<u>FINANCIAL CRISES: PREDESTINATION? PREDICTABLE? INEVITABLE, PREVENTABLE?</u>

<u>EMBARGO   final</u>

<u>(Introductory speech on the occasion of the Opening of the Academic Year 2009, Nyenrode University)</u>

Jules Muis

Mr. President, Mr. Rector magnificus, Faculty, Students and Alumni, Ladies and gentlemen,

It is a privilege for any 65-plus-student-in-accountancy [one never stops learning] to be invited to open the academic year of Nyenrode University; on a topic that can best be termed 'afterthoughts' on the deterministic -natural or supra-natural - the predictable, inevitable or preventable characteristics of the present profound and still lingering financial crisis. And by extension to scout the possible root causes of a next crises; if indeed, we are so casual as to let it happen again; especially if for the same frivolous reasons.

<u>Acknowledgment</u>

Your speaker to-day is, exceptionally, a most grateful product of vocational training; the tedious, evening and week-end NIVRA round-about-way to-wards the much appreciated RA qualification. Which effectively means I am neither blessed with, nor hindered by, formal academic training.

But I would be amiss not to acknowledge my genuine appreciation for the academic insights I gratefully took on board - extracurricular - in decades past. As a practitioner, input from the academic perspective has been critical in keeping my curiosity piqued, in reminding me to question vested wisdom and in putting my everyday professional challenges in a vitally useful broad perspective.

In particular, I count myself fortunate early in my career having been invited to join the 71/72 University of Chicago's Workshop of Accounting Research. The venue gave me access to alternative ways of looking at transparency, and accounting and auditing through organization-behavioral angles, information theory, linguistics, and philosophy of science. Every Friday, every fortnight, I could get intellectually drunk on the South side of Chicago, on American academic empirical cut-throat angles, analyzing accounting and auditing for what is; potentially, and in practice. This after having spent 8 years of inhaling Continental-European hypotheco-deductive, normative Austrian-Germanic economic schools of thought. And, not to forget, Limperg's unique very own school.

I will always be grateful for the professional peace of mind which academia on both sides of the Atlantic afforded me when faced with profound practical questions.

And appreciate the sense of humor with which academia suffered my occasional presence.

I trust today will not be different.

It is good on a day like this for us to step back and take a good look at the privileges, challenges and responsibilities that attach to academic research, teaching and learning; on what exactly it is that one does with independence of mind that goes with academic freedom, expertise and insights so offered.

In academia as in professional practice, there are first and foremost personal choices to be made. Simply put, one can use or misuse expertise or academic status. One can stand tall -- and sometimes at risk -- when circumstances require. Or one can opt to just monetize one’s professional or scholarly status. All it boils down to is what one wants to do with one's life. And how one wants to do it.

<u>Homework 2009</u>

This may also be the right moment to hand out your homework for this academic year: To answer the question “ And where was academia in the run up to this crisis? And what will academia do different in making a tangible difference to prevent a next one from happening?”

This not to be facetious.

Academia is one of the cornerstones, an informal gatekeeper, in the fabric of the financial markets equation, as a voice, as an educator, as a toolkit designer. Its independent views and instrumental contributions are too important not be heard *before* the next systemic shoe drops.

<u>Full disclosure</u>

For the sake of full disclosure, it is imperative I also confess my personal-educational- professional hang-ups. My lifelong troubled relationship with postulates and premises that is.

I nearly failed high school, because I could not wrap my head around the Newtonian intricacies of double-entry bookkeeping. In the same vein and at the same time I had great difficulty with algebra. I proved constitutionally unable to accept -- and hence kept questioning - postulates for what they are: postulates!

I had similar difficulties accepting the traditional premises of Dutch auditing theory of the sixties and, not very smart, made no secret of it. As a result I twice failed NIVRA's auditing exam. In an attack of pragmatic opportunism - remember under pressure everything becomes fluid - I narrowly passed at a third attempt by writing exactly what I was told my examiners wanted to hear. So - from a fundamentalist perspective - I sold my professional soul before I even qualified. It has been on my conscience ever since.

