Lehman Brothers: Looking Five Years Back and Ten Years Ahead

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Introduction

A fundamental principle in economics is that incentives matter. If the rules of the game provide advantages to some over others, protect players against the fallout of taking on excessive risk, or enable irresponsible behavior, we can be confident that the choices people make will be imprudent and the results of the misaligned incentives will be bad.

In the US financial system these conditions were in force during the decade leading to the Great Recession. It was a decade when monetary policy was highly accommodative; when government protections and subsidies were extended to ever more financial activities; when market discipline became a buzz word rather than a tool; and when the competitive advantage bestowed on some sectors of the industry led to a less competitive market.

More concerning is that five years after the crisis, despite new laws and regulations, we are replicating many of the conditions that contributed to the crisis, but we somehow are expecting things to end differently. How so?

This morning, I will discuss the parallels between this earlier period and now, and I will make a case for a bolder set of actions to address weaknesses in a system that continues to impede our financial markets and economy.

Setting the Stage: Low Interest Rates

Extended periods of exceptionally low interest rates undermine a sound economy. Their short-term effects on the economy can be favorable and dramatic, which creates a significant temptation for policymakers to keep rates low for a considerable period. However, history suggests that extended periods of abnormally low rates often lead to negative long-run effects as they weaken credit standards, encourage the heavy use of credit, and too often adversely affect financial and economic stability.

For example, starting with the Mexican financial crisis of 1994 through the Asian and Russian crises of the late ’90s, aggressive expansionary US monetary policy was used with apparent success. In each instance, the immediate crisis was staunched, markets continued operating, and the economy bounced back. Such success led to the expectation that monetary policy could clean up the effects of any financial excess or imbalance that the US economy might develop. Low interest rates became the expected remedy that would stimulate the economy and avoid recession, or that would prevent the proliferation of a crisis.

Having been successful during the ’90s, the Federal Open Market Committee (FOMC), "doubled down" its use of low interest rates during the subsequent decade as it encountered financial and economic weaknesses. Following the collapse of the tech bubble, the real federal funds rate was negative for most of the period 2002 through 2005. It is noteworthy that in June 2003, the nominal federal funds rate was lowered from 1 1/4 percent to 1 percent and remained there for nearly a year, despite the fact that the economy grew at a rate of nearly 7 percent in the quarter following this rate reduction.

Because there were no signs of accelerating inflation, the FOMC felt confident that there was no need to quickly reverse policy, so it remained either highly or relatively accommodative well into the recovery. The first increase in the federal funds rate occurred in June 2004, only after evidence was overwhelming that economic activity had begun to accelerate. Not until March 2006 did the federal funds rate reach its long-term average level.

Within an environment of a highly accommodative monetary policy and sustained low interest rates, credit growth accelerated and serious financial imbalances developed. During the period 2002 to the end of 2007, total debt outstanding for households and financial and non-financial firms increased from $22 trillion to $37 trillion, or almost 70 percent. In hindsight, of course, it seems obvious that problems would result.

This history begs the question, therefore, of how current monetary policy might affect economic and financial conditions in 2013 and beyond. The FOMC again is fully engaged in conducting a highly accommodative monetary policy. The target federal funds rate is currently zero to 25 basis points. Through the Federal Reserve's Quantitative Easing policy, its balance sheet and bank reserves have ballooned to nearly four times the size they were in January 2008. As a result, the real federal funds rate has been negative for most of the period from 2008 to the present.

As with the earlier period, inflation in the US remains relatively subdued, facilitating continued low rates. However, the US also is experiencing significant price increases in various assets, including, for example, land, stocks, and bonds. Banks and the entire financial sector are exposed, directly and indirectly, to significant negative price shocks in nearly all interest rate-sensitive sectors. Also, as capital desperately seeks out yield, there have been significant US dollar capital flows across the globe, causing what appears to be increased financial vulnerability, uncertainty, and instability.

Thus, the actions the FOMC has taken since the crisis ended are more aggressive and will be in place far longer than those taken in the early part of the last decade.

Those who support current money policy insist that circumstances are different this time - a phrase itself that should cause alarm. They suggest that policymakers have better tools to deal with imbalances in the form of renewed market discipline and macro-prudential supervision. However, as I describe below, financial conditions within the system are not as different than many presume. Market discipline has not been strengthened, and macro-prudential supervision may be a new name but it is hardly a tool that was unavailable in the earlier period.

