Michael Held: The financial crisis - perspectives from a decade on

Remarks by Mr Michael Held, Executive Vice President of the Legal Group of the Federal Reserve Bank of New York, to the Administrative and Banking Law Committees of the Association of the Bar of the City of New York, New York City, 15 November 2017.

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Introduction

Thank you to the City Bar and the members of its Administrative and Banking Law Committees. It's a pleasure to be able to speak with you. The views I express today are my own, and not necessarily the views of the Federal Reserve Bank of New York or the Federal Reserve System.[1]

I'd like to take my time here with you today to reflect a bit on the decade since the financial crisis. A decade later, while the most acute effects of the crisis have dissipated, American families and businesses—the Main Street economy—continue to feel or remember its longer term effects. Savings were depleted. Homes and businesses were lost. Many Americans' careers were fundamentally altered. Consumer spending dropped more severely on a year-over-year basis than it had since the Second World War.[2]

A decade later, recognition of the human element of the Great Recession motivates both the private and public sector to remain vigilant in our efforts to prevent a future crisis. Remembering the effect of the crisis on American families, business owners, and investors helps prevent personal and institutional memories from fading. And the potential for memories to fade is real. Last month, the Dow Jones Industrial Average reached an all-time high. Recent data suggest that families' incomes have increased between 2013 and 2016, although they also suggest that the wealth gap is widening.[3]

People, too, have changed. Even at the New York Fed, now, over 50 percent of staff were not with us at the time of the crisis. I suspect that the same is true at banks and law firms, where many professionals have practiced for less than a decade. These junior bankers and lawyers have not even experienced a turn of the business cycle let alone have a memory of the financial crisis.

Now, I recognize that the crisis and its aftermath is well trod ground. Indeed, my boss Bill Dudley delivered a speech on this very topic last week. That said, I think it is worth traveling down this well-worn path again. In doing so, I am mindful of a few aphorisms. First, those who fail to remember history are doomed to repeat it. Second, generals (and economists and even lawyers) tend to fight the last war. The third, which I will steal from a mutual fund prospectus, is that past performance is no guarantee of future results. All of this is to say that while it is critical to remember and draw lessons from what happened in that period of 2007–2009, and the response to it, it is also equally critical to remember that the next shock to the system is likely to look quite different in material ways.

Today, I'll start by talking about the broad range of innovative responses people within the Fed and other public sector institutions devised to restore confidence in part by providing liquidity, capital, and information during the chaos of 2008. Next, I will focus on some of the fundamental changes that have been implemented in the wake of the crisis. In my opinion, those changes go a long way toward making financial institutions and the financial system overall more stable and resilient. We should also recognize that, notwithstanding their increased resiliency, one or more firms will fail at some point in the future. It is imperative for US law to have an avenue to handle such a failure, and without systemic consequences. Finally, I will address some more recent legislative proposals to amend post-crisis reforms, emphasizing proposals relating to the orderly failure of major financial institutions.

Disorder and the unprecedented steps to right It

I will start with the obvious. The crisis caught the world off guard. Many have argued that the crisis should have, would have, and could have been predicted and averted. Others have claimed that bubbles are inevitable and that regulators should principally focus their time and attention on cleanup and mitigation rather than avoidance. I will not engage here in that debate. From my perspective, prevention and cleanup are not mutually exclusive. Indeed, in exploring how to survive a crisis, you inevitably think about how to avoid it.

When the crisis materialized and firms began to experience material distress or even fail, US law did not have a framework for achieving an orderly resolution of a systemically important institution at the corporate level. It had tools that have proved highly effective in managing corporate restructuring and depository institution receiverships, but none tailored for a major financial group. Instead, when large financial groups began to fail, policymakers relied on ad hoc interventions.

Some of the immediate interventions involved use of the Federal Reserve's "lender of last resort" functions. It was at this point that "Section 13(3)" entered the lexicon of modern central banking. For those few who are unaware, Section 13(3) was added to the Federal Reserve Act during the Great Depression. It gave the Board of Governors broad authority to permit a Reserve Bank to lend in exigent and unusual circumstances provided that the Reserve Bank was secured to its satisfaction. Prior to the crisis, Section 13(3) loans had last been made during the Depression, to such enterprises as a typewriter manufacturer and a vegetable grower.[4] Fed policy makers and their advisors pulled Section 13(3) back off the shelf, perhaps brushing some metaphorical dust off its cover. In 2008, loans made pursuant to Section 13(3) facilitated JPMorgan Chase's purchase of Bear Stearns. Loans under 13(3) also prevented the potentially catastrophic failure of American International Group (AIG).

