About the Similarities and Common Roots of Two Consecutive Financial Crises

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Abstract

During the process of identifying the causes of the crises emerging in economy we often come across simplified theories, that emphasize only one factor: whether it is the lack of integrity (unethical attitude), committing (accounting) irregularities, principal-agent problems, trust crisis, financial liberalization, the intensification of speculation, imbalance between personal interest and public interest, inappropriate incentive systems, short term orientation or similar issues. As a result of the complexity of our financial world, the occasionally occurring crises cannot be traced back to only one underlying cause; they are rather the indication of a systemic malfunction. This short summery study has the aim of presenting a systemic, multi-factor approach to the root causes of two financial crises emerging in the first decade of the 21st century, the so-called "Enron" phenomenon and the "credit market bubble", also searching for the common roots of the two crises.

Key words: financial crisis, short-term orientation, integrity, systemic deficiencies, enronization
J.E.L. classification: G01, G10, G12

1. Introduction

In less than one and a half decades between the end of the 20th century and the beginning of the 21st century three crises have shaken the financial economy of the world. Among these the second one emerged at the beginning of the 2000's, and became known as the Enron-phenomenon, a financial crisis that later crushed and buried four thousand American corporations, having been generated by the demand of a forced maintenance of the technological share valuation bubble that appeared at the American capital market in the second half of the 90's. This phenomenon manifested in massive scale accounting fraud, since in a short time after the bursting of the stock market bubble, they started correcting subsequently the balance sheets of thousands of companies because of accounting irregularities, and even fraud. Back then few people had realized that the former bursting of the stock market bubble and the accounting scandals might have had common roots. The world gained full conviction in this matter only after the devastation beyond all imagination that was caused by the 2007-2009 credit market bubble. The irrational overflow that occurred in just over a decade in the operation of the American capital market has brought a new perspective on the accounting scandals of the beginning of the current decade. This present study outlines the common roots, characteristics of these crises. The common root might have been the distortion of the interest correlations of the stock market.

2. Theoretical background

2.1. The financial crisis of the beginning of the 2000's (Enron-phenomenon)

In the beginning of the 21st century a mass corporate collapse results in a more significant loss of corporate and social values, than the amount of the profit-source that the stakeholders could get access to during the inflation of the bubble (the artificially pumped earnings of Enron have insured for a while a constant increase of share prices, allowing the corporate managers to make

considerable profit from selling the shares of their company). In the end the costs of the great collapse were paid off by the shareholders and employees of the corporation. When the $70 billion market capitalization of the company measured at the top was practically reduced to zero the employees of Enron lost their savings, retirement funds and their jobs as well (Brenner, 2002). *Formal and informal pressure put on companies in order to achieve aggressive profit targets shows a clear picture of how compiling false financial statements has become a forced necessity: in the sequence of events leading up to fraudulence the accounting system functions as a device, an instrument.The accounting irregularities* stem from and grow out of a certain form of corporate environment that is characterized by the following key elements: pressure generated by setting aggressive profit targets and the recognition that these strict profit targets must be accomplished at any cost (Young, 2002). No matter what form the accounting fraud takes, how concrete it is, whether it is "earnings management", "cherry picking" etc. (Denis, 2003), (Mulford and Comiskey, 2002) known as creative accounting, or applying SPE-s that help managers establish numerous off-balance-sheet subsidiary companies (this is where they hide the accumulated mountain of debt and this way they pump up the earnings of the parent company) (Litan, 2002), basically it endeavors to prove that the corporation has a more favorable economic situation, financial position, earnings performance, capital market attractiveness, capacity for development than in reality. *The underlying cause – in almost every situation – is the pressure to comply with the unrealistically high profit expectations*. The basis for the existence of joint stock companies and the stock market is the belief that the financial statements emitted by a corporate management are reliable, trustworthy (Kane, 2004). As soon as the suspicion arises that the financial statements do not have an objective content, and thus cannot provide useful and relevant information, the confidence of the stock market players might be shaken (Unerman and O'Dwyer, 2004).