It is postulates, stupid

Forty years later, first in 2004, challenged by paper-thin financial market operating assumptions, and too good to be true prevailing financial postulates and riches; fuelled by a deep suspicion developed during my World Bank years on ‘ceteris paribus’ claims [saw it as the snake oil of economists], I sensed a house of cards - better known as the global financial system - about to fall apart.

At the time I had spent about ten years lobbying in vain with the then powers that were, for mandatory dog-tagging of derivatives with an intelligible risk profile. If you can’t do it, don’t allow it to be traded. Having at the same time failed to convince my audiences interested in good governance and the financial architecture/annex systemic risks, to require annually results-based systemic assurance statements from their financial oversight agencies.

Either measure could have stopped us from an unnecessary worsening.

Both will need to be adopted, moving forward, lest we want to head for a next crisis like this, in considerably less than 100 years.

Today, clearly, appearances will be against me, but rest assured that any semblance of *Schadenfreude* is purely coincidental.

The financial-economic crisis: the present state of play

For any audience at Nyenrode University, there will certainly be no need to recite the mega numbers – we speak in the trillions these days -or to review the base dynamics or list the looming contingencies still embedded in the current financial systems, to take a best guess stock of the irreparable damage done by the financial crisis.

As an appetizer it might be good to remind ourselves of the initial reaction of our institutional financial gatekeepers to the first signs of sub-prime problems in 2007. First they reassured us that “It is only a liquidity crisis”. That was followed in short order by the less reassuring ‘assurance’ that “it is only a solvency crisis, not an economic crisis”. That, in turn, was followed in same short order by….. an economic crisis...

Let us see and say it for what it is: an index of how denial and silo mentalities trump holistic thinking in economics and finance, financial market management and oversight.

The residual core problem of the still-unfolding crisis can best be described as an oversized toxic “hair ball”, a mishmash of intractable hard-on-the-stomach financial products stuck in the craw of the financial system and/or parked on the balance sheets of, in particular, our financial institutions. The problem with toxic financial hair-balls is that they do not lend themselves to quick dissolution or resolution other than by drowning them in an overabundance of liquidities we really do not have but create *pour besoin de la cause urgente*; and/or fighting them with antidotes which are often equally toxic.

In the event, our fiscal and monetary authorities administer, specially for the occasion, doctored medicine, to keep markets liquid to the exceptional point of printing man-made, bottom-of-the-barrel priced, money; in the process de-leveraging the private sector, by leveraging the public. That is, leveraging future generations’ balance sheets.

We do so happily, counterintuitive; as if there is such a thing as a free lunch after all. Most of it through equally doctored, suspect accounting and limping disclosures.

Many governments took a fast-track course in the expedient art of off-balance-sheet accounting. They took a page, so to speak, straight from the failed-yet-too-big-to-fail private sector financial institutions' very own crooked books, resorting in their own accounting to the same form-over-substance rationalizations predicated on the same worn-out accounting- rationalizing technicalities, though this time in the name of the lofty political cause of saving us from a total meltdown. The ends serving the means.

The results are national balance sheets that basically window-dress both the liabilities assumed and the value-at-risk of the commitments made to and on behalf of the bailed-out companies; especially in situations where the governments have effective control, and the bailed out balance sheets are effectively but not very transparently put on our collective shoulders. Fannie Mae, with its multi-trillion dollars of debt, is probably the best, but certainly not the only, example.

Add to that distortion the allergic reaction of many governments, and the BIS, to fair-value accounting in both private and public sector. Fearing, presumably, an overreaction to the sheer magnitude and volatility of the revealing raw numbers.

What a dignified way to restore trust in the markets: seeking trust by sowing distrust. By refusing to accept that the public can exercise sound judgment in the best of traditions of accounting practices reflecting economic substance. By shooting the fair-value messenger.

As a result of this trust-corrosive approach, we now know one thing for sure: we shall have for many years to come no clue about the full fair value, the cost of capital if you wish, of our current financial black hole under present and/or normalized circumstances. Basically, we have substituted one set of unknowns in the equation by another set.

