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The New Crisis for the New Century: Some Observations on the Big-Picture Lessons of the Global Financial Crisis of 2008

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THE NEW CRISIS FOR THE NEW CENTURY: SOME OBSERVATIONS ON THE "BIG-PICTURE" LESSONS OF THE GLOBAL FINANCIAL CRISIS OF 2008

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I. INTRODUCTION

The unprecedented scale and complex contagion effects of the current financial crisis, which rapidly spread across geographic borders and market segmentation lines, forcefully underscored the urgent need for policy-makers, financial regulators, and market participants around the world to develop a deeper substantive understanding of the fundamental changes in the dynamics of modern financial markets. Although, in a historical perspective, all financial crises tend to display certain basic commonalities, two key factors make the crisis of 2008 qualitatively different from the panics and crashes of the past centuries.[1] First, this is the world's first truly global financial crisis. Second, this is a crisis rooted fundamentally in the successes of financial innovation and an unprecedented complexity of financial products, which resulted from such innovation. Each of these unique characteristics of the current crisis has major implications from the perspective of regulatory reform in the financial services sector, both on the domestic and the international level. This essay sketches in broad strokes some of these high-level implications.

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1. For an insightful and entertaining discussion and comparison of different financial crises, *see, e.g.*, CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (5th ed. 2005); *see also* Luc Laeven & Fabian Valencia, *Systemic Banking Crises: A New Database* (IMF Working Paper No. WP/08/224, 2008), *available at* http://www.imf.org/external/pubs/ft/wp/2008/wp08224.pdf.

II. THE GLOBAL SCOPE OF THE CURRENT FINANCIAL CRISIS

The first financial crisis of the Twenty-First Century is the first genuinely global one. All of the prior financial crises were generally confined either to the emerging markets[2] or to certain mature economies,[3] with only a limited spillover effect. By contrast, the current crisis, which originated in the U.S. subprime mortgage market, has directly affected every economy, regardless of its geographic location, size, or developmental status. The industrialized countries, including the United States, the European Union, and Japan, have suffered the bulk of the direct losses from the rapid decline in the value of mortgage-backed and other asset-backed securities, excessive leveraging of financial investments, and failure or near-failure of the world's largest financial institutions. China, Russia, Brazil, and other emerging market economies suffered the secondary effects of the stock market decline and credit shock in the industrialized world, as the demand for their exports contracted severely and foreign investors withdrew massive amounts of capital.[4]

At its heart, the current crisis exposed the fundamental tension between the increasingly globalized and interconnected nature of today's financial markets, on the one hand, and an inherently fragmented nationally-based approach to financial sector regulation and supervision, on the other. Although the crisis was clearly systemic in nature and stretched across geographic borders, the efforts to contain it were largely conducted by individual governments struggling to put together effective responses to their countries' particular problems. International and multilateral institutions, such as the International Monetary Fund (IMF) and World Bank, played a rather limited role in containing the crisis.[5] In this context, the

2. Such as the 1997 East Asian crisis or the 2001 financial crisis in Argentina.

3. Such as the U.S. savings and loan crisis of the late 1980s or the Japanese banking crisis of the 1990s.

4. *See, e.g.*, Congressional Research Service, The U.S. Financial Crisis: The Global Dimension with Implications for U.S. Policy (Nov. 10, 2008), *available at* http://assets.opencrs.com/rpts/RL34742_20081110.pdf.

5. This is not to say that multilateral institutions have not played any role in managing the global financial crisis. The IMF provided financing packages for several countries, including Iceland, Hungary, Ukraine, and Pakistan, and established a

critical importance of effective cooperation, information-sharing, and policy coordination among various national financial regulators and central banks became especially clear. At the same time, the crisis has shown how conflicting domestic policy concerns in times of stress pose significant potential threats to inter-governmental cooperation.[6] In the aftermath of the crisis, any efforts to establish a functioning international regulatory order will have to take a serious account of this fundamental tension between the rhetoric of cooperation and the reality of potential conflict among sovereign governments facing complex policy choices.

