

Some Observations About Policy Lessons from the Crisis

The Philadelphia Fed Policy Forum

Policy Lessons from the Economic and Financial Crisis

December 4, 2009

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The views expressed today are my own and not necessarily
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Welcome

Thank you all for joining us today for the Philadelphia Fed Policy Forum. It has been two years since our last gathering in Philadelphia, and a lot has transpired since then. We have experienced one of the deepest and most severe recessions in the post-World War II era, accompanied by a financial crisis that has challenged financial institutions, policymakers, and, most of all, businesses and consumers. During the last two years, the Federal Reserve has taken unprecedented actions in its role as lender of last resort as well as in monetary policy to mitigate the effects of this crisis and support a return to economic growth. The Congress and the Treasury have also taken extraordinary measures in fiscal policy and in their interventions into private markets.

We gather today as signs point to a recovering economy and an improving financial sector. Still, many challenges lie ahead, including making sure that we lower the odds of a future crisis while ensuring that we are better prepared to handle one when it arises. Today's agenda is intended to contribute to a thoughtful, objective discussion of some policy lessons we might draw from this crisis. Do we understand the key elements that gave rise to the crisis? Do we understand how the monetary and fiscal policy actions we took affected outcomes – either positively or negatively? Do we understand how the regulatory environment and our supervisory practices should be changed to help us avoid another crisis?

Before going any further, I want to thank Loretta Mester and other members of the Research Department, in particular, Mike Dotsey and Mitchell Berlin, for making this event possible. Through their efforts, we have assembled an extraordinary collection of speakers. Loretta has done her part while also on loan to the Division of Monetary Affairs at the Board of Governors for the last four months, and we are glad to have her back in time for today's event.

Regulatory Reform under Uncertainty

As the host for today's program, I am going to take the opportunity to share some of my own thoughts on important lessons arising from the crisis. But I begin with a caveat: I believe that it is important to be modest about what we actually know and realistic about what we can actually achieve. The race to reform will not serve the nation well if haste makes for faulty or misguided policies.

I believe that it is too soon to say with any confidence that we fully understand the current crisis. We are still in the learning phase, positing a wide range of hypotheses about the role of market failures as well as regulatory failures, and formulating some rough estimates of the relative weights to place on various contributing factors. I think it will take more forums like this one and more careful and dispassionate analysis before we fully understand what happened and why.

My own view is that in the face of so much uncertainty, we should move more deliberately in designing major regulatory reforms, certainly more deliberately than the current legislative calendar suggests. Making major policy reform based on anecdotes and narratives that have not yet met the test of more rigorous analysis is misguided. Rushing major policy reforms in the immediate aftermath of a crisis risks adopting policies that have unintended consequences.

We also need to be realistic about what we can achieve with regulatory reform. We should not assume that regulators have some crystal ball and thus can see the future with more clarity than market participants. We also should not assume that markets will stand still, nor should we want them to.

Of course, like everyone here, I have my own candidates for lessons learned. They are fairly high-level lessons that I think will be important as we move forward with regulatory reform. As we consider regulatory reform, I think it is important that we look beyond market failures and also consider policy failures. With that in mind, I'd like to spend a few minutes on two lessons that I have taken away from the crisis, neither of which is novel or unique to me. They certainly are not the only two lessons one can take away, and we will hear more about these two and many other lessons as we listen to our experts today.

The first lesson I would like to highlight is that moral hazard and the too-big-to-fail problem loom large and have contributed to the crisis in fundamental ways. If reforms do not adequately address these problems, then reform efforts will be a failure. The second lesson is that regulators are not perfect, and using regulations that excessively stifle the markets will also fail, because private interests will always seek to escape regulation. Thus, for reform to improve financial stability, it must rely heavily on making market discipline more effective and not simply rely on government rules and regulations. So let me talk briefly about each of these lessons and what I have learned from them.

Moral Hazard and Too-Big-To-Fail

For me, a major lesson of this financial crisis is how easy it is for discretionary policy choices to exacerbate moral hazard and the problem of firms deemed too big to fail. In my view, policy actions — before and during this crisis — vastly expanded the safety net for financial institutions.

