IMPROVING THE FED'S POLICY RESPONSE IN THE ERA OF SHADOW BANKING

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***Report of a Research Project On Improving Governance Of The Government Safety Net In Financial Crisis, with funding from the Ford Foundation.**

Levy Economics Institute of Bard College

Final Report of a Research Project On Improving Governance Of The Government Safety Net In Financial Crisis, with funding from the Ford Foundation

- Issues investigated by project:
  - 1. Is there an operational difference between commitments made by the Fed and by the Treasury?
  - 2. Are there conflicts between Fed's responsibility for normal monetary operations and the need to operate a government safety net?
  - 3. How much transparency and accountability should the Fed's operations be exposed to?
  - 4. Should safety-net operations during a crisis be subject to normal congressional oversight and budgeting? Should such operations be on- or off-budget?
  - 5. Is there a limit to the Fed's or Treasury's ability to spend, lend, or guarantee?
  - 6. What can we learn from the successful resolution of the 1930s crisis and the thrift crisis? What can we learn from successful crisis resolutions in other nations?
  - 7. What should be the main focuses of the government's safety net? Save individual banks?
  - 8. Does Fed or Treasury intervention create a burden on future generations?
  - 9**. Is it possible to successfully resolve a financial crisis given the structure of today's financial system? Or, is it necessary to reform finance first to make it possible to mount a successful resolution process?**

MR. MISHKIN. Thank you, Mr. Chairman. I think we're all trying to be cheery here. It reminds me a little of one of my favorite scenes in a movie, which is Monty Python's "Life with Brian." I remember the scene with them there all on the cross, and they start singing "Look on the Bright Side of Life". [Laughter]

January 29-30, FOMC 2008 Transcript

2012 Report: “Improving Governance of the Government Safety Net in Financial Crisis”

- Explored alternative methods of providing a government safety net in times of crisis.
- USA used two primary methods: stimulus package plus Paulson plan budgeted by Congress, and a complex, huge Fed bailout with assistance from the Treasury.
- We documented the Fed originated well over $29 trillion in loans through its “alphabet soup” of special facilities.
- Mostly took place behind closed doors, much of it took the form of “deal making”, some in conflict with spirit of 13(3)

Example: Term Asset-backed Securities Lending Facility

- MR. DUDLEY. The TALF, just to recap, is a program in which we would basically lend funds against AAA-rated consumer asset-backed securities on **a nonrecourse basis to basically anyone—not quite anyone, not foreigners, but pretty much anyone who wants to do it**—and we would conduct these transactions through the dealer community.

- MR. LACKER. **They would get all of the upside**?

- MR. DUDLEY. **Yes**.

- MR. LACKER. So if spreads close in the marketplace, then **they get the upside—so we are essentially lending to them to make a leveraged bet on the securities**.

- MR. DUDLEY. **The idea is that, if you offer more-attractive terms than those available in the market, the demand for these securities will increase.**

December 15-16, 2008 FOMC Transcript

TALF: Real Housewives of Wall Street

- Christy Mack and Susan Karches, for example.
  - Christy is the wife of John Mack, the chairman of Morgan Stanley.
  - Susan is the widow of Peter Karches, a close friend of the Macks who served as president of Morgan Stanley's investment-banking division.
- Neither appears to have any serious business expertise, apart from a few philanthropic experiences.
  - With an upfront investment of $15 million, they quickly received $220 million in cash from the Fed, most of which they used to purchase student loans and commercial mortgages.
- The loans were set up so that Christy and Susan would keep 100 percent of any gains on the deals, while the Fed and the Treasury… would eat 90 percent of the losses.

Matt Taibbi, The Real Housewives of Wall Street

Danny Wall's [FHLBB] Bailout of Thrifts

- Two of the largest winners were Ronald Perelman and Robert Bass.
  - Each made illegal donations of $100,000 to the Bush campaign.
  - Bass put up $350 million to purchase thrifts, and received $2 billion in subsidies;
  - Perelman put up $315 million to obtain $7 billion in good assets, $5 billion in cash to cover possible losses, and $900 million in tax write-offs.
- Representative Walter Fauntroy asked Wall, "**I have just one question for you, Mr. Wall, why is it only white folks who get that kind of deal**?"

