

FinReg21

Channel 21 | Week-in-Review

Time Warp: Reliving the Crisis

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David Evans, Editor-in-Chief FinReg21;

Robert Litan, Economist at the Kauffman Foundation;

John Taylor, Professor of Economics at Stanford University;

Lawrence White, Professor of Economics at New York University



Channel 21

Professors Robert Litan, John Taylor, & Lawrence J. White join FinReg21 Editor in Chief David Evans for the first episode of Week In Review. They discuss the causations of the financial crisis and the ramifications, successes, and shortcomings of the Obama Administration's proposal as well as some alternate solutions to the devastation the economy is currently experiencing. To watch the video of this interview, [click here](#).

EVANS: This is David Evans from FinReg21.com. It's Thursday, September 17th, and this is the first edition of our Week in Review. I'm joined today by Bob Litan of the Kauffman Foundation, by John Taylor of Stanford, and Larry White of New York University. We're all economists, and welcome to all of you. Thanks for joining us today.

President Obama traveled to Wall Street on Monday to deliver a rousing speech on the importance of the reform of financial regulation. I'd like to get your reaction to this. Let me just read you a brief quote from the speech.

He said, "Instead of learning the lessons of Lehman and the crisis from which we are still recovering, they" – by which he meant some in the financial industry – "are choosing to ignore them. They do so not at their own peril, but at our nation's. So I want them to hear my words. We will not go back to the days of reckless behavior and unchecked excess at the heart of the crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses. Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

So the first question for you, Bob. Is Wall Street back to its old ways already?

LITAN: Sort of. Wall Street certainly has changed radically since the Lehman and AIG, etc., collapse. Morgan Stanley and Goldman Sachs are no longer investment banks – they're now bank holding companies. There's been dramatic shrinkage of personnel. There's obviously new attention to risk.

On the other hand, outfits like Goldman are making record profits in trading, and there is some resumption of risk taking, although overall, if instead of we talk about Wall Street, we talk about the banking system as a whole, there's still is a tremendous amount of risk aversion in the system. And it's going to be one of the restraining forces to keep, I think, the recovery from being stronger than it would otherwise be.

EVANS: Larry, do you want to react to that, but also, take on the question of, just how big a role were the bloated bonuses in the financial crisis?

WHITE: Sure. I mean, I agree with Bob that I think there are green shoots of risk taking coming back, to use a phrase. And guys are talking now about securitizing life settlements, and – you know, it's clear, it's in the – there's a self-selection process. People went to work for Goldman, for Morgan Stanley, for Merrill, because they were looking for opportunities. It's in the bloodstream – it's in the DNA.

It's clear that there was some relationship between the risk taking and the incentive structure, so to the extent that the safety and soundness regulators – and I think that's where the focus should be, in terms of salary and salary structure. To the extent that they see salary structure as a safety and soundness issue, I think that's healthy.

Channel 21

But there were, of course, much larger things going on, which was, too many people were drinking the Kool-Aid, that housing prices can only go up, and if housing prices can only go up, then mortgages will never be a problem, and that means that the market securities will never be a problem. And when they did tank, then the very thin capital levels throughout the financial sector, and especially in the investment banking area, then meant that the securities value declined. The fall in those securities was going to devastate the financial sector.

So yes, salary structure made a difference, but there was a whole lot more that was going on as well.

EVANS: I think what I'm hearing from both you, Larry, and also from Bob, is that Wall Street isn't really back to its bad old ways, it's simply back to sort of normal behavior. Did I get that wrong?

WHITE: It's not fully back. I think there is still some feeling of oh, my gosh, there has been something that has happened over this past year, two years. And there's a whole lot less securitization that's going on. Certainly the whole subprime mortgage area has tanked, and hasn't come back.

So – but they're all – the blood, the DNA, the blood is still there. So again, I expect to see more. If the regulators will let them, I expect to see more risk taking, more trading, more opportunity, more efforts to take risk if they can possibly do so.

EVANS: John, you might want to react to that, but before you do, let me ask you another question. Is it really credible to say that the American taxpayers won't be there for the next fall?

