# Ten years from the crash: time to row back on financial regulation and compliance?

The collapse of Lehman Brothers on 15 September 2008 was the most significant single event of the 'Great Financial Crisis' (GFC). In his new book, *Crashed*, Adam Tooze writes that, "After September 15, 2008, avoiding another Lehman became an idee fixe of crisis managers around the world." And since then one of the fastest-growing activities in the US and the UK has been regulation of the financial sector and the associated compliance processes within financial institutions.

One arm of this development has been tighter prudential regulation – requiring banks to hold larger margins of assets over liabilities, so that they can better survive shocks without becoming insolvent. But the arm we consider here has been regulation of banks' conduct – to reduce the detriment caused to borrowers, investors and other stakeholders by misinformation and conflicts of interest.

This has been costly: just one of the UK's new financial regulators, the Financial Conduct Authority, costs over £500 million a year to run; individual banks have taken on many hundreds of compliance officers at the expense of their bottom line; globally, the regulators have forced banks to pay out some £260 billion in fines, penalties and redress between 2012 and 2016 (the UK big four, £70 billion).

Some believe these costs are unwarranted. In the United States, President Trump "drove out" the head of the Consumer Finance Protection Bureau (CFPB), Richard Cordray, and nominated Mick Mulvaney as the new head. Mr Mulvaney's attitude to regulation was well known. He had called the CFPB "a sick joke", and said he wished it didn't exist. This attitude was shared by many in the banking industry in the US, who believed it was time to row back on financial regulation and the associated compliance: a Financial Times headline on 4 Feb. 2017 read: "Wall Street welcomes Trump the deregulator"[i].

Those who led banks at the time of the GFC were mostly replaced soon after. Their replacements are now themselves giving way to a new generation. Memories are fading of the risky degree of latitude in the regulatory regime in place at the time of Lehman's failure. So it may be worth recalling some of the forgotten misconduct in the banking sector leading up to the GFC, and then some of the detrimental consequences of the GFC for western economies.

**Misconduct: reminders**

One area in which 'light touch' regulation and weak compliance contributed to the GFC is the provision of mortgage finance. Misconduct has been identified throughout the 'supply chain' which channeled international savings to US mortgage borrowers.

It all began with praiseworthy objectives: helping previously ineligible families to borrow to buy their own homes. Mortgages were made more affordable and flexible in their early years, with low 'teaser' interest rates and options to miss repayments (adding to the principal); high fees were not paid by the borrower at the outset but added to the principal; and higher interest rates kicked in only later. A new cohort of homebuyers was attracted; and this stimulated a housing boom and rising home prices. So long as prices continued rising, borrowers who could not meet the sharply increased payments after the teaser years could sell their home and pay off the principal. Alternatively they could default, leaving the lender with an asset which could fetch more than they were owed.

While prices continued rising, the lenders flourished: paradoxically, these 'low quality', subprime borrowers, who had previously been excluded from the mortgage market, represented for Washington Mutual (WaMu), one of the leading mortgage suppliers, "our most profitable mortgage loan" (2003 – see page 107 of this report).

The profitability of the new market caused the lenders to offer their mortgage negotiators strong incentives to sign up ever less credit-worthy subprime borrowers: at Federal Reserve hearings in San Francisco in 2006:

"Consumers testified to being sold these [flexible 'option ARM' mortgages] in their primary non-English language, only to be pressured to sign English-only documents with significantly worse terms. Some consumers testified to being unable to make even their initial payments because they had been lied to so completely by their brokers." (Page 109 of the report.)

According to a study as early as 2003, many brokers at WaMu, "felt these loans were 'bad' for customers". Nevertheless, these subprime option ARM originations soared from $65 billion in 2003 to $255 billion in 2006, when they were more than half of all originations (page 108 of the report). In impoverished Detroit, for example, 68 per cent of all mortgages were subprime (Deng, Seymour, Dewar and Manning Thomas, 2017, cited in Tooze, op.cit.).

The good times for lenders continued while the home price boom was sustained. And they needed extra funds to supply this new market.

So another new market was developed, to attract funds by 'securitising' mortgages: mortgages were bundled into large portfolios. Investors were invited to choose among securities representing different tranches of a portfolio. At one extreme were securities which would be first to take any hit from bad loans in the portfolio: they would be graded by the credit ratings agencies as more risky – say BBB, or even 'junk', and be compensated with a high interest rate. At the other extreme were securities which would suffer only if all the loans in the portfolio failed: these would be rated as AAA and carry a lower interest rate.

The banks selling the securities made more profit, the higher the ratings on their securities. The ratings agencies were therefore under huge pressure from these banks to inflate the rating. When asked whether the investment banks threatened to withdraw their business if they didn't get their desired rating, an employee of Moody's, one of the three ratings agencies, replied:

"Oh God, are you kidding? All the time. I mean that's routine. I mean they would threaten you all the time. It's like… Well, next time, we're just going to go with Fitch and S&P [the competitor agencies]."(Page 210 of the report.)