Martin Mayer, The Greatest-Ever Bank Robbery 1990

2013 Report: "The Lender of Last Resort: A Critical Analysis of the Federal Reserve's Unprecedented Intervention"

- Role played by Fed as "lender of last resort" in the aftermath of GFC
- Liquidity or Solvency Crisis?
  - Bagehot: lend w/o limit, against good collateral, at penalty rate
  - Fed deviated from all three
  - Banks relied on extremely short-term finance, questionable assets→ refusal to roll-over: solvency problems→ liquidity crisis
- Two kinds of subsidies:
  - TBTF → low rates on liabilities; Bloomberg: $83B to top 10 banks
  - Extremely low interest rates charged on Fed lending: top dozen
  - Loans continually renewed for 2+ years
- Volume of Lending, Rates, and Duration all point to Solvency Crisis

CHAIRMAN BERNANKE. Let me turn now quickly to the governance issues. Before getting into them, let me just say that, whatever difficulties we may have finding appropriate governance, it is certainly the case that the Federal Reserve Act did not exactly contemplate the situation in which we find ourselves today.

December 15-16, 2008 FOMC Transcript

2014 Report: Federal Reserve Bank Governance and Independence During Financial Crisis

- Focus on central bank independence and governance, with particular attention to challenges during periods of crisis
- Trace principal changes in governance of the Fed over its history—accelerate during times of economic stress
  - From the famous 1951 “Accord” and to the growing consensus in recent years for substantial independence of the central bank from the treasury
- Argue that concept of independence is not usually well defined.
  - Debate focuses inappropriately and excessively on independence to fight inflation
  - While Fed is substantially independent of day-to-day politics, it is not operationally independent of the Treasury
- Inexorable expansion of Fed’s power and influence raises important questions concerning democratic governance
- Fed is 100 years old and needs an overhaul!

2015 Report: Improving the Fed's policy response in the era of shadow banking

- Watchful Waiting: Fed crisis response, evidence from the transcripts
  - Detailed analysis of Fed's response
- Repeal of Glass-Steagall and Consequences for response
- Shadow banking and challenges facing central banks
- The profound perversity of central bank thinking
- Minsky's approach to prudent banking
- The Federal Reserve and perspectives on natural law, the Constitution and regulation
- Reforming banking to reform crisis response

Evidence from the 2008 FOMC Transcripts

- The transcripts provide a rare portrait of how policy-makers responded, in real time, to the unfolding of the world's worst financial crisis since 1929.
- They reveal lack of a satisfactory understanding of a **shadow banking system** that had steadily grown to enormous proportions over the course of the "Great Moderation"
  - an FOMC that neither comprehended the extent to which the fate of regulated member banks had become intertwined with the shadow banking system,
  - nor had sufficiently considered in advance what sort of policy responses would be required to deal with the possibility of a serious crisis in the shadow banking system.
  - (Thank goodness Bill Dudley was there—or, as Robert Redford might put it "All would be lost".)

Failure to Appreciate Severity of Crisis

- MR. BULLARD. My sense is that **the level of systemic risk associated with financial turmoil has fallen dramatically**. For this reason, I think the FOMC should begin to de-emphasize systemic risk worries. *August 5, 2008*
  - MR. PLOSSER. To agree with President Bullard's comments, **we should begin to deemphasize and de-stress the importance of systemic risk** because I think it is gradually dissipating as firms adjust to the more volatile and risky environment. *August 5, 2008*

- MR. ROSENGREN. The Boston forecast used for the June meeting expected that **the unemployment rate would peak at approximately 5.7%**. Unfortunately the unemployment rate has already [July] reached 5.7% percent. *August 5, 2008*
  - MR. STOCKTON. I can give you some probabilities, but I don't know how seriously you should take them [Laughter]. *October 28-29, 2008*

CHAIRMAN BERNANKE. I will just note for the record here that the NBER has finally recognized that a recession began in December 2007…. they also recognized that Christmas was on December 25 last year. [Laughter].