The example of the corporations that collapsed as a result of false financial statements proved that *corporate governance* as a system serves the interests of the managers operating the capital. As the practice of rewarding managers based on the increase of the values of share capital has become widespread, the capital operating managers have consciously undertaken the deception of the owner-investors by presenting distorted statements about corporate performance (Collins, 2001). The operational efficiency of the corporate governance system is definitely reduced by the fact that every official in corporate performance measurement is employed by the managers and fulfills their assignments. The fact that managers could continue making financial reports based on false data, even if this meant risking the collapse of the company, allowed the circumvention of information asymmetry as an ability. The interests of the so called "gatekeeper" establishments, institutions and regulators were closely linked with the interests of the managers and not the interests of the owners, which can be considered an imbalance with a serious effect. Instead of a strict compliance with the incompatibility rules, "coordinated independence", "the intimacy of board meetings" and "intelligent gambling" has become a widespread practice (Zandstra, 2002).

2.2. The financial crisis of 2007-2009

According to Allen et al. (2009) the starting point of the crisis should be identified as the fact that after the bursting of the technological share-bubble, the US Federal Reserve and the central bank have decided upon a low interest rate, which - combined with the booming demand of the Asian banks - resulted in a fast increase of real estate prices. The bubble reached its climax in 2006, and subsequently real estate prices started plunging in the United States and in other countries as well. Many believed that the crisis emerged as a result of the collapse of the residential property system, and called this market crash a secondary market crisis. According to Gorton and Metrick (2011) *secondary mortgage* – by virtue of its proportions – is not a sufficient trigger for the occurrence of crisis. Mishkin and Eakins (2012) come up with a persuasive explanation regarding the deeper issues around mortgage-based *securitization*, also emphasizing what an important role the *agent problem* played in the deepening of the crisis. Bernanke (2008) links the *increase of ethical risk* and *adverse selection* with the increasing complexity of structured goods, as a consequence of the strengthening of *information asymmetry.* According to Bresser-Pereira (2010) the triggers of the great crisis should be searched for in the previous years, when the financial transactions of securitization had become deeply integrated into the international financial system, and *financial innovations and speculations* rendered the financial system rather hazardous. Trichet

(2008) concludes that the occurrence of the financial crisis traces back to incorrect risk assessment.

Some have considered the decisive cause to be: channeling the *excess liquidity* of upcoming markets towards safe instruments (Global Risk, 2011, p. 6), namely the attempt to terminate *global imbalance*; another observer considered the root to be the globalization of resource mobilization and the increase of complexity in the financial instruments. Secondary markets cannot be the determining cause of the crisis, since they are just a small slice of the fixed-income markets. Another speaker of the Global Risk roundtable states that the range of low quality products traded at financial markets is a lot wider.

Regarding the fact that commercial banks have extended their activity to the territory of investments banks, Stockhammer (2004, p. 726) writes that commercials banks have enlisted themselves in the swirling whirlpool of speculations. Many mention the appearance of the shadow banking system (as a result of the deregulated financial market), related to which Gowan (2009, p. 13) points out that the regulated bank system - functioning as financial intermediary and primary broker – has charged the shadow banking system with huge fees and intermediary costs. The most important development of this choice was that these transactions were predominantly completed outside the stock market (over-the-counter), at credit derivative markets in the form of collateralized debt obligations (CDO). Mishkin and Eakins (2012) warn about the incompatibility of credit-rating agencies, with the argument that they were the ones who counseled their clients regarding the structuring of the complex financial instruments; while at the same time they were the ones who rated these products. This way the huge fees they obtained from their clients through the counseling services, created disincentives that were contrary to ensuring the accuracy of their ratings.

Emphasizing the *moral* causes of the crisis, Bresser-Pereira (2010, p. 20) claims that repackaging risky loans as depository receipts became a qualified case of *ethical risk.* Trichet (2008) talks about the fast and devastating transmission of "fear" as a result of a general loss of trust and the great number of correlations between financial institutes.

