10 Years on from Lehman's Collapse

Lessons from the Financial Crisis

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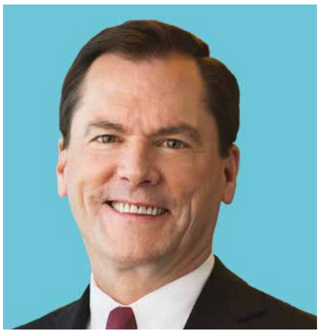
On September 15, 2008, Lehman Brothers Holdings Inc., the fourth largest investment bank in the U.S., which had been in business for 158 years, filed for bankruptcy. Virtually overnight, the rippling effects of a subprime mortgage crisis turned into a full-blown financial panic, with the world's capital markets brought to their knees. Ten years later, the anniversary of the Lehman collapse coincides with the longest U.S. equity bull market ever seen and one of the longest economic expansions in history. Still, for many observers the legacy of the Global Financial Crisis (GFC) that the Lehman bankruptcy touched off, considered the worst since the Great Depression, is still very much with us.

Central bankers are only now beginning to unwind the unprecedented policy measures introduced to stabilize the system but which have also distorted risk premia for the last decade. While banks and households have largely repaired their balance sheets since the GFC, global debt-to-GDP levels are higher than ever as government debt has soared, especially in China. Finally, anti-establishment political forces around the world have exploited widening income disparities since the crisis as proof that the "system is rigged" and are now upending nearly seven decades of political and economic institutions.

Roundtable Discussion

As investors weigh up the factors that could extend or curtail the current cycle, we ask senior leaders at State Street what lessons have been learned from the financial crisis and whether the global financial system is now better equipped to deal with the next set of challenges.

Taking part in our discussion are State Street CEO **Jay Hooley**, President and COO **Ron O'Hanley**, Chief Risk Officer **Andy Kuritzkes** as well as State Street Global Advisors CEO **Cyrus Taraporevala**, Global CIO **Rick Lacaille**, and Deputy Global CIO **Lori Heinel**.



Jay Hooley
State Street CEO

Ron O'Hanley
President and COO

Andy Kuritzkes
Chief Risk Officer

Cyrus Taraporevala
State Street Global Advisors CEO

Rick Lacaille
Global CIO

Lori Heinel
Deputy Global CIO

What are your memories of the day that Lehman failed?

Ron O'Hanley: I was CEO of BNY Mellon Asset Management at the time and the Friday before the announcement we thought some sort of deal would be reached over the weekend to have some kind of orderly takeover of Lehman. I was scheduled to take part in a charity sailing event on that Saturday in Rhode Island. I got the call on the race course from our Chief Risk Officer about Lehman's fate. I couldn't say anything to the crew, of course, but to this day they describe how ashen I looked after that call. I went straight back to New York and spent the next weeks and months working round the clock to deal with the crisis and its aftermath.

Andy Kuritzkes: I was head of Oliver Wyman's public policy practice at the time and had already worked on the endgame with Bear Stearns and was deeply involved with the New York Fed officials on the subprime mortgage crisis. Like Ron, I knew over the weekend that Lehman would not make it. There was an emergency meeting at the New York Fed on Friday night, with Treasury Secretary Hank Paulson flying up from Washington, D.C. I don't think anyone there was surprised that Lehman was not going to exist as a viable financial institution. The unknown was what the death spiral would look like. Up until that Friday evening, many people would have guessed there would be some sort of patch like the one that had been previously agreed for Bear Stearns or Fannie Mae and Freddie Mac. The Lehman failure was a major turning point. Within a one-month period you had 7 of the top 20 U.S. financial institutions being forced into a government takeover or a government-assisted merger or becoming insolvent: Fannie Mae, Freddie Mac, Lehman, Washington Mutual, Wachovia, AIG and Merrill Lynch.

Rick Lacaille: As Andy suggests, we at State Street Global Advisors had already been dealing with the fall-out from the subprime mortgage crisis for more than a year before Lehman went under. That crisis began in the spring of 2007, when a couple of Bear Stearns hedge funds came under pressure. But September 15, 2008, was nonetheless a memorable day for us, not least because at the time State Street shared a building in London's Canary Wharf with Lehman. From our office window, we could see Lehman employees walking out with their crates of belongings as well as hordes of camera crews. It was very dramatic.

