Exit Policies from the Financial Crisis—To What?

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Prepared for meeting of
Shadow Open Market Committee
Cato Institute, Washington, DC
30 September 2009

In due time, the economy will be growing again and the unemployment rate will be down to a normal level, perhaps to the neighborhood of 5 percent. Depending on the Federal Reserve's success in unwinding the extraordinary increase in its balance sheet, the rate of inflation will be near the Fed's target of about 2 percent, or possibly considerably higher.

Whatever may be the employment and inflation environment, the financial structure will be quite different from its pre-crisis characteristics. The major New York investment banks are gone, through either failure, merger, or conversion to bank charters. The commercial banking system is much more concentrated than before. Large banks have grown larger through mergers and many smaller banks have failed. Fannie Mae and Freddie Mac are now officially government enterprises, rather than merely government-sponsored enterprises.

The subprime mortgage market is gone, and will probably not revive any time soon. The prime mortgage market is almost completely federalized. Not only are most new mortgages assisted or securitized through federal agencies but also the Federal Reserve is the major buyer of mortgage-backed securities. By bidding the spread between MBSs and Treasury bonds to below normal levels, the Fed has displaced much of the normal private demand for MBSs. I anticipate that the Fed will indeed exit from supporting the mortgage market directly, but a private-label MBS market will be slow to revive. Given the Fed's role in supporting the mortgage market, there will no doubt be political pressures on the Fed to resume support whenever this market is perceived to have problems.

Most importantly, and the main topic I will discuss, federal policy during the crisis has created a much more serious problem of moral hazard. Too big to fail—TBTF—is a major problem. After the disruptive effects of the Lehman failure, it will take a brave Treasury secretary to let another large financial institution fail. If we assume that no creditor of any of these large firms will ever be at risk of losing any part of his investment, then the liabilities backstopped by the federal government have grown by several times the amount of Treasury obligations outstanding in August 2007 when the crisis broke open.

Everyone who gives serious thought to TBTF understands that it is an invitation to major future problems. I regard anyone who does not understand the problem as not giving serious thought. All too many observers fall in this category.

The reason that many fail to understand how serious is the TBTF problem is that in the near term it is unlikely to show its ugly head. Large financial institutions—I will just call them all "large banks" even though some may be insurance companies or even hedge funds—right now are cautious. Memories of how fast the markets can cut off funding are fresh. Thus, senior managers and company directors currently understand the risks of investing in longer maturity, risky assets financed by short-maturity obligations. But those memories will fade.

The memories will fade because the incentive for risky lending policies will remain; in fact, the incentive has been strengthened by the extension of TBTF. Short-maturity funding will be cheap for banks; yields will be only a bit above short Treasury yields. In the event of a problem, investors will expect that they will be able to exit by letting their short-maturity assets run off, and that any blow-up will be handled by the Fed, which will pump in cash and/or guarantees as necessary to avoid another Lehman. The Federal Reserve and Treasury seem to understand the problem, but their proposed policies are grossly inadequate to deal with it.

Treasury and the Federal Reserve, working together on financial reform, have three main proposals. One is "tougher oversight and supervision," whatever that is supposed to mean. The second is higher capital requirements and the third is creation of a systemic risk regulator with resolution authority.

Tougher Oversight

There are certain things bank examiners can do and do well. They can sample loan files to determine whether documentation is adequate. They can check for signs of self-dealing—loans to officers and directors. They are often successful in uncovering fraud. Supervisors can check for the existence of bank policies to control risks of various sorts, but they may not be well equipped to evaluate the effectiveness of the policies.

Bank supervisors cannot be counted on to uncover risks of the sort that created the current financial crisis. I retired as president of the St. Louis Fed in March 2008. I look back on my ten years in office and wonder how my Fed colleagues and I could have missed the crisis brewing from the house price bubble. We knew that there were consumer abuses in the subprime mortgage area. However, we did not realize that many bank portfolios held as assets large amounts of collateralized debt obligations backed by subprime mortgages, financed by short-term obligations such as 4-day commercial paper and very little capital.

Recent weeks have seen proposals in the United States and abroad to oversee bank compensation policies. The idea is to prevent banks from incenting managers to seek short-run gains that put the bank at longer-term risk. This proposal is most unfortunate. A recent study by Rüdiger Fahlenbrach and René M. Stulz, "Bank CEO Incentives and the Credit Crisis," concludes that bank CEOs had ample incentive to manage bank portfolios with an appropriately long-term horizon. Across the banking industry, on average their shareholdings at the end of 2006, before the financial crisis, were ten times their annual compensation.

There is no evidence that the government can design compensation practices superior to those designed in the private sector. Indeed, government compensation policies are themselves a mess, with above-market compensation for lower ranked employees and grossly below market compensation for senior executives. There is ample experience from periods of wage-price controls that controls do not work. If regulators do bear down hard, companies can evade compensation controls with a wink and nod. Verbal agreements between managers and subordinates leave no paper trail. Actual compensation can easily differ from what is provided in formal compensation policies. The effect of regulator intrusion in this area of management will be to lead managements to draft more vague policies that provide room to offer compensation necessary to keep employees deemed most productive. Banks will not sit back and permit key employees to be bid away by outside offers.

