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The 2008 Financial Crisis Revisited: Risks and Responses

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ABSTRACT

The 2008 Financial Crisis displayed a pattern of governance and management failures of financial firms, familiar from past crises and likely to manifest themselves in future crises. This chapter presents six major risk patterns, provides examples and reviews their underlying dynamics. The chapter presents Enterprise Risk Management (ERM) as a way that some firms successfully navigated the crisis and proposes that financial supervisors should focus on governance and risk management of major financial firms as a way to reduce harm from crises that inevitably occur from time to time.

Keywords: Governance, risk management, Enterprise Risk Management, 2008 Financial Crisis, supervision

"I made a mistake in presuming that the self-interest of organizations, specifically banks and others, was such that they were best capable of protecting their own shareholders."
-- Alan Greenspan, 2008

"*Risk is the price you never thought you would have to pay*."
-- Alex J. Pollock, *Finance and Philosophy*, 2018

INTRODUCTION

As the 2008 Financial Crisis recedes into memory and financial disruption from the COVID-19 pandemic is upon us, it is appropriate to distill lessons that seem applicable to crises. This chapter suggests six major risk patterns from the 2008 Financial Crisis that seem to repeat, albeit with differences in detail, over time. The chapter then looks at approaches that financial firms took that successfully navigated the crisis. Those approaches too can be generalized; successful firms applied a risk management discipline now known as Enterprise Risk Management (ERM). The chapter closes by looking at the principles of ERM and how they can help firms to detect and act upon major risks before they materialize to cause harm.

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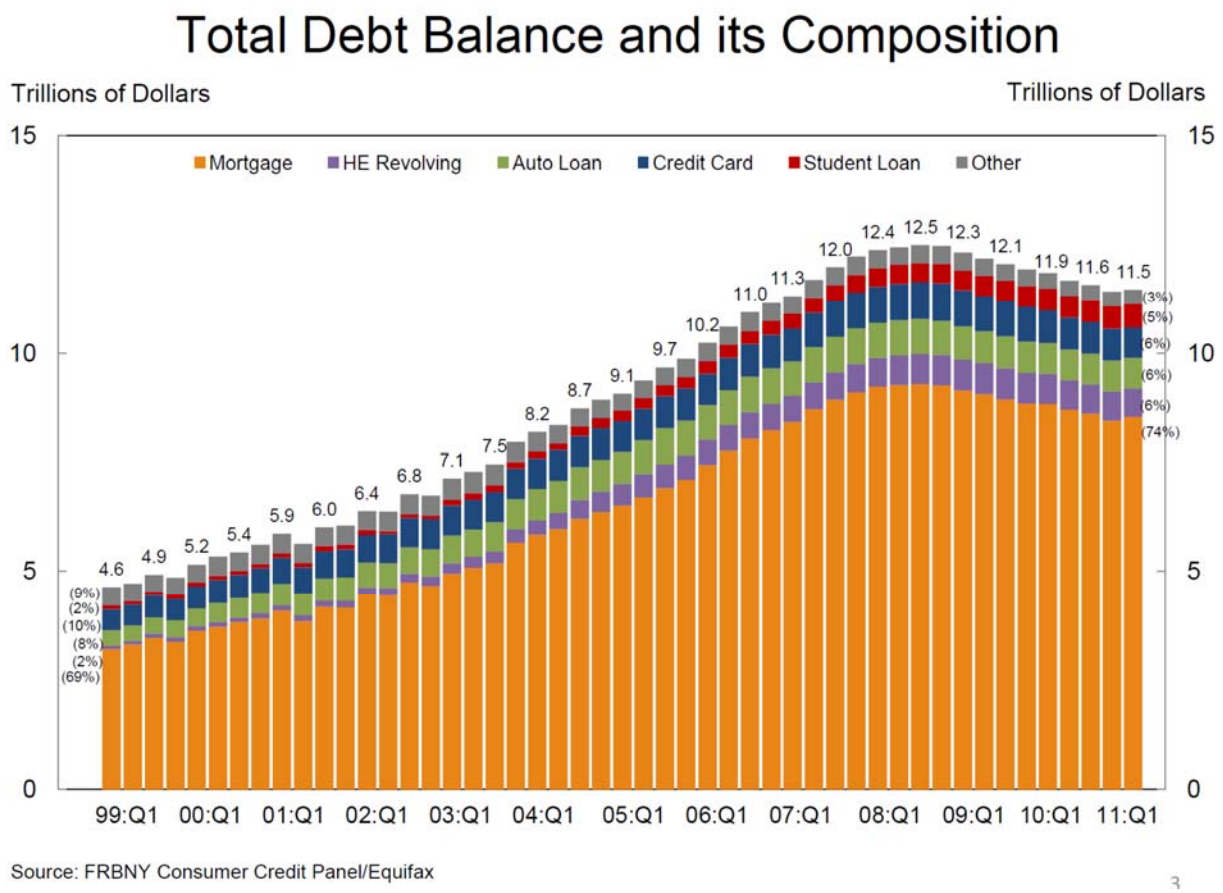
I. Major Risk Patterns

The 2008 Financial Crisis revealed six major risk patterns one might call: (1) Growth outrunning capability, (2) Complacency, (3) "Normalization of Deviance," (4) "Stanton's Law," (5) The curse that regulated firms may get what they seek, and (6) strategic risk. Many different factors contributed to the 2008 Financial Crisis; however for purposes of clarifying the six risk patterns, relevant facts have been brought into the foreground while other, similarly important facts have been set aside. What makes each of the risk patterns important is that their applicability can be generalized to many other financial debacles as well as to situations outside of finance. Consider each of the risk patterns in turn.

1. Growth outrunning capability

Over the course of a nation's financial cycles, there may be times when an abundance of funds encourages lenders to make loans with a lack of prudence that they might exercise if loanable funds were more scarce. One such period existed in the years before the 2008 Financial Crisis, when ample funds flowed into the United States from overseas and into the mortgage market and other sectors of the economy. Figure 1 shows the expansion of the residential mortgage market in the years before the 2008 Financial Crisis. At the beginning of 1999 home mortgage debt had a volume of just over $ 3 trillion. By the peak of the 2008 Financial Crisis in the third quarter of 2008, the volume of outstanding home mortgages had trebled to over $ 9 trillion.

Figure 1
Rapid Expansion of the Mortgage Market



Source: Federal Reserve Bank of New York, *Quarterly Report on Household Debt and Credit*, May 2011

The expanding mortgage market drove virtually uncontrolled growth at mortgage market firms. Between 2000 and 2003 alone, Washington Mutual, a savings and loan association, expanded its retail branches 70 percent, to 2,200 across 38 states. Revenues at Countrywide, the nation's largest mortgage lender, more than quadrupled, from $ 1.7 billion to $ 8 billion in the same period. In the secondary mortgage market in the same years, the giant government-sponsored enterprise (GSE) Fannie Mae, grew from $ 1.4 trillion to $ 2.3 trillion in size, including both total assets and mortgage-backed securities (MBS) outstanding. By 2003, low income housing advocates were pleading for the growth to slow down. They saw how excessive lending would lead to high levels of default and foreclosures on low-income homebuyers who never should have bought the homes in the first place (Saunders, 2003).

