Crisis Management and the Long Run

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I am pleased to be here today to offer my perspectives on the ongoing financial turmoil.

In recent weeks, I have raised concerns about the policy response regarding institutions considered "too big to fail." When events began to unfold in August 2007, U.S. policymakers reacted quickly to provide liquidity to markets and institutions. And, as matters deteriorated, there was a further escalation of policy interventions to an extent not seen since the 1930s. Some institutions have failed, others have received sizable infusions of taxpayer funds to support their operations, and the functioning of some key financial markets now depends heavily on government support. Despite these actions and some recent signs of improvement, markets remain under stress and the near-term outlook for the financial system and the economy remains uncertain.

Clearly, the magnitude, nature and scope of this financial crisis have posed significant challenges for policymakers here and abroad. The weakening economy has caused financial difficulties to escalate. But, in my view, the rush to respond has had negative consequences as well. Without a systematic plan for addressing the crisis, policy actions have been ad hoc, resulting in inequitable outcomes among firms, creditors and investors that have increased uncertainty and undermined confidence. Nowhere is this more apparent than in the treatment of large, complex financial institutions that have been labeled as "systemically important" and "too big to fail."

Today, I would like to place my recent discussion of the resolution of these large problem institutions in a somewhat broader context by taking a closer look at how we got into this difficulty and by discussing some of the longer-run consequences of the actions being taken to resolve the crisis.

Context for the Crisis

Many factors contributed to the financial excesses that spawned this crisis. But, at the root of our problems is a collective failure of market discipline and public policy. Over the past three decades, we have seen enormous growth in financial markets and institutions around the world. This growth has been spurred by technological advances and financial innovation. But, it was also supported by a philosophy that financial institutions and supervisors have the tools to measure and control risk while policymakers maintained an environment of stable prices and low interest rates. This philosophy, moreover, led many financial institutions and investors to take on more leverage, hold less in liquid funds, and downplay the risks of many of the new financial instruments and counterparty relationships. Also, the removal of certain barriers to geographic and activity expansion in banking provided an additional incentive that helped pave the way for ever larger financial institutions, whose failure could have broad repercussions across the financial system and the economy.

This new system of finance relies more heavily on market discipline to manage risks and maintain stability. But, as we have seen, there have also been factors that have served to undermine market discipline. These include: the increased complexity of financial instruments; institutional features that distorted incentives to take, measure and manage risks; and, importantly, the view that large complex financial institutions would not be allowed to fail. I think it is also fair to say that all regulators were complacent in performing their oversight responsibilities in an environment of strong economic growth, low inflation and strong financial performance.

These financial developments were supported by a very favorable macroeconomic environment, where a decline in inflation worldwide allowed central banks to maintain low

interest rates and ample credit availability, making debt and leverage more attractive. With these favorable financial and macroeconomic developments extending over a long period of time -- punctuated only occasionally by financial crises in some emerging market economies -- it is not too surprising that policymakers ignored the naysayers who warned of weaknesses in this system and did not develop a systematic plan for dealing with a major financial crisis such as the one we are currently confronting.

Crisis Resolution

From this introduction, let me now turn to my view on the resolution of large, complex financial institutions. While you may be familiar with some of my more recent remarks on the "too big to fail" issue, I have been concerned with this problem for some time. Previously, I said, "In a world dominated by mega financial institutions, governments could be reluctant to close those that become troubled for fear of systemic effects on the financial system. To the extent these institutions become too big to fail, and where uninsured depositors and other creditors are protected by implicit government guarantees, the consequences can be quite serious. Indeed, the result may be a less stable and a less efficient financial system." I also noted that "recent history throughout the world suggests that "too big to fail" may be the policy of choice in crisis situations, particularly when mega institutions play a large role in a country's economy and financial markets." I made these comments not this year, but in March 1999.[1]

In recent weeks, I have outlined a resolution framework for how we deal with the large, systemically important institutions at the center of this crisis in the United States. Boiled down to its simplest elements, the plan would require those firms seeking government assistance to put the taxpayer senior to all shareholders with the impact on managers and directors depending on

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[1] "Financial Industry Megamergers and Policy Challenges," March 25, 1999.
Available at: www.kansascityfed.org/home/subwebnav.cfm?level=3&theID=9983&SubWeb=6

the viability of the firm. Nonviable institutions would be allowed to fail and be placed into a negotiated conservatorship or a bridge institution, with the bad assets liquidated while the remainder of the firm is operated under new management and reprivatized as soon as feasible. This plan is similar to what was done in Sweden in the 1990s and what we did in the United States with the failure of Continental Illinois in the 1980s.

This plan has many advantages, including that management and shareholders bear the costs for their actions before taxpayer funds are committed. This process also is equitable across all firms; is similar to what we now do with smaller banks; and provides a definitive process for reducing market uncertainty. These all are important reasons we must implement this kind of resolution process.