TAYLOR: Actually, that's what I was going to start with, David. It seems to me the President's message is correct, but it's not credible right now, because nothing's been changed that enables the government to say no on behalf of the taxpayers. It's still in the mode of, I would say, a bailout mentality. It certainly relates to the risk taking that Larry and Bob are referring to.

And I think until that's fixed, we're going to continue to have these problems. So either – I think the President is correct, also, to mention dealing with the capital issues, but until something's changed that he can credibly say that we will not be there to rescue the creditors, then it's going to continue as it is. That's the most important thing to be addressing.

EVANS: Would you – Bob and Larry, any reactions to that?

LITAN: Well, I think I agree with John. Let's get back to the President's speech. I think basically, the President went to Wall Street to try a bank shot, all right? So his main message has got to be to Congress, because the efforts for financial reform have been flagging, as has been evident, for example, on a number of the postings on the FinReg21 website. A lot of the steam has been going out, because the economy's gradually recovering, the financial sector has been gradually healing itself.

And so, when the President went to Wall Street, largely to tell Wall Street, knock it off, don't tell legislators that they have nothing to do – in fact, I want to remind you, saying the President, that you guys still have some housecleaning to do, and by the way, don't oppose my reforms. And that's basically the message that he gave to Wall Street.

I don't know whether it's going to work in Congress, because as we all know, Congress now is totally preoccupied with healthcare reform. It's hard for them to do more than anything except one thing at a time. And so the President was trying to jumpstart –

Channel 21

EVANS: One thing I wonder about, Bob, is whether the real problem with bills in Congress is lobbying from the financial industry, as opposed to the resistance that the administration seems to be getting from the sitting regulators, who seem to be a little bit – not happy with many of the elements of the plan.

LITAN: That's true. That's true, but largely, we're getting a lot of lobbying from the financial industry. I know we're going to talk about the Consumer Agency, but the financial industry doesn't like that.

EVANS: Right.

LITAN: The financial industry doesn't like raising capital standards too much. They're nervous about a systemic risk regulator, and so forth.

And so, it's true. The Hill is hearing from all kinds of people, including the regulators. But I think right now, the financial industry has more clout than one would have expected a year after this crisis.

EVANS: So let's get into the Consumer Financial Protection Agency Act, since you mentioned that, Bob. That's really the first thing that the President mentioned in his speech. How much did stale consumer protection contribute to the crisis? John?

TAYLOR: Well, I think it's not very much. I think it's an example where we haven't had a full examination of the causes of the crisis in the government. You have the Angelides Commission that's been appointed, but they're not even supposed to report until December of next year.

And so now, we're kind of scrambling with different proposals, many of which, in my view, don't have too much to do with the crisis, and this is an example.

I'd say, rearranging the chairs, if you like, seems to me is not the place to go. It's the natural reaction to government. But if there's some problems with what the Fed did with respect to mortgage originations, or with regulating the institutions it's responsible to regulate, then let's focus on that.

There's some – obviously, some things that are related to the crisis, like the proposal to merge the OTS and the controller – that's important to do. But I think the consumer protection side seems to me, really, is too far from the crisis to be the focus. But it is the focus, because it's popular, and there's a lot of people who want to move in that direction. It's like the famous line about, let's take advantage of a crisis? Well, everybody wants to jump in with their pet projects and pet ideas, and push them through on the basis of the crisis, but we don't have a lot of evidence this is the factor.

WHITE: I agree. And I was distressed – I mean, in some sense, in the President's speech, there was no new news, other than he wanted to try to kick start the reform effort. I was distressed by the fact that when he ordered which of the important pieces of the legislative proposals he was going to mention first, he mentioned consumer protection, rather than the systemic risk regulator and receivership regimes, which in my mind, are much more important, and are much closer to the problems that generated the crisis, rather than, as John has just said, gee, yes, there were some people who got abused, who got – who didn't understand what they were signing, but that's not where the major cause of the problem was.

LITAN: Hey, David?

EVANS: Yes?