Rapid growth also meant that many of the expanding firms became virtually unmanageable. With an emphasis on volume and market share, many firms outran the capabilities of their leaders and employees and the capacity of their systems. Even before the 2008 Financial Crisis occurred, internal controls and accounting systems had failed at Fannie Mae and Freddie Mac. (See Stanton, 2007, and sources cited). The failures came to light in 2003-4. Both companies

took years and spent billions of dollars to restate their financial statements. Freddie Mac restated its earnings by $ 5 Billion and Fannie Mae by about $ 11 Billion. After the failures came to public attention, both companies ousted their CEOs, Chief Financial Officers, and many other senior officers. Had they not been government-sponsored enterprises, with perceived government backing of their obligations, the two companies would have gone out of business.

The pattern of this failure reflects the major risk that rapid growth can pose. Rapid growth meant that Fannie Mae and Freddie Mac outran the capabilities of their people and systems. Fannie Mae systematically deprived its internal audit organization of resources. The company tolerated staff shortages and lacked senior officials with the requisite expertise and experience in key parts of the company. The Senior Vice President for Internal Audit had had no experience or formal training as an auditor; the Controller was not a certified public accountant. The Office of Federal Housing Enterprise Oversight (OFHEO) conducted in-depth analysis of the failures at Fannie Mae and Freddie Mac. With respect to Freddie Mac, OFHEO found that, as it later found at Fannie Mae, stringent resource constraints led to ineffective business units: "Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac."

Examiners of Fannie Mae later told the 2008 Financial Crisis Inquiry Commission (FCIC) how Fannie Mae had outrun the capabilities of its systems before the 2008 Financial Crisis:

> To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their 'processes were a bowl of spaghetti.' [John] Kerr [a later examiner in charge of Fannie examinations (and an OCC veteran)] and a colleague said that that they were struck that Fannie Mae, a multitrillion-dollar company, employed unsophisticated technology: it was less techsavvy than the average community bank." (FCIC, 2011, pp. 321-322)

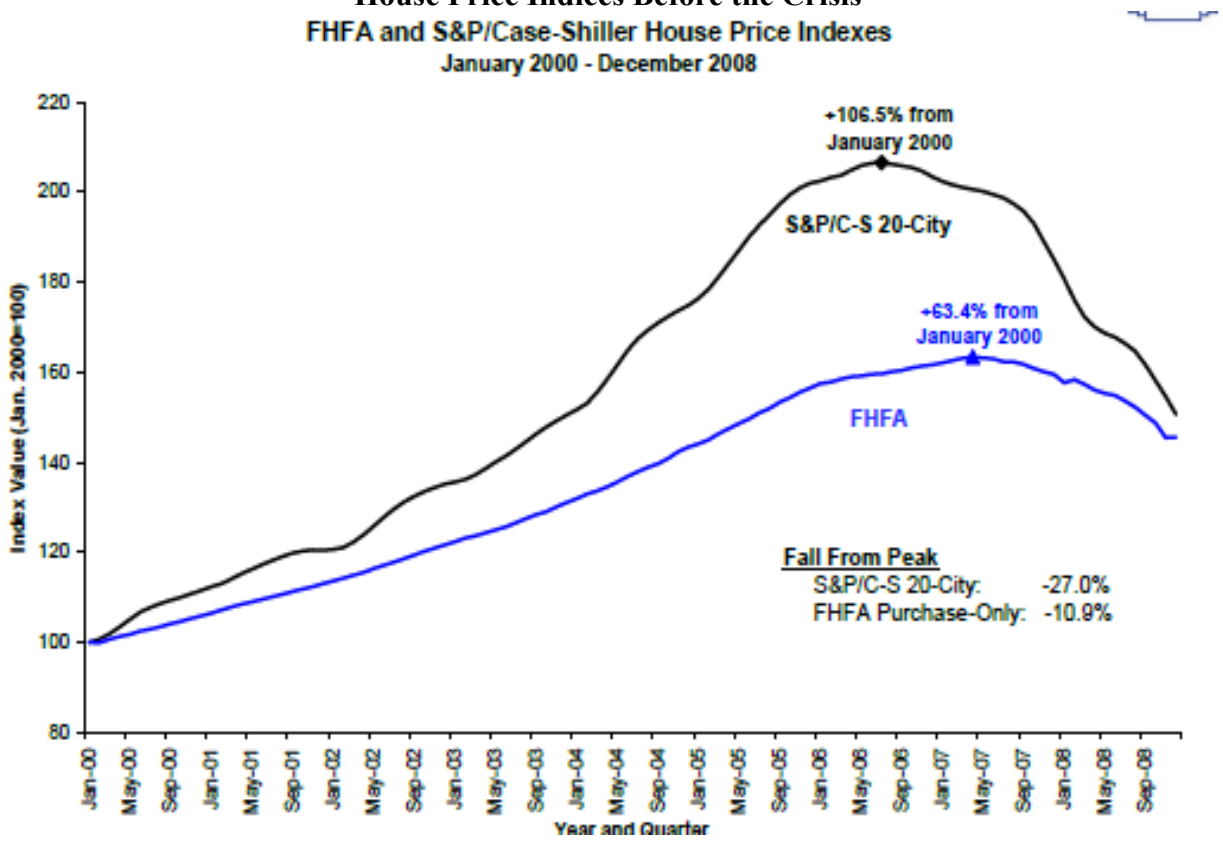
Even as rapid growth was eroding fundamental capabilities of their people and systems, the two GSEs were able to dominate their environment, obtaining avid support from key members of Congress and keeping their regulator weak. As the *Wall Street Journal* reported in 2006, "If, in the parlance of modern business, controlling one's environment is the name of the game, maybe Fannie controlled its environment too well, getting congenial answers until it was too late." Journalist John Connor made that observation already two years before the two companies failed and went into government hands. Numerous firms that failed in the 2008 crisis exhibited the same pattern of growth, hubris, avarice, and incompetence, exacerbated for many other firms by excessive and undigested acquisitions that the GSEs were not permitted to make under their charters.

2. Complacency

Dramatic growth in house prices in the years before the 2008 Financial Crisis fostered complacency about internal controls and management generally. In the years before house prices peaked in September 2006, it seemed that no market participant could make a mistake. If someone bought an unrealistically expensive house and took on too large a debt burden to carry, he or she simply could sell the house. Prices would have gone up and the homeowner might be

able to emerge financially unscathed. The same was true of the lender that imprudently extended credit to that homebuyer. Rating agencies that rated the increasingly complex mortgage securities in those years similarly could misjudge a weak security to be "AAA" and not have the mistake be found out, at least in the near term. Figure 2 shows how house prices more than doubled between January 2000 and September 2006 according to the Case-Shiller 20-city index. The Federal Housing Finance Agency (FHFA) index is the more moderate bubble that affected Fannie Mae and Freddie Mac which, under their charters, were not permitted to purchase the most expensive mortgages.

