

"Systemic Risk and the Response to the Crisis"¹

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Experts have identified many contributing causes of the credit boom and subsequent bust. For me, one influence is undeniable: in the years leading up to the crisis, financial institutions of all sizes and types were taking a lot more risk.

The evidence is clear in greater use of leverage, on balance sheet and off, larger and more aggressively managed trading books, greater use of poorly understood structured products, weaker liability structures, concentrations in riskier asset classes, and increased lending to weaker borrowers, both commercial and consumer.

Although this was evident throughout the financial system, it was most evident at the big Wall Street institutions. As one simple measure, in the eight years from the beginning of 2000 to the end of 2007, the assets of Goldman Sachs, Lehman, Merrill and Morgan Stanley together grew 350% to about \$4 trillion. Enabled, in part, by a change in broker-dealer net capital rules in 2004, investment banks, which had traditionally been small balance sheet, mostly agency, advisory and limited market-making businesses, became huge principal investing and trading machines with balance sheets to match.

¹ The views I express are my own and do not reflect the views of the Financial Stability Oversight Council ("FSOC") as a body, or any other member of the FSOC. Nothing I say today will be based on any nonpublic information that I have received through FSOC processes. An earlier version of this speech was presented at a symposium sponsored by the Berkeley Center for Law, Business and the Economy on March 11, 2011.

How to explain this increase in risk-taking across the financial system? In my view, the influence of rising moral hazard and sheer complacency resulting from various forms of government support for financial markets and the benign financial markets and economic conditions they created in the years leading up to the crisis was profound. This included:

- 1 Special support for the Too Big to Fail (or, "TBTF") class of commercial banks dating back at least to Continental Illinois.
- 2 Extensive signaling to markets by the Fed and other central banks that they would not allow losses to creditors and counterparties of a large financial institution to undermine confidence in the system as a whole. The "constructive ambiguity" referenced by Paul Volcker gradually eroded.
- 3 A pattern of ample Federal Reserve-provided liquidity support for markets and the economy whenever a potential for an economic downturn or a financial market disruption occurred. Notable examples include the Fed's response to the stock market crash of 1987, the Long Term Capital Management situation, the Asian financial crisis, Y2K, and the bursting of the NASDAQ stock market bubble. The pattern became so widely recognized in financial circles it was known as "the Greenspan put."
- 4 Assistance provided by the U.S. Treasury Department to Mexico through the Exchange Stabilization in 1995 that enabled the Mexican government to pay off bonds held by major U.S. financial institutions.
- 5 And not least, near explicit support for the government sponsored enterprises (GSEs) known as Fannie Mae and Freddie Mac. The formidable political capabilities of these institutions enabled them to grow their balance sheets, take more risk and undermine needed reform proposals without serious adverse consequences.

These influences were, in my view, a critical backdrop for the crisis, not a marginal contributor. A fairly broad consensus had emerged around the world that creditors and counterparties of big financial institutions would always get repaid.

Lehman's bankruptcy was a shock to the system, not because of fears that assets would be frozen, contracts couldn't settle or payments wouldn't clear. It was that markets suddenly realized that some very large weakened and over-leveraged financial institutions couldn't necessarily count on a rescue.

The crisis prompted fresh avenues for governmental support of the financial system in late 2008/early 2009. Notable were the conservations of Fannie Mae, Freddie Mac and AIG (the last famously enabling full payment to AIG's credit default swap counterparties); the TARP Capital Purchase Program; a number of government-encouraged or assisted mergers of large institutions; the emergency conversions of Goldman and Morgan Stanley to bank holding company status; and a number of programs providing guarantees and/or liquidity support for money and credit markets more broadly too numerous to name here.

The U.S. wasn't alone in providing broad-based commitments to shore-up its financial system. Similar types of support were offered in other countries. In effect, governments around the world cast an even larger safety-net over financial markets, in some cases at the expense of a substantially weakening their condition as sovereigns, Ireland being a notable example. It was the Greenspan put on steroids.

One side-effect of the US crisis response was that our largest institutions became even larger as a result of government assisted or encouraged mergers. The US now has four bank holding companies with total assets in excess of \$2 trillion and four with total assets in excess of \$1 trillion.

Let me put the size of these institutions in perspective. California is the largest US state measured by GDP – roughly the size of Spain, Portugal and Ireland combined. At the end of 2010, there were 251 banks headquartered in California -- 201 state and 50 nationally chartered -- with total assets of about \$430 billion. There were also about 440 credit unions with total assets of about \$125 billion.

So, all the depository institutions headquartered in the state combined had total assets of \$555 billion. By contrast, Wells Fargo Bank, N.A., a South Dakota headquartered bank, by itself had assets of about \$1 trillion.