Innovations under 13(3) also underpinned many of the Fed's broad-based facilities to provide market liquidity. The Fed created a variety of facilities under 13(3), giving rise to an alphabet soup of new acronyms.[5] Those facilities provided liquidity to different segments of our economy, ranging from primary dealers to issuers of commercial paper. Their broader purpose, however, was to facilitate the availability of credit to businesses and households through on-lending.

Not all of the Fed's responses involved lending, either under Section 13(3) or at the discount window. On the supervisory side, the Federal Reserve's Supervisory Capital Assessment Program (SCAP) (the "stress test" of the 19 largest US financial institutions) addressed uncertainty about their ability to weather additional losses. The results were disclosed publicly in a significant departure from standard practice to keep supervisory information confidential. Transparency, as well as the availability of a government backstop, encouraged confidence in US institutions.

Of course, the Fed's actions did not happen in a vacuum, but rather in the context of other actions taken by other regulators and Congress. Perhaps most notably, in October 2008, Congress passed the Emergency Economic Stabilization Act. That statute allowed, among other things, Treasury to create the Troubled Asset Relief Program to inject capital into financial institutions. In addition, the Federal Deposit Insurance Corporation expanded its guarantees of bank liabilities under the Temporary Liquidity Guarantee Program. The Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship. Non-US authorities responded to crises in their own jurisdictions. And really this is just a sampling of the diverse and creative array of public sector responses to the crisis.

Many commentators and policy makers have been deeply critical of the Fed's actions during the crisis. I am not here to suggest that leaders during the crisis were infallible or that decisions made during the crisis were always the right ones. What I believe is difficult to dispute, however, is the importance of having the ability to be agile in times of severe economic stress. Policy makers were both able and willing to try new things, to make adjustments as circumstances evolved, and to attack the crisis from different angles. Many aspects of the crisis were unprecedented. Room to innovate allowed the staffs of public sector institutions to craft targeted responses. It also allowed them to adjust those responses on the fly—through cooperation domestically and internationally, knowledge of the financial sector and familiarity with its participants, and the ability to instill confidence through the provision of liquidity.

As a lawyer, I am perhaps a bit of a pessimist. But I'm not a cynic. If there's one lesson I take from the crisis, it is the importance of having room to maneuver during a crisis. And, there will be future shocks to the system. When the next shock comes, regulators need to have both the legal authority to take risks and the will to act.

From disorder to order (hopefully)

In the years after the crisis, attention has been focused on mitigating the risk of another one. Legislators and other policymakers made substantial changes to the financial system to hold firms, and their managers and shareholders, more accountable. A great many of those changes have put both firms and the public sector in a better place.

Today, regulators and supervisors expect systemically important financial institutions to be more resilient. They must be prepared for unanticipated losses and shocks to the financial system, including through rigorous (if not always popular) capital and liquidity standards.

Supervised firms are also required to have a much greater understanding of the governance and controls supporting their critical operations. This includes, for example, governance frameworks, management information systems, and IT resiliency. This last point is particularly notable because, as many of you are now painfully aware from the data breaches at Equifax and Yahoo (and those are just the most recent ones), cybersecurity risk has increased dramatically in the last several years.

Resilience goes a long way. It prepares firms to be ready to fight not only the last war, but also the unanticipated stresses of the next one. It prepares them not to rely on past performance as a guaranty of future performance. But, increased preparedness should not be cause for overconfidence. Supervision and regulation should not and cannot drive all risk from the financial system, and the probability of a systemically important institution's failure will never be zero. The largest firms must be prepared for a rapid and orderly resolution under the US Bankruptcy Code.[6] Among other things, these firms must now also ensure that critical activities or services provided to the market will not be disrupted in the event they find themselves in recovery or resolution. Moreover, if an institution fails, there must be sufficient tools to manage its failure in a way that reduces the chance that its failure will cascade systemically through the financial system. In other words, if one institution gets a cold—or worse—it should not become an epidemic.

The Fed's use of Section 13(3) during the crisis was not uncontroversial. Concerns were expressed about moral hazard—that the Fed was somehow "bailing out" troubled institutions and that this would only lead to excessive risk taking in the future.[7] As a result of this concern and others, Congress amended Section 13(3) to prevent the Fed from engaging in the kind of institution-specific lending that was directed at Bear Stearns and AIG. Going forward, the Fed may only lend under Section 13(3) as a part of a broad-based program directed at providing liquidity to the financial system and not to aid an individual failing firm.