Coping with potential failure of systemically important, internationally active financial conglomerates has also highlighted a broader trend toward decreasing the level of autonomy national financial regulators are able to exercise in their domestic policy-making. Because of the cross-border operations of the world's largest financial institutions, certain purely domestic actions by one country's government often force the hand of another country's government.[7] Moreover, the sheer size of the asset base of large, internationally active financial conglomerates fundamentally undermines the ability of many countries' central banks to act as a domestic lender of last resort and save these institutions from failure. In the post-crisis environment, it is impossible to hold on to the illusion of complete sovereignty in financial sector regulation and supervision.

specialized short-term lending facility for providing liquidity support to individual countries. For further information, *see* International Monetary Fund, Financial Crisis, http://www.imf.org/external/np/exr/key/finstab.htm (last visited Feb. 8, 2009).

6. Perhaps, the most vivid illustration of this complex dynamics was the infamous conflict between the United Kingdom and Iceland over the U.K. depositors' funds at troubled Icelandic banks. In October 2008, the U.K. used anti-terrorist laws to seize the estimated £4bn ($6.8 billion) in assets of a failed Icelandic bank, Landsbanki, and put the U.K. subsidiaries of another Icelandic bank, Kaupthing, in bankruptcy proceedings, which led to Kaupthing's nationalization. Iceland's government threatened to sue the U.K. for these actions. *See* Sarah O'Connor, *Iceland to sue over "bullying" reaction*, FIN. TIMES, Oct. 13, 2008.

7. One example of such externally induced policy response was the decision of the Belgian government to sell the Belgian operations of Fortis Bank S.A./N.V. to a French bank BNP Paribas after the Dutch government backed out of the existing rescue plan and unexpectedly nationalized Fortis' Dutch operations in October 2008. *See, e.g.*, Press Release, Fortis, Fortis Confirms Sale of Banking and Belgian Insurance activities (Oct. 6, 2008), *available at* http://www.fortis.com/press/info/UK_PR_Fortis_06102008.pdf.

This raises a fundamental issue of whether or not the time has come to establish a truly supra-national regulatory regime in the financial services sector. Structurally, potential choices in this area range from the proposals to set up a single "global financial regulator" to the more modest plans to establish cross-border colleges of supervisors for a coordinated oversight of the operations of large, internationally active financial conglomerates. The leaders of the G-20 countries, meeting in Washington, D.C. in November 2008, expressed their explicit support for the latter solution in the near term.[8] It remains to be seen how effective this new scheme will be in practice and whether or not it will serve as the first step toward a more comprehensive system of global financial regulation and coordination.

III. COMPLEXITY, RISK, AND FINANCIAL INNOVATION

Although the initial trigger for the financial crisis was the bursting of the bubble in the U.S. subprime mortgage market in the summer of 2007, the true causes of the current financial turmoil are more intricate and intimately connected to the very process of financial innovation in the decades preceding it. The unprecedented speed with which the crisis has spread through the global financial system was a direct result of the complexity of innovative financial products, including various derivative instruments, and the high degree of interconnectedness these instruments created among the individual market actors and the entire market segments.

For instance, it was the emergence and expansion of the wholesale markets for sophisticated mortgage-backed instruments, including collateralized debt obligations (CDOs), that created an increasing demand for mortgages and other credit products. Without the ready availability of distribution channels, the origination of loans, including subprime mortgages, would not have reached such disastrous proportions or quality.[9] As this crisis

8. *See* The Group of Twenty, Declaration of the Summit on Financial Markets and the World Economy (Nov. 15, 2008), *available at* www.un.org/ga/president/63/commission/declarationG20.pdf.