Public policy making has now moved past crisis management into the post-crisis response phase. In thinking about risks to financial stability, and evaluating the public policy response to date, I draw several conclusions from my narrative that may be relevant:

1. Rising moral hazard and complacency resulting from market perceptions about explicit and implicit government backstops of the financial system contributed to increased risk-taking prior to the crisis.
2. Post-crisis, one of the central problems to address is the revealed preference of governments around the world for bailouts over market discipline. The response to the crisis, necessary though it may have been, significantly compounded the challenges of moral hazard mitigation.
3. As a result of crisis containment measures, concentrations within US financial markets have increased, and consequently so have the risks.

In the U.S., the post-crisis response has included implementation of the Dodd Frank Act (DFA), implementation of other regulatory/supervisory enhancements unrelated to DFA, and early consideration of what to do about the GSEs and the moribund mortgage market. Other nations are in various stages of pursuing their own reform agendas. For example, in the UK, the Vickers Commission recently issued its much anticipated report on UK banking. And of course we have Basel III as an internationally coordinated response.

DFA and Basel III bashing are popular sports these days. Under a headline entitled: "Dodd-Frank Pummeled at Chamber of Commerce Event," the *American Banker* recently reported that JPMorgan Chase CEO Jamie Dimon called DFA "backward and misguided." In another forum, he reportedly said regulators were getting "extreme and excessive" with Basel III implementation. I would have to say, in return, that given what the world has gone through, such comments from

one of the world's leading bankers are not constructive. Let me explain, starting with Basel III.

Basel III

In the US, the economic recovery is gaining steam, but it rests on some shaky foundations. The anticipated wind down of monetary and fiscal policy stimulus is becoming a political and economic necessity, but it will pose challenges too. Labor market conditions, notably in California where the unemployment rate remains in excess of 12 percent, are still weak. Household and public sector finances have been seriously damaged, and so the deleveraging of these sectors is likely to be with us for some time to come. Across the country, a significant number of residential and commercial real estate borrowers remain underwater on their loans, and a backlog of pending foreclosures weighs on real estate markets. Fundamentally, at the macro level, the US has an underinvestment and an overconsumption problem that has yet to be solved.

Global financial and economic conditions remain very fragile as well. Inflation is surging in many fast-growing developing markets. There are signs of overheating in these markets, especially in real estate markets, and their governments are moving toward tightening. In Europe, pricing on intermediate term bonds issued by Ireland, Greece and Portugal indicates that the risk of sovereign debt defaults among them is now acute. European banks within the core of the Eurozone, where US banks are exposed, are unlikely to escape undamaged. Geopolitical risks in the Middle East and North Africa loom large. And the highly indebted Japanese government has been badly shaken – literally – by the disastrous earthquake and all of its tragic consequences.

We need to be humble about our ability to predict how these risks and vulnerabilities could manifest themselves in US financial markets and what market participants and supervisors might be able to do to mitigate them within a reasonable time frame. In the face of this uncertainty, very healthy capital and liquidity buffers are just prudent.

Large US bank capital ratios have improved since the crisis, but they look thin to me given these risks. Given these considerations, and the generous timetable established for Basel III implementation, I would not characterize Basel III implementation plans as “extreme or excessive.”

It is worth noting that since the start of the 20th century, bank capital ratios have fallen by a factor of about five in both the US and UK. A sizeable body of recent academic research has made the case that substantially higher capital requirements would not be as costly to individual banks as they have claimed, and that higher capital ratios are absolutely necessary to mitigate the substantial negative externalities that can occur when large financial institutions are in distress.²

Referencing this research, a recent letter to the Financial Times signed by 17 of the most prominent professors of finance in the world noted that “everyone suffers from the consequences of the greater systemic risk associated with highly leveraged banks.” And: “Once banks are safely capitalized, which would require them to have significantly more equity on their balance sheets than they currently have, paying dividends would be appropriate.”³ (*emphasis added*)

Systemic Risk and the Dodd Frank Act

As a result of the crisis, bonds of trust and reliance among a broad range of market participants – originators, broker-dealers, credit rating agencies, investors, to name a few – were seriously damaged if not broken. Regulatory confidence in the corporate governance and risk management frameworks at some of the largest and supposedly most sophisticated financial institutions in the world was damaged too. I think of Dodd Frank as the political system’s reaction to these same forces -- a broad-based loss of trust in financial institutions, financial markets and the regulators who were responsible for overseeing them.

² See for example, “Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is *Not* Expensive,” by Anat R. Admati, Peter M. DeMarzo, Martin F. Hellwig, and Paul Pfleiderer, Working Paper Draft, March 18, 2011

³ “Banks Should Not Be Allowed to Pay Dividends Until They Are Much Better Capitalized,” *Financial Times*, February 15, 2011

DFA surely over-reaches and over-burdens in some important respects. Most anyone that is involved in its implementation, or that is affected by it, will find provisions to dislike. Full regulatory implementation will be years in the making, and it will be years more before we can assess the full consequences.

