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UNRAVELLING THE 2008 FINANCIAL CRISIS: A COMPARATIVE ANALYSIS OF THE FCIC REPORT AND ALTERNATIVE THEORIES

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1. Introduction

The 2008 financial crisis was a pivotal moment in modern economic history, sending shockwaves through the global financial system and precipitating the Great Recession. In its wake, numerous theories emerged to explain the complex factors that led to this catastrophic event. Among these, the Financial Crisis Inquiry Commission's (FCIC) report stands out as one of the most comprehensive and well-researched explanations.

This article will examine the FCIC's theory in detail, highlighting its strengths and explaining why it provides a more holistic understanding of the crisis compared to alternative theories proposed by Peter J. Wallison, Michael S. Barr, and Gary Gorton. By critically analysing these different perspectives, we can gain a deeper appreciation for the multifaceted nature of the 2008 financial crisis and the importance of considering multiple factors when studying complex economic phenomena.¹

2. The FCIC's Theory: A Comprehensive Approach

The Financial Crisis Inquiry Commission (FCIC), established by the U.S. government in 2009, conducted an extensive investigation into the causes of the financial crisis. Their final report, released in January 2011, presented a nuanced and multifaceted explanation that identified several key factors contributing to the crisis.

2.1 Failures in Financial Regulation and Supervision

The FCIC argued that a significant cause of the crisis was the breakdown of financial regulation and supervision. They highlighted how deregulation and lax oversight allowed financial

¹ Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, U.S. Government Printing Office, January 2011.

institutions to engage in increasingly risky behaviour. Key points include the repeal of the Glass-Steagall Act, which had separated commercial and investment banking, leading to riskier investment activities by commercial banks.² The failure to regulate over-the-counter derivatives left a significant part of the financial market without adequate oversight, contributing to systemic risk. Additionally, the SEC's decision to relax net capital rules for investment banks allowed these institutions to take on more leverage, increasing their vulnerability. Inadequate risk management practices at financial institutions further compounded these issues, as firms underestimated the risks of complex financial products. Some of these are:

2.1.1 Corporate Governance and Risk Management Failures

The report emphasised how many financial institutions failed to adequately manage risks, often prioritising short-term profits over long-term stability. Excessive leverage and reliance on short-term funding made institutions highly vulnerable to market fluctuations. The inadequate risk assessment of complex financial products, such as mortgage-backed securities (MBS) and collateralised debt obligations (CDOs), meant that firms were often unaware of the true level of risk they were assuming.³ Misaligned incentive structures, which rewarded executives for taking excessive risks, further exacerbated the problem, leading to decisions that prioritised immediate gains over sustainable growth.

2.1.2 Excessive Borrowing and Risk-Taking by Households and Wall Street

The FCIC highlighted how both consumers and financial institutions took on unsustainable levels of debt. The housing bubble was fueled by easy credit and lax lending standards, allowing consumers to borrow more than they could afford. The proliferation of subprime mortgages and predatory lending practices targeted high-risk borrowers, increasing the likelihood of defaults. The increased securitisation of mortgages spread risk throughout the financial system, as these risky loans were packaged into MBS and sold to investors globally.⁴ This interconnectedness meant that problems in the mortgage market quickly spread to other parts of the financial system, amplifying the crisis.

2.1.3 Systemic Breakdown in Accountability and Ethics

The FCIC report highlighted a systemic breakdown in accountability and ethics within the financial industry. Mortgage lending standards deteriorated significantly as financial institutions

² Id.

³ Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, at 27 (2011).

⁴ Id.

issued risky loans, such as subprime mortgages, without proper regard for borrowers' repayment abilities. This was driven by a profit motive, leading to widespread lending to unqualified individuals. Credit rating agencies failed to accurately assess the risk of mortgage-backed securities and collateralised debt obligations.⁵ Conflicts of interest and inadequate oversight led to these agencies assigning high ratings to risky securities, misleading investors and contributing to financial instability.

The report also pointed out a lack of transparency in financial markets. Complex financial products were often poorly understood, and their true risks were obscured. This lack of clarity prevented investors and regulators from accurately assessing the stability of the financial system, exacerbating the crisis.⁶

2.1.4 Collapsing Mortgage-Lending Standards and the Mortgage Securitization Pipeline

The FCIC emphasised the erosion of mortgage-lending standards and the complex securitisation process as key factors in the crisis. Nontraditional mortgages, such as interest-only and negative amortisation loans, became prevalent, increasing the risk of defaults. These risky loans were bundled into securities and sold to investors, spreading the risk throughout the financial system.

