in asset market bubbles such as the Dot.com crisis and the lax lending environment underpinning the current Subprime Financial Crisis. Complacency in the East Asian financial crisis therefore came

in the form of developing country governments believing that they could continue to prop up their ailing currencies in a fixed exchange rate system in the face of increasing international interest rate differentials. This simply flies in the face of the basic economic principles of Interest Rate Parity (Clinton, 1988). Further, such countries' governments believed, wrongly, that they did not have strong regional competitors to whom their customers could switch with the onset of economic problems (or that switching costs were high). All that it took for the 'bubble to burst' was interest rates to rise in other countries consistent with their business cycles and for other regional trade competitors to emerge.

The Long Term Capital Management Crisis of 1998 was set in motion by, of all people, two Nobel prize winners in Economics. Lowenstein (2000) and Dunbar (2000) describe how Myron Scholes and Robert Merton set up a hedge fund specifically to trade government bonds on the basis that their rates should converge, trading on the small rate differences between bonds on a highly geared footing. However, partly because the Russian government defaulted on its bonds in August 1998, investors moved their capital into perceived safer US bonds, thereby raising interest rate differences rather than reducing them. As a result, the fund had to sell its bonds at diminished values (to maintain yields), a credit crisis was precipitated, and interest rates increased dramatically. The Federal Reserve, in conjunction with a range of US banks, stepped in to save LTCM for fear of wider contagion, the Fed dramatically cut interest rates to stimulate liquidity, and the fund was ultimately liquidated two years later. Evidently, even Nobel prize winners cannot spot crises in advance. Complacency here took the form of an overriding belief in economic theory – *ceteris paribus*, that bond prices would adjust to restore yield equilibria. The problem was that all things were not held constant as a key government player in the bond market defaulted. This was an unusual but not an unimaginable event!

Leading up to the turn of the century, the world experienced a technology stock market bubble and subsequent crash known as the Dot.Com Crash, particularly in the US and the UK. This bubble was based upon an apparently unquenchable desire of investors for internet shares. The value placed by investors on many of these companies was based entirely on distant projected earnings, whereas most made no current profit at all, with some not even making any current sales (Ofek and Richardson, 2002). However, in March 2000, the bubble burst with NASDAQ eventually falling 78% in value by October 2002. The wider repercussions of this collapse in share prices were that investment in the real and financial economy fell sharply, leading to a slowdown in the US economy, with the Federal Reserve making a sharp cut in interest rates to stimulate the economy back into action. Many economists subsequently argued that this crisis, and its associated low interest rate environment, sowed the seeds for the

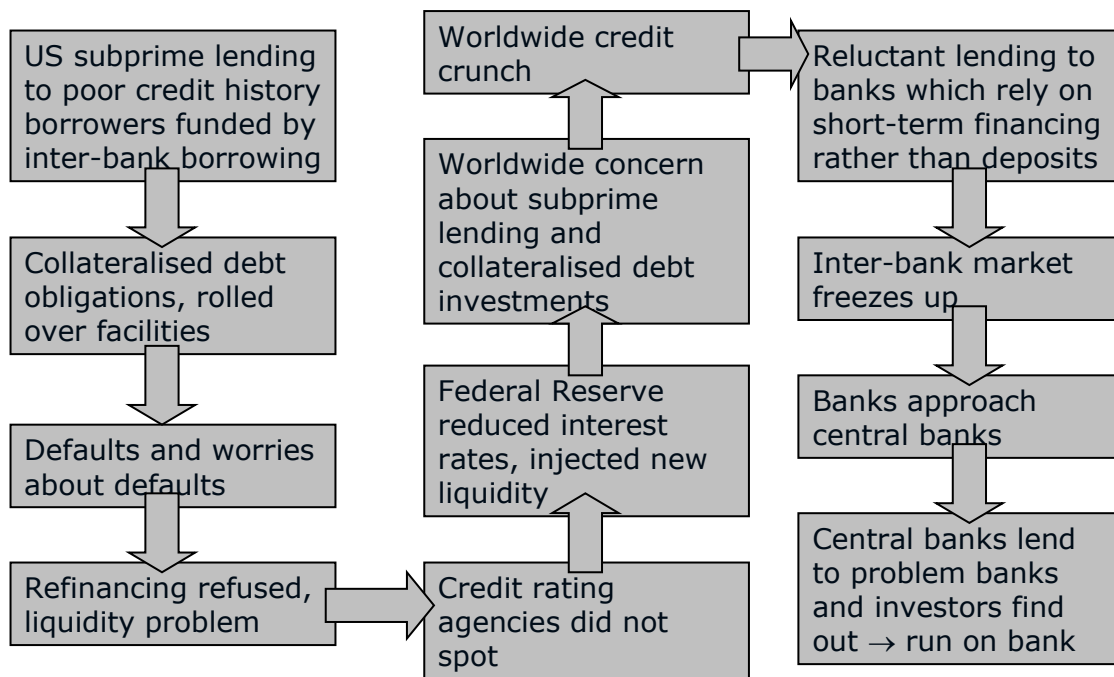
subsequent Subprime Financial Crisis some years later. Here, investors were the complacent party in the crisis, given their irrational belief that just because one or two high profile internet stocks had achieved fantastic returns, all such stocks would also deliver similar returns (Rau, Dimitrov and Cooper, 2001). The belief that an investor can join a booming asset market and exit it in such a manner that they can maximise short-term returns is not merely complacent but extremely naïve in efficient financial markets.