Figure 2
House Price Indices Before the Crisis



Source: Federal Housing Finance Agency (FHFA)

The pattern of complacency leading to major mistakes has long been recognized. Dartmouth Business School Professor Sydney Finkelstein, in his insightful book, *Why Smart Executives Fail and What You Can Learn from Their Mistakes* (2003), made this observation:

> "Want to know one of the best generic warning signs you can look for? How about success, lots of it!....Fantastic success or overwhelming dominance doesn't mean that bad things are happening or will happen. However, there are an extraordinary number of times when precisely these attributes are in place in companies that run up against failure."

The housing finance market was an environment that encouraged complacency among all participants, including regulators of financial firms, except the most disciplined. Consistently

rising prices obscured differences in performance between skilled mortgage market companies, and their much less skilled competitors. Indeed, as researchers later pointed out, firms that reaped the most generous profits in the years before the 2008 Financial Crisis were those that fell the farthest after the crisis occurred (Beltratti and Stulz, 2009). Or, as Warren Buffet famously observed (2001), "After all, you only find out who is swimming naked when the tide goes out." For the mortgage market, the tide started going out in September 2006 as the level of housing prices proved unsustainable.

Even after the 2008 crisis, complacency continued to exert its influence. At least three of the companies reviewed below as having successfully navigated the crisis suffered serious setbacks after the crisis that a deeper investigation might well attribute to complacency, among other factors. JPMorgan Chase lost over $ 6 billion in the "London Whale" incident only a few years after the 2008 crisis; Goldman Sachs helped the Malaysian Development Fund known as 1MDB raise $6.5 billion in a series of bond issues in 2012 and 2013, much of which was ultimately stolen; and Wells Fargo was discovered to have opened thousands of fraudulent customer accounts in response to management imposition of excessive employee performance goals.

3. "Normalization of Deviance"

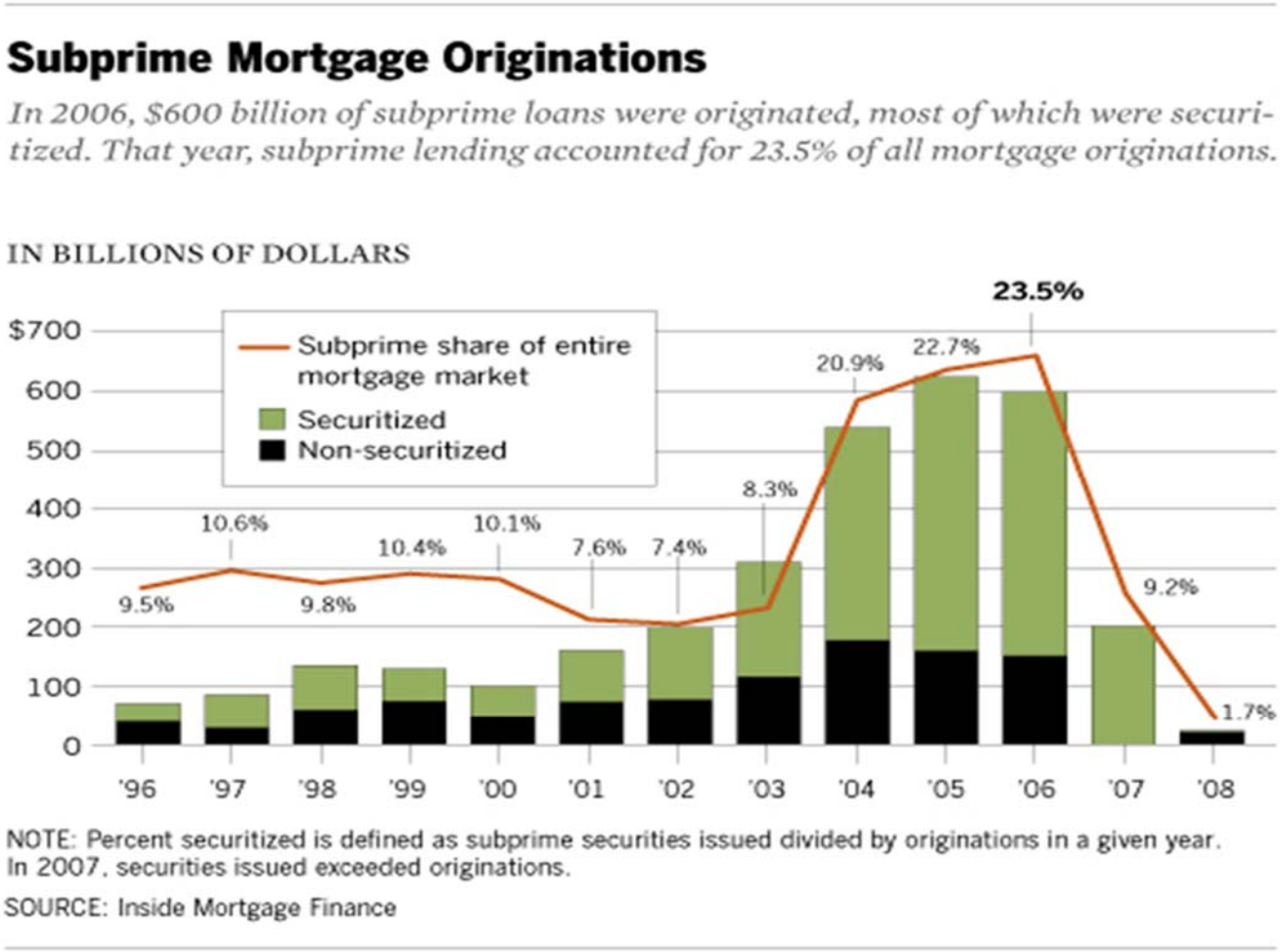
Sociologist Diane Vaughan (1996) coined the expression "normalization of deviance" to explain the process by which actors take increasing risks as previous risk-taking seems to validate that further risk taking is safe. The idea is that deviance from normal safety concerns proceeds until continuing deviation becomes normal. To use a metaphor, the decision maker keeps moving towards the cliff and finally finds it.

Vaughan studied the 1986 disaster of the space shuttle Challenger that blew up on take-off and killed all astronauts aboard. Investigation showed that the failure resulted from a part known as the "O-ring" that plugged a gap in the joints of solid rocket boosters. At warm temperatures the O-ring was spongy and flexible and able to fill the gap. However, leaders of NASA, the space agency, launched shuttles at increasingly low temperatures until finally launch occurred at a temperature that indeed caused the O-ring to become brittle and to fail, allowing hot propellant gases to come into contact with an external tank containing liquid hydrogen and oxygen. This happened despite long-standing knowledge among engineers about the O-ring flaw and their communication of concerns to top space shuttle officials who chose to take the risk.

