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THEORETICAL FUNDAMENTALS OF 2008 GLOBAL FINANCIAL CRISIS: INFLUENCE OF FINANCE AND ACCOUNTING APPROACHES ON THE CRISIS♣

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ABSTRACT

In 2008/09 global finance crisis, the problems of excessive borrowing and securitization, and risk management failures in the banking sector occurred. It is once more claimed that bubbles in housing prices and problems stemming from housing derivatives led to the crisis. In addition, the valuation of financial derivates and off-balance sheet transactions reveals the relationship between the crisis and accounting. This study has analyzed the role of accounting practices and the effect of finance managers' applications based on finance theory in the emergence of the global financial crisis. The effects of capital structure in finance theory, risk management, financial derivatives and market efficiency on the crisis are treated under separate headings. The study has shown that finance managers inspired by the financial theories have used excessively leveraged transactions and stretched the rules of risk management. As a result, risks in accounting and auditing practices related to financial derivatives have emerged.

Key Words:*2008/09 Global Finance Crisis, Theory of Finance, Accounting approaches*

Jel Codes: *G01,G32*

ÖZET

2008/09 Küresel finans krizinde bankacılık kesiminde aşırı borçlanma, menkul kıymetleştirme sorunları ve risk yönetimi başarısızlıkları öne çıkmıştır. Yine konut fiyatlarındaki balonların ve konut türevlerinden kaynaklanan sorunların krize neden olduğu iddia edilmektedir. Ayrıca finansal türevlerin değerlemesi ve bilanço dışı işlemler krizin muhasebe ile ilişkisini ortaya koymaktadır. Bu çalışma, küresel finans krizinin oluşmasında finans yöneticilerinin finans teorisinden kaynaklanan uygulamalarını ve muhasebe uygulamalarının etkisini analiz etmektedir. Finans yöneticilerini krize yönelten finans teorileri, sermaye yapısı, risk yönetimi, finansal türevler

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ve piyasa etkinliği alanlarından doğmuştur. Sonuçta finans yöneticilerinin teorilerden esinlenerek, kaldıraçlı işlemleri gereğinden fazla kullanması, risk yönetimi kurallarını esnetmesi, finansal türevlerle ilgili muhasebe ve denetimde uygulamaları riske maruz kullanması sorunları ortaya çıkmıştır.

Anahtar Kelimeler:*2008/09 Küresel Finans Krizi, Finans Teorisi*

Jel Kodu: *G01,G32*

Introduction

One of the questions that need to investigate most concerning the financial crisis of 2008/09 is "*What is the role of finance theory in the crisis*?" The importance of this problem stems from two points. Firstly, could the approaches in finance theories lead to crisis? Secondly, could the theoretical structure formed by the finance theories create an infrastructure for the crisis. It is normal that the managers who have a modern finance education background try to apply the approaches of finance theories. Finance theory is effective in the perception and application of finance through PhD programs, finance journals and financial institutions. (Ardalan, 2004). In a research conducted by Graham-Harvey (1999) in finance literature with data obtained from 329 Chief Financial Officers (CFOs), the reflections of theoretical finance education on practice were investigated. The findings suggests that, in areas such as net present value (NPV) approach and the Capital Assets Pricing Model (CAPM) theory, finance education has a high impact on finance managers' decisions. Moreover, evidences were found concerning the fact that theories such as trade off and pecking order were sometimes effective in the decisions in question. This research indicates that finance theories are effective in directing managers who have financial education. Thus, main topic of this paper is discuss whether finance theory was effective in the emergence of the financial crisis.

This study aims to analyze the effect of finance theory and accounting practices in the emergence of global financial crisis. In addition to, this paper intends to determine the effects of finance managers' applications in context with finance theory of Modigliani-Miller, compensation theory, the efficient market hypothesis, and fair value approach that is a accounting approach, and accounting of risk management instruments on financial crisis. The study firstly handles the causes of financial crisis in general. In the second part of the study, the claims and approaches of finance theories that could lead to the crisis are examined. Then, the problems that could lead to the crisis in accounting approaches are analyzed.

