The Financial Crisis and Policy

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With the benefit of a year’s hindsight, we can look at the financial crisis with some perspective. What was really the central problem? What are the most important policy changes needed to avoid a repetition?

In my view, the usual suspects are not that important — “global imbalances” of saving or imports, the Fed’s low policy rates, a housing “bubble,” subprime mortgages, or fancy derivatives. Once we put all that aside, I think we can focus much more quickly on the real basic problems and their solution.

1. What is central.

The signature event of this financial crisis was the “run,” “panic,” “flight to quality,” or whatever you choose to call it, that started late September 2008, and receded over the winter. Short term credit dried up, including the normally straightforward repurchase agreement, interbank lending, and commercial paper markets. Without this panic, it’s unlikely that anything really terrible or much worse than the dot-com bust and mild 2001 recession would have followed.

This “panic” was followed by a very sharp recession, for pretty obvious reasons. It’s hard to get much done if you’re scrambling for cash and the normal way of doing business just fell apart. Now that the short-term credit crunch is over, it seems likely to be followed by a quick recovery, at least if the government doesn’t get in the way with too many counterproductive attempts to fix things.

We like to think ourselves exceptional, but this pattern is really nothing new. The events are similar to the panics of 1857, 1873, 1897, 1907, 1921, and 1929 really, though the latter is a good example of what happens with too much government meddling.

2. Why a panic?

Now, let’s back up a step. Why was there a financial panic? There were two obvious precipitating events: The Lehman failure, in the context of Fannie/Freddie, AIG, and Wamu, and the chaotic week in Washington surrounding the TARP legislation.

Now, why would Lehman’s failure cause a panic? Why, after seeing Lehman go to bankruptcy court, would people stop lending to, say, Citigroup, and demand much higher prices for CDS protection?

Nothing technical in the Lehman bankruptcy caused a panic. The usual “systemic” bankruptcy stories did not happen. We did not see a secondary wave of creditors forced into bankruptcy by Lehman losses. Most of Lehman’s operations were up and running in days under new owners. Lehman CDS paid off. Sure, there was some mess – repos got stuck in UK bankruptcy court, some money market funds broke the buck – but these issues are both easy to fix once you ask “what exactly was wrong with the Lehman

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bankruptcy?” and they are not even vaguely plausible mechanisms by which Lehman’s failure could cause a general panic.

Lehman’s failure didn’t carry any news about asset values – “Gee, if Lehman failed, maybe Citi’s toxic mortgages are worth even less than we thought.” It was obvious already that those assets weren’t worth much, and illiquid anyway.

Only one story makes any sense. After the Bear Stearns bailout, markets came to the conclusion that investment banks and bank holding companies were “too big to fail” and would be bailed out. When the government did not bail out Lehman, and in fact said it lacked the legal authority to bail out Lehman, everyone reassessed that expectation. Maybe the government won’t, or can’t bail out Citigroup? Now, it makes perfect sense to run like mad.

Buttressing this story, let’s ask how, by what mechanism, did the equity injections and debt guarantees in October eventually stop the panic? An increasingly common interpretation is that, by putting the government in the way, these steps signaled the government’s determination and legal ability to keep the large banks from failing. That too makes sense in a way that most other stories do not.

In sum, the government was stuck in an awful situation. Once everyone expects a bailout, it has to bail out or chaos results.

Obviously, in this view there is nothing inherently “systemic” about Lehman brothers or other large banks. What’s systemic is the expectation of a bailout. The policy question is simply how to escape this horrible moral-hazard trap.

The TARP mess did not help. The Fed Chairman, Treasury Secretary, and President of the United States got on television to say, basically, “The financial system is about to collapse. We are in danger of an economic calamity worse than the great depression. We need $700 billion, and we won’t tell you what we’re going to do with it. If you need a hint, we just made it illegal to short-sell banks stocks."