Channel 21

LITAN: I'd like to register a mild dissent from what I've just heard. First, as a tactical reason, I think the President mentioned consumers, the Consumer Protection Agency first, because that particular piece of legislation is going to be marked up by the House committee – House Financial Services Committee first on September 23rd, so he's probably doing that as a warm up exercise, just as a tactical thing.

But when we get to causes of the crisis, I like to say that really, the crisis had two major causes. One is the match that lit the fuse – the match, of course, was subprime lending. And the fuse was greatly amplified, and we ended up with a huge explosion, because of massive leverage throughout the financial system.

So if you look at the match, which was basically much too much subprime lending, I think if we had had sensible regulation way back in, let's say, 2003 and 2004, which would have insisted that there be 20% down payments, or at least 10% down payments, and we would have had documentation on the loans and so forth – if we had, in other words, sensible underwriting to begin with, the match may never have actually been lit, and it's conceivable we wouldn't have had the following explosion.

So, if in fact, we get a new consumer regime that will restore some sensible, prudent underwriting standards, that could prevent at least a recurrence of what we saw before. That's my view.

EVANS: Are those sensible underwriting standards, if one really believes that housing prices are going to keep going up?

LITAN: You mean, would underwriting keep housing prices from going up? Is that the idea?

EVANS: No. Well –

WHITE: Let me put David's point a different way. As I understand some of the ideas for what the Consumer Protection – Financial Protection Agency might do, they might insist that a 20% down payment option be available. But then, if you really want to go ahead and put no money down, or that you're still – that you're not going to be prevented from doing that. And as David just asked, if someone really believed that housing prices could only go up, he or she was going to want to sign up for a zero down loan, and the lender was going to be happy doing that, because if the lender also believed, etc., etc.

So it's – again, the Protection Agency works to deal with abuse with people not understanding what they are signing. They don't deal with a mass hysteria of everybody drinking the Kool-Aid, that housing prices can only go up.

LITAN: That's a fair enough point. I mean, I think at some point, we're going to have to have somebody, at least, have some minimum prudential rules on underwriting, and it's – you're right, that –

WHITE: That's a prudential issue. That's not a –

LITAN: Yeah, that's right. And the Consumer Agency, the focus of that, is certainly going to be on disclosure, and that's where it should be.

WHITE: Yeah.

LITAN: And if it does a lot more than disclosure, we're probably going to get into trouble, so I agree with you there.

WHITE: OK.

EVANS: Let me move to another topic, then. One of the continuing controversies, and the President does touch on this, is dealing with systemic risk. The plan, at least as I understand it, is to put the Fed more or less in charge of systemically risky companies, very broadly defined, and then to have a council of regulators that would try to – I guess, sort of make sure nothing falls through the cracks by having continuing dialogue.

So I'm not sure who to start with. Why don't I start with John? Do we know how to identify systemically risky firms, and if we don't know how to do that today, could we figure it out in a reasonable space of time?

TAYLOR: I don't think we do. I think, first of all, no one defines systemic very well. You know, systemic risk is used all over the place, and currently, in the Fed's purposes manuals, they're in charge of looking at systemic risk, that before the crisis began.

So I have problems with giving the Fed this, I think, significant power to decide whether an institution is systemically risky or not. And I think that can – we're talking about legislation that will last for many years, and that can be abused. And then once those institutions are the focus, all sorts of other things can happen. They'll be worried about failure –

EVANS: John, if I can interrupt you before you go ahead, and just ask you, when you expressed the concern about the Fed, assuming that someone has this role, do you have a concern over the Fed having it versus some other agency having it?

TAYLOR: Well, my preference –

EVANS: Is the Fed less preferred?

TAYLOR: Sure. My preference would be to have something like the council that's proposed, and that purpose is to make things don't fall into cracks, like you said, but also, to resolve conflicting responsibilities – serious people who recognize this. I think that could go a long way to resolving some of the things that happened, like with respect to the SEC and the broker/dealers.

With respect to systemic risk, define it, and the Fed could monitor that. I think, no problem with the Fed monitoring. But I don't see why any agency has to go out and designate firms in a completely discretionary way who are now systemic. You know, somebody said there's going to be 19 – I don't know, maybe 119, before we're finished.

