Learning small lessons from a great crisis

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Abstract :
In the words of Nietzsche, "What does not kill me, makes me stronger". But are we really stronger after having emerged from this great crisis? Have we learned all there is to learn? How can we prepare for the next crisis that is sure to happen one day? I believe that now is the time to step back and try to take a more positive look at these historic events.

But first, I would like to mention the book[1] I wrote following my career in the investment industry with Sinopia, Crédit Agricole Asset Management and lastly with Aviva Investors. For around two decades, I oversaw teams managing several hundred billion euros in Paris, London and worldwide. The majority of these funds were invested in bonds which were one of the causes of the excesses that contributed to the catastrophe. They were, incidentally, the speciality of Bear Stearns and Lehman Brothers which both collapsed ten years ago. The book is split into three separate and complementary sections. In the first, I look to provide an informative summary of the run up to the crisis, the crisis itself and its aftermath. Next, I collated one hundred chronicles covering investment opportunities and risks that were published in *Option Finance* magazine between 2002 and 2015 – all the chronicles are included without exception. Lastly, I try to give a critical analysis of these chronicles and to draw a number of lessons from them.

My presentation today will also be divided into three parts followed by a brief conclusion. Afterwards, I would be delighted to discuss these issues with you. In order, the three parts will look at the scope of this great crisis and its origins, the lessons learned regarding investment and the probability of future crises occurring. My slightly philosophical conclusion is that the crisis was very severe but rather useful in a number of respects.

[1] Boulier J.-F. (2018), *Chronique d'une très grande crise,* Éditions MA.

English version: Translation Centre of the French economy and finance ministries

A great crisis

Should we not have celebrated the end of this global tremor which had enormous impact, dispersed consequences and caused interminable upheaval? It was clearly the most serious crisis since 1929. However, in a number of respects, it was less earth-shattering than other crashes such as that of October 1987, with its causes and progress being more commonplace. Some of its aspects could even be considered positive as strengths that had hitherto been partly concealed were revealed.

The extent of the economic and financial losses was subject to discussion right up to the end of the crisis. On the markets, the most whimsical speculation in both directions was rife.

Like in the aftermath of a tidal wave, the extent of the crisis was only able to be assessed once it had passed. Overall, before the recovery started, a good third of global capitalisation was lost within the space of six months. In the US, where the epicentre of the shockwave was situated, the stock market only needed two to three years to wipe out this loss whereas, in Europe, this took twice as long.

Losses on bonds were also substantial with junk bonds recording default rates of around 25% while investment grade bonds momentarily plummeted by 15%, especially in the banking sector. The notorious subprime segment suffered losses of over 30%! Prior to the crisis, a number of these securities were the best-rated and most sought-after. The subsequent shockwave in the euro area put paid to any illusions and the traditional reference points for sovereign securities; raising the question as to whether they were without risks as we had been only too happy to assume.

The number of bank failures in both the US and Europe was unprecedented in the post-1945 era. Governments entered the fray by forcing through mergers and bailing out the largest financial institutions that were experiencing serious problems well before the economic crisis took a grip. The markets for certain securities disappeared overnight and the impression of permanent liquidity vanished from the very places where it had been concentrated, namely on the securitisation markets. This even occurred in robust sectors and on interbank money markets thus obliging central banks to come up with new schemes for providing stakeholders with liquidity. The crisis brought to light the unacceptable behaviour of individuals such as Madoff and Kerviel, countless instances of benchmark and exchange rate manipulation, and the subsequent huge clean-up efforts included over $350 billion in fines!

The “Great Recession”, to coin a term adopted by the Americans, then went on to hit the entire planet and weigh on the global invoice, even in countries whose banks had been little affected by the problems facing their counterparts. The collapse of Lehman Brothers in September 2008 triggered anxiety and spurred widespread distrust that affected economic stakeholders, order books, business activity and household consumption – with the latter fortunately suffering less impact as the crisis was largely incomprehensible to the man in the street. There were severe macroeconomic shocks, a 2% recession, representing a 6% fall in the global economy’s growth rate, and even more in certain countries. The US took around three years, and the euro area double that, to make up for lost ground. Although the latter had recovered faster, it subsequently found itself mired in the sovereign debt crisis.

