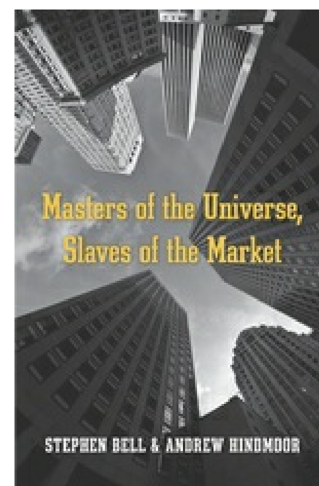
Book Review: Masters of the Universe, Slaves of the Market

03/08/2015

Offering an alternative account of the Global Financial Crisis in 2008, ***Masters of the Universe, Slaves of the Market*** *analyses how bankers and state elites interacted within an institutional framework they themselves created, but which then enslaved and ultimately overwhelmed them. Using tools of political science and behavioural finance theory,* ***Nicholas Thomason*** *finds this to be an excellent addition to the existing literature.*



Masters of the Universe, Slaves of the Market. Stephen Bell and Andrew Hindmoor. Harvard University Press. 2015.

How was it that in 2005-2006 an estimated 64,000 securities were issued an AAA credit rating when only a dozen listed companies were considered equally credit worthy? Why were credit rating agencies allowed to advise on the packaging of securities they were also rating? To what extent did US regulators question the proliferation of lending to those with no income or job? Hindsight is of course always 20-20, and many books have already been written on the Global Financial Crisis. Whether by journalists, economists or bank insiders, these accounts often depict greedy financiers recklessly riding a wave of cheap money whilst passive regulators look on idly.

Stephen Bell and Andrew Hindmoor, Professors of Politics at the Universities of Queensland and Sheffield respectively, offer an account of the Financial Crisis which utilises a refreshingly different approach. By employing tools of political science, particularly institutional theory, as well as behavioural finance theory, the crisis is analysed in terms of how bankers and state elites interacted within an institutional framework they themselves created, but which then enslaved and ultimately overwhelmed them. Across a second dimension, the book also contrasts banking systems in the US and the UK to those of Canada and Australia to show how differing incentives and bankers' beliefs led the former to implode whilst the latter did not.

Lax regulations, complex derivatives and dubious lending practices were certainly part of the story, but the authors argue these were permissive in nature and did not actually drive banks or the behaviour of bankers. Fundamentally, it was instead the impact of liberalisation and 'financialisation' of the market system which spurred a frenzied level of competition and allowed some banks to pursue extraordinary risks in creating new financial products. The ultimate fallout from of all of this is now well-known and continues to reverberate today. But why and how did this environment form? To understand this the authors analyse both the ideas and basic cognitive processes of financiers and the institutional contexts around them.

A key insight the book makes is that participants in the financial system were not simply responding to skewed incentives such as remuneration schemes which rewarded risk taking; they were what the authors call "true believers". Again, with hindsight it seems delusionary, but many bankers believed their trading activity, their levels of leverage and the complex products they were inventing were largely risk-less, even risk-reducing. These views persisted, even in the face of signals to the contrary, because agents in the system – financiers, regulators, politicians, investors – were acting with a bounded rationality (H. Simon, 1957). Information was incomplete and this helped shape a myopic, over optimistic view of the system and the activities which were to prove so devastating. Flaws in the concept of *homo economicus* and the notion of perfect information have seen emerging research fields within behavioural finance and behavioural economics look to address this lack of realism. The rational actor account of agency is dropped in favour of bounded rationality under which agents employ heuristics, suffer from cognitive biases such as "irrational exuberance" (Shiller, 2000) and search for solutions under conditions of uncertainty and constrained optimization. The recent popularity of Kahneman's *Thinking Fast and Slow* (2011) is

perhaps the most widely known distillation of these concepts, and there are clear applications to the behaviour of bankers in the run up to the crash. Most clearly, a large number were not routinely updating their beliefs or assumptions despite warning signals and new evidence. Instead they displayed “confirmation bias”, focusing on information which confirmed prior beliefs and discounting evidence to the contrary.

Image Credit: Rafael Matsunaga. Wikipedia. CC-BY-2.0.

Agents were not operating within a vacuum here. They were instead part of an institutional framework that shaped their actions and critically managed to shape their own preferences. The liberalisation and deregulation of finance in the UK and the US is fundamental to the authors’ argument as to the origins of the crisis. This is due in part because once unshackled from regulation such as Glass-Steigel, competition amongst banks reached a feverish level. In turn, as margins from traditional lending practices shrunk, banks begun to pursue much riskier forms or trading activities, in the process reengineering their balance sheets to attain additional profits in areas such as highly levered MBS trading (debt instruments backed by multiple, sometimes dodgy, mortgage loans). There is an irony simmering away throughout this line of thought. Banks lobbied to be free of what they saw as onerous regulation – they shaped the institutional setting which dictated subsequent rules and norms. But this ‘freedom’ induced a level of competition that saw banks reinvent themselves to be highly risky entities which were then trapped and enslaved within a system with dangerous systemic risk. As the authors phrase it: ‘Only as the crisis was breaking did bankers come to realise what they had created. They ceased being true believers at precisely the moment that it became too late”.

However, the authors make an important caveat: Canadian and Australian banks were able to make significant profits through traditional lending practices and did not face the same levels of competitive pressures. As a result they did not reinvent themselves as trading banks or gear up their balance sheets and thus ultimately avoided the fate of their overseas counterparts. Interestingly, at an intra-country level the authors describe the variation in outcomes between banks as some avoided the herd mentality and irrational exuberance.

Within the UK, banks such as HSBC and Lloyds TSB (prior to their fateful takeover of HBOS) managed to emerge from the crisis much better than their rivals. In the US, Wells Fargo, JP Morgan and Goldman Sachs are shown to have understood the inherent risks and then acted accordingly. The character of certain agents, particularly strong willed CEOs, and the importance of corporate cultures, it is argued, meant some banks interpreted the same context differently and were able, sometimes in the face of intense market pressure, to act with a pragmatic discretion. Thus within the same institutional setting, there did exist variation in agent’s ideas and micro-capabilities.

For those interested in understanding the crisis in general and from an academic standpoint there is much to enjoy in this excellent book. By setting up a rigorously formed picture of how bankers thought, why they did and in which context they acted, the authors are able to offer an account of the crisis which is able to stand out from the plethora of existing literature. As the crisis of 2007-2008 slowly and unevenly recedes from view, it shall be interesting to note how many of these detailed and penetrating insights are truly acted upon and what will be forgotten by the time of the next crisis.

Nicholas Thomason currently works as an Analyst for an Alternative Investment firm. He completed his MSc in Political Science and Political Economy at the London School of Economics in 2011. Prior to this he received a BSc in Economics from the University of Bristol.

- Copyright 2013 LSE Review of Books