Institutional Investor

# Five Questions: Tom Stanton on Lessons from the Financial Crisis

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It may be too soon to bestow a mantle of historical perspective on causes of the financial crisis, but Thomas Stanton comes close with a new window on missteps, blunders and malfeasance that cause financial debacles.

Slated for publication in July by the Oxford University Press, “Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis” arms institutional investors with a better grasp of factors that govern success or failure in the companies they own. More than a decade before the financial system nearly ground to a halt, Stanton called attention to catastrophe lurking at government-sponsored entities Fannie Mae and Freddie Mac. Using exhaustive interviews conducted by the Financial Crisis Inquiry Commission, where Stanton was a senior investigator, his new book tackles themes from repairing public and private institutions to corporate organization and the supervision and regulation of financial firms. Mainly, he dissects winners and losers in the financial crisis for clear lessons that can help prevent a relapse. *Institutional Investor* contributor Steven Mintz spoke with Stanton, a fellow at the Center for Advanced Governmental Studies at the Johns Hopkins University.

**1. In your book JPMorgan Chase looked like a hero. Not any more. What happened?**

JPMorgan Chase was a success story in 2008. In the lead-up to the crisis, they used effective information flows to detect that something was going wrong in the subprime market. At top levels they argued about it and then reduced their risk before other companies acted. That's how risk management should work. JPMorgan Chase is different now. Jamie Dimon is not the Jamie Dimon of 2006 when the bank began to de-risk. Complacency set in. Apparently risk management stopped functioning properly. It's a familiar pattern. The London office didn't convey an accurate picture of risk to top management, among other problems. That's how big companies stumble.

**2. What does this stumble say generally about large complex institutions?**

What we saw in the financial crisis was how complacent and overconfident CEOs can drive companies off a cliff. JPMorgan Chase also reminds us how distracted management can lose its way, even at otherwise successful firms. The absorption of WaMu was more troublesome than expected. Likewise, meltdowns of internal controls diverted Fannie Mae and Freddie Mac's management before the crisis. Dick Fuld at Lehman sidelined his risk manager when he didn't get answers he wanted. Martin Sullivan at AIG and Charles Prince at Citi lost sight of risk management, to put it charitably. With Citi in trouble, Mr. Prince urged regulators to intervene. Of course if regulators did try to stop them, you'd have heard a fuss about regulators overreaching.

**3. Are you saying that failure is the offspring of success?**

The late economist Hyman Minsky showed how financial stability leads to instability. When things are good long enough — remember the goldilocks economy — complacency sets in. People reduce standards. Banks opt for the most lenient regulators in races to the regulatory bottom. Risk isn't scary any more. Few leaders can resist blandishments when everything goes well. Consumers hear the refrain that housing prices always go up. Firms that thrived saw that something was wrong. Maybe they didn't know exactly what, but alarm found its way to the top. They applied the brakes and came through intact if not unscathed.

**4. Same story for MF Global?**

MF Global furnishes the starkest example of consequences when evidence from the crisis is not absorbed. By all accounts, CEO Jon Corzine simply wasn't taking feedback.

According to news reports, senior managers tried to raise warning flags about bets on sovereign debt. A risk officer was terminated and a successor was told his mandate excluded reviewing the sovereign debt position. More telling, when board members questioned Corzine he reportedly said that if they didn't like the position then the board could find another CEO. That was a perfect invitation to demand more information. But the board missed it.

**5. Is there a solution?**

It's surprisingly basic if not easy to implement. Regulators must regularly ask, "What major decisions did the company make? How were decisions informed by input from the board, from the risk management structure, from an engaged management team, from the regulators?" If the company can't point to improved and robust decision making then that is close to an unsafe and unsound condition. Before decisions lead down dangerous paths, examiners must probe decision-making processes almost to protect CEOs from themselves. Investment managers might ask companies the same questions.