And I don't see the reason for that. I think that the crisis wasn't caused by a failure to identify them – it was a failure to not regulate the ones that were supposed to be regulated.

WHITE: Well, all right. Let me offer a counterview, and I'll just – as an example, GE Capital, OK? \$600 billion financial services entity - \$600 billion in assets. Gosh, if they went under, if they had to declare bankruptcy, I think that would be a rather messy and disruptive event. And so – and right now, except for a small piece of that \$600 billion, which is a Utah-chartered industrial loan corporation, the rest of that entity is not subject to any prudential regulation.

Somewhere, somehow, there's got to be some prudential regulation of that \$600 billion entity – otherwise, they've got an incentive to go off, and take more risk, etc., etc., etc. So somewhere, somehow, there's got to be prudential regulation.

Channel 21

I also don't like the idea of the Fed being the regulator here, because gee, they didn't do such a hot job leading up to this crisis. They were responsible for bank holding companies, and that's been a big part of the problem. The holding company of Citi, at the time of the crisis, was almost a \$1 trillion holding company. It's now shrunk a bit. And that holding company, no deposit insurance there, no receivership regime available for dealing with it if it got into trouble – we've got to do better.

And so, I like the idea of a risk identifier and a prudential regulator for entities that aren't otherwise covered by prudential regulation, and I would put bank holding companies into that category, because the Fed wasn't doing all that great a job.

So – but having a council of – having, say, a board where the Fed Chairman and the Secretary of the Treasury, and separately, the head of OCC and the head of FDIC, maybe the SEC Chair as well, having a five-person board, an executive director, fully staffed to be able to do examination and supervision – that strikes me as a good direction to go.

EVANS: The asset threshold for systemically risky companies, the Tier 1 companies, is \$10 billion of assets. Doesn't that seem a little bit on the low side?

WHITE: Way too low. Way too low. That needs to be expanded by at least a factor of ten, maybe even bigger than that. But yeah – ten, wow. I mean, that's way too low. Sheila Bair can handle a \$10 billion receivership without blinking an eye.

No, way too low.

EVANS: Bob, do you have any thoughts on this?

LITAN: Yeah, I'm closer to Larry than I am to John. I think if we look out over the last five years, the capital requirements and capital structure of the financial institutions have been exactly backward. The larger institutions have ended up having lower capital ratios than the smaller institutions, when in fact, we now know that it's the larger and more interconnected ones that spread more damage. And that's why we ended up, of course, rescuing them.

So we need to have some kind of progressive system where the bigger guys have a higher capital ratio, and probably higher liquidity ratios than the smaller guys.

Now, we get into the religious issue about whether we are going to identify the ones in particular. Well, you know, as a practical matter, even if you didn't identify them and all you had was a progressive structure that said, basically as you get larger, you have a larger capital ratio, de facto you've identified them, as a practical matter. So whether you do it de jure or de facto, I think at the end of the day, we're going to have a lot more intensive monitoring of the big guys.

Now, a separate issue, who's going to do all this – as a practical – I think at the end of the day, we're going to have a council of some sort, and they are going to do what John says, and I think what Larry agrees to. They're going to look for things that could fall through the cracks, so, fast growing asset categories, new instruments that present different kinds of risks that we haven't thought about before. They'll probably want to have sophisticated software programming to figure out interconnections among financial institutions and so forth.

So the monitoring function, I think will be carried out by somebody, whether it's going to be the Fed, or whether it's going to be an oversight council, or whatever. But we still have this lingering question

Channel 21

of who is going to look after the non-bank systemically important institutions, the really big guys. Like, let's say, GE Capital. Or let's say a future AIG.

Do we really trust state regulators, for example, to regulate a future AIG or some other form? I'm not sure. Especially – it makes me uncomfortable when I know that there's a significant prospect that a big guy that's not a bank could be rescued and have taxpayer funds put into, and yet, we're going to have no federal entity look at them. Makes me nervous.

