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Predicting the past to avoid financial crises

By ***Philip Fliers***

It is often said that people who fail to learn the lessons of history are fated to repeat it, both at the micro and the macro level. Many will argue that the assertion is as true of the banking industry as any other field of human activity.

I personally would argue that the disastrous financial events which began to unfold in July 2007 when the asset-backed commercial paper in the USA began to dry up, and gained momentum with the collapse of Lehman Brothers in September the following year, could have been avoided by learning from our financial past. At the very least, the scale of the impact of what has come to be known as the Global Financial Crisis could have been much reduced.

"Banks that find themselves in trouble because of their own business strategy and tactics should, as far as possible, be allowed to go bust."

I make my case based on the research conducted for the paper *Predicting the past: Understanding the causes of bank distress in the Netherlands in the 1920s*, which I co-wrote with Chris Colvin of Queen's Management School, Queen's University Belfast, and Abe de Jong, Professor of Corporate Finance and Corporate Governance, at Rotterdam School of Management, Erasmus University.

A brief history lesson would probably be helpful as not everyone will be immediately familiar with the specifics of Dutch financial history dating back almost a century. Dutch businesses benefited greatly from the First World War, a conflict in which the Netherlands remained neutral. A short post-war boom prolonged their prosperity.

Then, in the early 1920s, the Dutch economy suffered a sharp deflationary recession. It is against this macroeconomic backdrop that the financial crises of the day broke out. The large and sustained declines in aggregate demand and prices sustained in the 1920s were the consequence of falling export demand and monetary policy due to the gold standard. Debt deflation put pressure both on Dutch businesses and on the banking sector that they had come to rely on. Instability for banks has since been widely classified as constituting a financial crisis.

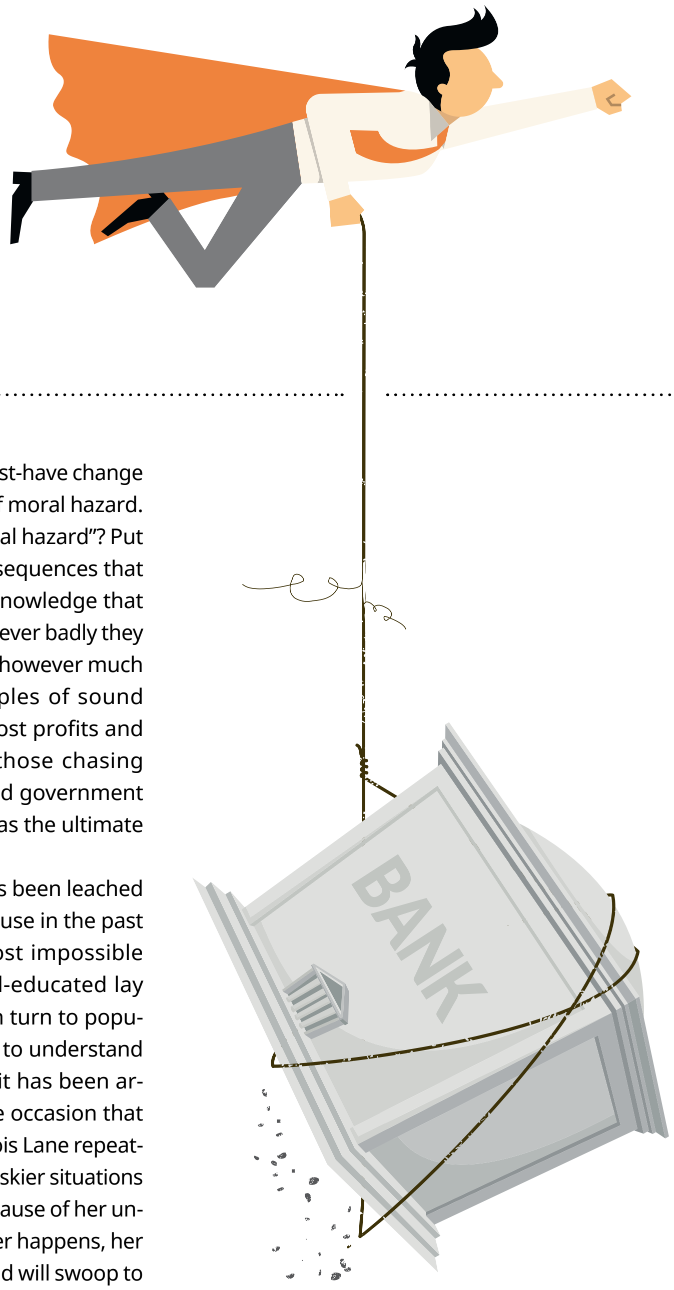
In our research, which is built on an extensive quantitative archival reconstruction of the financial sector at the time of the crisis, we found that banks that failed were more highly valued before the crisis than those that did not.

In the paper, we do not try to draw a literal comparison between the two separate crises, but there are clear similarities. For the median bank, for each percentage increase in leverage, we found that the probability of banks' distress increases by about 50 per cent, showing that lower equity buffers make banks vulnerable to shocks. This might sound horribly familiar to readers who are acquainted with the details of today's continuing global financial instability.

But equally there are clear differences. In the 1920s, for instance, there was no expectation among investors and bankers of government or central bank intervention. Struggling banks had little option but to resolve their own problems, either by addressing their lack of liquidity, by merging with or being acquired by another bank, or by going bankrupt. As a result, the crisis of the 1920s cost taxpayers significantly less than the more recent events, an estimated €1bn-€2bn in today's terms.

Moral hazard

As the financial industry, governments, central banks and regulators strive to return to "normal", but demonstrate that they have learnt from the



experience, one vital must-have change is surely a revaluation of moral hazard. But what exactly is "moral hazard"? Put simply, it relates to consequences that arise from the certain knowledge that big banks have that however badly they conduct their business, however much they abuse the principles of sound banking in order to boost profits and the remuneration of those chasing profit, central banks and government will ride to their rescue as the ultimate lenders of last resort.

It is a phrase that has been leached of all resonance by overuse in the past few years, and is almost impossible to explain to even well-educated lay people. Perhaps we can turn to popular culture for an easier to understand analogy. For example, it has been argued on more than one occasion that Superman's girlfriend Lois Lane repeatedly finds herself in far riskier situations than her peer group because of her unerring faith that whatever happens, her super-powered boyfriend will swoop to her rescue. This Lois Lane Syndrome is moral hazard by another name.

If not eliminated, this phenomenon must at least be severely reduced in its impact. But for that to happen there has to be a change in the mindset of central banks and their governments. If Lois Lane can be chastised for taking on more risk than she ought to, she can in turn defend herself by arguing that she never asked for Superman to provide her with constant protection. For Superman, read central banks and governments.

The insistence of central banks and governments on riding to the rescue is very much part of the problem rather than a solution. Banks that find themselves in trouble because of their own business strategy and tactics should, as far as possible, be allowed to go bust. Unless the needs of the public outweigh the risks and costs involved in propping them up.

If moral hazard is to be neutered as a threat to national and international banking systems, central banks and governments must discipline themselves. They must instead learn to let market events and thus financial evolution take their natural course. ■

The paper *Predicting the past: Understanding the causes of bank distress in the Netherlands in the 1920s*, by Christopher L. Colvin, Abe de Jong and Philip T. Fliers, appeared in the journal *Explorations in Economic History*, Volume 55, January 2015, Pages 97–121. DOI: http://dx.doi.org/10.1016/j.eeh.2014.09.001

Philip Fliers *is a Lecturer, Department of Finance, Rotterdam School of Management, Erasmus University.*
EMAIL *pfliers@rsm.nl*

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