# Systemic Financial Crises – Lots of money, but a real Doug

Keith Rankin, 17 June 2013

Sir Douglas Graham and three other convicted directors of the former Lombard Finance, following a failed appeal, will likely be given a custodial sentence for misleading the public. Sir Douglas faces triple jeopardy given his prominence in public life last century, and given the knighthood gained for his work in facilitating Treaty settlements with Tainui and Ngai Tahu.

Being a knight means, to some people, that Graham's culpability for the failure of Lombard was greater than that of others within the Lombard community, and that therefore the indignities he must suffer should also be greater.

In reality, the directors of New Zealand's finance companies – at least those finance companies lending to property developers – were between a rock and a hard place in late 2007. And nobody, not even independent commentators, could easily convey the full truth. Finance, more than any other activity (theology possibly excepted), is an industry that depends on faith.

Because finance is so suspect to systemic failure, the issues are best explored in years other than those in which such failure is incipient. So now is the time to dig into this issue.

The story we are often presented with is one of innocent amateur 'investors' being defrauded by negligent or devious finance-sector professionals. In this story, the 'mum and dad' investors are at fault only to the extent that they are deemed to be financially illiterate. In this context, financial illiteracy is generally taken to mean an unawareness of the relationship between risk and return, and failure to spread one's risk.

The reality is that, in the financial community, the amateur savers and the professional intermediaries share a similar world view; they share the same blind spots. The community, by and large, understands that there are risks associated with lending rather than spending. And the community as a whole tends to be blind (some would say "wilfully blind") to the systemic risks that arise when the ratio of saleable assets to economic output becomes too high.

Someone like Sir Douglas Graham, from a relatively privileged 'old money' family, had a substantial stake in the financial community. He will not have been financially illiterate, but will have shared in that wider naivety, the lack of appreciation of systemic risk.

The financial system is ultimately grounded in the economic system. But regularly – even predictably – financial assets come to be bought and sold for prices well above their actual worth. The financial community becomes seduced by these rising prices; participants believe that they have discovered the yellow brick road to indefinitely increasing self-worth.

In the 1710s, even Sir Isaac Newton, hardly an unintelligent man, bought into the South Sea mania. Rising asset prices are very seductive. When the mania was exposed as a bubble in 1720, he lost the equivalent of millions today.
(http://www.guardian.co.uk/books/2009/aug/16/newton-counterfeiter-thomas-levenson)

As an asset mania reaches its penultimate phase, a sense of fear sets in; a fear that must be concealed lest panic be unleashed. Faith must rule. In 2007 in New Zealand there had already been failure of a couple of finance companies lending on used cars. It was important for the directors of Lombard, and other intermediaries exposed largely to the property sector, to convince themselves and their creditors that this was not the beginning of a systemic crisis. Rather, it was, they hopefully believed, confined to the used-car end of the finance market.

The reality was that somebody had to pay the high deposit interest rates then on offer, and that the economy simply couldn't support those rates. Lenders had little choice but to make increasingly risky loans, and to borrow to pay their creditors.

At that time it was widely understood that the market should not be spooked by loose talk. The financial community, holding assets that were unrealisable at the prices the holders of those assets had paid for them, would need to present a broad front of assuredness to the public. Journalists and economists, many themselves being members of this community, had to be very careful not to be seen to undermine this fragile confidence.

The Herald's John Roughan noted ("Sir Douglas should keep title", 8 Jun 2013) that "the directors [of Lombard] have been convicted mainly for what [the 2007 prospectus] didn't say". Who has never been slightly economical with the truth when revealing the full truth could trigger substantial adverse consequences for one's family, community, business, or political party?

In the financial universe, the years from the 1940s to the 1960s were anomalous, following the tumultuous events from 1914 to 1945. (Indeed, we should understand both world wars as events of substantial financial rebalancing, even if that is not primarily the way we think of those events.)

The years that give us insight are the 1850s to the 1920s. In this epoch of high capitalism, international financial panics and crises occurred each decade, with each tending to become more intense than its predecessor. Seven or eight years of unbalancing (or 'leveraging') would be followed by a year or two of defaults and 'haircuts', but never by a complete rebalancing or deleveraging. So, each crisis would take place at a higher level of credit-debt imbalance than its predecessor.

It is not hard to foresee further crises in this decade, and the next. (If history is a guide, the years ending in '8' may be particularly critical.) Now, a full half-decade away from the vulnerable '8'-year, our economists, our financial journalists, and our legislators should be addressing these systemic issues. We have better things to do than persecute the hapless scapegoats of past crises.

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