Extending the Safety Net: Adding Risk to the System

During the early part of the last decade, at the time the US was engaging in a systematic expansion of monetary policy, it had just extended the public safety net to an ever wider set of financial activities and firms. In 1999, the Glass-Steagall Act was repealed, which confined the safety net – defined as access to the Federal Reserve liquidity facility and FDIC insurance -- to commercial banks. In its place, the Gramm-Leach-Bliley Act was passed to allow the melding of commercial banking, investment banking, and broker-dealer activities. These changes were intended to enhance the market's role in the economy, to increase competition, and to create a more diversified, stable system.

In practice, however, Gramm-Leach-Bliley undermined that very goal. It allowed firms with access to the public safety net to control a much wider array of financial products and activities, and it provided them a sizable advantage over financial firms outside the safety net. It enabled firms inside the net to fund themselves at lower costs and expand their use of debt -- that is, to lever-up. Under such conditions, firms outside the net, to survive, found it necessary to join this favored group through mergers or other actions. The result is a more highly concentrated industry that is more dependent on government support and where, in the end, the failure of any one firm threatens the broader economy.

Gramm-Leach-Bliley fundamentally changed the financial industry's business model. Previously, commercial banking involved principally the payments system that transfers money around the country and world, and the intermediation process that transforms short-term deposits into longer-term loans. That model cultivated a culture of win-win, where the success of the borrower meant success to the lender in terms of the repayment of the loan and growth of the credit relationship.

After Gramm-Leach-Bliley, as broker dealer and trading activities began to dominate the banking model, the culture became one of win-lose, with the parties placing bets on asset price movements or directional changes in activity. Thus, broadening the range of activities and risks that banking firms could bring within the safety net changed the risk/return trade-off and significantly changed the incentive structure in banking. While such non-traditional commercial banking activities are essential to the market's function, placing them within the safety net became lethal to the industry and to the economy.

A related effect of the government's rich financial subsidy was a significant increase in industry leverage, especially among the largest firms. Between 2000 and 2008, the leverage among the 10 largest US firms reached unprecedented levels, as the ratio of tangible assets to tangible common equity capital increased from 22 to 1 to levels exceeding 47 to 1.[1]

Once the financial panic was set in motion and confidence was lost, firms were forced to rapidly deleverage their balance sheets, creating a chaotic market. The effects were channeled through a highly interconnected financial system to the real economy, causing significant declines in asset values, wealth, and jobs. Between 2008 and the end of 2009, well over 8 million jobs were lost within the US economy alone, and containing the crisis required enormous amounts of FDIC and taxpayer support.

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[1] Tangible common equity capital is total equity capital less non-Treasury preferred stock, goodwill and other intangible assets.

Now, five years after the crisis, we should not ignore that many of the conditions that undermined the economy then still remain within our financial system. These conditions include: a few dominant financial firms – those that are too big to fail - controlling an ever greater portion of financial assets within the US; continued government protections and related subsidies; and the continued reliance on a business model with its heavy use of debt over equity and increased risk in the pursuit of higher, subsidized returns on equity.

Yes, the Dodd-Frank Act introduced hundreds of regulations designed to control the actions of financial firms. It gives financial supervisors increased oversight of firms and activities, and it requires the Federal Reserve and the FDIC to oversee the development of resolution programs for the largest firms. However, when you work through the details, the law and rules mostly reiterate powers long available to supervisors. It adds numerous rules and moves responsibilities among regulators, but it makes no fundamental change in the industry's structure or incentives that drive firms' actions.

Dodd-Frank adds new supervisory and resolution authorities intended to end bail outs of financial firms and related subsidies. However, this is an old promise and has yet to be successfully implemented. Consider that the US financial system is more concentrated today and the largest firms hold more market power than prior to the crisis. The 10 largest financial firms control nearly 70 percent of the industry's assets, up from 54 percent in 2000. The eight globally systemic US banking firms hold in assets the equivalent of 90 percent of GDP, when you place the fair value of derivatives onto their balance sheets. Moreover, given the breadth and complexity of activities of these firms, they remain highly interconnected and the failure of any one will likely cause a systemic crisis, demanding government intervention.

Dodd-Frank introduces new rules designed to check the expansion of the subsidy. The Volcker Rule, for example, is supposed to move bank trading activities away from the insured bank. However, the rule has yet to be implemented, and even if it is fully implemented, it allows broker-dealer activities to stay within the same corporate entity, which itself benefits from the government's safety net.