At the same time Congress constrained one potential source of liquidity in the event of a crisis—Section 13(3) —it also created a new source of liquidity in Title II of the Dodd-Frank Wall Street

Reform and Consumer Protection Act[8], which established the Orderly Liquidation Authority (OLA) and the Orderly Liquidation Fund (OLF).

In the Dodd-Frank Act, Congress expressed its preference for the use of "ordinary insolvency" under the Bankruptcy Code.[9] However, Congress also recognized the importance of establishing an alternative resolution mechanism with features tailored for resolving a systemically important firm, and in a way that minimizes moral hazard.[10]

OLA includes a public sector resolution authority—the FDIC, an agency well-versed in resolving depository institutions under the Federal Deposit Insurance Act (FDI Act) and working with other domestic and international authorities. OLA empowers the FDIC to step into the shoes of the failing institution to resolve a "financial company" at the corporate group level. The FDIC must ensure that responsible managers and directors are removed, and the FDIC or Federal Reserve Board may seek certain industry bans for culpable directors and senior executives.

OLA also includes the OLF. Congress recognized that the ability of the FDIC to borrow funds from the Treasury Department to provide emergency liquidity to a failing systemically important institution is crucial to the success of its resolution. The OLF is not prefunded, and the FDIC's capacity to borrow to fund the OLF is capped at 90 percent of the fair value of the assets of the institution that are available for repayment. The provision of OLF liquidity does not fall ultimately on the American taxpayer. Shareholders may not recover until the OLF is repaid. The FDIC is authorized to assess financial sector participants if necessary to repay the funds advanced by the Treasury to fund the OLF.

Reevaluate, but don't forget the disorder of the crisis

The breadth of changes that have been made to the regulatory landscape since the onset of the financial crisis is huge. Given the scale of the changes, it is entirely appropriate to take stock of these changes and reevaluate their effectiveness. It is not surprising to think that some recalibration might be necessary. It is also worth considering what additional reforms are needed to make the financial system more resilient and resistant to future, unanticipated shocks. Sometimes I get asked the question of whether the financial sector is where it needs to be in terms of resilience. My answer is usually that things are better, but they can get even better still. And I suspect that, in even the best case scenario, that will always be my answer. Because threats and risks evolve. Financial institutions, and regulators for that matter, must recognize changing risks and ensure that their approaches evolve in kind. We need to ensure that when the next economic downturn occurs, the financial system will bend, but not break.

Of course, increased resilience does not come without costs. It is important to continually reassess whether those costs are appropriately balanced with the evolving risks. There are a number of potential areas that may be worth reassessing. One place to start is with regulations pertaining to smaller banks. People of all political stripes tend to agree that Congress and regulators should reassess the effect that regulations have had on these firms and whether such regulations are commensurate with their level of risk. For these smaller banks, whose failure will not directly inflict large costs or stress on the broader financial system, the regulatory and compliance requirements should be reconsidered. Indeed, banking agencies have announced many proposals for small banks,[11] including one that would simplify the capital rules for such banks consistent with their risk.[12]

With respect to systemically important firms, I think it would be terribly myopic to forget the crisis. There have been a number of different types of changes proposed with respect to these firms. Today, I'd like to focus on the proposals relating to resolution regimes.

Congress established OLA when memories of Lehman Brothers' failure were fresh. It bears repeating that Congress did so after facing the terrifying realization that the lack of a credible resolution mechanism for dealing with failing systemic firms left only bad choices, such as lending into a run, bailout, or the collapse of the financial system. Over the past several years, there have been efforts in Congress to repeal OLA and create a new, bespoke process for systemically important firms under the Bankruptcy Code. That process would largely mimic many of the features of the FDIC's single point of entry strategy intended for use in an OLA proceeding. Those efforts have picked up steam this year with the passing of two different bills in the House of Representatives.[13]

From my perspective, there are attractive aspects to both OLA and the Bankruptcy Code. OLA is largely an administrative process that has the benefit of agility. It is administered by the FDIC, which will already have insight into the institution though the living will process. The FDIC also communicates with foreign regulators regarding systemically important firms.

OLA has particular advantages in the context of a cross-border resolution, which means in this day and age the resolution of pretty much any systemically important institution. US regulators have established relationships with their foreign counterparts, and resolution processes similar to OLA now exist in many globally important financial centers. This familiarity can facilitate cross-border cooperation and coordination in the event of a failure of a systemically important institution, and stem competing insolvency proceedings in multiple jurisdictions and the ring-fencing of assets. This last point shouldn't be discounted. It's worth remembering that after Lehman Brothers' parent company initially filed for bankruptcy in the US, many foreign proceedings were initiated for Lehman affiliates around the world. It took over six months to establish a cross-border protocol among the representatives of the more significant Lehman Brothers affiliates. The protocol was meant to improve communication and cooperation among the representatives as well as minimize costs and maximize recoveries for creditors. In the case of one of the most significant Lehman Brothers affiliates, Lehman Brothers International Europe located in the UK, no agreement was ever reached.