The Federal Reserve is deluding itself if it believes it can influence compensation practices over the long run by making compensation policies subject to Fed approval. The formal policies will indeed be written in a fashion that satisfies regulators. To understand implementation of these policies, however, the Fed will have to conduct detailed studies of how actual compensation fits within the policies. The exercise will either descend to detailed regulation of compensation employee by employee or become merely another bureaucratic hurdle banks must jump over.

What can we realistically expect of bank supervision and regulation? With regard to CDO assets, for example, bank examiners could check to see that the assets were rated triple A, which they were. Neither bank supervisors nor any of the rest of us in the Federal Reserve understood that the rating agencies were doing a poor job. When I say "any of the rest of us," what I should say is that whatever concerns there might have been in the Federal Reserve staff about the rating agencies did not rise to the policy level that I saw.

The rating agencies did a poor job not only because so many mortgages were poorly underwritten but also because they did not understand the risk posed by falling house prices. A significant decline in house prices was regarded as so unlikely that the possibility did not enter into the analysis behind security ratings. In the Fed, we knew that house prices could not continue to rise at the rapid rates of 2003-05, but we also did not anticipate a significant decline in the national average price. The problem was one of basic economic analysis rather than of regulation.

We need to think through the division of labor in a market economy between responsibilities left to the market and responsibilities assumed by government. Despite the fact that the private sector constructed far too many risky portfolios that violated banking 101 principles from the 19th Century, there is no evidence that government management of the financial sector, or any other sector for that matter, will work better. Keep in mind that the failure of economic analysis occurred in both the public and private sectors. Few thought house prices could fall significantly on a national average basis. Those who did have concerns about falling house prices did not connect the dots to a financial crisis. Portfolio managers did not deliberately buy mortgage assets expected to decline in value. Analysts in the government, including the Federal Reserve, and the private sector studied under the same professors and read the same textbooks. We all missed the potential for a financial crisis from declining house prices. It seems so obvious now, but it was not obvious at the time.

There is one area of increased regulation that would be useful to pursue. Longstanding practice in over-the-counter derivatives markets provides that positions with triple-A firms do not need to be collateralized. Regulators can and should enforce a rule that collateral be posted following the same practices maintained by derivatives exchanges. A requirement that all banks follow such collateral practices would have prevented exposure to the AIG credit default swaps positions that became deeply under water, with no posted collateral. I believe that regulators could enforce such a rule under current authority to regulate safety and soundness.

In the future, there will be further developments that risk financial crisis. The worst ones will be those that we all miss together. And we *will* miss them. Tougher oversight will not prevent such mistakes.

Higher Capital Requirements

Higher capital requirements are a good idea, but the requirement needs to be structured appropriately. Higher equity capital is not what is needed. What is critical is that some creditors be at risk. When a bank writes down assets and its stock price declines, the bank is not forced to do anything. Of course, the bank will probably end up in a negotiation with regulators about raising more capital, but that process can be lengthy. To provide rigorous discipline, the higher capital requirement should take the form of subordinated long-term notes. This is the subordinated debt proposal that has been advocated for years by many students of regulation.

Suppose every firm with a bank charter were required to maintain a block of 10-year subordinated notes equal to 10 percent of its total liabilities. Every year, the bank would have to roll over the maturing notes; if the market were unreceptive, the bank would have to shrink its total assets by 10 percent to live within its remaining block of outstanding subordinated notes.

Stability of the banking system and market discipline might be further enhanced by providing that a bank could conserve cash that would otherwise be used to redeem maturing sub debt by converting the sub debt to equity at a predetermined ratio. The bank would still have to restructure to fit within its outstanding stock of sub debt. The subordinated notes would provide a substantial cushion to protect the deposit insurance fund and other short-term creditors, and would do so through a healthy dose of market discipline. Sub debt creditors would be at risk of having their debt involuntarily converted to equity with less total value than anticipated when they purchased the sub debt.

Unfortunately, it appears that Washington is not pushing for subordinated debt as the key to a larger capital requirement. Moreover, it also appears that Washington is not willing to act outside an international agreement. Finally, it seems likely that no international agreement is obtainable that increases capital requirements to an adequate extent.

The United States should proceed to impose a subordinated debt requirement on all firms with bank charters with or without international agreement. A rigorous U.S. standard will tend to spread to other countries. U.S. subsidiaries of foreign banks would be subject to the requirement. If U.S. firms want to borrow abroad from banks not subject to the requirement, so be it. In the long run, the sub debt requirement, if sound on its merits—and I believe it is—will dominate banking practice in most countries for it increases the stability of the banking system.

Believers in the market may recoil at the idea of a rigorous sub debt requirement. The issue is how to deal with TBTF. Particularly in our electronic age, a sound banking system is a logical extension of the government’s responsibility to maintain a sound currency. TBTF is a fact; it encourages banks to rely on more leverage and to accept the risk of a mismatch of duration of assets and liabilities.