Consistent with these observations, there is a long list of studies documenting the existence of a government subsidy unique to the largest firms that extends across their balance sheets. While the industry vigorously argues that no subsidy exists, the preponderance of evidence suggests otherwise.[2] Thus, while new authorities designed to mitigate this subsidy have been introduced, they have yet to be used or successfully tested. It is worth noting, for example, that under the Bank Holding Company Act, regulatory authorities have long had the authority to force divestiture of non-bank affiliates if they threaten the viability of the related bank. To my knowledge, this authority has never been used.

Therefore, as before the crisis, too big to fail and its subsidy continue to affect firms' behavior. They enable the largest firms to fund themselves at lower cost than other firms

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2 http://www.fdic.gov/news/news/speeches/litreview.pdf
http://www.richmondfed.org/publications/research/special_reports/safety_net/pdf/safety_net_methodology_sources.pdf

providing a competitive advantage that facilitates the biggest firms' dominance within the industry and multiplying their impact to the broader economy.

Also, although the US has introduced a supplemental leverage ratio to the capital standards, these largest firms carry significantly more leverage following from the subsidy than the industry more broadly. Using International Financial Reporting Standards, the average leverage ratio of the eight globally systemic US banks is nearly 25 to 1.[3] This leverage is comparable to what the largest US firms carried in the years leading up to the crisis in 2008 and, as events demonstrated, it reflects too little capital to absorb significant shocks that might occur within the financial sector.

These leverage ratios stand in contrast to those for the remainder of the US banking industry. For example, the average leverage ratio for each category of banks -- from community, to regional, to super-regional -- is less than 14 to 1. This lower ratio reflects the fact that creditors of these firms are more directly exposed to loss should failure occur and, therefore, they insist on a larger capital cushion.

Thus, in comparing today's financial system to that of 2008, I worry that the industry is more concentrated, that the system remains vulnerable to shock, and that the economy remains vulnerable to crisis. Even within the confines of Dodd-Frank, the industry's structure, incentives and balance-sheets are more similar to 2008 than different. And, as always, we can't anticipate the source of the shock until it strikes.

Rethinking Status Quo Solutions

It has been noted that, "We cannot solve our problems with the same thinking we used when we created them."[4] The economy has struggled through this recovery in a post Dodd-Frank environment perhaps because the public realizes that while we have more rules, too little has changed. It is my hope that people remain cautious so that five years from now – ten years after the collapse of Lehman Brothers – we will not be in an all-too-familiar place, facing an all-too-familiar banking crisis.

We need to regain our economic footing by rethinking our solutions. As I have been suggesting since before joining the FDIC, the US requires a monetary policy that better balances short-term and long-term policy goals. We need to rationalize, not consolidate, the structure of the financial industry and narrow the federal safety net to its intended purpose of protecting only the payments and intermediation systems that commercial banks operate.[5] At a minimum,

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[3] The International Financial Reporting Standards (IFRS) approach to financial statement reporting is set by the International Accounting Standards Board. A significant difference between U.S. GAAP and IFRS is IFRS only allows the netting of derivative instruments on the balance sheet when the ability and intent to settle on a net basis is unconditional. http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios2q13.pdf

[4] The quote is widely attributed Albert Einstein, though scholars have not verified its authenticity. http://www.albert-einstein-quotes.org.za/

[5] "Restructuring the Banking System to Improve Safety and Soundness" white paper by Thomas M. Hoenig and Charles S. Morris - http://fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf

simplifying the structure would enhance the FDIC's ability to implement its new authorities to resolve institutions should they fail. In addition, the US must lead the world in strengthening and simplifying the capital requirements for regulated financial firms, particularly for the largest, most systemically important firms.[6] A strong capital base for individual firms and the industry is essential to a strong, market-based financial system.

A decentralized financial structure supported by a strong capital base and market accountability, too long ignored but fundamentally correct, would further change industry incentives and strengthen its performance. Finally, and importantly, these conditions would make the industry more responsive to the market, providing opportunity for success and failure -- both of which are essential elements of capitalism.

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"A Turning Point: Defining the Financial Structure" speech by Thomas M. Hoenig to the Annual Hyman P. Minsky Conference at the Levy Economics Institute of Bard College. April 17, 2013 - http://fdic.gov/news/news/speeches/spapr1713.html

[6] "Basel III Capital: A Well-Intended Illusion" speech by Thomas M. Hoenig to the International Association of Deposit Insurers 2013 Research Conference in Basel, Switzerland. April 9, 2013 - http://fdic.gov/news/news/speeches/spapr0913.html