OLA also provides for backstop liquidity through the OLF, a feature not available in the ordinary bankruptcy process. During the financial crisis, lender of last resort liquidity from the Fed was critical to promoting faith in the financial sector. So, too, will backstop liquidity be important for restoring faith in a recapitalized institution in resolution under OLA and preventing a run.

The bankruptcy process also offers many positives. The US Bankruptcy Code is admired around the world and has been the model for similar regimes in other countries. The court-administered nature of bankruptcy provides transparency and predictability to parties and provides stakeholders with a meaningful opportunity to be heard. However, as many have noted, the current bankruptcy laws were not designed to resolve systemically important financial institutions. Although firms have worked within the existing bankruptcy framework for purposes of resolution planning, revisions to bankruptcy law could be a means of facilitating the orderly bankruptcy resolution of a major financial institution. However, the devil is, of course, in the details. The bills that passed the House earlier this year include many helpful changes regarding current bankruptcy law. They may help facilitate the resolution strategies of most of the systemically important financial institutions. Notably, however, these proposals do not include a credible source of backstop liquidity. Congress recognized the importance of such a facility in the OLF. Any bankruptcy regime without one may lack the scale and speed needed to bolster market confidence and may not be as effective in preventing contagion, particularly with respect to a systemically important firm.

Conclusion

In conclusion, I believe the legislative and regulatory reforms to the financial system over the last 10 years have made the system more flexible and resilient. At the same time, it is entirely appropriate to revisit these reforms now and assess their efficacy. In doing so, though, let's keep my aphorisms in mind and not risk history repeating itself. I say this because the American public does not deserve to have history repeated.

Improved resilience should permit financial institutions to weather another shock and, if needed, fail under the Bankruptcy Code as contemplated by the living will process. Under the living will process today, firms must approach their bankruptcy using tools geared toward corporate restructuring. Any changes to the regimes under which financial institutions can and will fail should be carefully considered before enactment, particularly to the extent they retain, or not, a credible source of liquidity going forward. This isn't abstract financial theory. This concerns the ability of people on Main Street—employees, retirees, small business owners—to persevere in times of severe financial stress. Returning to the human element of the crisis, these are the same people who suffered during the Great Recession and who expect us all to do better during the next period of stress.

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1 Lisa Kraidin and Ben Snodgrass assisted in the preparation of these remarks.

2 See Mariacristina De Nardi et al., Consumption and the Great Recession, Economic Perspectives, 1st Quarter 2012, at 1, 1.

3 See Jesse Bricker et al., Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances, Federal Reserve Bulletin, Sept. 2017, at 1, 10.

4 See Thomas C. Baxter, Jr. & David Gross, *The Federal Reserve's Response to the Crisis*, *in* International Monetary and Financial Law: The Global Crisis 293, 298–99 (Mario Giovanoli & Diego Devos eds., 2010). Use of 13(3) had been authorized during the 1960s, but no loans were made. See id.

5 These facilities included, among others, the PDCF (the Primary Dealer Credit Facility), the TALF (the Term Asset-Backed Securities Loan Facility), and the CPFF (the Commercial Paper Funding Facility).

6 The US Bankruptcy Code refers to Title 11 of the United States Code, as amended.

7 See, e.g., S. Rep. No. 111–176, at 6 (2010) ("The Federal Reserve's emergency lending authority, under section 13(3) of the Federal Reserve Act, in the past allowed the Federal Reserve to make loans to individual entities like AIG. While such lending played an important role in ending the recent financial crisis, it also created potential moral hazard.").

8 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111–203 (2010).

9 See 12 U.S.C. §§ 5365 & 5383.

10 See 12 U.S.C. § 5384; H.R. Rep. No. 111–517, at 865 (2010) (Conf. Rep.) ("When the authority is used, the FDIC is appointed receiver and must liquidate the company in a manner that mitigates significant risks to financial stability and minimizes moral hazard.").

11 See Joint Report to Congress: Economic Growth and Regulatory Paperwork Reduction Act of 1996, 82 Fed. Reg. 15900 (March 30, 2017).

12 See Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 82 Fed. Reg. 49984 (proposed Oct. 27, 2017).

13 See H.R. 10, 115th Cong. (as passed by House, June 8, 2017); H.R. 1667, 115th Cong. (as passed by House, Apr, 5, 2017).