Avoiding another Big Financial Crisis

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The global financial crisis of 2008-09 was devastating. Nearly 9 million Americans lost their jobs. More than 5 million lost their homes. Nearly $13 trillion in family wealth was destroyed, wiping out almost two decades of gains. It took nearly six years for U.S. per capita output to return to pre-recession levels, and many workers, consumers, homeowners, investors, borrowers, banks, and businesses haven't recovered fully. Even worse, the Great Recession appears to have done lasting damage to the U.S. economy's long-run growth rate.

Anyone with any sense wants to reduce the chances of anything resembling a repeat of 2008-09. A lot has been done to accomplish that. Some has been done well, some hasn't, and some essential steps have yet to be taken. Presidential candidates should take a close look at what was done in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and what has been done by financial regulators in the U.S. and globally—and then decide what needs altering. The next president cannot avoid these issues so the candidates shouldn't avoid them during the campaign. Candidates should spell out the actions they would take in the White House to shield the nation and the rest of the world from another financial meltdown.

The politics of this issue are treacherous. Wall Street has regained its clout and its kvetching. Some Republicans in Congress would repeal Dodd-Frank, and that is interfering with bipartisan efforts to fine-tune it. Some Democrats and some Republicans are deeply suspicious of big banks and are pressing to break up the biggest ones, toughen regulation, and limit further the discretion of regulators. Financial institutions and some of their customers, meanwhile, point to unwelcome consequences of the new rules. They argue regulation is starving the economy of credit, burdening the banks with costly oversight and making it costlier to buy and sell bonds quickly, which could be a big problem in a crisis if a lot of people want to sell bonds at once. But the stakes are too high to let the politics scare presidential candidates away from revisiting these issues. Making the financial system more resilient is a work in progress, and there's more progress to be made.

A short essay like this one cannot be comprehensive; it can hit only a few salient points. For more comprehensive accounts, all of which helped inform this piece, see the Volcker Alliance proposals and a Bipartisan Policy Center critique and this PowerPoint presentation by Martin Baily of the Brookings Institution and Aaron Klein of the Bipartisan Policy Center.

What Has Been Done Well

Sometimes lost in the often-partisan argument over Dodd-Frank is one simple fact: there is solid evidence that the Dodd-Frank requirements have made the financial system safer and more resilient. First, big U.S. banks are in better shape now than they were at the time of the financial crisis, in large measure because regulators have forced them to hold bigger capital cushions (which means they can absorb bigger losses without endangering each other and the whole financial system). Had today's capital framework been in place in 2007, the largest, most complex financial institutions would have been required to hold roughly twice as much common equity as they actually did. With greater common equity, perhaps fewer banks would have needed government rescue. Now, periodic stress tests, supervised by regulators, have forced bank managers to prepare for worst-case scenarios. The fraction of loans that aren't being paid is half what it was at its peak in 2010. Metrics that track the risks that banks pose to the financial system are reassuring. The bottom line, according to the International Monetary Fund: "Compared to the pre-crisis period, [U.S.] banks have strengthened their capital positions, including relative to their international peers, hold more liquid assets and are less levered."

Equally important, Congress has given financial regulators legal authority they didn't have when Bear Stearns, Lehman Brothers and AIG ran aground. In 2008, the Federal Reserve and other policymakers faced an ugly choice: bail out (Bear, AIG) or bankruptcy (Lehman). The former was unpopular and arguably unfair; the latter was perilous in the midst of a financial crisis. The new mechanism created by Title II of Dodd-Frank creates a process to liquidate a large, complex financial company that is close to failing. It's untested. Thus, it's not clear it will work in the event of a large financial institution that sprawls across national borders. And not everyone endorses it. But regulators are far better equipped than they were in 2008-09.

Consumer protection is no longer a step-child for financial regulators, whose primary job is preserving the safety and soundness of the banking system. The new Consumer Financial Protection Bureau has the sole mission of looking out for consumers and a very broad mandate to look across the financial system, and it's off to a strong start. As Martin Baily and Aaron Klein put it: "It's hard to think of any new federal regulatory agency that has had as much impact in its first few years."

What Has Not Been Done Well

The financial crisis exposed the weaknesses of the archaic and fragmented financial regulatory system. Financial institutions—most notably AIG—exploited the crevices between regulatory agencies. No agency had overall responsibility for monitoring financial stability. Even when risks were noticed, turf battles and inconsistent mandates interfered with effective response. Dodd-Frank did require the agencies to sit at a single table—the Financial Stability Oversight Council (FSOC) that is chaired by the Secretary of the Treasury. But the law failed to streamline or consolidate what Treasury Secretary Jack Lew calls the "spaghetti" regulatory structure. The Obama administration decided that Congress simply wouldn't do that because congressional committees so jealously guard their turf. Merging the Securities and Exchange Commission (SEC) and the Commodities Futures Trading Commission (CFTC), a proposal that has been made repeatedly, has gone nowhere, largely because the SEC reports to congressional banking committees and the CFTC to the agriculture committees (because commodity trade began with agriculture). For the past century, every decade—except, for some mysterious reason, the 1950s—has seen debate over consolidating federal financial regulatory agencies with almost no success. (For the long, sad history, see Elizabeth F. Brown's "Prior Proposals to Consolidate Federal Financial Regulators.")

