Lehman *Lessons*

While regulation is important, we need a change in culture to prevent another crisis.

BY ANDREAS DOMBRET

On September 15, 2008, the U.S. investment bank Lehman Brothers collapsed and sent a shock wave throughout the financial system. What followed was a global financial crisis and a worldwide recession. Since then, the fall of Lehman Brothers has become a symbol of all that is wrong with banking, with the financial system and—to some—with capitalism itself.

Two questions emerge from this: "How did it all happen?" and "What can we do about it?" Certainly these two questions are closely interlinked. We have to learn from the past in order to shape the future.

The roots of the financial crisis stretch back a long time, far beyond the day Lehman failed. And to some extent, the financial crisis had the same origins as many earlier crises: high credit growth, fueled by an environment of low interest rates.

There was, however, a specific element to this crisis: financial innovation. In the 1990s, new types of securitization were added to the toolbox of financial engineers. These made it possible to bundle together large portfolios of loans and to sell small tranches of them. In essence, securitization is an instrument to enable the efficient allocation of risks. However, there were two problems that turned this otherwise beneficial instrument into a "financial weapon of mass destruction": distorted incentives and a lack of transparency.

During the 2000s, many financial firms granted large amounts of loans, especially in the subprime segment of the mortgage market. However, they did not intend to hold these loans on their own books for long—the loans were only "ware-

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housed." Instead, the firms securitized the loans and eventually sold them on to other investors.

This originate-to-distribute business model destroyed incentives for prudent behavior. The originators of the loan knew they would swiftly shift the risk further down the line, so why should they bother to take particular care in evaluating the creditworthiness of the borrower?

The crisis began with financial innovation.

This induced a fall in lending standards and led to a flood of cheap mortgage loans to subprime borrowers. The associated risks were spread throughout the whole financial system. And due to a lack of transparency, no one really knew on whose balance sheets the risks eventually ended up.

Then in 2007, housing prices in the United States started to falter and U.S. subprime borrowers started to default on their loans.

Once that happened, a crucial asset in financial markets just vanished: trust. As no one knew the exact extent of banks' exposure to securitized mortgage loans, market participants began to mistrust one another. At the same time, many banks found it difficult to assess their own exposure, and they began to hoard liquidity.

As a result, money market liquidity quickly dried up. Banks were no longer able to tap into the interbank market to secure their funding. And such a squeeze of liquidity can break even a solvent bank's neck. At the same time, prices of financial assets began to fall. This induced banks to sell their assets as fast as possible to limit their losses. Everyone was rushing for the exit. This sent the markets into a downward spiral, reducing the sometimes already-thin capital cushions of banks.

Dick Fuld, then head of Lehman Brothers, knew how essential capital and liquidity were. One of his alleged sayings was: "You always need a lot of cash on hand to ride out the storm." However, the liquidity Lehman Brothers held was not sufficient. And over the course of 2008, the bank got into trouble. But how to deal with a large, international, and interconnected bank that runs into difficulties?

Back in 2008, no one had an answer to that question. During the crisis, the authorities were unsettled by the unprecedented pace of events. Each impact seemed to send policymakers in a different direction. The rescue of the investment bank Bear Stearns in March 2008 was the subject of much criticism. The U.S. government was accused of practicing "socialism for the rich." Against this backdrop, the government took a harder stance toward Lehman Brothers.

However, the moment Lehman filed for insolvency, everyone in the room knew that chaos reigned. First, nobody could reliably assess the interconnections in the financial system—the reason being, again, a lack of transparency. Second, it was unclear what the insolvency of Lehman Brothers in New York would mean for its subsidiaries in London and Frankfurt. There was no international regulation on the resolution of systemically important banks.

Even a brief overview such as this provides some valuable lessons. It highlights the problem of distorted incentives, the lack of transparency, the inadequacy of capital and liquidity buffers, and the lack of mechanisms to deal with the failure of systemically important banks.

The account of the crisis presented here began with financial innovation. However, we should not inhibit such innovation. Just like the real economy, the financial system thrives on innovative ideas. Nevertheless, regulators have to ensure that new financial instruments do not pose systemic risks. That means addressing the problems of distorted incentives and the lack of transparency with regard to securitization.