The "originate-to-distribute" model further reduced lender accountability. Lenders originated loans with the intent to sell them, diminishing their incentive to ensure loan quality. This led to a significant rise in poor-quality loans, which ultimately defaulted in large numbers, triggering financial instability.

Failures in the securitisation process were also critical. Due diligence was often inadequate, with insufficient checks on the quality of underlying mortgages. This led to the widespread distribution of flawed securities, which, when defaults surged, contributed to the crisis.

2.1.5 Over-the-Counter Derivatives

The FCIC report highlighted the significant role of unregulated over-the-counter (OTC) derivatives, especially credit default swaps (CDS), in exacerbating the crisis. The lack of transparency in the OTC derivatives market meant that the extent of risk was not well understood

⁵ Id.

⁶ Id.

by market participants.⁷

CDS contracts created a web of interconnected liabilities. When defaults occurred, the impact was magnified due to the widespread use of these derivatives. The near-collapse of AIG, heavily exposed to CDS, underscored the systemic risk posed by these unregulated financial instruments. Overall, the FCIC report's analysis of OTC derivatives illustrated how their misuse and lack of oversight played a pivotal role in deepening the financial crisis.

3. Strengths of the FCIC's Approach:

The FCIC's explanation of the 2008 financial crisis stands out for its comprehensive scope. Unlike other analyses that focused narrowly on specific aspects, the FCIC considered a wide range of factors, including regulatory failures, risky financial practices, and cultural issues within the financial industry. This breadth allowed for a more complete understanding of the crisis.

Another strength of the FCIC's approach was its reliance on empirical evidence. The commission conducted extensive interviews with key players and analysed vast amounts of data to support its conclusions. This rigorous methodology ensured that the report was grounded in factual information, adding credibility to its findings.

The FCIC also adopted a systemic perspective, recognising the interconnected nature of various factors that contributed to the crisis. Rather than isolating individual causes, the commission presented a holistic view, illustrating how different elements interacted and compounded each other, leading to the financial meltdown.

Additionally, the FCIC placed the crisis within a broader historical context. The report traced the evolution of financial markets and regulatory frameworks over the decades, showing how past developments set the stage for the 2008 collapse. This historical analysis provided valuable insights into the long-term trends that contributed to the crisis.

Finally, the FCIC balanced its analysis between immediate triggers and underlying causes. The report distinguished between the specific events that directly triggered the crisis and the long-term structural issues that made the financial system vulnerable. This nuanced approach highlighted

⁷ Id.

both the proximate causes and the deeper, systemic problems that needed to be addressed to prevent future crises.

4. Alternative Explanations and their Limitations:

4.1 Peter J. Wallison: Government Housing Policy as the Primary Cause:

Peter J. Wallison, a member of the FCIC who dissented from the majority report, argued that government housing policy was the primary cause of the financial crisis. He emphasised the role of government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac in promoting homeownership, suggesting that their policies led to an increase in subprime and other risky mortgages. Wallison also highlighted the impact of the Community Reinvestment Act (CRA), which he claimed encouraged lending to low-income borrowers, further contributing to the proliferation of risky loans.⁸

4.1.1 Limitations of Wallison's Theory

One major limitation of Wallison's theory is its narrow focus. By concentrating primarily on government housing policy, Wallison's explanation overlooks other significant factors that contributed to the crisis, such as regulatory failures and excessive risk-taking by Wall Street. This narrow view fails to capture the complexity of the financial meltdown, which was driven by a multitude of interconnected issues.

Additionally, Wallison's theory places an overemphasis on the role of GSEs. While Fannie Mae and Freddie Mac did play a role in the crisis, research has shown that they were not the primary drivers of subprime lending. The majority of subprime mortgages were issued by private lenders, and the GSEs were more followers than leaders in this market segment. This misattribution of blame limits the explanatory power of Wallison's argument.

Furthermore, Wallison's theory does not adequately address the international aspects of the financial crisis. Similar housing bubbles and financial crises occurred in countries with different housing policies, indicating that factors beyond U.S. government housing policy were at play. By ignoring these international parallels, Wallison's theory fails to provide a comprehensive explanation of the global nature of the crisis.

⁸ Peter J. Wallison, *Dissenting Statement*, in *The Financial Crisis Inquiry Report* 443-530 (2011).