October 28-29, 2008 FOMC Transcripts

Banking in the Shadows

January 29-30, 2008 FOMC Transcripts

- MR. DUDLEY. Another thing that is not very well known is **what their assets consist of**. We have **rating buckets**, but **we don't know what those ratings actually apply to**. We don't know who they have reinsurance with.

- MR. DUDLEY. Some people think that they're **reinsuring each other** to an extent or they have reinsurance with subsidiaries that they own so that the **insurance is not at arm's length**. So there's **quite a bit of cloudiness** about what their true condition is.

- MR. DUDLEY. Unfortunately**, there is not much transparency as to the counterparty exposures** of the guarantors on a firm-by-firm, asset-class-by-asset-class, or security-by-security basis.

- MR. LOCKHART. Do we have direct contact with them [the monolines] to get any insight beyond what we get through analysts and rating agencies? I think you said that **they are not terribly transparent in terms of asset class and individual securities as to what they really hold**.

Incremental Policy-Making

- The Fed's response to the 2007-2008 global financial crisis consisted of a series of ad-hoc measures devised, in real time, to respond to ongoing events.
- Each of these measures, individually, could be justified as merely an incremental step.
- The consequences of this were twofold.
  - First, the **Fed did not seize the reigns** and actively shape the course of the crisis. Instead, it **improvised a response** to the **ever-expanding reach** of the crisis.
  - Second, the series of **incremental steps** eventually added up to a response that was greater than the sum of its parts. As Dudley said, **each incremental action was based on a judgment call** – usually made quickly, in response to cascading events, and often with limited and unreliable information.

Ad Hoc Judgment Calls

- *CHAIRMAN BERNANKE*. **The ideal way to deal with moral hazard is to have in place before the crisis begins a well-developed structure** that gives clear indications in what circumstances and on what terms the government will intervene with respect to a systemically important institution.

- **We have found ourselves, though, in this episode in a situation in which events are happening quickly, and we don't have those things in place**. We don't have a set of criteria, we don't have fiscal backstops, and we don't have clear congressional intent.

- **So in each event, in each instance, even though there is this sort of unavoidable ad hoc character to it, we are trying to make a judgment** about the costs—from a **fiscal perspective**, from a **moral hazard perspective**, and so on—of taking action versus the real possibility in some cases that you might have very severe consequences for the financial system and, therefore, for the economy of not taking action.