Experts agree broadly on the chain of causation behind this economic and financial maelstrom. An over-long American cycle, which was not sufficiently slowed by rate hikes, led to a property frenzy, principally in the US, but also in a number of European countries, that were "doped" by cheap credit. The financial mechanisms that spread this property bubble were related to innovations such as the subprime asset-backed securities market, derivatives and structured loan products. Inadequate control and the over-estimated standard of some of these products had elevated them to the status of quasi-money in transactions between financial stakeholders. Their global spread, due to their seemingly high yields, caused damage even to banks in countries without any true property concerns such as Germany. Confidence slumped and, as investors had only limited knowledge of these products, driving out toxic assets led to spiralling loss of value, the disappearance of markets and even some players. What was difficult to foresee was the combination of these two phenomena. With many indicators, particularly those for property prices, yield compression had been duly identified but their multiplying effect had not even been considered. Moreover, financial crises often lead to recessions that are more serious than the others.

But, during this crisis with its huge financial and job losses, certain stakeholders acquitted themselves well, at least after the fact. For instance, the public authorities acted particularly tellingly – perhaps spurred on by the awareness that they had taken insufficient preventive action – and were able to coordinate internationally which was something that was lacking in 1929. In addition, central banks, with the Fed leading the pack, were able to rapidly and then sustainably adjust their liquidity injection strategy for struggling banks and for the wider economy. The most emblematic measure is quantitative easing and, inter alia, the massive purchase of bonds by central banks whose balance sheets have increased three- or even five-fold. Since the turn of the century, the amount of money in circulation has jumped from around 8% to over 30% of global GDP. This is a first and, is itself, a source of risks.

In respect of many essentially positive developments during this major crisis, we can't see the wood for the trees. Examples include China throwing off the shackles of poverty, the remarkable growth of emerging economies, which was principally driven by China, the significant increase in world trade and the partial desynchronisation of economies which may have provided a certain amount of stability. The euro proved resilient and even strengthened although, admittedly, this was a difficult process. Europe converged although there were certain failures. Credit derivatives markets expanded considerably and came through their baptism of fire. Alternative management strategies, which were disappointing in several respects, found their feet and became fully formed. Mathematical tools, particularly those for risks, totally recast incumbent approaches to management. The credibility of central banks heightened substantially. Inflation remained low with some observers considering that it was too low. The currency war failed to materialise although there were great concerns surrounding this. Without being overly optimistic, this period, which was characterised by the most severe financial crisis in a century, may not have been all that negative after all!

Drawing lessons from the crisis

Never again! The action of public authorities was combined with an exhaustive review of the regulatory system for financial markets and banks. However, in the aftermath of the crisis, the stakeholders themselves overhauled their processes and analysis procedures. One of the main conclusions was that the liquidity of investments and balance sheets should be better managed. Lastly, a positive lesson from these fifteen years is that long-term management can be effective in terms of protecting portfolios and investment opportunities.

Banking regulations were tightened in light of the amount of taxpayers' money spent to bail out the most affected institutions. Capital requirements were substantially bolstered and, most importantly, new liquidity ratios were introduced to manage flow variances between assets and liabilities. In addition, measures to combat conflicts of interest, which had begun to be introduced following the Internet bubble at the turn of the century, were reinforced by an unprecedented strengthening of controls and compliance throughout the financial system.

Financial doctrine had never truly addressed the issue of liquidity as it was sometimes considered that this was a question of practical implementation best left to the experts. Market efficiency assumes that markets are pure and perfect! It is possible that this lack of reference points led to over-confidence in market resilience. Whilst this did not hamper the stock market, it did have a strong impact on bonds and interest rate derivatives. Worst affected were the money markets that remained frozen for many months. There is a distinct lack of understanding concerning the mechanisms for the disappearance of liquidity, contagion from one segment to another, as well as the cost of liquidity. In this respect, ground-breaking measures were introduced by all the stakeholders. In a professional asset management organisation, I helped integrate liquidity management processes into fund regulations.