Lori Heinel: I was working for Citigroup's private banking business. I remember all activity ground to a halt on that Monday and it was hand-to-hand combat to determine how we as an organization were affected, how our investment strategies might be impacted and communicating that to clients. Citi had its own SIV (structured investment vehicle), so there were questions about how that was going to bleed into the broader bank. We also had several leveraged, hedge-fund-like strategies that effectively went to zero and Citi had to inject capital. In the following weeks, there was also the added drama of leaving work on Friday not knowing if you would have a job to return to by Monday because events were spiraling so quickly out of control as Washington Mutual, AIG and so many other major institutions were affected.

Did you think the system as a whole might fail?

Jay Hooley: It was scary, and there were moments when you had to ask yourself whether the system would hold up. The day Lehman declared bankruptcy, State Street's senior leadership was in London for our board meeting, since every other year, we host the meeting in a non-US location. It was a dramatic and traumatic week. The system seized up very quickly after Lehman and we spent the next weeks figuring out how to continue funding major financial institutions. It was very hectic, especially after the Reserve Primary money market fund "broke the buck" (i.e., the net asset value or NAV of the fund fell below $1) within days of the Lehman failure.

Ron O'Hanley: It was remarkable how rapidly the system locked up. Like State Street, the Bank of New York was an important provider of liquidity to the interbank market. We were on the front line of deciding to which banks we would extend liquidity, and knowing full well that our actions were constraining liquidity further. We quickly arrived at the point at which we were no longer able to roll the commercial paper for a particular institution or provide additional funding in order to limit the bank's own exposure to a host of unknowns.

Money markets also started gumming up almost immediately in a quite unanticipated way. My biggest concern was about potential cascading effects and the belief that a failure of a money market fund would create even more systemic problems and cause a self-reinforcing downward spiral. It was in fact a classic example of behavioral finance: if you believe things are bad, then they become bad; and if you believe they will get worse, they do get worse.

Cyrus Taraporevala: I was head of North American distribution at BNY Mellon Asset Management at the time, and I remember those daily telephone calls to discuss the inflows and redemptions for our money market funds. Every day we would do the math to figure out by 3.30 pm whether we needed to gate the funds! Those were tense moments, and they persisted for many weeks.

What finally restored stability?

Andy Kuritzkes: We came very close to a financial meltdown. The light at the end of the tunnel came with the Troubled Asset Relief Program (TARP) that was signed into law on October 3. The stress tests for the banks had to be coupled with an equity bail-in with the TARP in order to stabilize the system.

Jay Hooley: Confidence was everything. All nine of the major U.S. banks were called to Washington, D.C., to take the capital being issued to them and within hours all 9 banks had signed their preferred issuance. I give Treasury Secretary Paulson, NY Federal Reserve President Tim Geithner and Federal Reserve Chair Ben Bernanke huge credit for putting a floor on the system by capitalizing the banks. It was an explicit statement by the government that it was not going to let these institutions fail.

Ron O'Hanley: I agree with Jay: not enough credit has been given to that triumvirate of officials. They each complemented each other so well. Chairman Bernanke in particular understood better than anyone else that this was about human behavior. It was clear that his number one concern was how to inspire confidence in the system. That is why the TARP was such an important priority. Subsequent reports suggest the $700 billion figure was not precisely calculated; the three just knew the number had to be big enough to restore confidence and it did.

What were the most important lessons you learned both professionally and personally?

Andy Kuritzkes: I often say that success has a hundred fathers while failure is an orphan. But when it comes to the financial crisis, it's the other way around. There are at least 100 different explanations for what went wrong in the crisis; everyone has a pet theory. But if I had to look for one unifying risk management lesson from the crisis, it was the failure of top-down risk governance.

There were certainly many aspects of day-to-day risk management that came up short: risk models that weren't properly calibrated, lessons around liquidity as the oxygen that allows financial institutions to breathe. But the overarching lesson is really how several of the world's biggest and most sophisticated institutions had serious gaps in their ability to aggregate risk exposures across different businesses and products to understand the significance of the risks they were taking. How they failed to link risk to strategy, which was often revenue-led, and incentive structures that were completely upside down in terms of paying for current production without heeding the latent downstream risks.