In contrast to this suggested approach, a policy of "too big to fail" raises important issues. For example, it worsens the already significant problem of moral hazard in which investors do not monitor risk appropriately, assuming, correctly it would seem, that the government will bail them out of financial problems. Capitalism is a process of failure and renewal, and a policy that undermines this process makes the financial system and our economy less efficient.

Also, when firms are treated as "too big to fail," they receive an implied subsidy and a competitive advantage over other firms.

Critics of the approach I suggest have raised three main objections. First, they argue that these institutions are too large and complex, with many international linkages, to be resolved in a timely manner. I agree that these resolutions would be complex. But, historical experience also shows that forbearance is often more costly, especially to the taxpayer, than resolving the institutions in a timely manner. Second, critics suggest the failure of one of these institutions could be very disruptive and worsen the crisis, citing Lehman as an example. I am not at all

advocating the approach taken with Lehman. Rather, I am arguing for a timely, managed and orderly resolution of large, insolvent institutions, with their basic functions continuing under new management. Third, critics suggest that government resolution of these institutions amount to their "nationalization." I believe this is a misnomer, as we are taking a temporary step that is aimed at cleaning up a limited number of failed institutions and returning to private ownership as soon as possible. This is something banking agencies have done many times before with smaller institutions and, in selected cases, with very large institutions. In many ways it is also similar to what is done during a corporate bankruptcy, but with an emphasis on ensuring continuity of services.

Longer-term Consequences

In the heat of a financial crisis, policymakers are in a reactive mode, especially in the absence of a systematic plan to address the crisis. In this environment, it is tempting to downplay the longer-term consequences of short-term decisions. But there are some significant implications of the policy actions taken in this crisis that will shape the financial system and the economic environment in the future. Let me conclude my remarks today with a discussion of some of the longer-run consequences of the policy response to this crisis.

One key issue, of course, is what financial regulatory structure we want going forward if we are to prevent a repeat of the current crisis on an even larger scale. While much of the discussion about regulatory reform will focus on who should be the regulator of what institution or activity, I believe there are two more important issues that need to be addressed. First, what should be the span of regulation and the federal safety net; that is, which institutions or segments of the market should be covered by government guarantees and other support mechanisms? Also, how should these entities be regulated to limit safety net exposure? A second key issue is

how should we deal with large, systemically important financial institutions on a more permanent basis? In this regard, I fear that if we pour in enough public funds to see us through the current crisis, we will then breathe a sigh of relief and back off from implementing any comprehensive solutions to controlling the use of government guarantees and to addressing the problems posed by systemically important institutions.

In my view, this would be a serious mistake. While a carefully constructed safety net and a better resolution procedure for large institutions are critical, we also need to think about how to prevent such institutions from holding us hostage in the future. This may require breaking them up, limiting their activities or size, increasing capital requirements, or taking other steps to limit the systemic risks they impose on the financial system.

More broadly, however, during this crisis we have seen an enormous extension of government guarantees and support to institutions and markets that had not previously been covered. Going forward, we must credibly convince financial markets and institutions that such coverage will not be easily forthcoming in the future. A key step in accomplishing this is to take the steps that I have suggested to resolve large problem institutions. If we fail to do so, we will see moral hazard problems escalate far beyond their current levels, with enormous adverse implications for the efficiency and stability of our financial system.

This crisis will also have an enormous fiscal cost that will place a large future burden on taxpayers, even as we come closer to the tsunami of looming Social Security and Medicare obligations. Going forward, we need to ensure that managers, shareholders and creditors of financial institutions bear the full costs of their risk-taking, and I think we need to make it harder for policymakers to pass these costs on to taxpayers.

Finally, let me comment on some of the longer-run implications of the Federal Reserve's role in the policy response to this crisis. This crisis has involved segments of the financial system that operate outside of the traditional federal safety net, which has been limited to depository institutions. In fact, many of the players in this crisis would not be given access to the discount window during normal circumstances and have been subject to little in the way of prudential supervision. The Federal Reserve's response to this crisis in providing liquidity and support to institutions and markets outside of its traditional purview has been significant, creative and timely.

However, in stepping outside its normal sphere of operations and making decisions about which markets and institutions to support, the Federal Reserve has also moved into credit-allocation decisions which are more properly performed by the marketplace itself and by fiscal authorities when necessary. These decisions have also caused the Federal Reserve to greatly expand its balance sheet and have almost certainly set expectation for similar responses in any future crises. All of this will make it more difficult for the Federal Reserve to quickly remove its policy accommodation in the future and, thereby, will subject it to new tests of its independence as a monetary authority.

Concluding Comments

We have expended considerable resources addressing this difficult crisis, but still, we have a ways to go before markets will function effectively without government assistance. In my view, this process will go faster and with less ultimate cost if we take decisive steps to resolve insolvent institutions in a timely manner, regardless of their size and complexity. Over the longer term, we face the difficult task of redesigning our system of financial regulation to provide more stability, while maintaining innovation and efficiency. This is always a difficult

balance to strike, but it will be nearly impossible if we do not address the problems posed by large, complex financial institutions.