On both accounts we have made good progress. In many jurisdictions, originators of securitizations have to keep a portion of the risks on their own books. This aligns their incentives with those of investors that buy the securitized products. Furthermore, originators are expected to make transparent the underlying portfolios of assets.

The good news is that banks today are much better capitalized.

These are certainly important steps to address the specific causes of the financial crisis. Even so, we should be aware that no two crises are alike. Thus, we need to enhance the resilience of the financial system. It will then be better able to withstand shocks, no matter from which direction they come. The starting point for this exercise should be the individual bank.

The good news is that banks today are much better capitalized than they were five years ago. This is in line with the new international regulatory standards. Basel III requires banks to hold more and better capital. It thereby raises bank's capacity to absorb losses and makes them more resilient against sudden shocks.

In this regard, it is to be welcomed that Basel III retains the concept of risk-weighted assets. Despite all criticism, risk weights set proper incentives for prudent risk management—and these should not be foregone. Nevertheless, the risk weights assigned to different asset classes need to be reassessed. It is to be doubted whether the zero risk weight for government bonds is adequate. The European sovereign debt crisis clearly suggests otherwise.

But during the crisis, it was not only inadequate capital buffers that posed a problem. Many banks also had inadequate liquidity buffers. In fact, it was liquidity, or rather the lack of it, that dominated the first round of the crisis. And now, five years later, we have, for the first time ever, decided on an international standard on liquidity. This standard may not be perfect, but it can shield banks to a certain extent from a liquidity squeeze in the money market.

Yet individual banks getting into trouble was just the first step toward the brink. What really defined the crisis was its systemic aspect of a large bank failing and pulling others with it into the abyss, also known as the too-big-to-fail problem. If a too-big-to-fail bank runs into difficulties, the government will have to step in to prevent a systemic crisis. This entails an unhealthy asymmetry to the detriment of the taxpayer—heads, banks win, tails, taxpayers lose.

We cannot solve all of our problems through regulation.

Against this backdrop, we have to ensure that even large and interconnected banks can fail without causing a systemic crisis. Toward this end, a new international standard on recovery and resolution of systemically important banks has been developed. This is a major step forward. However, at the end of the day, the willingness to let an institution go bankrupt will be crucial. And that is a political rather than an economic decision.

But in contrast to 2008, such decisions will at least be better informed today as transparency has been increased. Banks' risk disclosure rules have been tightened, and it is now easier to assess the interconnections in the financial system. It is easier to find out who is dancing with whom—and how closely.

We have to move at a faster pace.

To assess all the reforms we have undertaken so far, one question needs to be answered: If a major bank were to fail tomorrow, would we be better prepared for it than we were five years ago? There is no doubt that we have come a long way since September 2008. But we have not yet achieved our objective. What still has to be done? The first priority is certainly to implement the revised regulations, implementing them consistently across sectors and jurisdictions.

But there is more on the agenda. In fields such as the insurance sector, further conceptual work is required. Just one day after Lehman collapsed, the U.S. government had to invest more than $180 billion to bail out the insurer AIG—another institution that was deemed too big to fail. Five years later, the regulation of systemically relevant insurers is far less advanced than it is for banks. A relevant framework is slowly emerging, but some groundwork has been done only recently.

Then there is the shadow banking system: an area of bank-like business that is still outside the perimeter of banking regulation. The shadow banking system is a place where systemic risks can emerge because of unregulated liquidity and maturity transformation, because of the build-up of leverage, and because of pro-cyclicality. Thus, the shadow banking system is high on the G20's agenda and progress has already been made. Nevertheless, there is still further work required, for instance in the areas of repo and securities financing business.

The failure of Lehman has taught us a number of lessons. And five years on, we have translated many of those lessons into new regulatory concepts. We have chosen the right way but we have not yet reached our destination: a stable financial system that serves the real economy. And to achieve that objective in due time, we have to move at a faster pace.

However, one thing should be clear. We cannot solve all of our problems through regulation. Financial stability begins in the hearts and minds of those who work in finance: investment bankers, stock market brokers, hedge fund managers, and everyone who invests other people's money.

What we need is a change of culture. The time of "greed is good" should have long been gone. We should see the financial system as what it is: a service provider for the real economy. Subscribing to this notion of finance will probably be the most important step toward financial stability. ◆