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# LEARNING FROM LEHMAN
# REIMAGINING REGULATION

Ten years after the Great Financial Crisis, more, not less, financial sector reform is urgently needed in India

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LONG STORY

On September 5, 2008, just 10 days before the Lehman bankruptcy shook the financial markets globally, D. Subbarao (left) took charge as the new governor of Reserve Bank of India from his outgoing counterpart Y. V. Reddy (right) at the RBI headquarters in Mumbai ABHIJIT BHATLEKAR/MINT

Until Lehman Brothers filed for bankruptcy on 15 September 2008, home loans going bad in some pockets of the US seemed like a small problem for the world. It was a local issue unlikely to cause a problem even for the US economy. If a bank gave a loan to a household who could not pay it back, it was going to be a problem for the individual household, not even particularly for the bank. It was assumed that the bank would be able to absorb small losses.

Banking regulators did not worry too much even if a bank had a lot of such loans on their books. Governments did not look to see if a large number of banks had a lot of such loans on their books. No one really worried that non-bank financial institutions were also buying up some of these mortgage backed securities.

### CONSUMER PROTECTION

With the bankruptcy of Lehman Brothers and the unfolding of the Global Financial Crisis (GFC), it came to be understood that mis-selling of financial products to consumers can create risks to the entire financial system. By banks giving loans for nearly the entire value of the house being purchased, assuming that when house prices rise, the loan could be repaid, they created a risk. When lots of banks gave lots of such loans, they created a risk for the banking sector. And, when they created derivative products of these loans that were bought and sold to many other financial institutions, both in the US and globally, they created risks for the global financial system.

The entire edifice was based on the assumption that house prices could not fall. Once house prices started falling, home loans started going bad. Foreclosure under the US law, or simply handing over the keys of the mortgaged house to the bank and walking away was the most rational step for borrowers to take. As banks' books started going bad and they sold their sub-prime loans to other parts of the financial system, the problem became widespread.

Among the biggest lessons from the GFC for financial regulation was that consumer protection must lie at the heart of financial sector regulation. Consumer protection goes beyond the concept of consumer complaint and redress. It is about not being allowed to sell loans that the consumer may not be able to pay back. The consumer may not even understand what is being sold to her. It is the job of the adviser to advise the consumer so that she is not sold such a product. It is not enough to get consumers to sign off on small print disclosure statements that they do not read.

A financial product, unlike a cup of coffee, is not something we consume when we pay for it. What we receive by buying a financial product is a promise by a financial firm to pay us sometime in the future. In bank deposits, it is a promise to pay back the principle and the interest in the future. In insurance, it is about the promise to pay under certain states of nature. In pensions, it is a promise to invest your money well and pay you the principle and returns when you retire. Under annuity, it is a promise to pay you regularly in return for your one-time payment, or purchase of the annuity.

Now, what happens if this promise is not fulfilled by the firm? First, there may be sheer fraud. Second, the firm may go bankrupt. Third, the entire financial system may collapse. The job of regulation is to minimize the risk of all of these. Note, it has to minimize the risk, not completely eliminate it. So it has to allow firms to sell financial products, not ban them, and still find ways to protect consumer's interests.

Often only the financial firm understands how the money it has raised from its customers is being invested. It may put it in very risky assets in the hope of getting high returns. Managers who get paid bonuses based on high returns may choose risky assets. The regulators job is to reduce the risk of failure of the firm, of the system as a whole, and of the obligation for the taxpayer to pay for such failure. Given the complexity of finance, the way a financial adviser often gets a commission to sell a financial product, be it a loan or an insurance policy, or a savings product, there is ample scope for mis-selling.

### SYSTEMIC RISK

Post Lehman, it was understood that when mis-selling is done on a large scale, it can lead to the risk of failure of financial institutions and the financial system as a whole. The regulation of institutions, or micro-prudential regulation, which was the old job of regulators, and looked at whether a bank was taking on too many risks and could fail, was not adequate. There had to be a systemic view of the financial system as a whole.

Systemic risk could arise from two sources. If too many banks had the same kind of risks, say the risk of failing if house prices fell, the system as a whole could have a crisis. Even if only some banks failed, but were "too big to fail", so big that they could pull down the financial system as a whole, then there would be a crisis.

Before GFC, the boundaries of financial regulation were more limited. Subsequently, it was understood that a Bear Sterns was "too networked to fail", but since it was not a bank, it was not similarly regulated. AIG, an insurance company and not a bank, had assets and liabilities that no one even knew about because it was not regulated under a resolution framework. So far hedge funds had been left more or less to themselves as their investors were rich and well educated and did not need to be "protected" as the poor did.

But now it was understood that hedge funds had big positions that could impact the financial system as a whole. If the system as a whole could collapse due to the activities of some firms and if taxpayer money had to be used, then these boundaries needed to be expanded beyond the hitherto regulated entities to those who had so far been unregulated. New tools of regulation: macro-prudential tools were created. New powers were given to regulators. They were now to look for where was the risk being concentrated. Bigger financial institutions saw greater scrutiny.