September 16, 2008 FOMC Transcripts

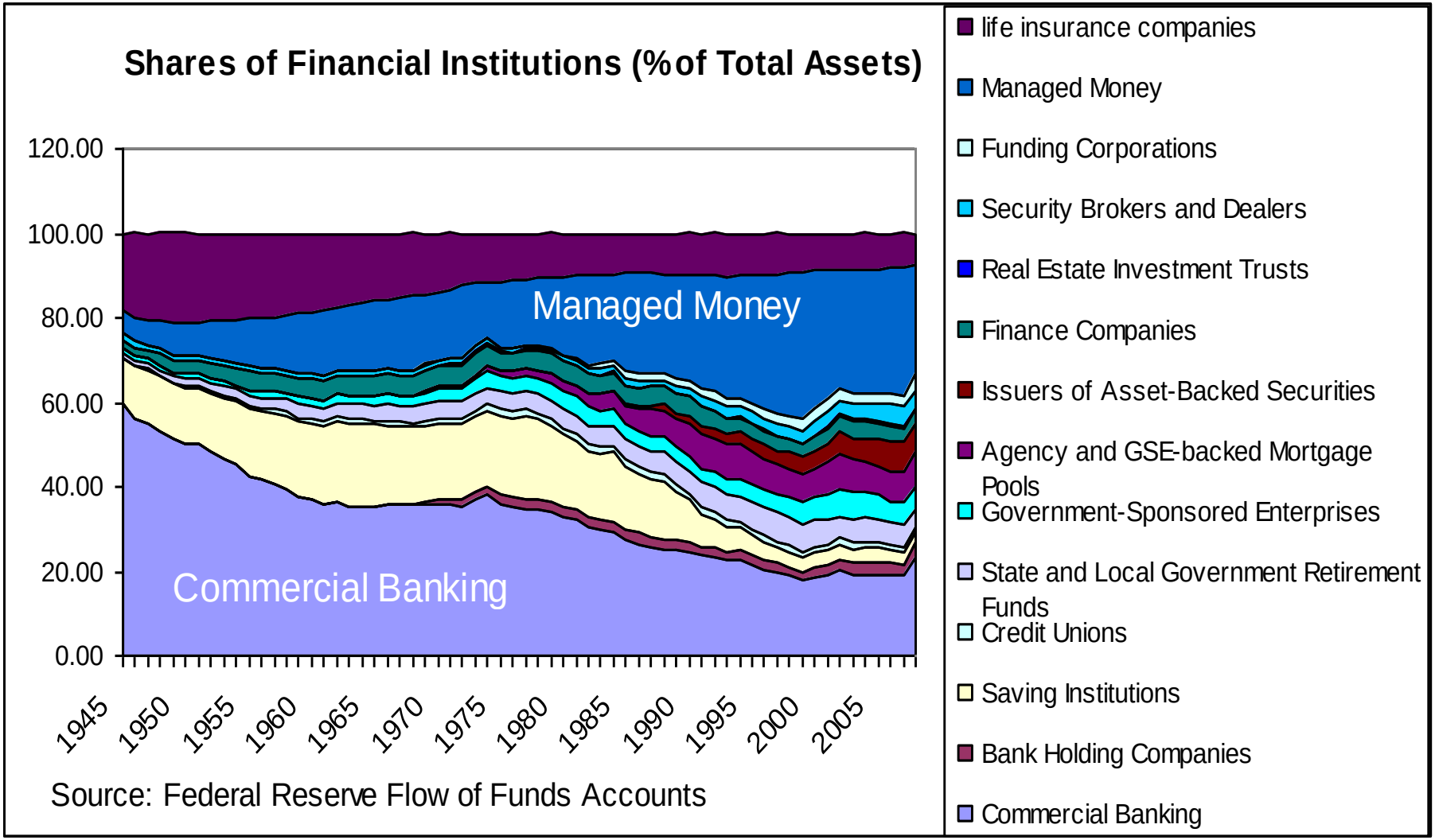
Chairman Bernanke: Frankly, I am decidedly confused and very muddled about this.

September 16, 2008 FOMC Transcripts

Money Manager Capitalism and Shadow Banking

- Minsky began warning of rise of Money Manager Capitalism in late 1980s
- Financialization + Leverage + Shadow Banks
  - Gutting the New Deal + Inequality
  - Goldilocks + Bubbles
  - The Great Moderation: a Radical Suspension of Disbelief
- All of this adds up to …Money Manager Capitalism
  - A much more fragile financial system
  - That does not finance the capital development of the economy