This should go down in history as “How to start financial crisis 101.” Now, in the Washington context it makes sense, and I understand and sympathize with the awful position Bernanke and Paulson were in. They wanted legal authority to bail out the likes of Lehman, and they needed to scare the bejesus out of congress to get the money, where stubborn right-wing fiscal conservatives like Barney Frank were saying impolite things like "No one in a democracy, unelected, should have $800 billion to spend as he sees fit.” Alas, the speeches leaked out of the beltway and scared bejesus out of everyone else too.

We don’t need to argue which of these events was central. They both contributed. They both point to the central problem precipitating a panic. And that problem was not anything technical or systemic about Lehman or Lehman’s bankruptcy. It was a panic induced by the moral hazard that comes from 30 years of too big to fail, and the actions of Government officials.

3. Back one more step. Why failures/bailouts?

Now, let’s go back one step further. Why did Lehman fail – and Fannie/Freddie, AIG, Wamu, and nearly Citigroup and Bank of America? Here’s where I part company on the usual worries about bubbles, imbalances, silly mortgages, and so on.
The underlying decline in wealth was not that large. Comparable wealth disappeared in the dot-com stock market bust, with no financial crisis and a mild recession. Yes, fortunes were lost, and a generation of web designers had to find new jobs, but we did not have a financial panic and 10% unemployment rate.

Why not? Well, you may be unhappy if your stocks lose half their value, but there’s not a lot you can do about it, and no way for your losses to spark a panic in short-term debt markets.

For this reason, in 2007, most commentators, and the Fed (who, remember, is going to be regulating all this next time around) were saying that the problem was “contained.” Most estimates put subprime losses around $400b. The stock market absorbs losses like that in days.

Well, we all turned out to be wrong. The difference is that mortgages were held in very fragile financial structures. An extreme example: Mortgages were pooled into securities, and the securities were held in special purpose vehicles, funded by rolling over short term commercial paper with an off-the-books credit guarantee from a large bank. Less extreme: when Bear Stears failed, it was holding a large portfolio of mortgage-backed securities, funded at 30:1 leverage by overnight debt. In both cases, when the mortgages lose value, the debtholders refuse to roll over and the whole thing blows up. When your (and my) pension account loses value, nothing but our dinner conversation blows up.

These structures attempt to take risky assets – mortgages – and turn them into risk free assets – short term debt. But we all know you can’t do that – you can slice and dice risk but you can’t get rid of it.

Here’s what this financial structure does instead. First, it turns a “smooth” risk, like equities, which is repriced every day, into “earthquake” risk, that either pays a steady stream or fails catastrophically and unpredictably.

Second, it turns a “nonsystemic” risk, into a very “systemic” one. Now, for the fundamental investors to lose any money, we need to see a default or a bankruptcy, which is always expensive and chaotic. The losses can drag down brokerage, derivatives, market-making and other “systemic” businesses having nothing to do with simply sitting on credit risk. There was even talk that the ATM machines might go dark. And it turns a perfectly good security – an MBS – into one that is prone to “runs” when investors refuse to roll over overnight debt.

Third, it hides risk and avoids regulations, which may be much of its design. An institution that issues short term debt to hold mortgages is what we used to call a “bank.” Why call it an SPV? Because the regulations assessed lower capital requirements on this structure. It also arbitrages between investors who really do want higher risks and higher yields, and regulations that specify types (commercial paper) and ratings of securities they must hold.

Thus the regulatory system ends up encouraging artificial obscurity and fragility. It’s often accused that “free deregulated markets failed.” No, the free, relatively deregulated equities market absorbed massive losses this time, as last time, with relatively little turmoil. It was the regulated, supervised part of the market that failed.

Nothing in this fragility is specific to mortgages or mortgage backed securities. If we tried to hold equity or corporate debt in highly leveraged entities funded by short term debt, we’d have the same problems. Actually, we did, back in the 1930s.
Thus, the second challenge for policy and Wall Street, going forward, is to devise a financial system in which risks are held in less fragile ways.