At the Global Risk (2011, p. 15) roundtable conference, regarding the over-the-counter derivatives markets, Morgan emphasizes the complexity of the relationship between private and public actors. In the opinion of Mishkin and Eakins (2012) the seeds of a financial crisis are sown when countries become committed to financial liberalization, the liquidation of the barriers of financial markets and institutes, or the introduction of new types of credit and other financial products.

3. Methodology

During the investigation and comparison of the characteristics and roots of the studied crises, we have based the description of the systemic malfunctions on principles like asymmetric information, the principal-agent relationship, ethical risk, the conflict of interest, the stakeholders, the capital market bubble, irrational overflow at the stock market, the incentives, short term orientation, fundamental instability and innovation, securitization, as well as trust and ethics. The principles and theories mentioned above create a framework, within which not only the elements of separate accounting and financial issues can be planted and effectively analyzed, but the whole of the system as well. In the framework presented above we have relied on academic resources, corporate analyses and definitely secondary data and information.

4. Findings

4.1. Simplified, one-sided explanations versus systemic approach regarding the financial crisis of the beginning of the 2000's (Enron-phenomenon)

As an attempt to identify and explain the causes of the events, a large number of theories emerged in the past years that investigated different tendencies regarding the causes of the crisis, each specifically emphasizing a given factor. At the unraveling of the analyzed corporate crisis-series, many have considered *accounting irregularities* and *unethical behavior* to be the main root, and their search for a way out was also channeled in this direction by introducing more rigorous regulations and legal restrictions. After a short time however many have realized that a single

factor explanation is untenable, since the issue is not merely the accounting irregularity, but also the manifestation of the malfunction of the stock market system. False corporate financial statements are much rather the result of the distortion of the corporate environment and the operation of the stock market, than just the result of individual or organizational abuse within a corporation. It was necessary to recognize that in the controlling and rewarding system of the corporate performance measurement there are certain distortions that can occur and these cannot be traced back to only one factor: the effect of unethical actions. We cannot understand the motivations behind making false financial statements based on distortions if we do not investigate the interests and actions of stock analysts, auditors and credit rating agencies.

As a result of a research that was fundamentally based on American financial-economical experiences (Szász, 2011) we can conclude that the following factors have played a crucial part in the emergence of false corporate financial statements:

- the accounting fraudulence of corporate performance reporting;
- the trust-ethical factor;
- the inner deficiencies of the corporate governance system;
- the deficiencies of self-correction in the stock market.

The Enron-phenomenon and all its different forms have been readily considered both by professional and public opinion as an example of isolated *ethical violation*, as the deformation of the ethical intactness of the managers. Corporate accounting fraud as a sign of *unethical behavior* is undeniably a significant factor, yet it cannot be accepted as a universal explanation to fraudulence. In many cases it is evident that corporate decision makers with intact ethical integrity start committing fraudulent actions under organizational pressure. Unethical behavior in corporate management resulted in an excessive decrease in investors' trust; and the ones who suffer the most damage because of the deficient application of *the trust-ethical principle*, are the owner-investors. Every single instance of accounting fraudulence demonstrates that the interests and aims of the owner as principal get into conflict with the aspirations of the manager operating the capital as agent. *The information asymmetry* present on all sides between the parties only adds to this conflict. To mention only one example related to this: when the reward of the managers who operate the capital is connected to the fluctuation of share prices, then apparently the capital operator and the owner have common interests. Based on the principle of *trust* the owner has every right to think that higher share prices reflect higher fundamental values; and this serves the long term interests of the owners. The capital operating managers do not honor the investors' trust whenever they adopt explicit or even less substantial forms of accounting fraudulence; moreover they put at risk the demands of every single stakeholder.

The principal-agent theory, the stakeholder principle and the unduly high amount of ethical risk had an especially huge role in the fact that the lack of efficiency in the *corporate governance system* of certain corporations has affected negatively the long term interests of the owners. If corporate governance mechanisms are surrounded by numerous conflicts of interest, then neither the board of directors, nor the inner audit committee or the rewarding department can control effectively the activity of the managers. No effective barrier can be set up for the prevention of accounting fraudulence without strengthening every element of the corporate governance system.