In the run-up to the 2008 Financial Crisis, financial markets too exhibited the normalization of deviance. In the mortgage market, financial ratios such as the ratio of the borrower's debt to his or her income, and the ratio of the mortgage loan to the value of the mortgaged property, have long been known. However, steadily increasing house prices generated excessive optimism that led many (not all) mortgage lenders to relax their standards of credit quality and make increasingly risky mortgages. As traditional mortgage standards became relaxed, the deviance, to use Vaughan's term, became normalized. Figure 3 shows the increase of subprime mortgages that deviated from traditional credit standards, as a percent of the total mortgage market. Starting in 2003 the percent of subprime mortgages in a growing mortgage market began to increase until they constituted 23.5 percent of the market in 2006. This pattern mirrors an increase of risk-

taking in other areas of the financial sector as well, such as commercial real estate and leveraged loans to corporations, that later caused substantial losses.

Figure 3
Growth of the Subprime Mortgage Market

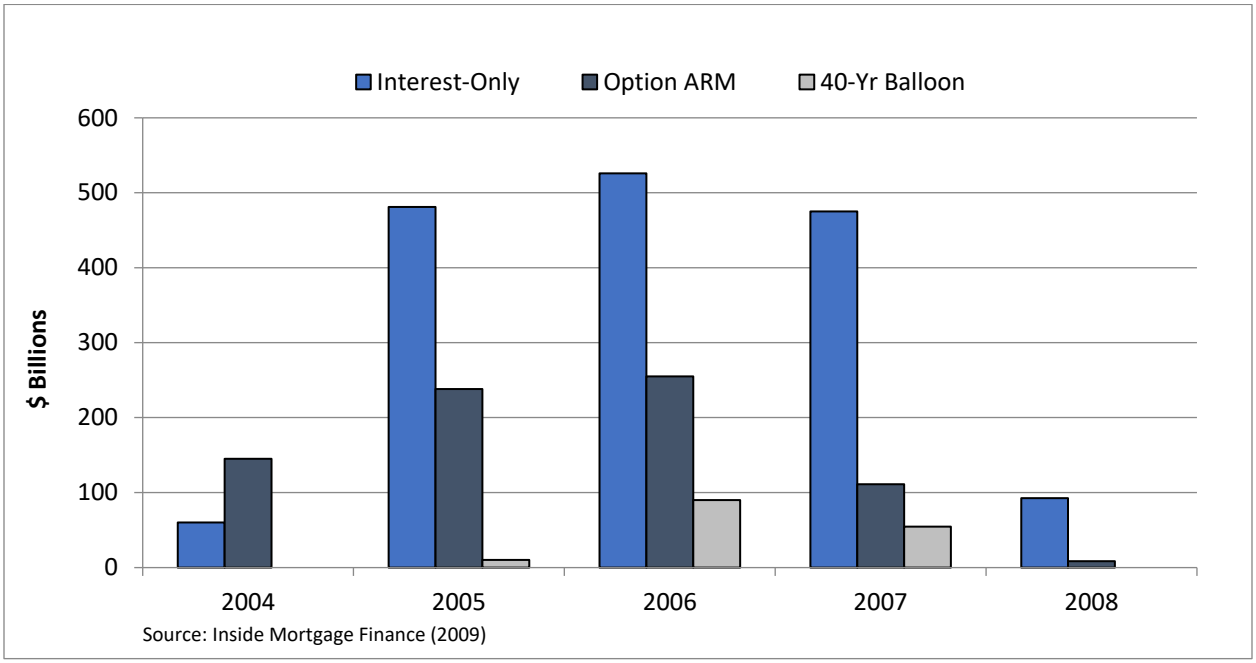


Source: 2008 Financial Crisis Inquiry Commission *Final Report*

Normalization of deviance in the mortgage market expanded farther than merely the share of subprime mortgages that firms originated. Figure 4 shows the growth of so-called affordability mortgages that were designed to reduce monthly payments to allow otherwise financially unqualified borrowers to make the home purchase. Affordability products became necessary for the industry if it was to continue funding mortgages for homebuyers despite the high level of house prices. These products, while different from one another, allowed the borrower to make smaller monthly payments, at least initially, than would be possible if he or she took out a standard self-amortizing mortgage with monthly payments that included repayments of principal as well as interest. The figure shows three different kinds of low-monthly payment mortgages. An interest-only mortgage allowed the borrower to postpone payment of the entire principal until the mortgage came due. The option adjustable-rate mortgage (ARM) allowed the borrower to select the amount to pay each month. That option allowed the unpaid monthly obligations to accrue as added principal and lasted until a specified amount of the unpaid mortgage obligation

accrued, at which time the borrower would need to make standard monthly payments that might not be affordable. Finally, like the interest-only mortgage, the 40-year balloon mortgage was intended to allow the borrower to pay only interest each month and then to pay the entire principal once the mortgage came due.

Figure 4
Affordability Mortgage Products



4. "Stanton's Law"

Stanton's Law is the precept that "Risk will migrate to the place where government is least equipped to deal with it." When the Congress finally bestirs itself, usually after a crisis, to enact improved safety-and-soundness legislation, the general pattern is to patch one part of the financial services sector, thereby creating incentives for market actors to arbitrage and send business to institutions subject to more lax regulation. This happened in 1989, after the costly failure of over a thousand savings and loan institutions in the 1980s. The Congress delayed enacting necessary safety-and-soundness measures for many years, but finally reacted with legislation increasing capital requirements and imposing modest safety-and-soundness supervision, promptly driving hundreds of billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were even weaker (Stanton, 1989, p. 41).

The U.S. financial system is fragmented for historical reasons among a variety of large and small financial firms, ranging from smaller community banks and credit unions to large complex financial holding companies (Calomiris and Haber, 2014). Regulation too is fragmented, among state and federal regulators and, in the federal government, among a congeries of regulators including the Federal Reserve System (with its regulation and supervision divided between the

Federal Reserve Board and the 12 Federal Reserve Banks), Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and National Credit Union Administration, to say nothing of the Government-Sponsored Enterprises and their diverse regulators.

While a diversified financial system may be useful in encouraging the flow of credit to a variety of borrowers, it also creates a financial system in which regulators compete to attract institutions to regulate. This often includes proposing more lax oversight than a competing regulator offers, resulting in a race to the regulatory bottom. That competition was seen, for instance, between the Federal Reserve and the Office of the Comptroller of the Currency to become the primary regulator of large complex financial institutions once they were decontrolled by the Gramm-Leach-Bliley Act of 1999. The Federal Reserve won that political competition by offering a system of "Fed-Lite" and promising that its supervision of financial holding companies would not extend to the myriad of non-bank components of those firms.

