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Greed and the Desperate Chase for Bonus Checks: The Great Financial Crisis' Primary Culprit

The Great Financial Crisis of 2007-2008 saw the death of hundreds of banks and trillions of dollars in economic damage, and it exposed the faults in Wall Street's fundamental risk strategies. Mortgage-backed securities (MBS) were specific culprits and are financial derivatives created by investment banks that bundle American mortgages and represent an indirect ownership interest. The fees and profits on these products were monumental, generating hundreds of billions of dollars for central investment banks such as Bear Stearns, Lehman Brothers, Merrill Lynch, and others. In light of these profits, many Wall Street firms ignored or failed to see potential risks that could have pointed to a worldwide financial meltdown. Analyzing 2008 reports from the Federal Reserve Bank of New York (FRBNY), SEC Filings, The Financial Crisis Inquiry Commission (FCIC) 2011 Report, and other primary sources makes it possible to pinpoint the crisis to several factors. The crisis in Wall Street's risk management regarding MBS can be attributed to the following factors: inadequate risk factor assessment, misaligned incentives within financial institutions, and regulatory oversight shortcomings, however, incentivization practices were the primary catalyst and alone would've resulted in the crisis.

Traditional risk assessment models on Wall Street often overlooked the complexities of MBS, leading to shortcomings such as a failure to assess dynamic market changes. These quantitative practices encompassed a range of risk assessment methodologies aimed at quantifying and mitigating potential risks inherent in various financial instruments. According to the FRBNY report on The Supervision of Risk Management in Financial Institutions, “these methodologies often relied on quantitative models to assess factors such as credit, market, and liquidity risks” (FRBNY). However, despite the sophistication of these models, they often failed to account for the complexities of MBS adequately. The role of risk management in assessing MBS was incredibly challenging due to the inherent opacity and complexity of these instruments. The FCIC 2011 Report noted that “risk management models struggled to accurately capture the interconnectedness of MBS with other financial assets and the potential for contagion effects during market downturns” (FCIC). The FRBNY oversight of risk management practices was pivotal in shaping industry standards. According to the FRBNY report, their supervision of risk management practices included regular examinations and assessments of financial institutions' risk management frameworks. However, as highlighted in the FCIC report, gaps in regulatory oversight meant that some risk management weaknesses went undetected until it was too late. Therefore, while risk management played a central role in Wall Street's operations, the limitations of existing methodologies and regulatory oversight contributed to the failure to assess the systemic risks posed by MBS to the broader financial system.

The misalignment of incentives within Wall Street firms was the primary perpetrator of the systemic risks associated with MBS, while regulatory oversight and fundamental mispricing of risk were major problems. The compensation structures of many executives incentivized short-term profit maximization over long-term risk management. According to a released congressional testimony from Harvard Business Professor Lucian Bebchuk, “One problem with past practices is that they have provided excessive incentives to focus on the short term.

Executives were rewarded for producing short-term gains even when doing so created an excessive risk of an implosion later on" (Congress). Executives of investment banks were rewarded based on immediate financial performance metrics, and this focus on short-term gains led to disregarding the long-term implications of risky investments, especially MBS. As a result, Wall Street firms were driven to engage in excessive risk-taking behavior, pushing the boundaries of risk tolerance until they broke in order to maximize short-term profitability. The misalignment of incentives, intertwined with the corruption and problems within the credit rating agencies, further worsened this. The FCIC report notes that "credit rating agencies underestimated the risks associated with mortgage-backed securities, leading to mispricing and excessive risk-taking" (FCIC). Credit rating agencies tasked with evaluating the creditworthiness of derivatives like MBS faced inherent conflicts of interest. These agencies were incentivized to provide favorable ratings for MBS to maintain lucrative relationships with Wall Street firms. This phenomenon, known as "rating shopping," distorted market perceptions of MBS risk and propagated the mispricing of these instruments. The issuance of high ratings for MBS, often undeservedly, facilitated their widespread adoption by investors who relied on these ratings as a measure of investment quality.

The regulatory oversight issues, particularly regarding disclosing MBS-related risks, compounded the systemic risks associated with these instruments. According to an internal Securities and Exchange Commission (SEC) review, "SEC regulations lacked clarity on the disclosure of MBS-related risks, … allowing issuers to obscure true investment grades" (EDGAR). Regulatory authorities, such as the SEC, failed to establish clear and comprehensive disclosure requirements for MBS issuers, allowing them to hide critical information from investors. This lack of transparency undermined market trust and hindered investors' ability to accurately assess the risks associated with MBS. The regulatory agencies held firms to minimal accountability, often turning a blind eye because of the positive economic consequences. Their failure to put credit rating agencies on a leash allowed them to operate without oversight and faced few repercussions for issuing inflated ratings. With the entire American investor market duped, investment banks were free to distribute MBS, contributing to the widespread use of risky financial instruments. It is evident that monetary incentives propelled the institutions that rated and packaged mortgages into these risky securities, and therefore, the incentivization practices would have led to the crisis regardless.