TAYLOR: And I think, by the way, on the capital requirements, capital ratios, leverage ratios, I certainly agree that those should be – I think they should be raised. I think it's difficult to decide large, interconnected, etc., the interconnected variables particularly hard to define. But I don't see any reason why those shouldn't be raised. I think that there's people in the industry who are going to complain about that.

Also, people legitimately worried if you do it too much, you will interfere with proper risk taking, and that's – you don't want to do that.

But I'd say now, especially given this too big to fail problem, where there's no way that government officials seem to be able to say no, that if you raised those capital requirements, that will start to deal with that. And I think it's – I agree, it's important to do that.

But my main problem here is going out there and designating institutions on a highly discretionary basis. If there's a council, and they see the development of a new asset category, or a new type of institution, then recommendations to regulate that make a lot of sense.

But in the meantime, the proposals out there have a – really given a lot more power to a small number of individuals, and to some extent, that's one of the problems we've had already.

EVANS: Well, let me turn to a sort of related subject. The FTC got slapped down earlier this week by Judge Rakoff in the Federal District Court in New York. In a rather remarkable development, he rejected their \$33 million settlement with Bank of America over its disclosures to shareholders on the Merrill bonuses.

Doesn't this raise a general problem, that one of the problems we've had is, the regulators have been surprisingly ineffective? So the FTC got slammed by their Inspector General for missing the Madoff Ponzi scheme, and now we have a judge saying that they reached a puny settlement. And I think in his words, maybe get a good press release.

How do we fix this?

TAYLOR: Well, let me just jump in real quickly, and there's a small point. I think a lot of these problems are making government work better. You know, is the regulators not doing their job, or is the officials investigating fraud not doing their job? And I think it's – so often, it's kind of boring, but making government work better. Accountability, rewards, motivating people. I've seen it all the time – I've been in government, and lots of people worked for me. It's a challenge.

But I'd like to see that as a focus – how will you get the Fed to do a better job on these bank holding companies? They've already got hundreds of people sitting in, simple to say it's not enough, sorry, I don't think that's the whole reason.

So I'd like to see a focus on that. It seems to me, it addresses a lot of these problems.

Channel 21

WHITE: I agree with John, that it is an issue of good management, better management, motivation. In some places, you probably do need better pay, better training.

The particular SEC thing is – and Bob, as a lawyer as well as an economist can comment here. I mean, to have a judge strike, invalidate an agreement that two parties come to, that basically say, we don't want to go to trial, we want to settle this thing, and to force them to go to trial is an unusual, unusual event.

This is a corporate governance thing. It's not one of our prudential regulatory things.

It's not so much a slap at the agency not doing a job, it's just this particular settlement – we don't want to go to trial, we'd prefer to settle it – this is unusual. Bob?

EVANS: Yeah, Bob – what's your take on this?

LITAN: Well, actually, I was involved in a similar kind of situation here, when I was at the Justice Department, and Larry was at Justice many years before me. But when I was at Justice in the '90s, we settled with Microsoft in the first –

WHITE: Oh, that's right. Yes, of course.

LITAN: We settled with them, and we went to Judge Sporkin in District Court, and Judge Sporkin rejected our settlement, and said we had to be tougher. We appealed it to the Court of Appeals, and the Court of Appeals slapped down Judge Sporkin, and said he was out of bounds.

And so, Larry, it does raise this issue, that it is a judgment call, when people are being investigated. People for all kinds of reasons can decide to settle litigations, and it is extraordinary for judges to go ahead and take this power.

Now – so therefore, I want to make two points about the FTC settlement. Number one is, the FTC may appeal this, and it's conceivable that an appellate court could tell Judge Rakoff that he was off the reservation. So that's – we don't know yet. That's point one.

And point two, though, if it's not appealed, and it stays the way it is, the one – there are a lot of messages from Judge Rakoff's decision, but one clear one is, is that the FTC sued the wrong parties. They went after Bank of America Corporation, and basically fined the corporation, which is equivalent to fining the shareholders, and telling the shareholders, you know, you guys were screwed because nobody told you about the bonuses, and now we're going to do it again to you, and we're going to make you pay for it.

And which Judge Rakoff was saying to the FTC, you shouldn't have sued the bank, Bank of America. You should have sued the executives of Bank of America, and made them pay for the failure of disclosure.