The shortcomings of the FSOC are abundantly clear: "The regulatory landscape remains fragmented, resulting in gaps, overlaps and the potential for delayed responses to emerging risks, and should be simplified over time," the IMF advises. My Brookings colleague, Donald Kohn, a former Federal Reserve vice chairman and an external member of the Bank of England's Financial Policy Committee, lists several shortcomings of the FSOC. It is composed of several independent regulators, some of which have mandates to focus on specific institutions or markets, not on stability of the overall financial system. Gaps in regulatory oversight may leave the financial system vulnerable in the future; important financial institutions or activities remain largely unregulated even after Dodd Frank. Data isn't shared among the FSOC agencies to the extent that it could be. The FSOC is likely to face big hurdles in implementing policies designed to make credit less plentiful in boom times and more plentiful in busts, known to insiders as "countercyclical macroprudential tools." Even after the FSOC reaches consensus on a policy, which can take a long time, it has limited power to force a federal regulatory agency to act. There are a variety of proposals to alter this structure. Kohn, for instance, would give each agency an explicit mandate to aim for financial stability and would remove the Treasury Secretary as FSOC chair and give the job to a presidential appointee. The Bipartisan Policy Center would create a single prudential regulator (to assure the safety and soundness of individual institutions) and another to regulate capital markets. Paul Volcker would create a new independent prudential supervisor overseen by a Fed vice chairman. About the only issue on which there is consensus is that the current FSOC structure is far from optimal.

Financial regulators failed to foresee and prevent the financial crisis. (Of course, just about every other check on the system failed, too. The credit-rating agencies. The lawyers. The supposedly sophisticated investors who bought mortgage-linked securities. Bank managers and their risk-management committees. Politicians. The press.) The Fed, Treasury and other arms of the government drew enormous criticism when they intervened to prevent the financial crisis from triggering a repeat of the Great Depression. That's understandable. To a lot of Americans, Wall Street got bailed out and Main Street didn't. Congress responded by giving regulators some new authorities (see above) by underscoring its determination to prevent future bail outs of bank shareholders, bondholders, and management, and by limiting the discretion of the Fed, Treasury, Federal Deposit Insurance Corporation (FDIC) and others to respond in a future financial crisis. Some observers applaud this third element or argue, as Stanford University's John Taylor does, that regulators still have too much discretion. To them, the crisis demonstrated the importance of clearly articulated rules that will reduce uncertainty and discourage banks or their investors from taking big risks with the wink-wink understanding that the government will be there if the bets go sour. But just as the president has the authority to respond quickly if the U.S. were to be attacked by North Korean missiles or terrorists, financial regulators need to be able to react swiftly in a financial panic—especially given the inability of Congress to act swiftly. Former Treasury Secretary Timothy Geithner says Congress unwisely created new hurdles to the FDIC guaranteeing the debts of the banking system—a move that proved a potent tool during the crisis—and some Fed veterans, Ben Bernanke among them, worry that Congress overreacted and put too many restrictions on the Fed's "lender of last resort" ability to make emergency loans to solvent financial institutions. There are proposals in Congress to further constrain the Fed's emergency lending powers in order to encourage bankers to be more prudent. Bernanke says this approach is roughly equivalent to shutting the fire department to encourage fire safety.

Bernanke and his successor, Janet Yellen, argue that the Fed should use interest-rate increases to avoid or let the air out of an asset-price financial bubble only as a very last resort. They'd use interest rates to steer the economy away from too-high (or too little) unemployment or too much (or too little) inflation. To manage the financial system, they'd rely on what's known as "macro-prudential tools," essentially targeted use of regulatory power. "Monetary policy faces significant limitations as a tool to promote financial stability," Yellen has said. "A macroprudential approach to supervision and regulation needs to play the primary role." One category of these tools is intended to make the financial system more resilient, such as the tougher capital requirements and the stress tests; on these, the U.S. has made substantial progress. Another category is intended to allow the Fed to—in the jargon of the trade—"lean against the wind." In practice, this usually means restraining mortgage lending because real estate lending almost always is a major factor in financial crises. In the UK, for instance, the Financial Policy Committee has set limits on the mortgage debt-to-income ratios. Compared to regulators in other countries, the Fed and other U.S. regulatory agencies have very few macroprudential tools to deploy, particularly on housing. A lot more work needs to be done if macroprudential tools are to be a workable alternative to hiking interest rates to avoid or burst a real-estate bubble.