The corrupt incentivization processes within Wall Street firms drove excessive risk-taking behavior and a culture of complacency. Executives, driven by short-term profit motives, often disregarded warning signs and dissenting opinions within their firms. This phenomenon is evident in internal communications and memos from the period leading up to the financial crisis. For instance, emails exchanged among senior executives at Goldman Sachs reveal dismissive attitudes towards concerns raised by risk management teams regarding the growing exposure to MBS and related derivatives. This email was sent amidst the worst fiscal quarter of 2008, and an executive analyst wrote, “it doesn’t matter, the markets will correct... We need to buy $1 billion of single names and $2 billion of the stuff below - today. I know that sounds huge, but you can do it - spend bid/offer, pay through the market, whatever to get it done.” (Goldman Sachs). Rather than critically evaluating the risks associated with MBS, executives downplayed or ignored these concerns to maintain the status quo and preserve short-term profitability. They even encouraged traders and analysts to purchase more. Firms lulled traders into a false sense of security, eventually leading to the system's downfall. However, not all the fault can be placed on the traders. Wall Street’s exorbitant bonus culture extended beyond executive compensation structures and became a part of the broader organizational culture within these firms. Any Wall Street investment firm is cutthroat, and incentive systems that reward individual performance over collective risk management efforts create a competitive environment. By way of this, employees prioritized personal gain over the collective welfare of the firm and the broader economy. This competitive culture stifled dialogue and criticism, creating dead zones where opinionated voices were marginalized or, to silence them, fired. As a result, crucial risk factors associated with MBS, such as deteriorating housing market conditions and rising default rates, were often overlooked or downplayed in favor of short-term profit objectives.

The influence of incentivization policies extended beyond internal decision-making processes and shaped external relationships with clients and counterparties. Investment banks, driven by profit motives, prioritized short-term revenue generation over long-term client relationships and their fiduciary responsibilities. Credit rating agencies were also pressured to rate bonds positively and not lose business from firms. In an email from a UBS banker to an S&P Senior Manager in 2006, the banker writes, "[H]eard you guys are revising your residential MBS [mortgage backed security] rating methodology - getting very punitive on silent seconds. [H]eard your ratings could be 5 notches back of [Moody's] equivalent.;[G]onna kill your resi[dential] biz.;[M]ay force us to do moodyfitch only cdos!" (US Senate). This short-sighted approach is evident in communications from when investment banks aggressively marketed MBS products as low-risk, high-yield investments without adequately disclosing the underlying risks. With the proof from credit rating agencies like Moody's, Fitch, and S&P, these securities seemed like credible and safe options for investment, with staggering returns. In reality, with banks threatening to "rating shop" around the block, rating agencies had no choice but to rank everything as investment grade to keep their doors open. Wall Street firms further worsened the widespread risks by prioritizing immediate financial gains over transparency and client trust. With credit-rating agencies themselves being sucked into this vortex of fiscal irresponsibility while trying to compete for profits, it was only evident that the economy would eventually crash.

The death of client trust and transparency in the name of profit only expanded the bubble, as investors relied on flawed information and misleading marketing materials provided by investment banks. The failure to disclose the actual risks of MBS products and the aggressive promotion of these instruments as safe and profitable investments misled investors and distorted market perceptions. An unnamed executive went on the record in the FCIC report, stating that: "…during investor presentations and marketing materials, the bank emphasized the diversification of MBS portfolios, highlighting the seemingly low-risk nature of these investments. They assured investors that the bundled mortgages were carefully selected to minimize default risk and maximize returns" (FCIC). This illustrates precisely how investment banks strategically crafted their messaging to attract investors. By creating the perception of a safe investment through diversification and risk mitigation, they were able to hide the underlying risks, such as the exposure to subprime mortgages and the potential for defaults. As a result, investors were lured into purchasing MBS products under pretenses. Billions and billions of dollars were paid to buy these products, and exponentially more money was made in fess, further blowing up the bubble and the severity of the crisis until it burst. This greed on Wall Street spread far beyond its internal decision-making processes— it shaped external relationships with regulatory authorities and policymakers. Investment banks often sought to influence regulatory policies and shape public sentiment to serve their interests. Lobbying efforts and campaign contributions from the financial industry significantly influenced lawmakers and regulatory agencies, leading to lax oversight and inadequate enforcement of existing regulations. This regulatory capture further intensified the consequences associated with MBS by allowing Wall Street firms to operate with almost total immunity, shielded from accountability and repercussions for their risky behavior.

Ultimately, the crisis was not a result of isolated incidents or a singular oversight but rather a culmination of systemic failures deeply rooted in the incentivization practices widely implemented on Wall Street. While factors like risk factor assessment and regulatory oversight played major roles, the misalignment of incentivization policies significantly worsened the crisis and was the primary cause. The pursuit of short-term profits, driven by compensation structures prioritizing immediate quarterly financial gains over long-term risk management, became widespread on Wall Street. The culture of revenue and profit maximization led to a blatant disregard for the long-term and more significant implications of risky investments, especially considering complex financial products and derivatives such as mortgage-backed securities. Moreover, the corruption and conflicts of interest prevalent in credit rating agencies only fueled the fire because they perpetuated excessive risk-taking and pricing practices. Investors with faith in the system were misled by this flawed and biased information, which, combined with aggressive marketing tactics by investment banks, contributed to the widespread utilization of these instruments. Despite some half-hearted efforts to mitigate risk and enhance oversight, the inherent flaws in incentivization practices ensured that the crisis was inevitable. Executive pay structure led them to pressure their employees for more profits, and they were promised a share in that profit. As a result, the employees pressured credit rating agencies, who had no choice if they wanted to keep making money. These poor “investment-grade” bonds went into the hands of investors, who paid the fees and put more money in the hands of the executives. The cycle repeated by giving banks and their executives more money until the economy couldn't bear it. Greed is to blame for losing trillions of dollars of economic value, millions of jobs, and millions of Americans' retirement portfolios. Regardless of other factors, in every single scenario, greed always prevails, and money rules Wall Street, for better or worse.

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