Literature

The theoretical roots of the debate that the capital structures of corporate are important in financial crises, which are one of the mostly discussed issues of global crisis, date back to Modigliani-Miller approach in 1958. M&M theory claims that investment decisions are independent from the financing pattern of investment under the conditions in which the investors have stock arbitrage opportunities in efficient market conditions. That is, the theory claim that the financing of a corporate through debt or equity will not change investment decisions. This claim has important contributions to the formation of modern finance and become one of the main analysis fields of academic finance books (Ross,Westerfield, Jordan, 2003;Vernimmen,2009). It is normal that managers who have an academic formation that has evolved thus behave with motivations such as benefiting from leverage advantage. Data obtained from 329 chief financial officers by Graham and Harvey (2001) verifies this influence even if partially. The most important field of discussion concerning corporate finance after global financial crisis is whether the losses will rise or not in case the capital structure of corporate is based on borrowing. Concerning this, the view that the firm values of enterprises are independent from capital structure as put forward Modigliani-Miller approach faces severe criticism (Kashyap, 2010). The most important issue for businesses in crisis is related to debt structure and congestion in credit market.

Criticism about the rationality of financial investors and effective markets has increased following the global crisis. Ball (2009) criticizes effective market hypothesis as it has limited effect because it does not explain abnormalities and is based upon the view that information is supplied without transaction cost. Moreover, bubbles in the housing market are not well explained phenomena. In other words, the rationality and effectiveness of financial markets is handled as a controversial subject. The debates about efficient market and rationality in the markets have discussed with criticism of behavioral finance (Muradoglu, 2009).

Another important area of debate in terms of finance is about financial derivatives and risk management approaches. Big losses of capital particularly in financial institutions, increase in credit default, and accounting approaches about risk management are among the causes of crisis. Especially the inadequacy of value at risk (VAR) approach in measuring risk is one of the debates brought about by the crisis (Stulz, 2008). The debate upon the risks of financial derivatives that began in the Asia crisis remerged with the 2008/09 crisis. Especially, due to the issues in underlying securities, financial derivatives could directly push financial markets into a systemic crisis. Therefore, the relation between crisis and financial derivatives and

risk management practices in financial theory is constantly questioned (Crotty, 2009).

The other major problem among the criticisms to accounting and audit is the valuation of risk management products. Particularly because financial derivatives are transactions about future, using fair value approach as valuation method makes it difficult the valuation of a product, whose real value will be determined at the end of agreement, during the process of accounting (Laux&Leuz, 2009).

Causes of Global Financial Crisis, Finance Theory and Accounting Problems

As a general cause of crisis which is specific to 2008/09 global financial crisis, abundance in global liquidity and the risks posed by global liquidity as a result of free capital movements can be mentioned. During 2000–2007 when financial abundance was at peak, it could be said that economies were far away from rationality and the appetite for excessive risk led to financial myopia. Among the causes of the crisis, demand for low quality assets, agency problems, mistakes in risk management, withholding of financial information by accounting and auditing firms, mistakes of rating companies, and risks stemming from financial derivatives can be mentioned (Yıldıran&Kısakürek, 2012). As the firms' investment, loan and borrowing decisions are also made by the managers, the managers have the opportunity to direct the market or abuse financial information (Myers&Majluf, 1984). In this case which is called as asymmetrical information in finance theory, they could determine the selections by directing the credit policy as they wish (adverse selection) and they could attribute the problems brought forward by their responsibilities to the public (moral hazard). In the last global crisis, the executives of global banks made credit policy as flexible as possible in order to be able get high prim and then formed an infrastructure for the government to bailout. For example, during the crisis, Susan McFarland who was a financial manager of Fanie Mae's, one of the regulatory agencies of the U.S. housing market before crisis is given 1.7 million premium (bonus). In addition to this, investments in speculative derivative tools, speculative investments with high borrowing are striking as the crisis-leading behavior of managements that held the authority of representation. Moreover, holding of privileged stocks, high premiums from the transactions and high compensation triggered speculative behavior to the crisis (Beecher&Monas, 2009). In a study carried out by Fahlenbrach,& Stulz (2011), factors such as off-balance transactions, the role of auditing firms, problems concerning financial reporting and the manipulation of accounting information stand out. Because of the fact that particularly financial derivatives and structured financial derivatives are kept off balance sheet, the measurement of the risks undertaken by the banks is prevented.

That financial derivatives in banks and structured financial instruments are off-balance sheet eliminates the obligation to hold reserves at the central bank. Therefore, off-balance sheet financial information makes guessing the crisis difficult and decreases the reliability of measurements. Auditing firms have played an important role in the emergence of the crisis. Particularly in the last two decades, leading accounting firms work as an oligopoly in the USA and England. These firms have served in areas such as acquisition and merger, exemption from taxes, reorganization of firms and consulting for privatization. Especially, although Sarbanes-Oxley Law (2002) that were put into effect after the ENRON case and other regulatory rules have banned the auditing firms' assigning both auditing and consulting tasks to the same firm, the fact that firms carried on to provide consultancy and audit to global investment banks was among the important causes of the crisis.

The Relation between Finance Theory and the Crisis

When the emergence of global financial crisis is examined, the problem that we first come across is the bubbles in asset values. The problem is not current and is the basic reason of the questioning of efficient market hypothesis. EMH is one of the milestones of modern finance theory. In fact, this discussion has been prevalent for a long time on account of the criticism put forward by the behavioral finance. Besides, Modigliani-Miller (M-M) theorem that holds the view of the irrelevance between capital structure of firms and firm value is discussed due to the effects of excessive borrowing during the crisis.

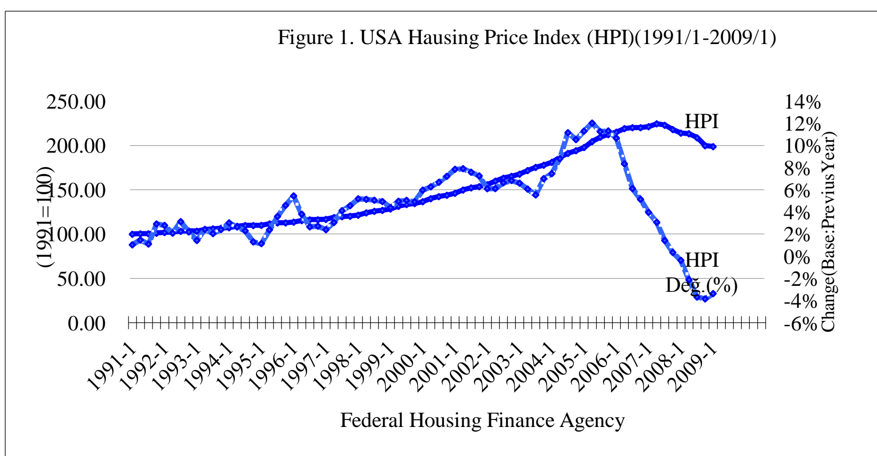
Bubbles in Hosing Prices and Finance Theory

In USA housing market, increase in real housing prices that started towards the end of the 90s continued until the second half of 2006. Price increases that led to the last crisis are the price balloon that continued between the last quarter of 2002 and the last quarter of 2006. In the mentioned period, housing prices increased 31,6 % and it corresponds to an annual increase of 7,1% (Baker, 2008).The basic factor that caused the increase in housing prices is very low interest rates. The expansion of loans to middle-income families as well as the widening of mortgage credits given to middle income families have been effective in the rising of housing prices (Özel, 2008).

When housing prices index (HPI) is examined, it is clear that there was an increase from the first quarter of 1991 to the final quarter of 2006.Though the change of housing prices index quarterly indicated a development which could be regarded as continual in the 1991-2001 period, there was a decline till the end of 2002. The most important peak before the crisis was the continual increase from the final quarter of 2002 to the final quarter of 2006. HPI change from the first quarter of 2007 is negative. This

indicates that the crisis which began at the early 2007 in terms of U.S. housing prices persisted till the first quarter of 2009 **(Figure 1).** The government's policy of incentive has also an important effect on the increase in housing prices and the boom in housing market. Having a house was encouraged by ignoring the increase in risky housing loans (Taylor, 2009). Adverse selection (increased in unsecured credits) and irrational incentive policy that was fundamental causes of the crisis is main indicators of ineffective markets. This situation involves the discussions about how asset prices showed correct value in financial market (Ball, 2009). Moreover, when considering the size of loans to low-income groups, banks have ignored assumptions of information sharing and having full information in markets (Stulz, 2008).

Figure 1. USA Hausing Price Index (HPI)(1991/1-2009/1)



Federal Housing Finance Agency

Capital Structure and Global Financial Crisis

M-M theory claims that capital structure has no relation to investment decisions and firm value in the global financial crisis. Nevertheless, the studies indicate that the firms changed their investment decisions before the crisis and made their investment decisions according to their financing decisions. Based on the questionnaire in which 1050 chief financial managers were involved, it was shown that financial structures were important for the firms' investment decisions. The idea that financial structures don't affect investment decisions could pose a negative impact on the shareholders' prospective property (Campello-Graham-Harvey, 2009). In another study it was found out that the financial positions of the firms were important in crisis and this had an impact on their investment decisions. This fact conflicts with the basic approaches of modern finance theory (Duchin, Ozbas, Sensoy, Berk, 2010). Especially, financial institutions in the USA and England developed strategies so as to increase their profits by carrying out high leveraged financial transactions. Therefore,

it could be alleged that M-M approach which is one of the basic theories of corporate finance has a dimension that could lead to crisis. Moreover, that the interest rates were low encourages borrowing by decreasing the reactions against it (Muradoglu,2009). In this case we can talk about the fact that conditions in the financial markets have a changing impact upon financing decisions.

Debt and equity alternative that constitutes the financial structure of business is a controversial proposition. Especially, provided the financial sources through securitization and financial derivatives are excluded from balance sheet, the firms' leverage ratio will not reflect the truth. Moreover, firm value and credit worthiness will be able to be changed through financial transactions such as credit defult swaps. Therefore, debt or equity selection (trade-off) will not be valid as claimed by modern finance.

Highly leveraged (heavily-indebted) financial transactions are major instrument in the expansion of liquidity and in the emergence of the crisis. Particularly the banks' total liquidity grew constantly through leveraged transactions. Total liquidity in financial markets can be understood as the growth rate of total balance sheet of finance sector (Adrian-Shin, 2010). Besides the increase in their active prices, the banks' balance sheet gets stronger. The banks both caused the bubble of the assets in the market and they indicated their actives as high through the swelling in the prices of actives which they obtained. Thus, by increasing their firm value this way, the banks have caused the investors to perceive them as more reliable. In this case the banks increased the risk by marketing risky and leveraged transactions more easily. Leveraged transactions are not only a problem in countries with banking sector; but they are also an important problem in various countries. Before the crisis, borrowing rates in non-financial sectors and public sector were relatively low. However, in some countries except for the USA, households debts, especially their mortgage debts and finance sector debts were at high levels. Particularly before the crisis, financial intermediaries in the USA and the capital structure of European banks were poor (McKinsey Institute,2010). After 2009, capital losses stemming from high borrowing in the finance sector were nationalized by financing by the governments; and this caused an important part of financial risks to be transferred into the government budget. In Europe, the share of total debts within GDP after the crisis rose constantly between 2009 and 2011. All these results indicate that the capital structure of financial institutions could be effective on firm value.

Risk Management and Global Crisis of Finance

Though risk management is done in order to be protected against risk, it may cause new financial risks because of the issues in underlying contracts. The consequences of risk management failures are clearly come

across particularly in financial crises. In 1997 Asia crisis, malpractices in terms of risk management such as the corporations' policy of debt over foreign exchange and the highness of off-balance sheet transactions in the finance sector in Asian countries are among the causes of crisis (Best,2010). As for 2008/2009 global financial crisis; poor credit policy of global banks, the unsound transaction which the credit derivatives are dependent on and the withholding off-balance sheet transactions and problems arising from risk management are among the causes of crisis. Risk management failures in the latest global crisis and risk management failures in banking via credit derivatives are discussed. Risk management failures can be classified as errors in risk measurement, failures in the choice of means and methods used in risk management, and the risk managers' errors and control errors (Stulz, 2008).

- ***Errors in Risk Measurement;*** mistakes in measurement of return of financial assets and in the risk prediction could make risk management unsuccessful. First of all, The assummption that returns indicates a normal distribution has a limited accuracy. The hypothesis of normal distribution makes risk calculations through possible consequences of averages and standard deviations. Therefore, VaR model is preferred for facilitating the predictability of losses stemming from the credit risk. However, the hypothesis of normal distribution is an approach which is generally not verified. Loss predictions of measurements made through normal distribution hypothesis are relatively lower than the actualized value. The VaR model leads to problems in the calculation of returns based on the normal distribution assumption. Moreover, VaR calculations may leads to errors in the calculation of losses. Though VaR calculations made by taking standard deviations within a certain confidence interval are an affective risk measurement method, it could sometimes lead to considerable errors (Kimball, 2000).

- ***Failures Arising from Risk Managers;*** particularly the ignorance of risks**,** not knowing the risks**,** communication problems in risk management and flexibilities in risk management are the failure cases that stem from the risk managers. The managers in the finance sector behave loosely in defining credit policies due to high compensations, bonuses and premiums. Managers also ignored the inadequacy of accounting system in measuring the risks and they did not care about the problems that could be caused by risk management tools left out of the balance sheet. Also, managers identify risks by acting according to historical data and certain assumptions. This condition cannot measure future hazards. For this reason, most of the risks for the variables in financial markets cannot be known. Risk managers are in the effort of making an optimal decision to maximize the firms' shareholders profits.

Risk management has to provide the board and top management with information for optimal decisions. Top management can perform risk management with a good communication in firm. That risk managements can't be giving information in time or the problem of reliability among the units could lead to a failure in risk management (Stulz, 2009a).

- ***Failures Stemming From Control and Inspection;*** Due to hedging strategies applied in risk management, inspection and control may be ignored. Moreover, it is calculated that there is not risk because credit rating agencies evaluates assets with high credibility with high grades (such as high credit grades AAA). Therefore, monitoring and control mechanisms are not well operated.

In the last crisis, global banks used external control methods such as Asset Backed Securities Index in order to monitor risks in financial derivatives based on housing credits. Though the products in this index were valued with the highest credit scores, they were exposed to big losses due to the sudden problems in the housing market. The enterprises' preference of inspections carried out by rating companies instead of their own inspection and control systems caused them to face big losses in the last crisis (Stulz, 2009a).

Financial Derivatives and Global Finance Crisis

Financial derivatives are tools that rapidly grew in the 2000s. At the end of 2003, transactions as big as 197 trillion dollars rose up to 595 trillion dollars at the end of 2007. Growth in the four year period was threefold. Credit derivatives particularly at the same period rose from 4 trillion dollars to 58 trillion dollars (BIS). An approximately fourteen-fold growth was seen. Due to excessive growth in credit derivatives, the view that derivatives led to the crisis was centralized in the analysis of global crisis. They were named by W. Buffet, one of the most famous investors in the world, as the "*mass weapons of financial destruction*" (Stulz, 2009).

While financial derivatives were used for managing commodity risks such as petrol and foreign exchange risks after 1970s, their field of use increasingly grew. Particularly by fixing prospective price fluctuations in the future, they contribute a lot to banks and enterprises in terms of getting protected from risk. One another point that should be emphasized is the claim that derivative markets do not create new risks and only facilitate risk management. At the basis of this claim lies the fact that when derivative products are used suitably to their purposes, they help to diminish the financial risks of films. Measuring or anticipating risk is not easy. In spite of hard efforts to control risk, long established investors or firms could come across sudden and unexpected big losses (Kayahan, 2009).

The emergence of credit problems indicated that global banks and particularly the investment banks did not have strong financial structures and were knocked down like a paper tower. The banks prefer financial derivatives because of the fact they can be off-balance sheet, have a high potential income, contribute to the increase in liquidity and the risks of credits can be transferred thanks to derivative products with the help of grading firms and there is no obligation of holding a reserve at the central bank for derivative assets (Crotty, 2009).

In the Asian crisis and 2008/2009 global financial crisis, the problems that arise when the risks concerning financial derivatives can be summarized as follows (Yıldıran&Kısakürek,2012):

- ***The Problem of Transparence;*** as financial derivative transactions can be left off-balance sheet, they give an opportunity to risk managers to hide the risks. When this problem arises suddenly in financial crises, the losses increase.

- ***Normlessness;*** as transactions concerning financial derivatives are carried out over the counter markets, the rules in agreements signed by the parties can remain out of the guarantees of the countries' legal system. When we take into consideration the fact that the parties may not fulfill their responsibilities, this case may increase the effects brought forth by the financial crisis.

- ***Contagiousness;*** at the root of financial derivatives, there is not a financial transaction based on a financial security. For example, if contingent asset is stock, a problem in stocks market may lead to a loss in derivative transactions. Therefore, financial derivatives may have an effect that fastens the contagion of crises.