The FTC says, well, we didn't have enough evidence to go after the executives. I find that hard to believe. I mean, after all, the executives of Bank of America – and I will disclose a conflict of interest here, they are my bank.

But even so, the executives obviously were in charge of disclosures, and it's conceivable to me that – or, it's inconceivable to me that if the FTC had evidence against the corporation, they couldn't have at least gone after the executives, and that's really what Rakoff was telling the FTC to do. You went after the wrong people.

Channel 21

EVANS: I have one final topic for today, which I'd like to cover quickly, if it's OK. So Tuesday was the year anniversary of Lehman going belly up. And the common wisdom is, that's the failure to rescue Lehman, and that's what tipped the financial system over the edge.

Now, John Cochrane and Luigi Zingales had an op-ed in the Wall Street Journal earlier this week that said that's wrong – that it was really the Bernanke/Paulson the sky is ending speech a week later that was the push over the edge.

John, I know this is something that you've written on and talked about. Do you want to maybe give us a comment here, and then I'll let Larry and Bob have the last word?

TAYLOR: I agree entirely with John and Luigi. In fact, they used in their article a chart that I produced just about a year ago to show this LIBOR-OIS spread, and it's an events study.

Since then, I've looked at many other indicators, much other evidence. But for example, the S&P 500 was higher a week after Lehman Brothers than it was before the bankruptcy. Then it was after that – it was really the following week, with the testimony of the Chairman and the Secretary that things really started to cave. And you look around the world, there's lots of evidence.

So I think they're right, and I think – I'm very happy to see that article. I think people will begin to come around, and look at the numbers, and not just jump to conclusions.

Obviously, that was a hit to the economy, that bankruptcy. But that was not the thing that spread around the world so quickly, and this really very harmful panic.

WHITE: But, John –

EVANS: But isn't it true that around that time, we were about ready to go off the cliff?

TAYLOR: I think there was a lot of things that probably should have been addressed earlier. I actually go back to Bear Stearns, and give them the benefit of the doubt on that intervention. It wasn't there. It's difficult to know what's going on in the room.

But right then, to lay out what's the strategy to deal with this obvious problem in the banking sector, and how is it going to be handled? And it didn't happen, and it was revealed it didn't happen when the TARP was put forth. Two and a half pages of legislation, \$700 billion, and what was proposed was not even what happened.

So I think there's a lot more thinking and work on this that's necessary. But the brink aspect, if you like, was more and more evident, but starting way back, in August – even earlier, 2007.

EVANS: Bob?

LITAN: You know, there is much in what you say, John. But am I correct that the market did fall substantially on that Monday of the bankruptcy? I think the Dow Jones Industrials fall 500 points, that's a major fall. And that ought to be telling us something about the way the event was perceived.

TAYLOR: Right, but that is small, compared to what happened later. And remember that it rebounded from that. The S&P 500 was 1,255 on the 19th of September – it was 1,252 on the 12th. And you can look at markets around the world, you see the same thing.

Channel 21

Yes, of course, it was a surprise. A lot of people expected that Lehman would be bailed out, or I should say, their creditors would be bailed out. So it was a surprise – people scrambled. But by the end of the week, things were moving, and it wasn't until the following week that I think you see the damage.

We're going to be studying this for a while. I'm just happy that there's a discussion going on right now.

EVANS: Bob, I'm going to close with you, and ask you to be a little bit of a prognosticator here. In terms of Obama's plan, what do you think is going to get passed?

LITAN: Well, that's difficult. So I think something will be passed by –

EVANS: We on have a few seconds.

LITAN: Well, OK. Something will be passed by a year from now – 50% chance we'll get a consumer regulator, we'll probably get an oversight risk council, we'll probably get something on derivatives regulation, and a few other bells and whistles. But probably, at the end of the day, maybe half his package, and not the whole thing.

EVANS: Thank you very much, Bob, Larry and John. It was great talking to you today, and I hope to see you next week.

LITAN: Likewise.

WHITE: Thank you, David.

TAYLOR: Thanks a lot.

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