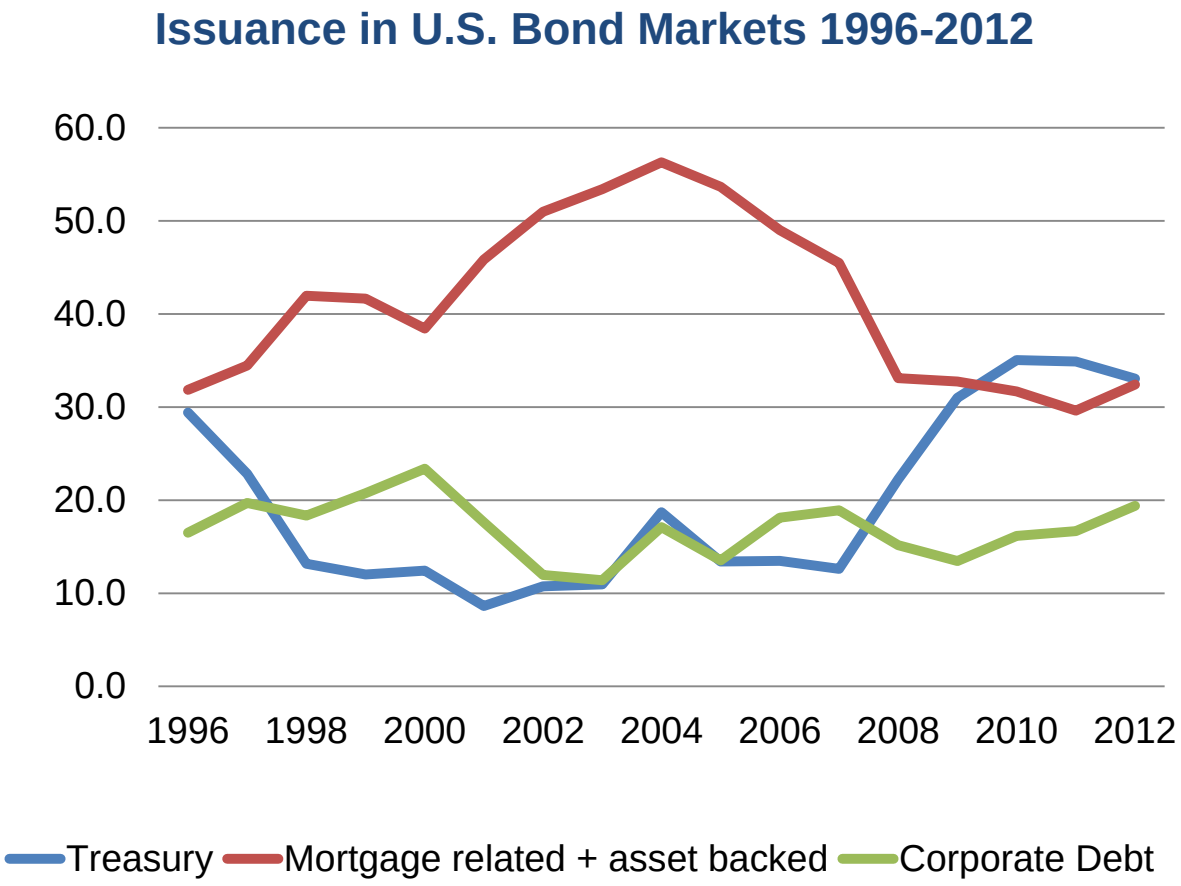
Decreasing Weight of the Banking Sector, rise of Money Manager Capitalism