After the 2008 Financial Crisis Senator Chris Dodd, Chairman of the Senate Banking Committee and one of the authors of the Dodd-Frank remedial legislation, understood that the political process had preserved the fiefdoms of all of the financial regulators except for the hapless regulator of the savings and loan industry that the Congress finally eliminated. Senator Dodd proposed to end the regulatory race to the bottom by consolidating supervisory powers of the four federal bank and thrift regulators, the OCC, OTS, FDIC, and the Fed, into a single safety-and-soundness regulator. The proposal immediately ran into what the New York Times called a "phalanx of industry opposition." (Labaton, September 20, 2009). When Senator Dodd brought his regulatory consolidation proposal to the Senate floor, it failed passage by a 91-to-8 Senate vote. Community banks, state chartered banks and regional Federal Reserve Banks all weighed in against the idea. One consequence of the Senate vote against consolidation, Senator Dodd pointed out, was to give large national banks an incentive to move from OCC regulation to less expensive, and less onerous, state regulation if the OCC pushed too hard on safety-and-soundness. (*Congressional Record*, daily edition, May 12, 2010, p. S 3573). A note of tribute is called for: as an experienced legislator, Senator Dodd knew how to count votes. He brought his amendment to the floor knowing that it would fail, but that it might at least serve as a marker for future legislation the next time around.

5. The Ancient Curse: Regulated Firms May Get What They Seek

In the US political system, supervisors are subject to influence from legislators who have authority to adjust the legislation governing a supervisor‘s authority or, in some cases, to diminish the agency's funding. Former Federal Reserve Governor Mark Olson told the FCIC (October 4, 2010) that even the Federal Reserve System, the most autonomous of the U.S. financial regulators, can feel pressure:

> "When the Congress decides to move aggressively to curtail a regulator, they can very directly narrow the focus of what a regulatory entity can do….Congress had a lot of weapons one way or the other that they could use."

Interested groups frequently use the political process to curtail oversight, especially in times such as before the 2008 crisis when a deregulatory mood prevailed in Washington. These groups have

special leverage over regulators that depend on annual appropriations for funds, such as the SEC and CFTC and the former GSE regulator, the Office of Federal Housing Enterprise Oversight (OFHEO). Former SEC Commissioner Harvey Goldschmid told the FCIC (April 8, 2010) that understaffing was a chronic problem at the SEC and that, "We never had enough people. The history of the SEC is almost adequate but never adequate resources, and then starvation." Former OFHEO Director Armando Falcon told the FCIC (April 9, 2010) that his agency "was starved of resources for many years," thanks to the political influence of Fannie Mae and Freddie Mac.

The tension between deregulatory perspectives of financial firms and responsive political officials, on the one hand, and the regulatory lessons of earlier financial crises on the other, tends to lead to a cyclical approach to safety and soundness, with increased support for improved regulation after a crisis occurs and greater deregulatory enthusiasm as memory of the crisis fades. For example, at this writing in 2020 after memory of the 2008 crisis has largely faded, some financial firms are using financial disruption caused by the COVID-19 to argue for reduced capital standards, despite the importance of building an increased financial cushion to try to absorb the greater credit losses that seem likely to hit their balance sheets.

Already in 2011, Treasury Secretary Timothy Geithner warned about pressures to hinder effective implementation of the Dodd-Frank Act that had been enacted in response to the 2008 Financial Crisis:

> "…we face two new risks in [implementing Dodd-Frank]. One is the effort by politicians and groups that oppose financial reform to starve the regulatory agencies of the resources they need to carry out their new responsibilities. The second is to use the confirmation process to block appointments. Those in the U.S. financial community who are supporting these efforts to block resources and appointments are looking for leverage over the rules still being written. There is a long tradition of similar efforts. They will not be successful in undermining the core elements of reform, but …[o]ver time, they will make it less likely that there will be enough capable people in the regulatory bodies to bring the care and judgment necessary for the new rules to work...We can't allow loopholes, gaps, and weaknesses to take hold and undermine the fundamental strength of our reforms. We've been down that road before, and it led us to the edge of the abyss." (Geithner, June 6, 2011).

The record of financial failures over the years is littered with examples of industry pressure leading to weakness of a regulator and subsequent failures of major financial institutions. Perhaps the prudential remedy that comes under most concerted industry attack is the issue of capital standards. Capital is an essential cushion to protect financial institutions from failing if they happen to run into adverse circumstances or perhaps a financial downturn such as occurs from time to time. Jamie Dimon, Chairman and CEO of JPMorgan Chase maintained what he called the company's Fortress Balance Sheet. While this can mean lower returns on equity than competitors, it allowed JPMC to emerge from the 2008 Financial Crisis stronger than it had been before. John Allison (2013, p. 190), then President and CEO of the libertarian Cato Institute, and

a retired Chairman and CEO of BB&T, a highly successful financial institution, has argued for substantially higher capital standards, among other reforms of the banking system:

> "*Require banks to have substantially more capital.* This would shift the risk from the taxpayers to the shareholders. The additional capital requirements would be phased in over 5 to 10 years. Banks should have at least 20 percent shareholders' equity in relation to risk-weighted assets." (Emphasis in the original).

As Mr. Allison makes clear, it is the desire to shift risk to taxpayers that makes capital standards an especially acute focus of industry pressure to lower capital standards. The fragmented nature of financial legislation creates competitive incentives as well. As reflected in the discussion of Stanton's Law, above, firms can gain considerable benefit if they can persuade Congress and a regulator to reduce capital standards on their part of the financial services industry vis-à-vis capital standards on their competitors. The resulting flow of business may allow them to reap generous profits even if they are less competent than competitors that are subject to higher capital requirements.

Thus, there is a gap in perspectives between advocates of higher capital and those who seek to minimize capital. Both are correct from their own vantage points, and the difference between them is one of time horizon. In the short term, a firm may reap supernormal profits from maintaining high leverage or from skimping on investments in personnel and systems. Depending upon a firm's implicit discount rate, the present value of supernormal profits over five or ten years before failing can yield greater shareholder returns (and returns to management) than accepting higher capital standards or levels of investments in the institution's personnel and infrastructure that result in lower returns. It is not by chance that analysts found that firms with the highest returns before the 2008 Financial Crisis were those with the greatest propensity to fail.

It is only in the longer term that higher capital levels and higher-quality infrastructure pay off. Jamie Dimon, for instance, has taken a longer-term perspective:

> "Go back to 1975, when I had my first job out of high school. Since then we've had multiple wars, multiple terrorist attacks, multiple countries going bankrupt—three times for Argentina—and multiple recessions. We've had interest rates as high as 21 percent and as low as 1 per-cent. These things happen. So when you're running a business, you have to run the business maturely, knowing that things are going to happen. The only thing that is unpredictable is the timing and, sometimes, where the punch is coming from. But you know it's coming, and nobody, in my opinion, has ever really picked the inflection points." (Quoted in Deutsch, 2006).

Consistent with this perspective, in April 2020, as the Cronavirus hit, Mr. Dimon again reported on his Fortress Balance Sheet:

> "..we have run an extremely adverse scenario that assumes an even deeper contraction of gross domestic product, down as much as 35% in the second quarter and lasting through the end of the year, and with U.S. unemployment continuing to increase, peaking at 14%

> in the fourth quarter. Even under this scenario, the company would still end the year with strong liquidity and a CET1 ratio of approximately 9.5% (common equity Tier 1 capital would still total $170 billion). This scenario is quite severe and, we hope, unlikely." (Dimon, 2020).