Muddy history has it that in a situation like this one has no choice but to fight fire with fire; choosing from among the least of necessary evils; monetary policy and accounting turned dirty dancing.

But note that the orchestrated attempt to neuter fair value accounting, is man-made. It is free will in action. Unadulterated evil; to be distinguished from a necessary evil.

There is no financial organization that can safely sail, can risk-manage itself, without not also monitoring its integral fair value status. There is absolute no sensible reason to keep, even on a best guess basis, that readily available information, even if just ‘guestimates’, away from all stakeholders.

<u>Accountability</u>

What we have is what we get if those responsible for a financial-economic stampede are allowed to stay in the saddle--in command and in denial. We are witnessing a man-made crisis in which the men who allowed it all to happen--dysfunctional financial gatekeepers from central bankers, economists and including, yes, accountants - are not only not held to account; but are allowed to continue to create the smoke and mirrors that keep stakeholders - taxpayers now being the key ones - from seeing the real cost of capital, their cost, their capital, of the financial systems bail out.

There is as far as our oversight and monetary authorities are concerned, no double entry bookkeeping in assuming accountability for this crisis. Good times and recoveries, so we are led to believe, are man-made. Bad times and mega crises, are Divine Intervention. Alternatively— especially for the agnostics among us-- bad times are chaos theory in action. But if this crisis is indeed chaos, nature in action, it is first and foremost *human* nature in action. A simple look at the history of financial calamities is telling.

The story of financial crises: A story of *deja vu*

There is a wealth of research and literature available that offers templates of past financial crises, and none of it would suggest that this crisis is particularly unique in its genesis or make up, except, perhaps, its once-a-century magnitude.

In addition we now also have available the analyses and remedial action plans prepared for the most part by the same financial gatekeepers we found asleep at the switch in the run-up to the crisis. Those also basically point to good -old-fashioned - financial-crisis history repeating itself for much of the same reasons. Where there are differences in root causes, they are not differences of principle, but of degree.
Remember, the great seventeenth-century tulip bulb crisis!

Their own analyses reveal the importance of measured, unconventional remedial action as well as serious political will in the clean-up. What is missing is the suggestion that a sprinkling of prescience, level-headed monitoring and oversight savvy, would also help. And that we do not always *have* to wait for a belated arrival of the benefit of hindsight.

In short, these crises commentaries give us straight from the horse's mouth that also this crisis could have been prevented--or at least strongly countered--before it did its destructive work.

In particular, if we are looking for a smoking gun, read the lucid 1994 analyses by the Dutch National Bank about the pitfalls of regulated and/or unregulated derivatives. Astoundingly, the revealing paper --recently rediscovered and republished on NIVRA's website 'Accountant.nl' --has been inexplicably and without explanation ignored by its own authors, our very own Dutch Central Bank, in the years following.

Moving up the ladder to the global diagnostics and remedial action plans proposed by the G8, G20, Basel, BIS, FSF, OECD, IMF, you name it, their observations are equally void of surprise, rocket science or black magic. One finds nothing we did not or could not have thought of earlier.
Except that their reports read as if the concept of systemic risk is a *novum*-- the best invention since sliced bread. Yet systemic risk – and its underlying

symptoms - has been known to man for decades. For ages we have built a pretty mature body of knowledge on the subject of financial fragility/stability. There is nothing new under the sun.

Consequently, they should be read as an unadulterated self-indictment of failed macro and micro financial oversight practices - in particular in ignoring *systemic* risks.
That is exactly why the Financial Stability forum was set up ten years ago.

To top it all, and most importantly, we saw a few individual warnings before 2007 that we were heading for a financial systems train wreck; coming predominantly from a macro-economic, financial system and monetary perspective. All, Paul Volcker not exempted, were benignly ignored. Generally, International Financial Institutional protocols are not very welcoming and do not allow much room for out-of-the-box thinkers, especially if they challenge the peace and quiet of optical success, vested wisdom and perverse self-interest.

Finally, had the macro-good-housekeeping lectures given to collapsing emerging economies in the late nineties been practiced by same developed world country-preachers in the ten years following, the financial world would have been a safer place.