Nevertheless, during this momentous period, the effectiveness of long-term management methods became patently clear. A number of the chronicles reproduced in my book testify to this approach in terms of leverage, risk and diversification. To put it simply, this relates to premium models which were shown to have contributed to managing portfolio allocation during this period. These instruments can assess the desired performance levels of categories of assets relative to each other. That said, their rollout owes more to art than science! In most cases, these methods involve going against the tide in relation to the other market participants. This calls for both serenity and tenacity which are not exactly the most widespread characteristics…

We are however very far from having learned all the lessons. Analysis work should continue and professionals should draw on the best practices that derived from the great crisis.

One avenue for action that deserves research, discussion and regulatory reform is the rollout of counter-cyclical stabilisers. This issue was debated prior to the crisis but has unfortunately contributed little to the drafting of new rules in its aftermath. As a result, regulations remain highly pro-cyclical from a financial standpoint. When and how will we be able to break this deadlock? What is required is work on collective behaviour, belief systems and excess confidence. We could pinpoint the keys to better understanding liquidity cycles and gregarious attitudes. The scope of the events and the volume of data on transactions and portfolio composition should allow us to better examine these phenomena and perhaps come up with safeguards.

What about the next crisis?

There will certainly be other crises. They will probably not be as severe in the near future, but who can tell? A beneficial effect of a crisis is that it forces the curbing of excesses. However, crises are fortunately rare without being impossible and, as a result, such an observation is made difficult. As matters stand, a number of causes of imbalances could combine to instigate the next crisis.

Crises encourage the driving out of excesses and, in particular, oblige their beneficiaries to accept a more stable balance. But how can we forestall excesses in democracies? For as long as we don't know how, or don't want, to limit them, on political or ideological grounds, excesses will only be corrected when the damage caused to the community appears greater than the gains derived by their beneficiaries. Crises are beneficial in this respect, but are they necessary? Some people think so! I feel that we should attempt to mitigate their scope in the same way as a vaccination limits the severity of an illness by preparing the body to fight it.

Several studies have been devoted to the dynamics of economic bubbles but their underlying phenomena have not been adequately assessed. I believe that the traditional approach of assuming that economic agents act rationally and that there is additive aggregation of the impact of their actions, is not the right one. This behaviour resembles physical or biological phenomena that we should attempt to transpose to financial circumstances. What is more, Gauss's law, which is often used in finance and in many other fields, is obviously poorly adapted, and even misleading, for representing financial fluctuations during crises. For fun, I estimated the recurrence interval of Black Monday in October 1987 by assuming the normal distribution of the Paris stock exchange index which plummeted 15% that day. The time required would have been something like the cube-root of the age of the universe! It's enough to make the inventor of the Big Bang theory turn in his grave…

What factors could destabilise financial balances and provoke another crisis? The first that springs to mind is liquidity. It is fairly paradoxical since there was a lack of liquidity and central banks were able to restore it and renew confidence by demonstrating great authority. But, will they be able to manage declining balance sheets? As these are uncharted waters, any decline should be closely monitored. For now, what is reassuring is that the Fed has successfully begun to reduce its balance sheet and that all the stakeholders are primed. Another factor to monitor is the shift to an economy in which digital technologies are gradually replacing the majority of incumbent processes, due to its scope and general nature. Could it be that the GAFAs are substantially over-valued? However, recently, the political risk has come to the fore and evidence of its repercussions is only just emerging in the shape of a trade war and, perhaps soon, a currency war.

Major disruption could be caused by this issue's global dimension and the significant mushrooming of international trade. Even more damage could be caused by the combination of two of these factors, inflation, innovation and populism, among themselves or together with traditional factors such as commodities, property or social problems.

Conclusion

There is no doubt that we have survived a great crisis and that we can emerge stronger from it if we have the necessary motivation. Errors will only be repeated if we fail to analyse them and do not assume, together, the resulting limitations. Ten years on from this great crisis, the slogan that bedecked Parisian walls fifty years ago, namely “It is forbidden to forbid” seems very outdated and highly debatable.