Thus, as in any industry, financial services firms differ widely in their time horizons and the propensity of their leaders to take unsustainable risks. The problem from the standpoint of the overall financial system, is that firms that systematically take excessive risks create externalities that make the financial system as a whole more vulnerable to shocks that taxpayers and national economies may need to pay for.

6. Strategic Risk

Strategic risk is the risk to implementation of a firm's strategy from a changing environment, including changes in economic circumstances, competition, and demand. As Clayton Christensen (1997) famously pointed out, firms may be serving their markets in a customary way when a competitor deploys a new strategy that can suddenly disrupt that approach to the point that it may threaten the company's viability. This happened in the financial sector in the years before the 2008 Financial Crisis.

Banks, savings and loan institutions, and especially government-sponsored enterprises, operate in sectors defined by their charters and the benefits that their charters confer. For instance, banks, savings and loans, and credit unions benefit from access to federal deposit insurance to back many of their liabilities. GSEs benefit from an even more generous federal guarantee that extends across all maturities of obligations and MBSs that they issued.

On the other hand the charters of all of these organizations also imposed limitations. After 1999, when the Gramm-Leach-Bliley Act permitted bank holding companies to include a plethora of non-bank institutions, their charter restrictions proved much less confining than before. By contrast, GSEs found themselves in their halcyon days, with Fannie Mae and Freddie Mac reaping supernormal profits as a duopoly in the secondary mortgage market.

It was their charter limitations that posed a major strategic risk for the GSEs, as it had done for the savings and loan industry starting in the late 1970s when Chairman Paul Volcker led the Federal Reserve to raise interest rates so that the borrow-short (through their deposits) and lend-long (in residential mortgages) strategy of the S&Ls became untenable. For Fannie Mae and Freddie Mac, it was technology that ended their dominance. Leaps in information technology capabilities allowed private firms such as Countrywide in the primary market to develop direct relationships with Wall Street firms that helped them to pool and securitize mortgages that they originated. This allowed primary market firms often to bypass the GSEs and reduce the GSE market share of the growing residential mortgage market. (Fannie Mae, 2005; Freddie Mac, 2007). The GSEs lowered their credit standards to try to meet the competition, but to no avail.

This could have been, and was, predicted:

> "Mercantilist institutions [i.e., institutions operating under special legislation and charters] thus have quite a different kind of market risk than other companies. They may

> enjoy oligopoly profits undisturbed for years, only to be confronted suddenly with new technologies that permit nonmercantilist companies rapidly to take away key portions of their customer base....Unlike such companies, the management risk of a mercantilist institution may jump dramatically when it runs into the limits of its enabling legislation and managers feel themselves forced to take greater risks within their permitted markets." (Stanton, 1994).

Consideration of strategic risk of financial firms fits well within the general pattern of major businesses. Felix Barber and colleagues (2019) undertook a study of 45 large European and US firms that suffered serious setbacks, which they call "stumbles." The study found that, "Two-thirds of the stumbles came directly from a failed strategy." While some stumbles resulted from CEOs failing to meet the challenge of strong pressure to innovate or reposition their ways of doing business, a far greater number of stumbles resulted when "CEOs developed ambitious plans to increase the pace of company growth that ended up destroying value." This happened in the 2008 Financial Crisis, especially as markets overheated in 2006-2008. Some firms – JPMorgan Chase, Goldman Sachs, Wells Fargo, and TD Bank, for example – gave up market share rather than chasing it. Many others – including Countrywide and Washington Mutual in the primary mortgage market, Fannie Mae and Freddie Mac in the secondary mortgage market, investment banks Bear Stearns, Lehman, and Merrill, and large complex firms such as Citigroup, Wachovia, and AIG – chased market share until they went out of business or received a government bailout. Companies with a short time horizon and driven to achieve market share and high quarterly returns on equity are most susceptible to threats to their viability that build up over several years before the hammer drops.

II. Successfully Navigating the Crisis

The pattern of firms that navigated the 2008 crisis successfully and those that failed resembled Tolstoy in reverse. Tolstoy's *Anna Karenina* begins with the observation that, "Happy families are all alike; every unhappy family is unhappy in its own way." By contrast, successful firms each had their own way to detect and manage risk, while unsuccessful firms were all alike – they didn't know what hit them. Thus, JP Morgan Chase and Goldman Sachs detected trouble signs in the market early and reduced exposure. By contrast, TD Bank and Wells Fargo resisted taking on or shed their exposure to risky products early, while unsuccessful firms continued to reap short-term profits taking on increasing volumes of what later became known as "toxic" assets, assets that seemed to embed low risk but in fact were much more risky than was reflected in their market prices.

Perhaps the most interesting case was Toronto Dominion Bank (TD Bank). In the early 2000s, Toronto Dominion Bank was proud of its active international business in structured products. Then, with little explanation CEO Edmund Clark announced in the company's 2005 annual report that, "We…made the difficult business decision to exit our global structured products business…While the short-term economic cost to the Bank is regrettable, I am pleased that we have taken the steps we have and that we can continue to focus on growing our businesses for the

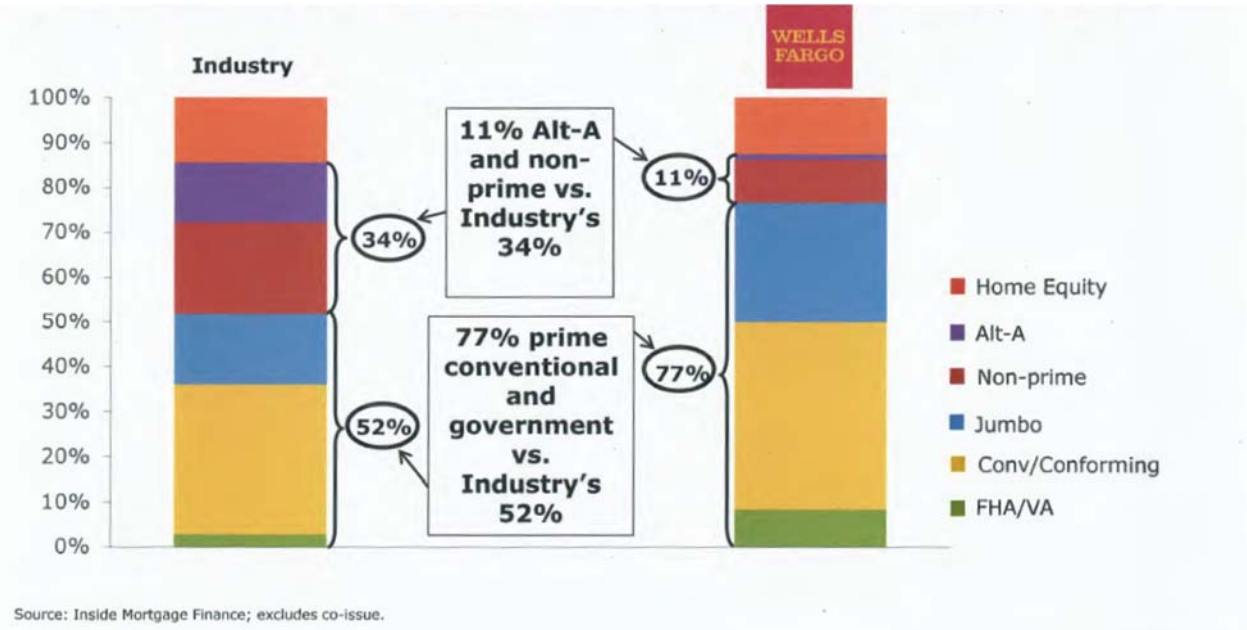
future to deliver long-term shareholder value." The company reported taking significant losses as it unwound its positions in 2005 and 2006.