9. *See, e.g.,* Jennfier E. Bethel, Allen Ferrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* (Harvard John M. Olin Discussion Paper Series No.612,

demonstrated, the interconnection between retail financial markets and wholesale financial markets is a complex phenomenon, which raises serious questions about the continuing wisdom of a deregulatory approach to wholesale financial markets. Not only did the crisis show that even the wealthiest and the most financially savvy investors are vulnerable to irrational exuberance and, at times, outright fraud,[10] it has also highlighted the extent of indirect exposure of the general investing public, the retail consumers of financial services, to the risks inherent in complex financial transactions in institutional markets. At the very least, this interconnection and interdependence between the wholesale and retail financial markets calls into question traditional justifications for letting the "big boys" play entirely by their own rules.[11]

Another key lesson of this crisis is that, contrary to the prevailing wisdom of the 1980s and 1990s, there is such a thing as too much financial risk, not only at the level of an individual enterprise, such as Lehman Brothers or American International Group (AIG), but also at the systemic level. One indicator of such excessive amount of risk is the inability of either the private market actors or the regulators to monitor or measure, effectively and accurately, the total exposure to risk at the level of a single institution or the entire financial system. Arguably, it is possible that, at a certain level of complexity, interconnectedness, and leveraging in global financial markets, risk simply cannot be "managed" in a reliable way. Despite its deceptive simplicity, introducing this basic assumption into our regulatory philosophy would have profound implications for the substance and architecture of financial sector regulation.

2008).

10. The unveiling of Bernard Madoff's "ponzi scheme" in December 2008 is an example of a successful fraud perpetrated on highly sophisticated and wealthy investors. *See, e.g.*, Complaint, The U.S. Securities and Exchange Commission v. Bernard Madoff, No. 08-CIV-10791 (S.D.N.Y. filed Dec. 11, 2008), *available at* http://www.sec.gov/litigation/complaints/2008/comp-madoff121108.pdf.

11. This was the fundamental premise of The Commodity Futures Modernization Act of 2000 (CFMA), Pub. Law No. 106-554, § 1(a)(5), 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.), which essentially exempted from regulatory and supervisory oversight over-the-counter derivatives transactions among sophisticated counterparties.

More generally, the current financial crisis has brought to light that, as a result of rapid financial innovation in recent years, risk has become a financial asset in its own right. As a financial asset, risk is continuously dissected, priced, and traded in a variety of increasingly esoteric transactions among sophisticated entities. The financial crisis also drew attention to a hidden paradox: while this virtually limitless "slicing and dicing" of financial risk may decrease risk exposure for individual market players, it tends to increase the overall riskiness and vulnerability of the financial system.

This fundamental transformation in the nature of financial intermediation has been going on for the last two or three decades. It took a major crisis, however, to expose the magnitude of the change and the depth of the schism between the financial industry's new business and risk profile, on the one hand, and the existing system of financial sector regulation, on the other. As we deliberate on how to restructure the regulatory framework for the financial services sector, it is critically important to focus the debate on the fundamental issues underlying the current crisis. A new regulatory scheme, whatever its ultimate shape may be, must reflect the transformation in the nature and patterns of distribution of risk in global financial markets and explicitly address the need to control risk in this new, and changing, environment.

From this perspective, the focus on regulating specific financial products or activities, such as credit default swaps or mortgage-backed securities, which were directly implicated in triggering or magnifying the effects of the current crisis, is fundamentally misplaced.[12] The next systemic shock is most likely

12. In the wake of the revelations of the ominous role credit default swaps played in the Lehman Brothers saga and the near-demise of AIG, there were several proposals to introduce regulation of these instruments. The Superintendent of the New York State Insurance Department, Eric R. Dinallo, announced in September 2008 that his Department would start regulating credit default swaps as insurance products, but later suspended his plan, as several private companies began actively setting up clearinghouses for credit default swaps. *See Dinallo Will Not Regulate Default Swaps As Firms Prepare Clearinghouse Operations*, BNA Banking Daily at D7 (Dec. 15, 2008). The Securities and Exchange Commission has also made an attempt to claim regulatory jurisdiction over so-called "naked" credit default swaps that did not fall under the category of insurance products for lack of the "insurable interest." *See, e.g.*, Emily Flitter, *SEC Seeks Authority Over Credit Derivatives*, Am.