So when I joined State Street in 2010, I focused on strengthening risk management from the top down, starting with the top-level oversight. We needed to specify what the role of the board was, how it would oversee risk-taking and how we would ensure that the right information was being followed up. Those are key ingredients.

Rick Lacaille: I think there were a number of important lessons we learned within State Street's investment management business. One of the main lessons was that if you have to achieve a return target and can do so only by levering up small incremental returns, you have a big problem. We are much more conscious now of the interaction of leverage, volatility and liquidity.

We also learned the importance of having truly independent control functions. Before the crisis, the risk function was often embedded within a particular investment team and the independence was not what it should have been.

I think we have also learned the importance of cultural guardrails. You have to be very careful of where and how people accumulate power within an organization. We saw examples in the run-up to the crisis where certain individuals became overconfident about their market expertise and because their business line was commercially successful, they brooked no opposition. Overconfidence with economic power, because a particular strategy or product is profitable, can be very dangerous.

Cyrus Taraporevala: The value of liquidity was one of the most important lessons. Liquidity is like water to a fish. You don't know how good it is until you no longer have it. In a crisis there is nothing like dry powder, and one of the abiding lessons is that, when appropriate in extreme market conditions, investors should find the intestinal fortitude to keep cash on hand and ignore the warnings of "performance drag." We should not subscribe to the false notion that "there is no alternative." There is always an alternative, and you don't have to keep dancing for as long as the music is playing. You can leave the party early. The crisis reminded us of first principles: buy only what you understand, don't get greedy and overstretch, and ask the hard questions about what might go wrong.

As a leader, you also learn very quickly how important it is for you to stay calm in a crisis. The reassuring energy you project is key, as is frequent and open communication.

What were the most important lessons you learned both professionally and personally? *(Cont.)*

Ron O'Hanley: Cyrus is right: as a leader you have to be the center of calm, even if you feel your own head is about to explode. But there is an important difference between not showing panic and pretending to have all the answers. You have to be prepared to admit that you don't have perfect understanding. And you have to acknowledge to people that you feel their pain. People did extraordinary work during the crisis, even when it looked like their efforts would result in eliminating their own jobs. Some were remarkably selfless. But many others were in panic mode and quite emotional. Still, as soon as the TARP was passed, we began to have better days. It was like being in a plane that had come dangerously close to the treetops, but in the end we were able to pull up.

Jay Hooley: There were moments during the crisis when you really relied on the brightest people within State Street to understand the issues. That level of leadership and decisiveness when individuals step up in a really difficult set of circumstances is impressive and lasts beyond the crisis moment. The crisis also underscored State Street's wider influence in the world. Obviously we work for our shareholders, but when an event like this happens, you realize the full extent of the stakeholders who rely on us and our impact on the entire global capital markets system.

Ten years on, are there areas of concern about what might cause the next crisis?

Ron O'Hanley: My big takeaway from the crisis was that the global financial system had grown so large and complex that nobody really understood it end to end. That in itself requires a heightened sense of vigilance and oversight in regard to any potential weakness in the system. Overall, I think the U.S. regulators have done a good job of lowering systemic risk, though I do worry that they have inadvertently diverted some of the risk to less transparent parts of the system. Second, no matter how much you think the system is only about data and analytics, there are always human beings behind the decision-making and one needs to understand the behavioral biases that drive those decisions. Third, we need to have a much better understanding of the secondary and tertiary risk exposures in the system, the so-called daisy chain effect.

In terms of what might cause the next crisis, I can't be sure, but I know it won't be what caused the last one. We are better prepared, but we are not perfectly prepared. We need to remain vigilant about risk in all of its potential forms.

I also think we need to think harder about the risks of liquidity transformation. Almost by definition, any kind of instrument you put into a comingled pool involves some kind of liquidity transformation. And we need to acknowledge that the capital that has flowed into fixed income mutual funds and ETFs is a large multiple of what it was before the crisis.