Lastly, Wallison's theory downplays the responsibility of the private sector. The financial crisis was significantly driven by private financial institutions that created and spread risky financial products, such as mortgage-backed securities and collateralised debt obligations. By minimising the role of these private entities, Wallison's explanation lacks a balanced view of the various contributors to the crisis.

4.2 Michael S. Barr: Focusing on Information Asymmetry and Incentive Misalignment

Michael S. Barr, a law professor and former Treasury Department official, emphasised the role of information asymmetry and misaligned incentives in the financial system. He highlighted how the breakdown of the "originate-to-distribute" model in mortgage lending created significant problems. Lenders originated loans not to hold them but to sell them, leading to a decline in lending standards and accountability.⁹ Additionally, Barr pointed to conflicts of interest in the securitisation process, where financial institutions had incentives to package and sell risky loans. He also underscored the failure of credit rating agencies to accurately assess the risk of these securities, which misled investors and exacerbated the crisis.

4.2.1 Limitations of Barr's Explanation

One limitation of Barr's explanation is its incomplete regulatory perspective. While his focus on incentive structures is valuable, it does not fully address the broader regulatory failures identified by the FCIC, such as inadequate oversight and enforcement by regulatory bodies. Furthermore, Barr's explanation pays insufficient attention to macroeconomic factors. It does not adequately consider the role of global imbalances and monetary policy in fueling the housing bubble and contributing to the crisis. Additionally, Barr's theory offers a limited discussion of systemic risk. It does not fully explore how the interconnectedness of financial institutions amplified the crisis, a critical aspect of the FCIC's findings.

4.3 Gary Gorton: The Financial Crisis as a "Run on Repo"

Gary Gorton, a financial economist, proposed that the crisis was essentially a "run on repo" – a breakdown in the repurchase agreement market that many financial institutions relied on for short-term funding. Gorton highlighted the role of the "shadow banking system" in creating money-like instruments that were widely used as collateral. The loss of confidence in the value of this

⁹ Michael S. Barr, *The Financial Crisis and the Path of Reform*, 29 Yale J. on Reg. 91 (2012).

collateral led to sudden illiquidity in the repo market, triggering a broader financial crisis. Gorton emphasised how the sudden withdrawal of short-term funding caused a cascading effect, destabilising financial institutions.¹⁰

4.3.1 Limitations of Gorton's Explanation

Gorton's theory has its limitations, primarily due to its narrow focus on a specific market. While the repo market played a crucial role, his theory does not fully account for other important factors identified by the FCIC, such as mortgage lending practices and regulatory failures. Additionally, Gorton's explanation focuses more on the mechanism of the crisis rather than the longer-term factors that made the financial system vulnerable. It also offers a limited discussion of regulatory failures, not adequately addressing how regulatory shortcomings allowed the shadow banking system to grow unchecked. Lastly, Gorton underemphasises the role of the housing market. His explanation does not fully explore the connection between the housing bubble and the overall fragility of the financial system, an essential element in understanding the crisis.

5. Conclusion

While alternative explanations offer valuable insights into specific aspects of the 2008 financial crisis, the FCIC's report stands out as the most comprehensive and well-rounded analysis. By considering a wide range of factors – from regulatory failures and corporate governance issues to the role of complex financial instruments and cultural problems within the financial industry – the FCIC provides a more holistic understanding of the crisis.

The limitations of alternative theories, such as Wallison's focus on government housing policy, Barr's emphasis on information asymmetry, and Gorton's concentration on the repo market, highlight the danger of oversimplifying a complex event like the financial crisis. While each of these perspectives contributes to our understanding, they fall short of providing the comprehensive explanation offered by the FCIC.

The 2008 financial crisis was the result of a perfect storm of interconnected factors, and any attempt to reduce it to a single cause or narrow set of causes is likely to be inadequate. The FCIC's approach, which recognises the complexity of the crisis and examines it from multiple angles, provides a more robust framework for understanding what went wrong and how we might prevent

¹⁰ Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. Fin. Econ. 425 (2012).

similar crises in the future.

As we continue to grapple with the lessons of the 2008 crisis and face new challenges in an ever-evolving global financial system, the FCIC's comprehensive approach serves as a valuable model for analysing complex economic phenomena. By considering multiple perspectives and examining the interplay between various factors, we can develop a more nuanced and accurate understanding of financial crises and work towards creating a more stable and resilient economic system.