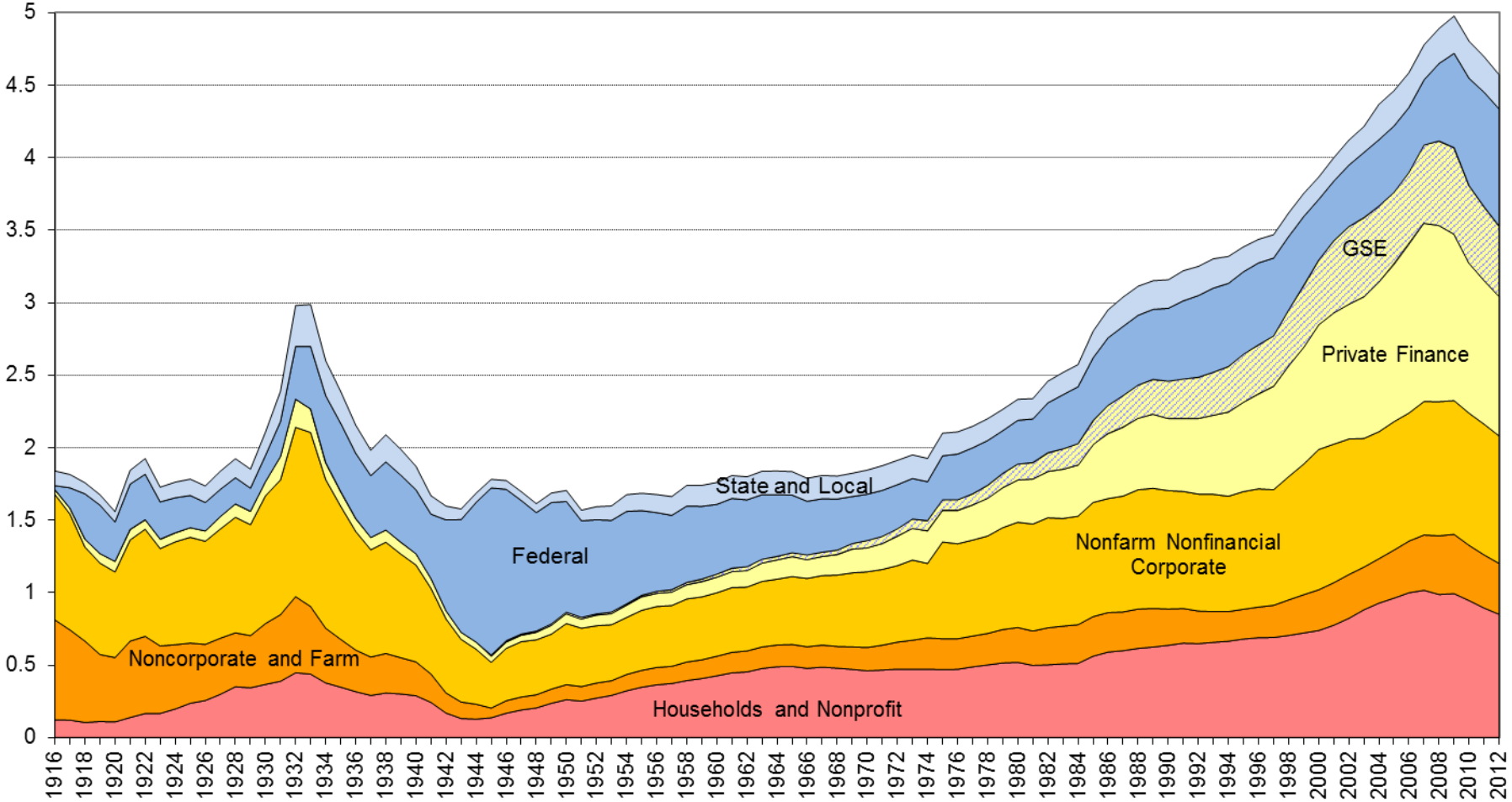
Source: Federal Reserve Flow of Funds Accounts

The Shadow Banking System

- Liquidity creation by shadow banks.
- 2007: assets of market based institutions 16 Trillion, 1.2x depository institutions
- They held 2/3 of the $11T home mortgages



Total Liabilities Relative to GDP



Sources: *Historical Statistics of the United States: Millennium Edition* (Tables Ca9-19, Ce42-68, Cj265-272, Cj362-374, Cj389-397, Cj437-447, Cj748-750, Cj751-765, Cj787-796, and Cj870-889), *Historical Statistics of the United States: Colonial Times to 1970* (Series X 689-697), NIPA, Flow of Funds (from 1945).

Note: The government sector excludes all financial activities of the government (retirement funds, GNMA, etc.). GSE sector includes government-sponsored enterprises and agency- and GSE-backed mortgage pools (includes, among others, GNMA and FHA pools). "Financial" excludes the GSE sector and monetary authorities (which are both part of the financial sector in the Flow of Funds accounts). Before 1945, data for financial institutions is computed from data of the Census Bureau by taking all the liabilities (excluding equity) of commercial banks, credit unions, savings institutions, life insurance stock companies, and property and life insurance companies, and by removing private banks notes, all deposits, and life insurance reserves. From 1945, the total liabilities of the financial sector excludes, net interbank liabilities of commercial banks, liabilities of monetary authorities, private and public pension fund reserves, money market mutual funds shares, mutual funds shares and the items previously cited. The liabilities of monetary authorities are not included anywhere.