A sub debt requirement is the most market-friendly option available. The only other effective option is for Congress to remove the authority of Treasury and Federal Reserve to bail out banks. That seems unlikely; few will want to take the risk that the banking system will cascade downwards as it did 1930-33 and almost did in 2008. With the skeptical view of regulatory oversight that most market enthusiasts share, the only option is to force more capital into the banking system.

Systemic Risk Regulator

Another idea pushed by official Washington is that Congress grant authority to some agency, presumably the Federal Reserve, to become the systemic risk regulator. A key part of the proposal is that the systemic risk regulator be granted resolution authority similar to that exercised by the FDIC. The FDIC can shut down a bank and arrange for insured deposits to be paid off or transferred to another bank. The FDIC has wide latitude in arranging for a merger or liquidation. The systemic risk regulator would enjoy the same powers over any financial firm it judges to be a systemic risk.

The proposal has major defects and should be abandoned. One very serious defect is that the range of firms covered is undefined, and proponents of the idea have not offered any guidance as to how they would define coverage. FDIC resolution authority covers firms with bank charters; there is no natural universe of nonbank systemically important firms. It is unsatisfactory on both legal and economic grounds for a regulator to have such a broad undefined grant of power.

Should the systemic risk regulator proposal be enacted, it will broaden the group of firms regarded as too big to fail. Given the AIG bailout, the market will probably judge that large insurance companies are covered. Their cost of funds may fall, if they are deemed to be protected. They may increase their risk—not necessarily consciously but led by market opportunities to increase leverage financed by short-term liabilities.

There are several “mays” in this argument. No one really knows what will happen. But there is one thing that seems quite certain. Once the systemic risk regulator has resolution authority, it will be strongly tempted to bail out a failing firm and exercise the authority to assume control of the firm. It seems doubtful that the regulator will force certain creditors to take losses, for doing so will spread concerns in the market about possible losses on assets invested in other similarly situated firms. Market concern could easily spread to banks, which may have pursued similar portfolio practices. By providing discretionary authority to regulators, rather than leaving resolution to bankruptcy court, the systemic risk regulator proposal will increase systemic risk.

Some Reflections

The official Washington vision of the financial system over coming years seems to be that it will look about the same as it does today, strengthened by “tougher” regulation. The vision does not include facing up to the necessity of permitting some creditors of a failing large bank to take losses. The idea is there in the abstract, to be sure, but no institutional changes are proposed to make the abstract idea a reality when the issue arises in stark form.

We should not have to rely on bravery of a Treasury secretary or Fed chairman to deal with a foreseeable issue. And it is foreseeable that eventually one or more large banks will get into financial trouble once again. The aim should be to build stability into the system by changing incentives.

The economy became too leveraged in recent years, and seems likely to return to that state once again, as memories of the financial crisis recede. Congress should change the tax law applying to all income tax returns to phase out the deductibility of interest. On corporate returns, bringing the statutory tax rate down from 35 percent at present to about 15 percent would be a revenue neutral offset to ending the deductibility of interest. It makes no sense to exhort everyone to be responsible in the use of debt while leaving the tax incentive for debt intact.

The financial crisis is a sobering experience for a Chicago-school advocate of the market. The federal government was not without blame for the crisis but the basic problem was that far too many financial firms pursued shortsighted portfolio policies. Banking 101 says that it is dangerous to design a portfolio with long-duration risky assets financed with short-duration liabilities and thin capital. That is what one financial firm after another did, and the government is not to blame for those misguided private-sector policies.

Throughout the ages, financial crises occur when liquidity dries up, usually because solvency concerns arise when risky assets decline in value. Why is it that the market seems to make the same basic mistake again and again? It is terribly important that we figure out the answer or answers to this question, because we also know that markets and not government-run economies generate economic growth. This financial crisis was very costly; if we cannot figure out how to make market economies more stable we risk growing government involvement, which we can be quite certain will make economies grow more slowly.

My tentative conclusion is that market participants systematically underestimate the probability of extreme events. They rely on instincts described by the normal distribution and by formal models based on normality. Yet, there is an enormous amount of evidence that the probability of extreme events out in the tails of the probability distribution is much higher than indicated by the normal distribution—the fat tails problem.

If this observation is correct, then an appropriate function of government is to create incentives that offset the market’s underestimate of tail probabilities. For large banks, the issue can be put as one of externalities. A large bank failure has costly effects on many third parties. Eliminating the deductibility of interest on tax returns would help to control the externality as would a stiff subordinated debt requirement for banks.

The argument that it would take a brave Treasury secretary to let another Lehman fail implies that any large bank that gets into trouble will be bailed out. There is, however, a contrary argument. Voters are rightly upset over bailouts, and may vote out of office the party that next engages in bailouts. Thus, the brave Treasury secretary is sailing down a narrow passage with the Scylla of potential financial market chaos on one side and the Charybdis of being voted out of office on the other side.

This situation is a truly dangerous one for the markets. The disruption following the Lehman failure was enormous in part because Lehman investors had good reason to believe that, following the Bear Stearns bailout, Lehman would also be bailed out. The emphasis must be on not permitting this dangerous situation to arise again. I fear that current Washington approaches have too little sense of urgency and are too timid to avoid another financial crisis in the future.