I can't possibly address all of DFA's provisions to strengthen safety and soundness of the financial system in the time I have available. To me, the FDIC's new orderly liquidation authority for systemically important institutions granted under Title II, supported by a robustly supervised requirement to maintain actionable living wills on an ongoing basis, is an essential feature of the law.

The ability to resolve a large financial institution in such a way that creditors and counterparties are subject to losses is a crucially important moral hazard mitigant. Reliance on regulation and supervision alone to ensure safety and soundness produces outcomes that are too mistake-prone and inefficient.

The orderly liquidation provisions will, in principle, enable resolutions that impose losses on creditors and counterparties, and therefore strengthen their incentives for ex-ante performance monitoring. Notice I said "in principle." Also important is the credibility of the commitment to the usage of this resolution authority. This, of course, has not yet been tested.

In his testimony before the Financial Crisis Inquiry Commission, Chairman Bernanke recognized this: "Simple declarations that the government will not assist firms in the future, or restrictions that make providing assistance more difficult, will not be credible on their own...a promise not to intervene in and of itself will not solve the problem." The unresolved issue implicit in the Chairman's comment is whether or not DFA's orderly liquidation provisions will actually be utilized. Does Title II solve the so-called time-consistency problem in financial markets – the tendency of public officials to override a long-run optimal policy in order to avoid the possibility of a messy a short-term outcome?

FDIC Chairman Sheila Bair expressed her resolve last week: "there will be no more bailouts." And she referred to the new resolution authority as a "game changer in terms of economic incentives." But there appears to be some skepticism about

the regulatory commitment to orderly resolutions, at least for the very largest and most interconnected firms. A number of observers have expressed concerns about weaknesses in orderly liquidation framework, its application to globally active institutions, the uncertainties it creates for creditors and counterparties, and the will of regulators to utilize it. *The Wall Street Journal* touched on some of these in an editorial titled, "Still Too Big, Still Can't Fail."

I would encourage skeptics to read the FDIC's analysis of how Title II could have been applied to the orderly liquidation of Lehman. It is a convincing case study.⁴

DFA and the FSOC

Let me conclude with a few observations about the Financial Stability Oversight Council. FSOC is charged with the responsibility for identifying threats to the financial stability, promoting market discipline, and responding to emerging risks to financial stability. Among other things, the FSOC is authorized to: designate systemically significant nonbank financial companies for consolidated supervision by the Federal Reserve; designate systemically significant financial market utilities and payment systems; and recommend stricter supervisory standards for the largest, most interconnected firms and financial market utilities.

The Council is at the early stages of life. The principals have only met four times. Among completed deliverables, FSOC has published: a study on how best to implement the so-called "Volcker Rule", which prohibits proprietary trading and certain private fund investments; a study on the impact of the new concentration limits in DFA; and a proposed rule outlining the criteria and procedures that will inform the SIFI designation process.

There is now a great deal of work underway through a number of committees and subcommittees covering the full range of our responsibilities and authorities as had been well reported in the press and in a recent Congressional hearing. I won't go into those details here.

⁴ "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act," FDIC Quarterly, Volume 5, No. 2, early release.

Importantly, I do believe that the establishment of the FSOC has achieved one of the intended goals of the Congressional authors. It has encouraged a much more robust dialogue among the participating agencies at all levels and a serious effort to understand and better respond to threats to financial stability.

I would also say that the participants have a sober-minded view of what the major risk factors and structural weaknesses are. Critics have pointed to a dearth of visible product to argue that the FSOC is off to a slow start. I disagree. In fact, I would argue that the FSOC's most important work may never be visible to the public.

During the policy debates that were part of the process leading to DFA, FSOC emerged as an alternative to a broad consolidation of regulatory bodies. It was viewed as a compromise measure, but there is one attribute that a council of regulators has that could make it superior to consolidation among regulators. One could usefully think about FSOC as a mitigant against the potential for regulatory capture at the individual agency level. Whether or not lax oversight of large financial institutions was, in part, the result of regulatory capture is debatable. It has certainly been alleged by some observers. FSOC can lessen this risk by giving voice to concerns fellow regulators may have about an agency's approaches to the regulation and supervision of institutions for which it has primary responsibility.

Conclusion

The long history of financial crises shows that memories of such events tend to be short-lived once a crisis has past. Listening to some in the private sector, one might get the impression that the credit bubble was an aberration and that it is time to get back to business as usual. I don't share that view, and I would say that few people operating in the regulatory arena do. It is important that regulators strike the right balance, but we all have much to do to ensure that we don't repeat these mistakes again. Thank you.