- ***Management and Control Problems;*** financial derivatives may be subjected to loss of value after determining contract. For example, option contracts can be used with different alternatives in accordance withdrawal from the contract and conditions on the market. Especially, in businesses that carry out their transactions with various foreign currencies and in various markets, the monitoring of developments in financial derivatives is high. Moreover, the managers may think that risk does not exist much thanks to credit scoring and insurance methods. The managers may use financial derivatives in order to cover up actual transactions. Because top management and investors increase their profits through dividend and prims in the short run, they may be flexible in fulfilling their control functions.

Problems Stemming From Accounting and Global Financial Crisis

Basic problems such as off-balance sheet applications and not abiding accounting rules can be mentioned among the causes of the crisis.

Concerning the crisis, off-balance sheet transactions, the role of auditing firms, problems regarding financial reporting and the manipulation of accounting information are important. Because particularly financial derivatives and structured financial derivatives are kept off the balance sheet, the measurement of the risks undertaken by the banks is prevented. That financial derivatives and structured financial instruments in banks remain off-the balance sheet eliminate the necessity of holding reserves in the central bank. Therefore, financial information left off the balance sheet makes the prediction of the crisis and the reliability of measurement difficult. Auditing firms played an important role in the emergence of the crisis. Particularly in the last two decades, important accounting firms operate as an oligopoly in the USA and England. These firms have served in areas such as taking over, merging, protection from taxes, reorganization of companies, and consultancy for privatization. Particularly when these firms fulfill their auditing function, they made suggestions which made leaving structured financial products and toxic debts off balance sheet easier (Arnold, 2009). Investments made on speculative derivative tools and the high risk of the investments made by the institutions to the credit derivatives before the crisis is the another facet of the problems concerning securitization. In addition to the views that regard financial derivative products as the basic cause of global financial crisis, there are also other views that financial derivative products are not a factor of the crisis but the transactions they depend on triggered the crisis (Chambers, 2008).The accounting of transactions in complex financial derivatives is difficult in terms of the financial reporting and accounting. Furthermore, in case these transactions are accounted with historical prices, they will not reflect their real values. Therefore, accounting is made on fair values. Any real valuation cannot be made as this situation will not show the real value due to the difference in value between the contraction day and the valuation day. Besides, scenario and statistical calculations rather than a table based on net calculations can be used to predict the results of financial derivatives. Therefore, it is difficult to indicate these in financial reports.

Among the realities that arose in the crisis period, the inability to guess off-balance sheet magnitudes and not knowing the dimensions of contracts which were held as security indicate the problems of financial reporting in terms of banking sector. For instance, while Citibank made provision only 14 million USA dollars as required reserve (provision for underlying securities) in the crisis, it is predicted that its loss that stemmed from securitization due to special purpose financial tools could be 1 trillion dollars (Mangan-Markarian, 2011).The problem of the valuation of financial derivatives and off-balance sheet transactions forces to make new expansions in the issues of measurement and reporting in accounting. There is a lot of discussion particularly about valuation and result transactions.

Instead of balance sheet endnotes and additional financial tables, alternative solutions may need to be discussed.

Conclusion

Besides the fact that 2008/09 global financial crisis lead to considerable losses in terms of financial markets and institutions, it also led to new discussion in terms of finance theory. Modigliani-Miller and Effective market hypothesis, which are the classical theories of modern finance, are discussed from various aspects. The expand using expanding use risk management strategies and the risks posed by the financial derivatives in the crisis are outstanding.

After the global financial crisis, the most important field of discussion in terms of corporate finance is whether the losses will increase or not in case the capital structure of enterprises is based on borrowing. Concerning this, the view put forward by Modigliani-Miller approach that the firm values of enterprises are independent from capital structure faces severe criticism. The distribution of housing credits without assurance and lacking information about people who were given the credits have brought forth new reasons to discuss the effective market hypothesis.

In global financial crisis, in the risk management, the inadequacy of approaches in the measurement of losses and the indication of financial derivatives through off-balance sheet transactions are among the gap financial standards. Moreover, due to the price variability of financial assets and derivatives and the difference of contract maturity, fair value approach emerged as a problem during the crisis.

In conclusion, financial theories and accounting approaches must be discussed because they led to global financial crisis. Concerning this, practical tests are important in that they give permanent results. Finance theories and accounting practices may have an opportunity to develop after the financial crisis.

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