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The Global Financial Crisis – Market Misconduct and Regulation from a Behavioral View

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Abstract

This paper explores the problem of the global financial crisis of 2008-9, using a behavioral perspective to examine in some detail the issue of governance failures. These failures are evident in the inadequate oversight/regulation provided by US financial market regulators, as well as the inability of financial market participants to adequately judge and assign risk measures to key financial instruments. In total, five elements of behavioral finance are shown to characterize the crisis. The paper shows how specific adjustments in government policy (dealing with market structural imperfections) and company governance (dealing mainly with risk management) can respond to the key elements of the crisis. It also points out that future financial crises cannot be avoided, so that mitigation is the only remedy to deal with such phenomena.

Key words: financial crisis; behavioral finance; corporate governance; bank regulation; financial markets

Introduction

The global financial crisis of 2008-9 offers an excellent example of a 'black swan' (in the words of Nassim Taleb) – namely a financial event so unusual that it defies common financial analysis in which probabilities show that such enormous financial upheavals are so unlikely as to be ignored in decisionmaking. One way to look at the event is to consider it as a highly unlikely occurrence that is non-repeatable and simply a case of 'bad luck'. This would be unreasonable, since such phenomena in fact have occurred repeatedly through the past several centuries; they just happen on a relatively infrequent basis. Alternatively, the analyst could explore the probability of the event, or look at modeling alternatives to try to capture the unusual distribution characteristics, toward the goal of anticipating or avoiding future events of this type. This alternative may produce interesting models, but it will not enable the financial system to avoid or better deal with future crises.