Mr. Clark had spent several hours a week meeting with experts to understand the credit and equity products being traded by the bank's Wholesale Banking unit and decided that the bank's exposure to subprime products was not worth the risk. As he later explained (Clark, 2010), it was important to play a long game:

> "[Prudence] does mean that you have to sit in marketplaces, as we did in the US, for a couple of years and grow our loan book less quickly than the market. It did mean that you had to exit structured products in 2005 and 2006 and have analysts write that you're an idiot.…But in the end of the day, it means that when the bad times eventually do come, that you don't get rocked by it."

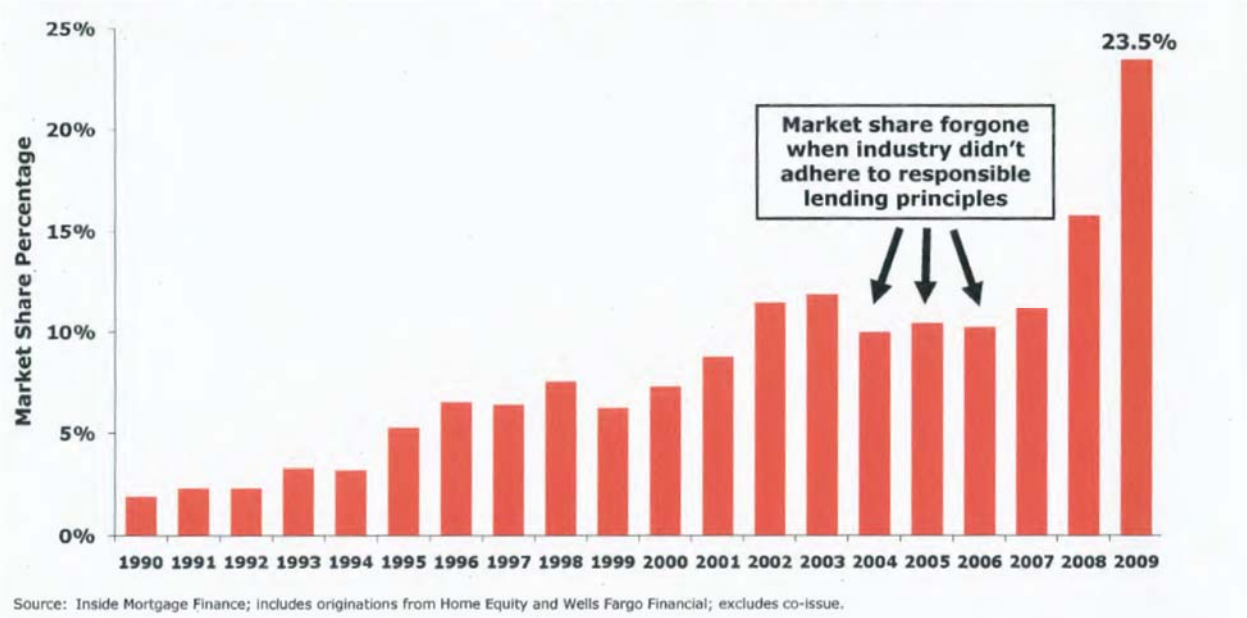
At the end of the 2008 Financial Crisis, with competition weakened, TD Bank was able to expand a chain of branches down the East Coast of the United States. Wells Fargo similarly navigated the crisis by giving up market share. Mark Oman, the Wells Group Executive Vice President, Home and Consumer Finance, provided the graphs in Figures 5 and 6 to the FCIC. He said that, while giving up the market for the most risky subprime products cost the company market share, it was worth it. Figure 5 shows how the company originated a much lower proportion of risky Alt-A and subprime mortgages than the market as a whole and figure 6 shows how Wells gave up market share, amounting to well over $ 100 billion in lost business, in the years before the 2008 Financial Crisis when industry standards had become excessively risky.

Figure 5
Wells Fargo Home Mortgage: 2006 Product Mix



Source: Wells Fargo Home Mortgage

Figure 6
Wells Fargo Home Mortgage: Origination Market Share Growth



Source: Wells Fargo Home Mortgage

By contrast to TD Bank and Wells, JPMorgan Chase (JPMC) and Goldman Sachs were able to detect and respond to warning signals in the market far before most other financial firms. Both JPMC and Goldman possessed cultures that encouraged the flow of bad news to the top of their respective organizations so that anomalies could be investigated and then addressed once they were validated as signs of major risk. This approach, although not explicitly called that at the time, has become known as Enterprise Risk Management, a practice discussed in the next section of this chapter.

In 2006 the mortgage unit of JPMC found that delinquencies on its mortgage portfolio had risen unexpectedly. The retail banking unit reported this bad news to the JPMC management committee that scrutinized the data and requested further information: among other questions, were JPMC's delinquencies higher than those of its competitors? This was a vital question: if JPMC's delinquency rates were higher than those of the market, then the problem was an internal one and the firm would likely need to adjust its credit standards. It turned out that JPMC delinquencies were *lower* than those of competitors, and this too provided important information, that something was amiss in the mortgage market that required a response. The firm shed its subprime mortgage portfolio in October 2006, far before other firms became aware of impending problems in the market.

In December 2006 Goldman Sachs too detected anomalies: the firm's mortgage unit lost money when Goldman's sophisticated models had indicated that the portfolio should make money.

Again, the head of the mortgage desk reported the bad news to the top of the organization. When the FCIC inquired of Dan Sparks, the mortgage unit head, why he had reported bad news to his superiors, he responded that, "Part of my job was to be sure people I reported to knew what they needed to know." Upon receiving the bad news, top members of the Goldman management team investigated, visiting Sparks and reviewing operations of his office. In response, Goldman hedged its exposure to the mortgage market and laid off a range of mortgage risks.

While their approaches differed, all four of the successful firms combined significant qualities:

(1) discipline and a longer-term perspective;

(2) strong communications and information systems to ensure that top management had access to information needed both to manage the firm and to understand enterprise-wide risks; Managers at successful firms solicited feedback continuously. Reporting of bad news was seen as part of the job rather than as something to be discouraged.

(3) seasoned managers in positions to add judgment to the output of quantitative models and respond to events based on experience;

(4) sensitivity to early warning signs and capacity to respond quickly and effectively; and

(5) a process of constructive dialogue between business units and risk managers, to consider each perspective and make a decision after investigating.