The conflicts of interest were acute. It was the sellers of the securities, the banks, who paid the rating fee, not the buyers who relied upon them. And for Moody's in 2007, half their ratings income came from these mortgage-backed securities. Moreover, the fee for rating one of these bonds was three times that for other comparable work they did – such as rating a corporate bond. (Page 118 of the report.)

Such misalignment of incentives was typical of the whole supply chain of subprime mortgage finance. It is comparable with the historic business models of suppliers of capital equipment such as aero engines or earth-movers. Suppliers used to make much of their profit from replacement parts when their products broke down: their interest lay in equipment failure. Now they are paid instead for the number of hours of efficient operation, and their interests are aligned with the customer's.

The Federal Crisis Inquiry Commission (FCIC) report an example of the lengths to which the credit ratings inflation was taken under the dysfunctional business model. Risky tranches of many mortgage related securities, almost half of them rated BBB or lower, were pooled in one new portfolio. Seemingly by magic, no less than 88 per cent of the tranches of the new portfolio were rated AAA (page 133 of the report). The implicit rationale was again diversification – that only a very small proportion of the underlying mortgages would ever fail.

**Boom to bust**

Many insiders were skeptical of these calculations. In her fascinating account of the process, Gillian Tett tells of a Bear Stearns employee who described such products to investors/clients as an "awesome opportunity"; but wrote in an email to a colleague:

"I'm fearful of these markets…It's either a meltdown or the greatest buying opportunity ever. I'm leaning more towards the former." (GillianTett, *Fool's Gold*, 2009, pp198-9)

And in the FCIC deliberations, Senator Carl Levin pointed out that:

"Goldman was selling securities to people and not telling them that they [Goldman] were taking and intending to maintain a short position against those same securities [i.e. betting that their price would fall]" (page 514 of the report).

The housing market peaked, then fell sharply. Many of the subprime mortgages were 'delinquent', with borrowers unable to keep up their payments when the initial teaser interest rates expired. And the market value of the houses which represented collateral fell below the value of the mortgage loans. 65,000 homes in Detroit alone were foreclosed; of these, 36,400 were just abandoned, so low was their value (Adam Tooze, op. cit., p.450). Correspondingly, the value of the securities backed by the mortgages fell, so that US and foreign banks holding them saw the market value of their total assets shrink, in some cases below the value of their liabilities. In many instances the banks were only saved by a government bailout. But bailout had been denied to Lehman on that fateful day ten years ago, leading to widespread panic in the financial markets, domino insolvencies in the banking sector, and massive costs in the wider economy.

**Where were compliance and the CEO?**

Apart from the obvious specific question whether Lehman should have been rescued, these experiences prompt challenging longer-term general questions, including:

1.Where were the monitoring/compliance staff in this story of conflicts of interest and misinformation at every link in the supply chain for mortgages?

2.Why did those insider executives who thought market prices of mortgage-backed securities unjustifiably high not move out of the mortgage-related business?

On the first question, an example from the FCIC bears on the issue we are pursuing, of whether it is time to row back on compliance. In June 2004 (long before the market turned), New Century's Quality Assurance staff reported "severe underwriting errors, including evidence of predatory lending… and credit issues, in 25% of the loans they had audited…COO [Chief Operating Officer], and later CEO, Brad Morrice recommended that these results be removed from the statistical tools used to tackle loan performance, and in 2005 the department was dissolved and its personnel terminated" (page 157 of the report). So much for the compliance function.

On the second question, the analysis of the GFC by Martin Wolf, the Financial Times' formidable chief economics commentator, includes a famous 2007 quotation from Charles 'Chuck' Prince, former boss of the mighty Citigroup:

"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing."

Wolf's comment goes to the heart of the case for regulation, explaining how laissez-faire failed:

"What is most fascinating about the now notorious remarks by Chuck Prince, the man who led Citigroup into the disaster, is that he understood what might happen and yet he felt he could do nothing to prevent it. Such was the pressure he was under, both from shareholders and the analysts to whom they listened, that he dared not try to prevent one of the world's biggest, most complex and most highly interconnected financial groups from going ever closer to the waterfall he could see ahead. By the time the boat went over the edge, a month later, it was too late. The government ended up having to rescue the boat, while he had to walk the plank, albeit with the consolation of a pay-off reported at $38 million."

**Information asymmetry and market failure**

So knowledgeable insiders repeatedly withheld crucial information from their clients. Asymmetry of information – sellers not sharing information with buyers – crops up at every stage in the mortgage supply chain. And long before the GFC, economists had explained the challenges that information asymmetry poses to the free market (unregulated) model.

