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If It Ain't Broke, Don't Fix It

*Kathryn Judge**

A prescription is only as good as the diagnosis on which it is based. This is just as true in finance as it is in medicine. And, in Hal Scott's assessment, the reforms adopted in the wake of the 2007-09 financial crisis ("Crisis") are based on a fundamental misunderstanding of the reasons for that crisis. The future is accordingly bleak.

In his thorough and thoughtful new book, *CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS* (2016), Hal Scott argues that the reforms underway are based on the faulty assumption that interconnectedness was the primary problem giving rise to the Crisis. Scott refutes this view by providing the richest account to date of the myriad vectors through which the failure of Lehman Brothers may have contributed to weaknesses at other financial institutions and the knock-on effects that would have been triggered had AIG also been allowed to fail. Having convincingly established that the actual losses arising from Lehman's failure were insufficient to explain the magnitude of the fallout that followed, Scott argues that the panic that ensued must instead be the product of "indiscriminate" runs, which he equates with contagion.¹ The answer for contagion is a robust lender of last resort, ideally coupled with the option of crisis-time guarantees. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") moved the needle in the wrong direction on both fronts, while adopting an array of other reforms that tackle the largely illusory connectedness problem. As a result, we are less prepared to deal with the next crisis than we were to deal with the last one.

The exquisitely detailed, institutionally sensitive treatment of its subjects are what make this book an important contribution to the already sizeable corpus of work on the Crisis. That this type of treatment is required to establish some of the points that Scott seeks to convey, however, also weakens some of his core claims. For example, in collecting information from the bankruptcy proceedings and numerous

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1. HAL S. SCOTT, *CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS* 67 (2014).

other sources that detail Lehman's actual exposures to other financial firms and the hedging undertaken by those firms that reduced their effective exposure to Lehman, Scott does succeed in showing that the actual exposures were generally modest.² By systematically identifying the major markets in which Lehman was active and the financial ramifications of its failure on those markets, Scott also provides insight into the operations of the tri-party repo market, money market mutual funds, and an array of other market structures that were central to the Crisis and yet remain beyond the comprehension of most. The very need to review such a wealth of material, however, also casts doubt on the notion that anyone could have known as much as Scott knows today at the time that Lehman failed. This is all the more true given the failure of the Federal Reserve and other financial policymakers to make a meaningful effort to better understand these dynamics prior to Lehman's failure, despite the warning signs and authority that could have been used to that end.³

More to the point, the runs that occurred throughout the Crisis were not nearly as "indiscriminate" as Scott suggests. They were widespread and included runs on institutions that we know, with the benefit of hindsight, to have been relatively well capitalized. But there was also remarkable and meaningful heterogeneity in the decisions short-term creditors made about what investments to exit and when.⁴ When viewed in light of the distinct incentives of money claimants, as opposed to other types of investors, they may be as readily explained by a lack of meaningful information as by coordination problems or hysteria.⁵ This does not undermine his normative claims, but it leaves unexplored a more nuanced analysis of the relationship between why money claimants fled and how best to stop the bleeding when the next crisis hits. Paying too little heed to information, as known and knowable, in real-time during the Crisis also results in a failure to address other tools that might further the very crisis-management aims that Scott highlights as critical.⁶

2. See *id.* at 19–58.

3. Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 COLUM. L. REV. 843 (2016).

4. See, e.g., Daniel Covitz, Nellie Liang, & Gustavo A. Suarez, *The Evolution of a Financial Crisis: Collapse of the Asset-Backed Commercial Paper Market*, 68 J. FIN. 815, 824 (2013); Gary Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425, 434–36 (2012).

5. See, e.g., Kathryn Judge, *Information Gaps and Shadow Banking*, 103 VA. L. REV. 411, 461–66 (2017); Bengt Holmstrom, *Understanding the Role of Debt in the Financial System* 3 (Bank for Int'l Settlements Monetary and Econ. Dep't, Working Paper No. 479, 2015).

6. See, e.g., MORGAN RICKS, *THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION* (2016); Judge, *supra* note 5; Ronald J. Gilson & Reinier Kraakman, *Market Efficiency After the*

None of these qualms detract from Scott's core insight. The most important lesson in *CONNECTEDNESS AND CONTAGION: PROTECTING THE FINANCIAL SYSTEM FROM PANICS* rests on a platitude that is even more banal than a faulty diagnosis: if it ain't broke, don't fix it. As great as the Great Recession was, it would have been far worse had financial policymakers failed to respond aggressively following the failure of Lehman Brothers. Legislators have stripped financial regulators of the very tools that proved most effective in containing the Crisis and may yet scale them back further. Scott sounds a much-needed alarm bell. We can only hope that he is heard.