Jay Hooley: I also don't think we fully appreciate from a risk standpoint the trillions of dollars in assets that have been bought up by central banks in their quantitative easing programs and how that will be unwound. The central banks have distorted the fixed income markets in a major way. I agree with Ron that we cannot know precisely how liquidity risk in some segments of the market will play out in a crisis.

I also worry about the potential instability caused by high-speed algorithmic trading. As we become more digitalized, in theory, we have a better ability to manage information, but the pace of digitization and high-speed trading is accelerating. I am not sure we completely understand the overall effect on the system. Obviously cybersecurity is another area where we need greater transparency and collaboration among large financial institutions and the government, and we are part of multiple industry efforts to improve that.

Andy Kuritzkes: Other things being equal, higher capital ratios have made the banking system safer and more resilient. We can argue about the calibration of regulations, but in general that was the necessary direction of travel. Whether that has pushed risk out of the banking system into less regulated sectors is an open question. But I do think it matters where risk is taken. Not all institutions are created equal: you should care more about systemic risk in a bank than in a hedge fund. The amount of equity value wiped out after the tech bubble burst in 2001 was enormous, even compared to the mortgage losses in 2008. But you still did not experience a systemic event, because the losses were all taken by investors in the form of pooled vehicles or mutual funds. In terms of the new risks brewing, I'm more worried about systemic risk outside the U.S. in Europe and elsewhere that could spill over to the U.S.

Ten years on, are there areas of concern about what might cause the next crisis? *(Cont.)*

Lori Heinel: In terms of the resiliency of the banking system, I think we're absolutely in a better place today than we were 10 years ago. The challenge, though, is you don't really know where the new risk might come from. Now that governments are increasing their leverage in places like China, where we have seen aggregate credit growth exceed GDP growth by three times, that is worrying.

For me, though, the real lesson of 2008 is how much of pricing is a confidence game. Part of what happened in 2008 was you had enormous opacity and investors were fearful of everything because valuations became completely unanchored from fundamentals. For example, in the U.S. you had municipal bonds trading above Treasuries although there was no basis for that in the fundamentals. Valuations just broke down because you didn't know who was levered or presented a major risk. The question today is where else could confidence be breached?

The finance industry still suffers from reputational damage a decade after the crisis. How can we repair that and restore trust?

Ron O'Hanley: As an industry we could have done a better job of shared sacrifice. Many believe that the banks and bank management were "bailed out," while millions of others lost their jobs. In retrospect, I think that named officers should have foregone all compensation for a year and been required to work for a dollar. To this day, I believe the public view of financial institutions would be fundamentally different if there had been serious compensation actions taken.

Rick Lacaille: In the asset management business, I think we need to behave in a way that makes it clear we put our clients' long-term interests first, even if that works against our own short-term business interests. That might sound strange on the face of it, but I think it is similar to trust equations in management training: if you want to build trust, do something that acts against your own narrow interests. It is similar to the car industry where you introduce safety features that might initially hurt your bottom line, but will ultimately lead to a better outcome for your clients. So, for example, we aim to build capital-efficient portfolios for our clients using systematic ways of capturing long-term, durable risk premia for lower fees where it makes sense to do so, rather than solely pushing active product for much higher fees.

Lori Heinel: I think Rick's example points to the broader industry tension between short-term and long-term interests, and I think the entire investment management industry needs to orient around the longer term. We need a more customized performance review that answers whether we are actually achieving the goals for our clients. The whole industry needs to get more serious about the entire investment management process: whether it is the upfront education, the array of investment products and advice we provide as well as the kind of customized performance management and reporting we develop. We need to demonstrate to our clients that we are here for them for the long term and dedicated to achieving their long horizon goals, not just pushing the latest hot dot product. I think that's the best way to regain trust and confidence.

About State Street

Our clients are the world's governments, institutions and financial advisers. To help them achieve their financial goals we live our guiding principles each and every day:

Start with rigour
Build from breadth
Invest as stewards
Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world.

Helping millions of people secure their financial futures.

This takes each of our employees in 27 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's third-largest asset manager with nearly US $2.7 trillion* under our care.

*AUM reflects approximately $32.9 billion (as of June 30, 2018), with respect to which State Street Global Advisors Funds Distributors, LLC (SSGA FD) serves as marketing agent; SSGA FD and State Street Global Advisors are affiliated.

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