Much-maligned mortgage backed securities are perfect for this effort by the way. If held by, say, pension investors in a long-only mutual fund that trades at net asset value, they provide high yields, and allow transparent and non-systemic losses. Think of the alternatives: Mortgages could be held by a bank, now big and global; the risk is pooled with all sorts of other stuff like internal hedge funds; monitoring is done by an international pool of equity and senior debt holders plus a new super-regulator. Or, mortgages could be held by the ultimate investors, who need only monitor the quality of those mortgages, who are set up to bear losses, and don’t need any regulation or supervision. The latter structure avoids at least all the “agency costs of equity.” Let’s get on with it.

4. Policy

Given my diagnosis of the central problem, it will be no surprise that I think much of the thrust of current policy is misguided.

First, a lot of policy seems aimed at stopping anyone from ever again losing money in the first place. This category includes “consumer protection,” extensive supervision and regulation of financial institutions, advice for the Fed to start pricking “bubbles”, and for governments and the IMF to address all sorts of vague “imbalances”, like how much the country saves, invests, imports, or exports.

This is hopeless. We can’t pin the stability of the financial system on the idea that nobody will ever lose money, without strangling the economy and financial innovation. It also requires a hopeless level of wisdom by our regulators. Keep in mind that they didn’t see it coming any more than the rest of us, and have a tendency tighten standards at the bottom and loosening them at the top too. They’re only human.

Supervision, the basic model that large global financial institutions will be allowed to do pretty much what they want, with a TBTF guarantee, but the Fed will impose risk management from above to keep them out of trouble, seems pretty optimistic. Banks want to be as global, interconnected, “systemic”, opaque and chaotic in bankruptcy as possible, to make sure they get bailed out. They want to evade the next round of tighter regulation as much as the last round, and devices like the SPVs they used last time seem like child’s play in retrospect. Well, at least my MBAs will be employed gaming the new round of regulations.

Second, there is a huge initiative of mostly pointless regulation: Trying to move derivatives and CDS on exchanges, regulating hedge funds, forcing originators to hold back some credit risk, and so forth. Each idea here has a downside and unintended consequence. For example, you can’t clear the fancy CDS that got AIG into trouble; moving to exchanges eliminates cross-netting between CDS and interest rate swap contracts, and if every mortgage broker has to hold and manage credit risk, you’ve just created a thousand new “systemic” institutions.

Most of all, none of this had anything to do with the crash. And the effort distracts us from the main, hard problems.

Third, we are headed for a “resolution authority” in place of bankruptcy. This will be run by administration officials, not judges. They will have immense power and few legal constraints. I suspect it will end up institutionalizing TBTF.
What should we be doing instead?

First of all, the central problem is how to escape the bailout expectations trap. To do this, we have to finally define what “systemic” means. And then, we must define clearly what is not systemic, and can really fail, we mean it this time.

This limit must be written, in law or regulation. We can’t rely on the good intentions of powerful administrators. Odysseus knew he had to tie himself to the mast. The only way to limit expectations of a bankruptcy is to not have the legal authority to do it. Lehman is actually a great example: It went to bankruptcy because the government could not save it. We need more of that! If everybody had known that ahead of time, rather than have it emerge from the usual weekend conclave in DC – if no one flew to DC because there was no point to doing so -- there likely would have been no panic, because Lehman’s failure would not have signaled anything about the government’s commitments to Citigroup.

To put this question at the discretion of any official, especially a political appointee, is practically to guarantee a bailout. In a crisis, everything looks systemic. In the last crisis, GM was bailed out, on the notion that unemployed auto workers and supplier sales were “systemic;” CIT was bailed out, on the notion that its lending to small businesses would not be taken up by competitors or the surviving company in Chapter 11, and thus was “systemic;” and insurance companies were bailed out on the idea that guaranteed return annuity contracts to retirees were “systemic.” Of course none of this makes any sense. But if you’re an official, with a failing company in front of you, you face a hopeless choice. If you bail out and it wasn’t systemic, what the heck, another few hundred billion of taxpayer money go down the drain. But if you let it fail, you will be on the hook for anything bad that happens. Unless you lack legal authority, it’s a hopeless choice. At a minimum, as Chrysler’s bondholders found out to their dismay, a politically appointed receiver can make arbitrary decisions.

