

The other side of the coin

In spite of the global economic repercussions of the financial market meltdown last year, the next such credit bubble too is unlikely to be mitigated by regulation, says **Govind Sankaranarayanan**



Several financial commentators have suggested that economic upheavals since the fall of Lehman Brothers will hitherto be mitigated by changes in the way regulators view markets. This approach, if accepted unquestioningly, can beguile us into thinking that the financial crisis was either inevitable or was completely unforeseen, implying somehow that things will be different the next time around.

This article, written a year after the fall of Lehman Brothers, examines this issue through an attempt to answer two questions. First, did regulators really not see the crisis coming (particularly the destructive dominance of derivative instruments) and could they have done something about it? Second, and more important, is it likely that they would take action in such bubble-like situations in the future, even with the lessons of the past fresh in their minds? Answering both these questions involves delving into the history of what regulators knew, and examining the politico-psychological reasons for their actions.

One is left to conclude that even in the future, during such asset bubble-type situations, the reactions may really be no different.

The blocking of regulation

Popular perception has it that, over the last 20 years, the financial services industry simply made an end-run around a bunch of naive regulators by inventing dangerous financial instruments, outside the purview of regulation. The reality is quite different.

As early as 1987, various western regulatory agencies were informed by the International Swap and Derivative Association (ISDA), the agency that governs protocols in the interest rate swaps space, that there were \$865 billion worth of derivatives contracts in the world, not governed by any level of regulation.

Staggered by this sum of unmonitored transactions, the Commodities Future Trading Commission (the US agency which monitors derivative contracts in commodities but not those in most other financial instruments) sought to regulate interest rate and currency swaps. Sustained lobbying by the ISDA in the US forced the Commodities Future Trading Commission to back off from their regulatory instincts, for the time at least.

Yet, the doubts about the growing risks of derivatives trading refused to go away. Early in the 1990s, Gerald Corrigan, the head of the New York Federal Reserve, repeatedly expressed surprise in public fora at why so many banks wanted to keep shifting their obligations from one form to another. Later still, in 1994, when companies like P&G and PaineWebber, and the Orange County municipality suffered huge losses through derivative trading that went wrong, there was a very public demand to control the sale of derivative contracts. By the middle of 1994, there were four bills in Congress to regulate derivatives. These bills did not get consummated into law.

The use of clout

The financial services industry is not without clout on Capitol Hill and managed to stall any regulatory change. It did not hurt, of course, that eminences like Robert Rubin, once a trader at Goldman Sachs, occupied senior positions in the administration.

Once more, in 1998, after the collapse of Long Term Capital Management, during which the New York Federal Reserve had to organise a bailout to avoid a systemic crisis, regulators wrung their hands in frustration. Ironically, despite this world-famous financial implosion in a very visible investment firm, government agencies still did not seek specific regulation of these markets. Perversely, when in 1999 the Commodity Future Trading Commission again suggested exerting its authority over the credit derivatives swaps market (a different type of derivative and incidentally the most serious culprit in the recent crisis), a Wall Street friendly Congress unequivocally stated that credit derivative swaps did not need to be controlled by any regulators. An extensive discussion of what regulators really know is detailed in *Fool's Gold*, the fascinating new book by Gillian Tett, the award winning financial markets editor of the *Financial Times*.

Future risk

No one therefore should be under any illusion that either the context or scale of the "Derivatives gone wild" story took place far away from the eyes of regulators. It is unlikely that the smartest regulators in the world could not foresee the risks of having the rug pulled from under the

credit markets, as happened last year. Regulators are generally serious and well-meaning individuals. By temperament, they appear more likely to err on the side of caution. Yet, over the past year, several commentators and experts would have us believe that the next time round, regulators will behave differently. Would they? Should they?

Answering these questions requires an understanding of the economic context in which the US operates. Since 1990 the desire to subsidise cheap housing and the desire to sustain a quality of life, way in excess of what has been justified by productivity or income, has become almost public policy. Total debt as a share of US GDP, which had been at about 120 per cent until 1990, reached 335 per cent by 2006. This credit growth was facilitated by a permissive approach to lending, non-regulation of large parts of the financial system and regulatory arbitrage. There is no shortage of material on the less savoury implications of weak oversight, such as steep drops in asset prices, foreclosures of homes and loss of jobs. In this process, it is easy to forget that a policy of easy loans did also have some sounder economic effects.

Although the US has been criticised for lax oversight, several countries including India have benefitted from the blind eye turned to the high leverage in the financial system. One should recall that the amount disbursed each year towards home loans grew tenfold over the past decade. During this period the market for cars and SUVs has grown between two-three times. Moreover, the rapid growth in the services or manufacturing sector over the past decade may have been far slower but for the cheap credit which allowed foreign companies and individuals to buy Indian exports.

Thanks largely to this era of profligate lending today, even after the downturn, employment and GDP growth in India remains way above its long run trend. Much of this growth is unlikely to have occurred in India if there had not been cheap credit (fuelled by the poorly monitored credit default swap market) which allowed individuals, funds and companies to invest in India.

Capital flows and economic growth

The above thesis that rapid growth in many countries including India was a direct result of slack US policies is not just guesswork. Former RBI Governor YV Reddy states on page 102 of his book, *India and the Global Financial Crisis*, "Non-food credit increased by 28.4 per cent in 2006-07 on top of 31.8 per cent the previous year. It largely reflected the surge in capital flows into the country and this favoured retail lending, housing, real estate and trade — sectors which were hitherto absent in the credit market." Mr Reddy, of course, was the star among central bankers, one of the few whose policies left India largely unscathed by the crisis.



This light touch approach to regulation does not suggest that the more egregious practices of the financial sector be allowed to continue in an unregulated fashion. Indeed there are many steps regulators will take to avoid a recurrence of the latest crisis.

However, the message of the last 20 years is that in the hierarchy of public policy, encouraging access to credit is generally given precedence over regulating practices that limit lending. This is a recognition that the growth of any economy (including the US) depends upon the access to capital for the maximum number of its people, so that the truly entrepreneurial can actually exploit it and create wealth. Countries cannot really grow as fast if credit is only given to those with AAA credit. Nations must often operate in the grey zone of credit quality, where lenders do not know for sure about the credit profile of individuals but will lend to them anyway.

Given this background, it seems unlikely that any regulator would seek to restrict credit expansion, however bubble-like it may be. Clearly, since credit can create a wave that raises many boats, regulators recognised this fact during the boom years this decade and will do so again. That is also why the next credit bubble is, correctly perhaps from a macroeconomic perspective, unlikely to be mitigated by regulation. ●

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