If managers present false balance sheets, lie and disclose misleading information, then they are aware of the overvaluation of their shares. The phenomena of false financial statements have created a stock market overvaluation that cannot be solved by a simple transformation of the rewarding and incentive system of officials; moreover it is obvious that introducing more restrictive regulations will not be enough on their own to offer protection from the harmful consequences of chronic overvaluation and from practicing irrational investor behavior. The financial crises emerging in the world, the appearance of new and even bigger bubbles indicate that there is a chronic tendency in the capital market to separate the price of securities from the fundamental values. In this situation it is doubtful whether the market's self-cleaning capacity would be sufficient for the liquidation of systemic malfunctions. In order to terminate the misinformation of investors, the confusion around the role of managers, analysts, investment advisors and auditors should come to an end, while distortions in their interests should also cease.

Introducing stricter accounting standards, encouraging regulations, retaining ethical intactness and an effective operation of the corporate governance system can hardly bring a solution on its own. Correct accounting statements, an institutional system of regulations exercising its function consistently, the unquestionable ethical integrity of all parties, a corporate governance that completely represents the interests of the owners and a market that always values corporate performance correctly – all these together can provide a way out from this crisis of performance measurement that has already become chronic.

4.2. Simplified, one-sided explanations versus systemic approach regarding the financial crisis of 2007-2009

Similarly to the previous crises, the most widespread explanations following this financial crisis were also simplified, and the sited causes are excessive credit growth, the bubble-like boom in asset prices and the irrationally exuberant behaviour of market players.

In the public opinion, regarding financial crisis, the role of liberalization has gained a lot greater emphasis than necessary. Though on a longer term financial liberalization facilitates financial development and stimulates the operation of the financial system in favor of an effective allocation of resources, however it has its disadvantageous sides as well (it may encourage exaggerated lending policy with continually softening conditions; it may bring about adjustment problems between the instruments and the resources; it may stimulate the increase of financial leverage beyond any limits; it may lead to neglecting a careful risk assessment; it may increase the problems triggered by asymmetrical information and ethical risk; it may distort the principle of "greater earnings only with the condition of increased risk-taking", exchanging it with the false promise of "greater earnings in return of lower risk"). On this basis there is little doubt that the basic root of the financial crisis is the infringement of several fundamental laws of financial economics.

The causes, characteristics mentioned above confirm the view that the correctness of the monocausal explanations of the financial crisis is questionable, and the occasional intensification of the tendency to crisis has deeper roots. Bélyácz and Szász (2014) mention and analyze the following possible causes:

- financial liberalization
- deregulation
- the great role played by markets outside the stock market
- adjustment problems between instruments and resources
- excessive application of financial leverage
- securitization
- the expansion of the shadow banking system
- the role of excess liquidity
- lack of careful risk assessment
- the occurrence of ethical risk
- the falsity of the "greater earnings in return of lower risk" principle
- the misleading ranking of rating agencies or
- the lack of liquid reserves

The phenomena mentioned above give evidence of the fragility of the financial system. The enumerated factors contribute – to varying degrees - to the emergence and persistence of instability in the financial system. All of the factors listed here express some kind of imbalance, malfunction and instability in their own way. The visible and invisible correlations between the factors cumulate into a financial systemic malfunction, thus isolated battle against individual factors may also become ineffective.

5. Conclusions

It is noticeable in the case of both crises that a simplified, one-sided explanation is not acceptable; the occurrence of the crisis had deeper roots. Many factors have contributed - to varying degrees - to the emergence of the crisis, cumulating through time into a systemic malfunction. At the same time, we can also mention such "adopted, well-established" common

elements and factors like asymmetrical information, conflicts of interest, short term orientation, lack of integrity, evading rules, the harmful effects of liberalization, inadequate incentive systems etc.; the intensification and correlation of these can trigger a crisis anytime. Even the battle against these will only be fruitful if it is not an isolated attempt, but aims at a systemic, collective correction of the factors.

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