to originate in a different pocket of the financial market. As the markets for some financial products are evaporating as a result of investor panic, the brightest and the most ambitious of the Wall Street wizards looking for the "next big thing" are creating new, even more complicated and opaque, financial instruments with high potential to generate profit – and, accordingly, risk. While it is important to remedy the obvious wrongs we are now aware of, an incremental reform through introduction of regulatory regimes for specific types of financial products will always miss the bigger picture. A truly effective regulatory reform involves a lot more than rationalizing the settlement and clearance process for credit derivatives or mandating additional disclosures by mortgage brokers. It requires a paradigmatic change in the way we approach the process of financial innovation and understand, monitor, and measure the overall dynamics of accumulation and distribution of risk in the global financial system, taken as a whole.

IV. THINKING ABOUT THE FUTURE

Changing the regulatory paradigm to accommodate the lessons of the current global financial crisis is a difficult task that would take many years of deliberation and debate among academics, policy-makers and industry experts. While it may be too early to develop a definitive list of post-crisis policy prescriptions, now is the critical moment to reconsider some of the basic assumptions underlying most of the current debate about the future of financial regulation. The legacy of the current crisis requires a creative, self-reflective, and open-minded approach to designing a new regulatory framework for the new century.

In the aftermath of the crisis, the very landscape of the global financial industry has changed dramatically. Perhaps, the biggest structural change is the disappearance of Wall Street's largest independent investment banks, some of which failed (Lehman Brothers) or were acquired by commercial banking organizations (Bear Stearns and Merrill Lynch) and some of which converted into bank holding companies (Goldman Sachs and

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Banker, Sept. 24, 2008.

Morgan Stanley).[13] This multi-faceted process of consolidation and realignment within the financial sector raises a new set of regulatory and supervisory challenges. An industry dominated by a smaller number of much larger global financial conglomerates, which have broader access to retail deposit-based funding, poses significantly higher potential systemic risks. This increased level of system-wide concentration of risk creates a correspondingly greater need for a stronger, and more effective, regulatory oversight of the financial sector.

The key dilemma, in this respect, is how to strike a proper balance between governmental regulation and operation of free market forces in the financial sector. While this dilemma is by no means novel or unique to the current situation, the range of potentially viable solutions may be a lot broader in the post-crisis era than at any point prior to the crisis.

In this regard, one of the most significant consequences of the crisis is a greater, and more direct, role of government actors in the modern financial sector. For example, in an effort to contain the crisis, the governments in the U.S. and Europe not only extended sweeping guarantees of financial institutions' obligations and provided other forms of liquidity support but also injected large amounts of capital into domestic banks and other financial institutions and took significant ownership stakes in them.[14] It remains to be seen whether, and to what extent, the governments are able, and willing, to retain and use their financial stakes in financial institutions as policy levers. It is even more difficult to predict how effective, or socially beneficial, any such efforts would be in the long run.

What is clear, however, is the need to overcome old ideologically driven stereotypes and engage in a serious discussion of all potential avenues for regulatory reform. A transformational

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13. *See, e.g., Changing Face of Wall Street, Goldman, Morgan become Banks*, BNA Banking Daily at D4 (Sept. 23, 2008); Liz Moyer, *Say Goodbye to the Investment Banks*, FORBES.COM, Sept. 22, 2008, http://www.forbes.com/2008/09/22/goldman-morgan-fed-biz-wall-cx_lm_0922bizgoldman.html?partner=whiteglove_google.

14. For instance, the U.K. government has acquired outright ownership of Northern Rock, as well as a 58% stake in Royal Bank of Scotland and 43% stake in the merged HBOS/Lloyds TSB. *See* John O'Doherty, *State to own 43% of merged Lloyds-HBOS*, FIN. TIMES, Jan. 12, 2009.

change in the regulation and supervision of the financial sector in the wake of a global crisis demands a significantly more nuanced and pragmatic approach than the one premised on simple juxtapositions of "free market" and "socialist expropriation." The world of modern finance is complex and sophisticated and requires an equally complex and sophisticated conceptual framework for understanding its workings and managing its risks.