<u>A micro, bottom-up look</u>

Allow me to cite my own alarm, set off at the Annual Jamboree of NIVRA ['Accountantsdag'] in 2004. Exceptionally approaching the problem from a micro, bottom-up, accountant's perspective, focusing in particular on the overabundance of unknowns in the financial systems (in particular systemic risk). I portrayed a financial systems collapse as an accident waiting to happen; spurred by an evident utter state of denial or disinterest for the unknowns among key financial actors at all levels of the financial market food chain. My very own, and many other professions had lost the ability to say "I do not understand". No one was adding up or pulling together the blanks. The concept of 'confluence' was collecting dust in research departments. Everywhere, it seemed, reigned the dictum that 'the show must go on', party-poopers to be shot at the spot or, even more effective, simply ignored into oblivion.

It is hard to make people who are blind and wrong, who are in denial and structurally unaccountable, part of a solution. Any solution.

My main buzz words at the time included "(credit)derivatives", "off balance sheet accounting", "unknowns in the equation", "credit rating agencies", "housing market", "short-termism, "perverse incentive systems","disjointed international financial architecture", "systemic risk", "unaccountable financial gatekeepers", "AIG", "Fannie Mae".

Teaming up with with co-author Dipu Ghosh, I followed up the 2004 speech with the publication in 2005 of a popularized but never very popular 'survival kit for accountants and auditors in a turbo-derivative world', published by NIVRA.

Knowing what we know now, we could more profitably have launched a product line of crystal balls on Craigslist.

An unauthorized protocol for free agent research

But this is not a victory lap. For one thing, any free agent has some fairly unfair advantages over the official 'guard' when it comes to making public his opinion. Retirees like myself do not have their style cramped by the imperatives that go with academic or institutional due process before reaching – and airing – alarming opinions or *any* opinions for that matter. Crying wolf is not good for one's career, particularly if you are still keen to have one. Free agents have a clear edge when it comes to free speech.

Secondly, vanilla economic boom-and-bust cycles are the natural rhythm of economic life, so we can all pretty much bill ourselves at any day of our choosing as prophets simply by predicting a bust on the way. Add to that that I was able to piggyback my micro observations on, notably, Paul Volcker's unnerving, but for my purposes reassuring, macro concerns.

Lastly, and more damming perhaps than all of the above, the research methodology at the base of my prediction could and would not pass academic muster at any self-respecting institution, this very learned house not exempted. My research consisted mainly of a number of inquisitive and spirited lunches and dinners in various parts of the world, *appellation tres bien controllee,* with handpicked financial market connoisseurs at various levels in the financial system food chain.

Worse, I did even not start out my discovery venture with an agenda, a thesis, a hypothesis, never mind a plan.
Just a lot of open-ended but determined curiosity to find out, both by deep drilling as well as helicopter approaches, how things could be broken down, interact. GDP and GDP growth, generally, and for the financial sector specifically? How come we see, predominantly, win/win situations in a context of, macro, zero base sum transactions? Why doesn't it add up?
For me to conclude in the end, by exhaustion, and with the help of some gut inspired jumping to conclusions: It didn't. It did not make sense. And nobody to explain!

Would my particular exercise have been replicable by, say the IMF, Basel, World Bank, Frediksplein, or Nyenrode for that matter?

No doubt a more formal and disciplined methodology and consensus culture that goes with these institutions would have been a help, but not greatly. As well as a handicap, but not lethal. The great advantage would have been better access to non public sources; and possibly water boarding techniques; assuming it worked as a truth serum.

Their greater advantage - brand name authority - would at the same time be their greatest disadvantage. None would like, for understandable reasons, trigger self-fulfilling prophecies, in particular if we talk extremes, such as a financial system Armageddon in the making.

Much of my speculative bottom line, even if confirmed, may well have been word-smithed into sweet-nothingness, before seeing the light of day.

But the indisputable core- “this situation is unsustainable, we are not ‘in control’ ” - would stand. Paving the way for timely and orderly corrective action. Helas.

Again: Those damned postulates

So what is still standing between us and credible financial stability in the future?