The root cause of the current Subprime Mortgage Financial Crisis, as its title implies, was the US subprime market. Subprime lending is the term used to describe lending to poor credit history borrowers to purchase homes, much of which is funded by inter-bank borrowing. The interesting feature of such lending is that much of the debt has then been bundled up and sold on i.e. multiple subprime mortgage assets were bundled up and sold on as mortgage bonds, often mixed with other debt assets of varying risk – these instruments are known as collateralised debt obligations or CDOs. With much of the risk effectively passed on to others in the financial system such as large investment banks, hedge funds and so on, the original lenders are able to lend to new clients and again pass on the risk. The CDO market effectively provides such banks with a rolling credit facility and a fairly safe business operation in interest rate spreads. However, this business model was implicitly flawed as many of the borrowers were of the Ponzi type, relying on increasing real estate values to be able to refinance and ‘stay afloat’. Ultimately such borrowers began to run up mortgage arrears and to default – they simply could not afford to repay or even service their mortgage loans, and with real estate values slowing or contracting they were unable to refinance. When the scale of this lax lending became apparent, the lenders themselves found that they could no longer sell on their CDOs and a liquidity crisis ensued. Interestingly, the credit agencies which pride themselves on gauging financial institution risk failed to adequately measure this deterioration in the debt ratings of the financial institutions involved. The US Federal Reserve decided to step in once it realised the extent of the problem, reducing interest rates over successive months and injecting liquidity into the market to support the banks. However, the damage was to some extent already done and world financial markets were shaken by fears over lax-lending and the extent of investment in CDOs. The fears ultimately led to a worldwide credit crunch – effectively a chronic lack of liquidity in the international banking system, or more specifically, the international inter-bank system.

The long-established nexus of bank dealings experienced a sudden change in character, with banks reluctant to lend to each other. Particular casualties here became those banks which relied on short-term financing in the inter-bank market to source their funds for lending on – the

inter-bank market effectively froze to the extent that even the oldest, most established and safest financial institutions would not consider lending to each other. Certain banks began to realise that unless liquidity was provided by their home central bank in its capacity as “lender of last resort” then they would go out of business rather quickly. International contagion effects, exacerbated by the ‘black box’ nature of banks, in that nobody knew who was heavily invested in US or other CDOs, led to the vulnerability of certain banks. Most notably, in the UK, the bank Northern Rock, ran into trouble as it relied on the inter-bank market for the liabilities side of its balance sheet as its depositor base was relatively small. Depositors in the bank became aware of the potential risk to their savings as a result of the financial press coverage and a “run on the bank” ensued. The transmission mechanism is illustrated in Figure 4.

**Figure 4 The transmission mechanism of the US Subprime Financial Crisis of 2007**



The impact of the current Subprime Mortgage Financial Crisis is a classic example of the financial contagion discussed earlier. The immediate impact of the crisis in the UK was focused on the possibility of failure of Northern Rock. The Bank of England intervened in its capacity as lender of last resort, providing liquidity to the bank at a penalty rate. However, to stem the flow of money from the bank (the run on the bank), the Bank needed to offer some reassurance to depositors. The current deposit insurance agreement offered only partial cover of deposits. The Bank was thus forced to improve the deposit insurance for Northern Rock depositors – the result



was that depositors in the bank felt reassured and the run on the bank ended, much to the relief of the whole financial system. The impact for Northern Rock was, however, a collapse in its share price and its eventual nationalisation, after numerous attempts to sell it as a private sector concern.

However, the wider impact of the subprime crisis is more pervasive. In the UK, for example, it has led to the beginnings of a correction in the real estate market. Furthermore, the UK has seen an end to lax lending and unsustainably low spreads on mortgage lending generally. The Bank of England itself has been subject to severe criticism, as has its tripartite relationship with the regulator of the wider financial system, the Financial Services Authority, and the UK Treasury. This tripartite system will have to review its operations. The impact on the UK banking system is that mortgage lending has become stricter and may tighten even further in the near future and Ponzi borrowers will no longer be welcomed customers. Even borrowers with relatively moderate risk may find themselves either excluded or priced out of the mortgage market. Most banks will see reduced profits and a number have declared large losses from subprime related investments. The overall impact is a serious loss in confidence in the UK financial system and a slowdown in the UK economy, and perhaps even other European economies, who have enjoyed stability for too long.