Barney Frank said wisely that markets “will never believe us” until we put one of the big financial companies to death. He’s right in the current system. But clearly denying the legal power to save such a company is the surest way to communicate that commitment.

Of course getting rid of regulations that cause problems in the first place would help. For example, we want banks to hold more equity and less debt, but we persist in giving a tax advantage for debt!

There are some things that are truly systemic. In my view there really aren’t any genuinely systemic institutions, but there are systemically dangerous contracts. There’s a lot less than everyone seems to think, but there is some.

Bank deposits are a good and familiar example. If you fund mortgages with bank deposits, there’s a problem. Deposits promise face value and they are redeemed in first-come first-serve order. Thus, there’s an incentive to run at the first rumor of trouble.

Thus, if we allow bank deposits, (it’s not obvious we have to allow this contract, or so much of it) they must be first in bankruptcy in order to stop a run, and there must be some backstop so that even if all assets run out the depositors get paid. The FDIC guarantee achieves that. Derivatives are similarly dangerous, and their absolute priority under the master agreement achieves a similar run-stopping effect.

Having given special treatment and a government guarantee, however, you need a risk limit on risk to protect the taxpayer, and some substitute for the now-missing discipline of depositors looking at the
soundness of their bank. If a bank can arbitrarily issue guaranteed deposits to fund the internal hedge funds or proprietary trading, we’re obviously in deep trouble.

We did learn, or re-learn, in the crisis, that short-term debt, including collateralized or repurchase agreements, brokerage accounts, and some other financial products are susceptible to similar runs. We always knew that some market-making activity such as keeping the ATM machines from going dark can’t stop even in bankruptcy. In terms of big picture, the same ideas apply: these need to be restricted, protected in bankruptcy, and separated as much as possible from risk taking.

Again, I think risk limits are much more likely to work if they operate by clear and simple rules. No, you can’t have internal hedge funds or proprietary trading if you engage in xyz activities. Institutions that offer “systemic” contracts must be as simple, small, and focused as possible. We are instead hoping that the Fed’s risk managers can stay one step ahead of large integrated global firms; “no, we think the tail risk on that prop desk in Hong Kong is really bigger than you do, cut it back.” In the detailed negotiation and capture of regulator and regulated, this seems much less likely to work. (In this context, the otherwise ridiculous limits on executive pay are having a wonderful unintended effect. The risky parts of large investment banks are leaving quickly to start up little boutiques, which can clearly fail.) Something of the philosophy of Glass-Stegall had some merit.

Admitting even this level of regulation is sometimes characterized as being anti-free market, but that’s not true. Bank deposits, subject to runs, pose an externality. We all understand that markets can fail when there are externalities. If we need to allow bank deposits, we need a guarantee or priority in bankruptcy, which leads to moral hazard, and puts the taxpayer at risk. Some regulation and a forced separation of these “systemic” contracts from arbitrary risk taking is then necessary.

But this is a very minimal level of regulation compared to the TBTF guarantee and extensive discretionary supervision and regulation now being applied to the entire financial system.

This is not a small issue, and it’s important to get it right, now. This was not an isolated event. We are in an ever-increasing cycle of risk-taking and TBTF bailouts, going back decades. Now we know that bank holding companies and investment banks are too big to fail, and their activities are not going to be fundamentally restricted in size and scope. This crisis strained the fiscal limits of the United States to make good on bailout expectations. The next one will be bigger. Where will it come from? State and local government defaults? Defined benefit pension funds? Commercial real estate? A new “Asian bubble?” Default by Greece Italy and Ireland? Who knows? We do know this: when the government no longer has the fiscal resources to bail out its financial institutions, the crisis will be much, much worse. Iceland can happen in the US if we don’t get this right.