First and foremost, we can cite the undigested legacy problems of the past. We all know the fine line our fiscal and monetary policy authorities have to walk in order not to fall into the black hole, remember the one of their own making. They must guard against precipitating an implosion of both the financial system and, in some ways even more difficult and simultaneously, regain the public trust and confidence.

Second, I would argue that it is folly to have the same people who allowed a crisis to happen not only to be charged with managing us out of this self-inflicted crisis; but also readying us for a new financial architecture strong enough to prevent a next one. It will take a whole a new generation, a new language, a fresh start.

Above all we have to rid ourselves of the language of yesterday that lured us into all sorts of false assumptions - postulates if you wish. Postulates designed to protect the old financial gatekeepers from criticism and hence mortgaging a robust recovery.

Which brings us full circle; back to same dammed near postulates that made it hard for me to get through school and stay sane at the same time. *Voila*, the top 5 of excuses, put together with some poetic license, since the advent of the current crisis:

1) " This is an Act of God" or, alternatively, "this is chaos theory in action". Donald Rumsfeld once infamously and less delicately coined same as "Shit happens". Sure it does. But the implication of this, 'predestination in action' is untenable: Financial systems are man made, and I like to keep it that way. And thus they can and should be designed such that it keeps God, Chaos, and Rumsfeld out of the mix.
2) "No one saw this coming". This is no line of defense especially coming from people whose job it is to make sure we see it coming.
3) "No one could have seen this coming". This one is even more telling, especially coming from same people presently charged with designing a financial system with predictive and preventive functionality in a post-crisis world.
4) "This is a once-every-hundred-years event". Statistically probably true but substantially a totally irrelevant postulate; meant only to put the opposition to sleep for the remaining 99 years.
5) "Regulation is always behind emerging practices". This is a convenient, defeatist and hence dangerous half-truth; which begs the question whether that is necessarily so; and/or should be tolerated. Even if we allow that, once we have introduced new rules the gaming of the rules will inevitably start, none of this is an excuse for not even going for the many low hanging fruit: Properly regulating derivatives and introducing proper, results based accountability and systemic assurance statements for macro gatekeepers. It does not require that much of an effort.

If you are still with me, my call is for a resounding 'yes' in favor of the evitable, the predictable, the preventable; assuming at least the political will and professional courage to see it through. The "Predestination" defense only works if we assume financial gatekeepers, and the people they oversee and serve, all to be brain-dead.

As for the present - for most part good but not good enough - proposals circulating to fix the system, the real question to ask goes beyond premature jubilation such as "we are making progress". That is fine, and a good start, but let us ask ourselves "will we get there?". "Will it ensure the system is systemically market-dynamic safe-proof so as to guarantee at a least the orderly functioning of the markets?".

Personally I think they are major progress but I do not think they go far enough. And I would in particular suggest keeping a close eye out for the massive assault, already started, by vested interests to de-claw even the initial proposals; including by governments and the oversight agencies themselves: Intra and inter-agency turf wars are inevitable; and regulatory competitiveness/arbitrage is seen as a national economic asset!

The history of governmental reforms so far can best be pictured as a treadmill direction progress, without ever getting there. It is no doubt to be tested again.

In closing

In closing, I would like to say to the new generation of professionals groomed in this very house that my generation has left your work cut out for you. But if you do find the time and want to spend some time challenging postulates, check out this presumed truism: “Transparency leads to better decision making, and assures more ethical behavior”.

Do me a favor, and do a reality check. It took me many decades to accept defeat, settling for less.
I hate to tell you, but history tells us that transparency leads to *different* behavior, *both for better and for worse*. Which turns our work into a different ball game. More ugly. More challenging.
Don’t worry if embracing that wishy-washy sounding new religion causes you to fail two exams.
Just make sure the third time around you do better than I did: don’t sell your soul, stick to your guns!

I wish you luck. You’ll need it, and more. You’ll need the expertise and the will to keep it up- stay ahead of the curve, healthy skepticism in all you do, and sticking to the courage of your convictions. In return you can be sure of getting the best bonus life has to offer: Never a boring day!

Thank you for your patience,