The most recent crisis is characterised by many of the incidences of complacency discussed in the previous section. Firstly, the very fact that subprime lending has occurred reveals an underlying complacency to the point of negligence. Subprime lending works in 'up-markets' but never works in 'down-markets'. Lenders surely must have understood that economic growth must eventually falter. Secondly, home-buyers, as broadly rational economic agents, must understand that they cannot indefinitely refinance their borrowing from increasing property equity – house prices have a history of periodic downwards correction. Thirdly, whilst banks have maturity transformation at the very centre of their business models, relying too much on shorter-term financing rather than developing their own depositor base is far too risky a model, yet investors and regulators were sold on this model as a new *modus-operandi* for the 21<sup>st</sup> century. Fourthly, even sensible lenders were not always sensible investors as many developed too great an exposure to collateralised debt obligations, ignoring inherent risk and instead 'running with the herd'. Finally, governments and regulators were far too complacent in assuming that the future will merely follow recent past trends – large scale corrections or paradigm shifts were simply not in their mindset, and even if they were, the ability of key players to prepare contingencies was limited by the cumulative result of long-term institutional

structures, rules, regulations, and norms. There are few features of the current crisis which are not intrinsically bound up with the culture of complacency.

## **5. Summary and conclusion**

The aim of this paper was to consider the role of complacency in financial crises over the last two decades, with a particular focus on the ongoing Subprime Mortgage Financial Crisis. Arguably financial crises would not occur if economic agents were not complacent, and therefore complacency plays a pivotal role. On the basis of the discussion of the key drivers of recent financial crises in this paper, what are the four fundamental characteristics of complacency which conspire to create a fertile environment for such crises? Some generalisation would appear useful. Firstly, it is clear that the complacency of economic agents increases through time. Economic agents become increasingly self-assured with each period of economic stability and accompanying relatively buoyant financial markets. Increasing complacency in turn leads to a lowering of the accepted boundaries of rational economic behaviour, leading to lower lending standards, increasing investment in financial and real assets where risk is not commensurately rewarded, and so on. Secondly, it is argued that as complacency increases so does herding behaviour. In the context of financial markets, herding behaviour leads to increased financial contagion and less considered individual analysis of risk-return tradeoffs. This led to an increasing appetite for risky investments in the recent subprime crisis, and was a fundamental factor underpinning an increased acceptance of subprime-related collateralised debt obligations. As western financial markets are generally held to be efficient, then following the market and 'piggy-backing' on others to analyse the financial risk-return mathematics would appear rational and even sensible, until periodically the market is proved to be wrong. Thirdly, this paper has determined that institutional complacency compounds financial market problems in down-markets. When financial markets are buoyant, financial institutions, investors and borrowers feel less need for robust institutional monitoring and control. However, when markets slow and perhaps become down-markets, then the absence of proactive institutional oversight becomes an issue. Recent events in financial markets may simply be characterised by a governance approach of "if it isn't broke then don't fix it". The intrinsic optimism of the financial system, where markets only recognise and attempt to address governance problems in down-markets is most certainly a result of complacency. Complacency is both institutional and inherently institutionalised in financial markets. Fourthly, there arguably exists a complacency of belief that financial crises arise from entirely unique conditions and thus we can do little to prevent them when they from occurring. However, there are many early warning signs of financial crises which

recur through history. If governments and their respective country financial systems cannot learn from past mistakes to prevent crises, or at least spot the symptoms when they begin to emerge, then financial markets will continue to be characterised by crises into the future. This paper reveals some of the transmission mechanisms of recent crises – whilst they do indeed have some unique features, all emerging economy transmission mechanisms are in fact very similar, as are all asset market bubbles.

In sum, to prevent financial crises we must first address the culture of complacency of economic agents. At first glance, this would appear to be a somewhat daunting task, though is in actuality more straightforward than might be imagined. Economic agents must be forced to address the risk-return tradeoffs in all economic transactions – this can be achieved through better financial education and training at all levels, along with the development of better risk metrics. Adequate governance of the financial system is also essential, with the development of proactive rather than reactive crisis remedies. Herding behaviour will never cease in financial markets whilst information and analysis remain costly. However, the development of better and cheaper information systems should at least enable more economic agents to analyse for themselves the intrinsic value of real and financial assets. Finally, if economic agents learned more from their mistakes rather than blindly assuming that each successive crisis is unique, then perhaps we could prevent them from recurring, or at least diminish their effects when they do. Complacency will never be driven out of financial markets, though its impact can most certainly be diminished.

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