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REGULATORY LESSONS FROM THE 2008 FINANCIAL CRISIS

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Ten years after the collapse of Lehman Brothers, it is plain as daylight that this was a crisis waiting to happen. The meltdown that shook the foundations of the financial system, and, incidentally, froze Iceland, had sent some signals, but no one seemed to take serious notice.

Several months earlier, the Financial Stability Forum, the forerunner of the Financial Stability Board, in its report on enhancing market and institutional resilience, observed inter alia, that “as the turmoil of 2007 spread, increased risk aversion, reduced liquidity, market uncertainty about the soundness of major financial institutions, questions about the quality of unstructured credit products and uncertainty about the macroeconomic outlook fed on one another.” The forum also took note of the aggressive expansion of the originate-to-distribute model products and the distortions in incentivization. Briefly stated, clever originators, subscribing to the philosophy “Mischief , thou art afoot, take thou what course thou wilt!” peddled complex products to unsuspecting recipients while regulators looked on in ignorance and indolence.

In April 2008, on the sidelines of a dinner, Henry Paulson Jr, then secretary of the treasury, had expressed to Richard S. Fuld Jr, chief executive officer of Lehman Brothers, that he was “anxious about the staggering amount of leverage that investment bankers were using to juice their returns”. The anxiety remained just that.

Flip flops in decision-making also contributed to uncertainty, and, in the process, to fear and distrust in the system. The proposed Fed bailout to Bear Stearns was pulled back and JPMorgan was “cajoled” into taking it over. As for Lehman, it was encouraged to hold parleys with intending acquirers, but when Barclays, with the endorsement of the Bank of England, was on course to transact, the Fed refused to play ball. Conspiracy theorists, not without reason, attributed the Fed’s reluctance to bail out Lehman to the supposedly pathological dislike that Paulson, the former Goldman Sachs head, had for Dick Fuld. They said it was payback time, since Paulson, then with Goldman, had reached out 10 years earlier to Fuld for help in bailing out Long Term Capital Management, and had been rebuffed. We will never be certain that Lehman fell because Paulson persuaded Bank of America to look in Merrill’s direction and avert its gaze from Lehman. And we thought that institutions were more important than individuals.

The plea of helplessness tugs at one’s heartstrings. Speaking to Barrons a few days ago, Paulson said, “We had a balkanized outdated regulatory system without sufficient oversight or visibility into a large part of the modern financial system, and without the necessary emergency powers to inject capital, guarantee liabilities or wind down a non-banking institution. So we did what we could on a case by case basis.” Nearer home, the banking regulator, after a public proclamation regarding the absence of powers to regulate public sector banks, seems to have persuaded a parliamentary committee that such indeed was the case. Meanwhile the non-banks, shadow banks if you will, are having a ball, thanks to much less regulation.

Ten years on, what has changed? Regulators caught napping in 2008, have, with an eye on self-preservation, got into hyperactive mode. The world over, new regulations have been, and are being, written as knee-jerk responses to individual transgressions. Bankers have begun to complain about the increasing intrusiveness of regulators. Every blow aimed at Wall Street, or its equivalent, is being applauded by Main Street. Not to be left behind, lawmakers are enacting legislation that fundamentally redefines roles and responsibilities, limitations and liabilities. It is

now much better recognized that in the dictionary, “grief” comes only a couple of pages after “greed”.

Yet, much remains to be done. Systemically important institutions, often classified as “too big to fail”, must be subject to continuing regulatory glare. Lapses on the corporate governance front must be put down with an iron hand. Regulatory coordination and cooperation must be reinforced and one-upmanship among regulators should not be countenanced. Regulatory gaps must be identified and plugged. Remember that in the late 1990s, many investors in collective investment schemes, as they came to be known later, were persuaded to believe that money grew on trees. It is equally necessary to address perceived regulatory gaps. Remember the disquieting Insurance Regulatory and Development Authority of India—Securities and Exchange Board of India spat on regulating unit-linked insurance plans. If entity regulators and functional regulators do not act in concert, the woman on the street, in whose name they act, will end up paying the price.

Strengthening regulatory organizations is an urgent non-negotiable necessity. Central to a strong regulatory authority is functional autonomy, which subsumes financial autonomy. It goes without saying that such entities, besides being numerically strong to act quickly and effectively, must have skill sets that are relevant to their roles and responsibilities. This is best illustrated by the high priority accorded by a securities market regulator in Europe, post 2008, to recruit a number of PhDs in mathematics to better understand the modelling underlying some of the fancier products floating in the marketplace.

Statutes and regulations must be informed by clarity, certainty and continuity. Vagueness in statutory or regulatory content confuses the average person and gives rise to the possibility of avoidable, expensive and protracted litigation. It is heartening that a project, involving students in law schools, is presently underway to simplify existing regulations and to rid them of verbiage and internal inconsistencies.

Anniversaries bring with them both hope and fear. There is the expectation that, given the severity of the Lehman crisis, lessons would have been learnt and regulatory responses readied to address any systemic shortcomings of a destabilizing nature. At the same time, the prophets of doom are talking of a recession accompanied by institutional instability. In such thought-provoking times, it is useful to recall Arthur Hugh Clough’s comforting line: “If hopes were dupes, fears may be liars.”

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