For example, we had a major moral hazard problem on our hands long before the crisis arose, one that became a major contributing factor to the severity of the crisis. The government-sponsored enterprises, or GSEs — and Fannie Mae and Freddie Mac, in particular — were rife with long-standing moral hazard problems. Despite warnings from many economists and many Federal Reserve officials, these entities were allowed to operate for private profit but with essentially a government debt guarantee. There is no more classic example of moral hazard than this arrangement. Fannie and Freddie had the incentive to take extraordinary risks at taxpayer expense. As we know, these GSEs were placed in conservatorship by the Treasury and they have already received almost \$111 billion in taxpayers' funds. My own guess is that the taxpayer costs of rescuing Fannie and Freddie will easily exceed that of any other financial institution that has received taxpayer support from either the Fed or the Treasury. Yet, neither of the two major proposals in Congress has dealt with the flawed structure of these institutions nor with the failure of government oversight.

Unfortunately, rather than limiting moral hazard and the too-big-to-fail problem, we have made them worse during the crisis. In trying to stabilize the financial system, we have led creditors of large financial institutions to expect that the government will protect them from losses, which in turn means they need not monitor risk-taking by these firms.

Prior to the decision to bail out Bear Stearns' creditors, few market participants would have put a small firm like Bear Stearns on a list that regulators would consider too big to fail. Here's a case where size isn't everything. Complexity, interconnectedness, and the ability to generate spillovers to other financial firms can all raise the stakes when failure looms. During this crisis and through the implementation of the stress tests, we have effectively declared at least 19 financial institutions as too big to fail — many of which would not previously have been considered a systemic threat. The bailouts of GM, Chrysler, Fannie, and Freddie have further reinforced the message that government will provide taxpayer support to large financial and, in some cases, nonfinancial firms.

Not only does the too-big-to-fail badge generate moral hazard at these institutions, it also creates powerful incentives for other institutions to become large and complex and take risks at taxpayers' expense. In my view, this situation is untenable and must be reversed. No firm ought to be too big to fail.

If there is any doubt that the presence or absence of moral hazard can change the behavior of firms, consider the reaction of a number of firms when Lehman was allowed to fail. The failure of Lehman signaled that the government may not choose to rescue all creditors of the largest financial institutions. That realization, in part, led the remaining

major investment banks to make significant changes: Merrill Lynch sold itself to Bank of America, while Goldman Sachs and Morgan Stanley sought bank holding company status, subjecting themselves to higher capital ratios and more supervision. One can't help but wonder what Lehman and other firms might have done differently had Bear Stearns' creditors not been rescued.

I want to emphasize that the policy responses — from the rescue of Bear Stearns, to the failure of Lehman, and to the bailout of AIG — have aggravated the too-big-to fail problem.

In the case of these nonbank financial institutions, we faced added challenges because we were extremely limited in our ability to permit failure in an orderly manner. The lack of an acceptable mechanism to fail these large interconnected financial firms clearly put policymakers between a rock and a hard place — either run the risk of creating potentially large, unknown risks to financial and macroeconomic stability or take the unpalatable step of increasing moral hazard. The Fed chose the latter, but we must now face the consequences of these actions and develop a better regime to rein in the moral hazard created. Doing so requires that policymakers articulate a transparent, consistent, and predictable policy regarding bailouts, and, perhaps a more difficult task, policymakers must commit to follow the policy. Indeed, the regulatory regime must be designed with built-in commitment mechanisms that make it difficult for policymakers not to implement the policy. Failing to develop such a new regime will risk sowing the seeds for the next crisis and ever more frequent, and perhaps costly, taxpayer bailouts.

The Need for a Resolution Mechanism

One essential piece of a new policy that helps rein in moral hazard and manage the too-big-to-fail problem is the development of a mechanism for safely allowing the failure of large and interconnected financial firms.

As I said, no firm should be too big to fail. A resolution mechanism would encourage greater market discipline on the decisions made by systemically important firms. But we need to think carefully about the various options for resolution. If Congress merely expands the safety net by enlarging the list of firms that have access to government resources or increases the opportunities for the government to take over firms, we will have failed to solve the problem. In my mind, a resolution mechanism is a bankruptcy mechanism. That is, shareholders are wiped out, unsecured creditors face losses, and the firm is either liquidated or sold to other private parties rather than becoming a ward of the state.

During the recent financial crisis, shareholders of failed banks have lost their investments, but only some bondholders have suffered any losses. Furthermore, the shareholders of the largest financial institutions on government assistance have been diluted, but they haven't lost their investments. And bondholders and other creditors at these institutions haven't suffered losses at all.

If the resolution authority won't wipe out shareholders and force creditors to bear losses, then it inevitably undermines market discipline and promotes moral hazard. This is hardly a new idea. It is, in fact, the guiding philosophy of FDICIA (the FDIC Improvement Act of 1991).

One option would be to change the bankruptcy law to take into account the special needs of financial institutions, or to create a specialized bankruptcy court to handle financial firms. This might be a more credible way of permitting systemically important financial firms to fail than current proposals to create an expanded resolution authority on the model of the FDIC's existing authority to operate bridge banks. Of course, this type of solution also raises questions. How will bank regulators interact with the court? How will the court maintain its expertise, given that financial crises are infrequent? Who assigns firms to this special court?

We might also more broadly apply the principles of FDICIA's prompt corrective action. FDICIA and prompt corrective action attempt to tie the hands of regulators to limit discretion — and the risk of forbearance — and thus try to ensure that failing banks actually fail or are dismantled. The guiding idea of prompt corrective action is that supervisors are required to take specific actions against a bank as its capital level falls below an adequate level well above insolvency. Prompt corrective action could be enhanced by including other actions to try to limit any systemic fallout from a poorly performing institution. For example, at a stage well before insolvency, regulators could consider requiring the institution to sell off parts of the firm, insulating systemically important parts of the firm, and requiring the firm to adopt a simpler internal structure.

But another lesson of the recent crisis is that the passage from “well-capitalized” to “undercapitalized” can happen in a heartbeat — making the “prompt” in prompt corrective action difficult to achieve. So, regulatory reform must enhance market discipline and regulators' use of market signals to guide interventions.

Market Discipline and Regulation

The financial crisis has certainly underscored the need to reconsider our financial regulatory structure. Some have suggested the lesson of this crisis is that detailed regulatory rules must supplant markets. I disagree. In my view, a major lesson of the recent crisis is that our regulations did too little to promote market discipline and in some cases actually discouraged market discipline. For example, in the case of Fannie and Freddie, their flawed structure and insufficient regulatory oversight actually undermined market discipline.

The case for greater use of market discipline and market signals as regulatory tools is a powerful one. Financial markets are dynamic, forward looking, and innovative, and despite the events of the past two years, they remain one of the great strengths of our economy. But the dynamism of our financial markets also places a serious constraint on feasible regulatory reforms. Markets will inevitably seek to evade excessively costly or

poorly drawn regulations by innovating around them. (As Nobel Laureate Merton Miller said, taxes and regulation are two of the three primary sources of financial innovation.) Even with the best of intentions, regulators will be behind the curve, especially when market participants are looking for ways to evade regulations. If regulators don't harness market forces in an intelligent way, regulatory reform will surely fail.

One example of using market forces to strengthen financial regulation is the use of mandatory convertible debt, variations of which have been proposed by a number of academics, including Doug Diamond, who is here today. The common element in their proposals is that large financial firms would be required to maintain an additional layer of debt that would convert into equity in periods of stress. This provides a type of prepackaged recapitalization.

Contingent capital would be a lower cost alternative to simply requiring institutions to hold more capital; thus it would reduce incentives for financial firms to seek ways to evade the regulatory requirement. In addition, the market price of the debt would provide regulators with information about the financial health of the firm and about market perceptions of systemic risk. The various proposals differ in what would trigger conversion. But, in general, the threat of conversion would mobilize creditor discipline, and actual conversion of the debt would lead to greater regulatory scrutiny of the firm. In this way, market discipline and regulatory discipline would complement each other, and information generated by market participants would play a central role in strengthening the application of prompt corrective action.

Conclusion

These are a few of the lessons I have taken away from the financial crisis. There are others here today with different perspectives, and I look forward to hearing the views of our distinguished panelists and all of you as well.

We are slowly emerging from the crisis, yet we are emerging to uncertain times. The rush to reform is palpable. Yet, we must take time to share perspectives, so that we gain enough understanding to make meaningful reform. That is the only way we can adopt policy remedies and future policy actions that will address the right issues.

Thoughtful action that results in a sounder financial system will be the test of whether we have truly learned the lessons of this crisis.

I look forward to your help in shaping that understanding. Again, welcome to the Policy Forum.