JPMorgan Chase and Goldman Sachs maintained an enterprise-wide view of risks facing the firm and made disciplined decisions when they detected early warnings that the market might be troubled. This contrasts with many other firms in the market such as Citigroup and AIG, where some parts of the firm were shedding exposure while other parts were increasing their exposure to low-quality mortgages.

One further area deserves mention: corporate governance and the relationship of the CEO to the board of directors. The value of a strong board has long been recognized, especially as a source of constructive feedback:

> "Create a climate of trust and candor…Foster a culture of open dissent…Dissent is not the same thing as disloyalty. Use your own resistance as an opportunity to learn. Probe silent board members for their opinions, and ask them to justify their positions. If you're asked to join a board, say no if you detect pressure to conform to the majority. Leave a board if the CEO expects obedience. Otherwise, you put your wealth and reputation – as well as the assets and reputation of the company – at risk." (Sonnenfeld, 2002).

By contrast, overbearing CEOs too often dominated weak boards. Retired senior UK Treasury official Paul Myners (2008) observed that, "The typical bank board resembles a retirement home for the great and the good: there are retired titans of industry, ousted politicians and the occasional member of the voluntary sector." Nestor Advisors, a London-based consulting firm specializing in corporate governance, examined extensive data concerning boards and directors of six large complex U.S. financial firms and concluded (2009) that, "Overall, we think that certain patterns of director entrenchment, asymmetric power by one executive leader, non-

executive sloth, and inexplicably low levels of expertise in the boards on some of the most complicated business in the world does emerge from our analysis." By contrast, boards need to be composed of people who can be expected to provide constructive challenge to the hard-charging CEO of a major financial institution.

Edmund Clark, CEO of TD Bank, valued his board as a source of feedback:

> "Good executive management teams want a strong board. If they're going to add value they need to ask the tough questions. They need to challenge us on our assumptions. So I tell my Board to wander through the organization; meet the executives; ask for any document you want. And if any executive refuses, tell me and I'll have a conversation with him or her and make sure they know they have to let you have it. Before each Board meeting I go through the agenda item by item. I tell the directors where the problems are and point out where they might want to press for more information on issues." (Clark, 2004).

This contrast with the norm among major financial institutions before the 2008 crisis highlights a recurring issue: Good governance and management practices are well known, but the variation in leadership across firms determines the extent that those practices are actually applied. Sections III and IV below suggest that government supervision can be an essential way to strengthen firms and their governance and risk management practices.

III. Enterprise Risk Management: A Tool for Organizational Self-Defense

While various commentators define Enterprise Risk Management (ERM) differently, a useful definition comes from the Association for Federal Enterprise Risk Management (AFERM):

> "ERM is a discipline that addresses the full spectrum of an organization's risks, including challenges and opportunities, and integrates them into an enterprise-wide, strategically aligned portfolio view. ERM contributes to improved decision making and supports the achievement of an organization's mission, goals, and objectives."

This definition includes several components:

1. ERM focuses on major risks that could affect the ability of an organization such as a large complex financial institution, to achieve its objectives. In the 2008 Financial Crisis some firms were distracted by smaller risks rather than focusing on the major risk looming in the run up to the 2008 Financial Crisis. Thus, Fannie Mae focused on "the last war" and concerned itself with interest rate risk rather than the credit risk that brought the firm down.

2. ERM calls for an organization to take a portfolio-wide view of risks. Large unintegrated organizations such as Citigroup or Washington Mutual were unable to view their risks across the entire firm. By contrast, firms such as Goldman Sachs and JPMorgan Chase

were able to elicit important risk warnings from deep in the enterprise, bring them to the attention of decision makers, and address them before they could cause harm.

3. ERM includes consideration of challenges as well as opportunities. By gaining an understanding of the contours of a decision, leaders of firms such as Wells Home Mortgage or TD Bank were able to balance the allure of returns on exotic mortgages against the downside risks.

Enterprise Risk Management works through a sequence of "conversations" and "prioritization," as Canadian ERM expert John Fraser puts it, followed by implementation. The final step in ERM, once the firm's leadership has decided on a course of action to address a major risk, is to implement the decision. The "conversations" part of ERM is based on an organizational culture that encourages the flow of information about major risks to the decision makers who need it. In the 2008 Financial Crisis, failure of firms frequently related to resistance of the head of a major unit to allow risk officers to monitor their activities. Classic in this regard was the AIG Financial Products (AIG-FP) unit that brought down AIG, and its combination of excluding the central AIG corporate risk office and neutralizing its own internal risk function. The next important step is "prioritization" of identified risks. In the Wall Street phrase, "don't pick up pennies in front of a steam roller." Too many firms have focused on relatively smaller risks, only to be blindsided by major risks such as those leading to the 2008 Financial Crisis.

Perhaps most important, ERM addresses a major problem identified in the business-school literature. In their book, *Think Again*, Sydney Finkelstein and colleagues report that their research shows how bad decisions come from two factors: (1) an influential person in the organization makes an error of judgment, and (2) facts are not brought to the table to challenge the flawed thinking and expose errors and correct them before the decision is implemented. Errors of judgment, they report, arise from a variety of human biases and mistakes.

The function of ERM is systematically to bring facts to the table as a part of the way that a firm does business rather than as an act of personal courage by someone down in the organization who sees a major problem and tries to bring it to management's attention. The present author, for instance, interviewed one Chief Risk Officer (CRO) at a major institution who said that she faced a dilemma, either to be a pain in management's neck by raising repeated warnings or to become known as the CRO at a firm that failed. She left the firm in 2006 and the firm failed in 2008. A more lengthy discussion of risk management at firms before the crisis may be found in Stanton (2012) and sources cited. Dynamics of the ERM process are highlighted nicely in a Harvard Business School Multimedia case study (Mikes, 2010).

One problem before the 2008 crisis was the way that many firms established a risk function but positioned it as an empty gesture rather than a source of added value to the firm's performance. Failed financial firms frequently dismissed (Freddie Mac), sidetracked (Lehman), isolated (AIG), layered the risk function far down in the firm (Countrywide), compensated them for production (WaMu and AIG-FP), or otherwise disregarded them (Fannie Mae). This is something that a

firm's supervisor can seek to evaluate and require firms to correct. Especially in the current time of deregulatory enthusiasm, a regulatory focus on stronger corporate governance and risk management may be one of the few important areas left where supervisors can seek to obtain the political leeway to address a major factor that influences whether a firm can successfully sustain itself over the longer term.

IV. Conclusion

The 2008 crisis resulted in almost 10 million foreclosures, substantial loss of wealth, high levels of unemployment that lasted many years, and other disruption to people and their well-being. As Reinhart and Rogoff (2009) so nicely capture in the title of their book, *This Time is Different: 800 Years of Financial Folly*, financial calamities inevitably continue to happen, just as the COVID-19 has created a new one. The contention here is that risk patterns regularly repeat themselves, albeit in different forms, and that effective supervisory enforcement of improved governance and risk management practices can reduce the human and social and economic costs when a crisis occurs.

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