Fannie Mae and Freddie Mac, the two government-sponsored mortgage companies, were essentially nationalized during the crisis because they held or guaranteed so many mortgages that weren't paid back and were secured by houses worth less than the mortgage. Along with the Federal Housing Administration, Fannie and Freddie were behind 70 percent of the new mortgages made in the first quarter of 2015. When then-Treasury Secretary Hank Paulson took over Fannie and Freddie in 2008, he didn't expect them to be wards of the federal government seven years later. But they are. Fannie and Freddie are making money again, and barring an adverse decision in pending lawsuits by some Fannie and Freddie investors, this arrangement can go on for a long time. Proposals to phase out Fannie and Freddie and/or replace them have been floating around for years, but haven't moved.[i] Congress is in no rush to revive the private mortgage market—but, at some point, presumably, it will, so candidates need to weigh the competing alternatives.

What's Not Clear

An overarching goal of Dodd-Frank was to end "too big to fail" (TBTF); that is, to prevent banks from getting so big and interconnected that the government can't let them go under because that'd do so much damage to the economy. A lot has been done to implement this idea, including requirements that the biggest banks hold more capital and the creation of "orderly liquidation authority" in Title II of Dodd Frank. FDIC Chair Marty Gruenberg recently stated that "the progress [towards ending TBTF] has been impressive and somewhat under-appreciated." But the eight biggest banking institutions in the U.S. now hold $10.6 trillion in total assets and account for 57 percent of total assets in the U.S. banking system—not materially different from the $9.4 trillion and 60 percent of total assets in 2009.[ii] There are credible analyses suggesting that investors still are willing to lend to TBTF institutions more cheaply than to others because they still expect the government to stand behind them in a crunch. On the other hand, pending capital surcharges for systemically important financial institutions have offset some of these advantages. Moody's Investors Services, in a milestone announcement, says it no longer assumes the government will stand behind big banks' debts. Progress has undoubtedly been made towards alleviating the "too big to fail" problem. The open question: Has enough been done?

New rules, guidelines and regulatory pressures have pushed risk-taking out of the core of the American banking system. That is by design: letting banks gamble with federally insured deposits poses unwelcome risks to taxpayers. Let the government supervise and stand behind banks that take deposits and make loans, the thinking goes, and let other entities—entities that can safely be allowed to fail—make riskier investments. As bank regulatory requirements are ramped up, financial activity has been and will continue to migrate outside the banks where there is less oversight and less transparency. The FSOC has the authority to designate nonbank financial institutions as systemically important (and thus more intensely supervised), although companies resist such designations aggressively. The open question: Is the U.S. fragmented regulatory system equipped to monitor and mitigate risks outside the banks—in securities and derivative markets, for instance?

Financial regulation always involves a trade-off: If regulation is too light, the odds of financial catastrophes rise. If regulation is too tough, the economy is starved of credit and grows too slowly. Financial crises often provoke an overreaction, a plethora of regulation that snuffs out even economically constructive risk-taking. British finance minister George Osborne once warned against "the financial stability of the graveyard." But failing to learn the right lessons from a crisis and failing to take advantage of the weakened political clout of big finance after a crisis to modernize regulation is just as big a mistake. Predictably, Wall Street says the U.S. has gone too far; Wall Street's critics say the U.S. hasn't gone far enough. With so many actors, both domestic and international, it's very hard to sum the effects on the economy of all the new financial regulations and very hard to be sure the benefits of that last percentage point or two of new capital and liquidity requirement outweigh the cost. The open question: Have we gone too far? Or not far enough?

Candidates will be pressed to take stands on a host of issues from reviving the fortunes of the American middle class to managing an assertive Vladmir Putin. To many politicians and voters, matters of financial stability are mind-numbingly complex. But we learned the hard way in 2008-09 what happens when we neglect this sphere of public policy or leave it entirely to technocrats in competing fiefdoms. Candidates will have different views on the shape and form of financial regulation. Some will want stricter, more intrusive regulation; others will want to strengthen the banks' financial footings and let them figure out how to run their businesses. Candidates will have different views on striking the balance between too much regulation of finance and credit and too little. But the issues enumerated above will inevitably confront the next president. Candidates owe it to voters to consider these issues seriously enough to describe their approaches and their stance on the big questions raised in this essay.

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[i] See, for instance, Alex J. Pollock of the American Enterprise Institute (May 31, 2013) https://www.aei.org/publication/what-to-do-with-fannie-and-freddie/, John Griffith of The Center for American Progress (September 6, 2012) https://www.americanprogress.org/issues/housing/report/2012/09/06/36736/7-things-you-need-to-know-about-fannie-mae-and-freddie-mac/, and The Corker-Warner bill (June 25, 2013) http://www.warner.senate.gov/public/index.cfm/pressreleases?ContentRecord_id=da03f027-9876-485e-82d6-78fe5f8485f6.

[ii] Brainard, Lael, "Dodd-Frank at Five: Assessing Progress on Too Big to Fail", *Board of Governors of the Federal Reserve System,* July 9, 2015, http://www.federalreserve.gov/newsevents/speech/brainard20150709a.htm; see also: Avraham, Dafna, Patricia Selvaggi, and James Vickery, "A Structural View of U.S. Bank Holding Companies" (New York: The Federal Reserve Bank of New York, July 2012), http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf.