

Jay Light: This Time is Different

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Jay Light says this time is different. In a conference call with alumni December 16, the Dean of the Harvard Business School said the origins and effects of the current crisis are unlike those we've seen before. And it is definitely more dangerous than any of the previous half-dozen market downturns he has endured.

In addition to his role at the business school, Light is a director of the Harvard Management Company, a member of the Investment Committee of several endowments, a director of several private firms, and an advisor/trustee to several corporate and institutional pools of capital.

“Over the last 15 years a new financial system developed,” Light said. Innovations such as credit default swaps (CDS) were great ideas, he said, but combined with factors like the interconnectedness of financial institutions and a lack of accounting transparency they led to rapid, fundamental change that increased systemic risk in the markets.

Recent vulnerability in the markets is due to the “LTL” factors, according to Light: leverage, transparency, and liquidity. Excessive leverage, a lack of transparency and knowledge of who owned certain risks, and liquidity that was less than what it appeared to be combined to create the crisis.

Long Term Capital Management (LTCM), which failed spectacularly in 1998 was an early warning signal, Light said. But this signal was ignored, and parts of the financial system grew even bigger and riskier than LTCM.

Solving the Crisis

Light compared today's markets to a patient in the emergency room, and recommended approaching treatment in three stages: stabilizing the patient, fixing the problem, and helping the patient rehabilitate and recover..

According to Light, the patient is not yet stabilized.



Stabilization is difficult in the current environment because of the lame duck administration, which Light singled out as having worsened the crisis through its lack of political and financial leadership. “Intermittent policy responses have left the impression that we may not know what we are doing,” said Light. “It did not have to get to this point.”

Light is hopeful that better leadership will emerge, and he called for clearer, more consistent policies and a more collegial political process.

Some financial institutions will be “effectively nationalized” as the government provides further guarantees and engages in additional recapitalizations, Light said. These nationalizations will not be explicit, and he hopes they will be temporary.

After the markets are stabilized, policy makers will move on to fix the underlying problems. What will emerge will be something very different from the financial markets of the last decade, Light predicted. “We were too unstable and we did not have a global approach,” he said, adding that the goal should be a “new kind of financial system that is more stable and less prone to shock.”

The Role of the SEC

Historically, the SEC has been largely directed to issues of disclosure, and it has not had the tools required to address many aspects of the current crisis. He called for a “stronger and better financed” SEC with an expanded set of powers.

Over the last five years, Light noted, the SEC has called for greater transparency and a central clearing process for the CDS market, but these requests have stalled on Capitol Hill.

“Whatever the SEC does has to be coordinated with the rest of the securities industry and done on a global basis,” said Light.

The Madoff scandal reveals the lack of global institutions that can administer the type of regulatory oversight to prevent a breach of fiduciary duties. But, as Light noted, the lack of integrity exemplified by the Madoff scandal was not central to the cause of the financial crisis.

The Auto Industry

The automobile industry is “too close to the edge,” Light said. It would “be a folly to not respond in a meaningful way.” The industry desperately needs to restructure, according to Light, and it will be very hard for it to regain profitability.



Stakeholders are now engaged in a game of “chicken” with one another, refusing to make concessions in the hope of major changes, such as additional loans, once Obama takes office, meaning there is little incentive to settle the issues now.

“It will be a lot easier to solve after January 20,” Light said. “But I am not sure it can be settled.”

His Greatest Fear

In a recent interview, HBS professor Michael Porter said his greatest fear is that market participants will lack sufficient patience for proper solutions to be implemented. Light agreed with this sentiment, but went even further, saying that this lack of patience or the lack of a proper policy response “could trigger another significant downturn in the economy.”

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