Nobel Laureate George Akerlof used the example of the sale of 'lemons' in the used car market to analyse the scope of the detriment arising from sellers withholding information about the quality of the goods they were selling. He concluded that failure to disclose threatened to undermine the whole market, with the costs from cheating of driving legitimate business out of existence often exceeding the amount by which the seller had cheated the buyer.

Baruch Lev applied the argument to financial markets where the problem of assessing the quality of a security is often greater than that of assessing a used car:

"At the extreme, suspecting gross information asymmetries, uninformed investors may quite rationally withdraw from trading…altogether. A massive withdrawal of uninformed investors from the market will…deprive the economy of the allocational and risk-sharing benefits of large and efficient capital markets." (Baruch Lev, *The Accounting Review*, 1988, 63:1, p.7)

When investors in the markets realised they had been misinformed in the period leading up to the GFC, the shrinkage of markets was rapid and massive. Financial markets froze: a witness to the FCIC reported: "The REPO market [for overnight borrowing], I mean, it functioned fine up until one day it just didn't function" (page 136 of the report). And the panic and losses spread to the real economy.

**Bailout, recession and austerity**

In Gillian Tett's words, "What had…started with a set of bad loans in the heartland of America's mortgage market had now spiralled into a truly global financial storm." "Millions of ordinary families, who never even knew that CDOs [sophisticated mortgage-backed securities] existed, far less deal with them, have suffered shattering financial blows." (Gillian Tett, op.cit., p.281)

For the UK it has been estimated that the present value of total lost output as a result of the GFC was somewhere "between one and five times annual GDP". A much more drastic collapse was only avoided by wise though painful government intervention. Apart from guarantee commitments of over a trillion pounds, cash bailout payments by the UK government alone to rescue banks reached 133 billion pounds, 46 billion pounds to rescue just RBS.

These expenditures inevitably inflicted great damage on the government finances. One authoritative study concludes that:

"Declining revenues and higher expenditures, owing to a combination of bailout costs and higher transfer payments and debt service costs, led to a rapid and marked worsening of the fiscal balance."(Reinhart and Rogoff, 2009, P.231, quoted in Wolf) In the UK, the government borrowing requirement rose from around 3 per cent of GDP in 2007 to over 11 per cent in 2009. This was primarily driven by the banking crisis, not, as advocates of a small state have cleverly but misleadingly maintained, the result of profligate government spending in general (Martin Wolf, 2015, op.cit. pp30-31.).

Followed by falls in private investment and – on the argument of some eminent economists – an over-zealous, even perverse, government austerity programme, the GFC heralded years of stagnation – a lost decade. The Maddison Project and the Conference Board report that it took almost eight years for UK real GDP per head to recover to the level of 2007 – an even weaker recovery than was achieved in the Great Depression, when the 1929 level was restored within five years (Martin Wolf, 2015, op. cit.)

Some have argued the consequences go wider. Adam Tooze, in *Crashed*, draws some comparisons between 2008 and 1914 as a turning point in western history. He links the GFC and its aftermath to dramatic political developments including the United States' abdication of its role in globalisation, populism in Europe, and the UK's Brexit.

**Deregulate?**

So, ten years on from Lehman, is it now time to row back on regulation and compliance activities in the financial sector? Has the prospect of another 'Lehman moment' disappeared? In some respects, times are better compared with the immediate aftermath of the crisis. So why not ease up?

Distinguished economists who have studied violent financial crashes sound an alarm.

Martin Wolf reminds us of the repeated cycle of boom and bust in financial markets: in "good times, when people are prone to believing just about anything, the level of fraud rises, but it mostly remains invisible. In bad times, when people want their money back, the fraud is revealed." (Martin Wolf, 2015, op.cit., p.122.)

And he draws on experience of an earlier shattering financial crisis with a quotation from Galbraith's book on the 1929 stock-market crash:

"In good times, people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle [embezzlement] increases rapidly." The case for watchfulness and skepticism, regulation and compliance, is stronger than in bad times: "In depressions all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved." (John Kenneth Galbraith, *The Great Crash of 1929*, (Boston and New York, Mariner, 1997, p.133))

So it is because the good times are precisely when misconduct flourishes that it is then most dangerous to drop your guard in regulation and compliance.

*[i] The background to the CFPB affair is that Mr Cordray had led the CFPB in imposing a $185 million fine on Wells Fargo. Their misconduct? Two million 'phantom' accounts were created in clients' names without the clients knowing. Junior staff had been responding to pressure to meet tough targets for opening fresh accounts. 5,300 junior staff were fired for misconduct. The bank's CEO insisted that the misconduct had never been brought to his attention. The bank's top five executives had received $45 million in performance-related pay since 2012.*

*Notes:*

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