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### MINT SHORT STORY

#### WHAT

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#### HOW

It became clear that when mis-selling is done on a large scale, it can lead to the risk of failure of financial institutions and the financial system as a whole. There had to be a systemic view of the financial system as a whole.

#### WHO

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The post-GFC period saw a major re-haul of the financial sector laws and regulatory architecture. The Dodd-Frank Act in the US, a new regulatory architecture in the UK in the form of "twin-peaks model" towards furthering prudential regulation and conduct regulation of market participants are some examples. South Africa has been the most recent addition to the list of countries that have overhauled their financial sector regulation in the aftermath of the global financial crisis.

By then financial regulators in Britain, Australia and many other countries had already moved away from sectoral models of regulation—such as separate banking regulators, insurance regulators, pensions regulator and so on—to regulators who looked at the different businesses and arms of a financial company that could involve banking, insurance, derivatives etc. These now also started setting up systemic risk regulators, or macro-prudential regulators, and gave them new powers. In some cases these were placed inside central banks such as the Financial Policy Committee in the UK, and in some cases in a council of regulators such as in Australia.

In the US, the Treasury had to put in billions of dollars of taxpayer money to bail out some of the biggest banks which could not be allowed to fail. Small banks were allowed to fail as the FDIC (the Federal Deposit Insurance Corp.) undertook an orderly resolution process. After the crisis more than 30 countries enacted laws for bankruptcy for financial firms and set up resolution corporations.

### LESSONS FOR INDIA

The Indian financial system was much less developed compared to the sophisticated ones that witnessed the crisis. It was at the other end of the spectrum, where instead of worrying about sophisticated derivatives products being traded, most derivative products have restrictions, or are banned, and the bulk of the population has no access to bank loans. The Reserve Bank of India, in some speeches after the crisis, claimed that the world should learn lessons from Indian regulators because we weathered the crisis well and were protected because of our policies.

However, beyond the rhetoric, there were few takers for banning financial products and services in the manner that Indian financial sector regulators had done. While the IMF advocated that only permanent capital controls like those in India and China could protect countries from capital surges and capital flight, countries that did impose controls after the GFC imposed only temporary controls.

One lesson from the crisis was that each regulator looking at risks in her sector was unable to see risks arising across the financial sector as a whole. To address the issue of financial stability the government of India created a non-statutory council of regulators, the Financial Stability and Development Council (FSDC). This body was expected to review the system as a whole.

However, no new macro-prudential tools were created and the body was not given any legal power. For example, it decided that regulation making by financial sector regulators must follow a better and more formal regulation making process that involved board decisions about regulations, the need for them to be clearly outlined, taking feedback from stakeholders, responding to the feedback. This process was outlined in a manual, a handbook for regulation making. But not all regulators changed their ways. The FSDC lacked legal powers.

A number of expert committee reports that looked into the problems being faced by Indian finance recommended changes in regulations and the regulatory architecture. However, these could not be implemented under the present legislative framework. For example, to create a framework for bankruptcy of firms required the Indian Bankruptcy Code to be enacted. Similarly, to enable changes in the way financial regulations are made, the Financial Sector Legislative Reforms Commission (FSLRC), set up by the Government of India, proposed the Indian Financial Code—a blueprint of a comprehensive law to create a reformed financial regulatory framework.

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Though the Indian Financial Code was not tabled in Parliament as a single piece of legislation, many elements of the law were implemented. These included the merger of the commodities regulator (Forwards Market Commission) with the securities market regulator (Sebi), the shift of regulation of non-debt capital flows from RBI to the Ministry of Finance and the setting up of an inflation targeting regime and a Monetary Policy Committee of the RBI.

Two more bills were tabled in Parliament and later withdrawn. The first aimed at developing a deep and liquid bond market in India. It was to enable setting up of a Public Debt Management Agency and unification of debt market with the securities market infrastructure and regulatory framework. The second aimed at created a legal framework for orderly resolution of failing financial firms, where there exists a vacuum in India today. The act was to enable the setting up of a resolution framework for financial firms and a Resolution Corporation. Today, without a framework for bankruptcy and orderly resolution for financial firms, India faces the risk that if a large private sector bank goes bankrupt, there is no legal way of dealing with it other than to force a public sector bank or insurance company like the Life Insurance Company to buy it out. This is a bad solution as it could weaken the firm buying the failing bank.

The Indian solution has been to treat the lesson from the crisis as going even more slowly on financial sector liberalization than it had in the past, rather than to allow financial sector products and services to be sold and to regulate them better. However, to serve the growing needs of the economy for debt, equity, payment systems, and innovations in financial products and services require that regulatory reform is undertaken with much greater speed.

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