Approaching Reform

- To Reform the System We must Understand:
  - What is the nature of the financial system today?
  - What is the nature of the crisis?
  - What should a financial system do?
  - How can we reform the system so that
    - It serves a public purpose
    - It can be managed
    - It can be rescued

Minskian view of banking

- Banks “create money” lending own IOUs
  - Extending loans creates deposits
- Banks are <u>not</u> primarily intermediaries
  - They don’t move “savings” around
- Private liquidity is highly <u>endogenous</u>
  - Grows in booms, “disappears” in busts

    => Bank credit can be highly destabilizing

    Procyclical credit as accelerator
- This is the core of Minsky's instability theory!

Market-Based Finance and Instability

- Mainstream: repeal Glass Steagall to facilitate competition and eliminate inefficiencies in banking.
  - Yet, “too much” competition was precisely the reason for enacting GSA!
  - Competition under money manager capitalism manifested itself in two ways: demise of underwriting and rise of securitization.
- Minsky: MMC is necessarily unstable as a “potential run from these funds will lower asset values”
  - Shadow banks not banks after all: their ability to create liquidity depends on their access to the market and to commercial banks
  - “The degree of layering of financial institutions and the asset-liability mix of these institutions is a “parameter” of the aggregate “robustness” or “fragility” of a financial system.”

Minsky on Prudent Banking (1959)

- The prudent banker does good underwriting
- The prudent banker's customer relation is one of mutual trust and confidence
- The prudent banker expects to make some mistakes; builds in a margin of safety
  - Uses Cash-Flow analysis: "where is the cash flow the borrower will use to repay me?"
- The prudent banker does not purchase assets with the expectation of selling at profit, but does want some liquid assets for liquidity purposes
- The liquidity and solvency constraints on the banker are peculiarly tight: must hold some liquid assets and cannot survive a substantial fall of the value of assets

A Prudent Banker Would Not:

- Originate to distribute
  - Mortgages, student loans, auto-related debt
- Purchase assets to trade, or lend against assets whose value could fluctuate
- Purchase property, commodities, businesses
  - Goldman Sachs, Morgan Stanley, JPMorgan Chase own oil tankers, run airports, control huge quantities of coal, oil, gas, metals, food products, uranium, refineries, pipelines
  - Gramm-Leach-Bliley: allows business “complementary” to financial activity
- Bet against its own customers
  - Goldman Sachs and Magnetar
- Purchase “insurance” to hedge against risk: CDS

Lingering Problems

- Off Balance Sheet activities
  - Fed vs FDIC's Tom Hoenig on Capital
  - Stress Tests (Fed vs Jessie Jones)
- Systemically Dangerous Institutions
- Echo Bubble in Stocks
  - Weakest econ recovery on record yet stock prices and valuations are in bubble zone
  - Artificially low risk perceptions (stocks, Euro bonds)
- Fed cares more about well-being of individual banks than in transparency and investor protection
- Use of mainstream theory and models (DSGE)
- Moral Hazard: stability is destabilizing

Reforming Finance

- Reducing concentration plus retaining risk can reorient banks back to relationship banking
- Role for gov't to play in re-regulating and re-supervising
  - There are no magic formulas (capital ratios, living wills, skin in the game)
- Role for gov't in direct provision of financial services
  - Payments system
  - Direct lending to serve public purpose
  - Guarantees for public-private partnerships

Reforming the Fed

- Calls to Audit the Fed; or to “End” the Fed; Calls to reduce power of NYFed
- Leaks: Senator Warren and Rep Cummings sought briefing and info on possible leak of mkt-moving info at Sept 2012 FOMC meeting
- Regulatory Capture: Carmen Segarra’s secret recordings.
  - Do examiners have sufficient support of superiors to do their jobs?
- Revolving door—especially NYFed (Geithner, Fuld, Friedman, Dudley); Greenspan, Bernanke
- Rigging Markets: everything from LIBOR to Govt Securities to Commodities—with regulators who care more about “monetary policy” (inflation fighting) than supervision

Reforming Policy Response

- Transparency, Democratic Governance
- Simplify, Segment, Reduce layering/leverage
  - Global (BHC) leverage ratio
  - Divorce the payment system from banking?
    - Or, make banks “fund” with deposits?
  - Limit central banks' MMLR role
  - Tougher collateral rules
  - Stop the "too-big-to-fail" policy; resolution not bail-outs