

MEMORANDUM FOR THE RECORD

Event: Vince Reinhart, ex-Federal Reserve, AEI scholar

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Team Leader: Wendy Edelberg

Location: 1717 Pennsylvania Ave, Suite 800

Participants - Non-Commission:

- Vincent Reinhart

Participants - Commission:

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Summary of the Interview or Submission:

- [How did the financial system change over time?] There is the real side and the financial side. For the last 25 years we have as a nation provided a very high return for financial institutions to get complicated in a couple of ways. Regulators, complicated tax system, complicated accounting. To some extent, what rocket scientists did is not create financial instruments that shed risks, it was importantly tax arbitrage. Securities structured in a certain way had advantages for the final holder. Advantages because of Basel I and Basel II – giving preference for securities that were highly rated; how income was generated.
- Financial institutions could adjust their balance sheet to take advantage over every arbitrage opportunity. Lehman had 4000 subsidiaries. Citi: 2400. It became extremely difficult to regulate them. How do you supervise an institution that is so intricate? Basel II concedes – we can't assess your risk from the outside. It made it impossible to enforce market discipline.
- Counterparties look to the main name of the holding company. Equity owners didn't discipline managers. You had the CEO star status.

- The least number of hostile takeovers is in finance. In big financial institutions are a black box from the outside. The only way to pry open the cover is to own it.
- Third, there are all sorts of principal-agent problems internally. Managers didn't exert enough risk discipline on risk takers. Abuses. People taking risks were not looking out for the longer term health of the firm.
- Over time, we had let financial institutions over time get complicated. The markers on that road include Basel II; the rating agencies; allowing special purpose vehicles, the SIVs, to let firms manipulate their balance sheets.
- With institutions there was a demand for complicated securities because of regulation, accounting, and the tax system.
- Complexity could be supplied because intermediaries could split up your balance sheet.
- We had this differentiation of underwritten securities because nobody gets an excess return by selling a [pass-through.] There was very little standardization of the type of securities. They had an illusion of a market price when it was really mark-to-model. Each of those instruments marketed separately were not standard across those markets and did not trade in a deep market.
- [Why would investors invest in such complicated instruments?] Basel II meant they could set aside less capital if it was AAA.
- [Did the Fed appreciate that this was happening?] I doubt that.
- The other big result of complexity is too-big-to-fail. TBTF is too complicated to fail. Government may become too worried that a firm would be too interconnected to fail.
- You make yourself complicated for lots of reasons. The more complicated you make yourself, the harder it is to replicate the institution, the more leverage you have with regulators. I don't think BS was betting too much on TBTF. But it gains you an advantage with regulators. Think about how the industry pushed back on any effort to commoditize its products... any attempt to systemic risk. Geithner was trying to clear uncleared derivatives contracts. They got into a big room, listened to exhortations from FRBNY, and said, our clients won't like this, our clients like bespoke products.
- The simplest example – there is no standardized record of deposits. What is the game plan for the FDIC to resolve a large financial institution? They pay everybody's insurance. Everyone is

listed as an account holder... when the FDIC tried to put in place consistent records, the industry complained. Uniform Deposit Records.

- The industry can just say no or delay.... It lowers the bar for being TBTF as a depository institution.
- [How much was fragility understood?] The risks of SPVs were unappreciated. It was supposed to reduce the risk for the depository. While something might not have recourse to the holding company in a contractual sense, there was a reputational risk that was significant. I did not appreciate the extent to which the contractual form did not insulate the firm from its SPV.
- If you thought the underwriting entities to create the SPV, we didn't fully appreciate the cost associated with that, allowed them to get complicated more quickly.
- [You've written it was a solvency problem not a liquidity problem.] What's the market price? One reason TARP was redirected and repurposed was exactly the issue. You had the market-clearing price, the return to risk-aversion... you might hear that these institutions were insolvent at firesale prices but firesale prices were inappropriate.
- **I date the start of the crisis to August 1, 2007, when Bear Stearns tried to hold the auction of securities held by its two hedge funds and had to stop the auction because there was no market-clearing price.**
- I think that authorities were too willing to raise their own estimates for the true value of underlying securities relative to the market, than was appropriate.
- My complaint isn't about government action, that having misdiagnosed the problem they used the wrong instruments, in ways that potentially made the run worse. **If Bear Stearns is a liquidity problem, it's appropriate to use Lender of Last Resort – it's all about asserting that there is underlying value.** If instead you think the institution is insolvent, you think instead about the right resolution mechanism. It should have been the Treasury involved if the government were to be involved. **By setting the precedent with Bear Stearns and then the PDCF, it created the precedent of support to investment banks. It was not the right resolution.**
- We still don't have a good understanding of the alternatives that were possible. We're told either Bear Stearns is facilitated by the Fed or there is complete market chaos. I find it hard to believe that there weren't things in between.

- LTCM was a marker in a number of ways, including that the New York Fed's facilitation of a private sector deal actually changed the incentives of LTCM's management so they turned down an offer that was on the table.
- The Federal Reserve for a long time continued to characterize it as a loan to Bear through JPMC.
- Why did the SEC regulate those financial holding companies? The answer is, under Basel II, they needed a lead regulator.
- **[Was the Fed worried?] The Fed created a section that was to look into systemic risk. It started a regular internal report on financial stability. It did do stress tests based on the information of the depository sector. It knew that there was a responsibility for systemic risk.**
- However, investment banks were not regulated by the Fed.
- **[Reliance over time on self-regulation. Was that a good idea?] I think there was an intersection of two failures. The first failure was the view that reliance on markets would impose sufficient discipline so that firms acting in their own self-interest would make themselves resilient in a time of market stress. There was a view that firms will do that themselves. The second part was an under-appreciation of the extent to which self-interest was also making the financial system complicated, so that the first premise didn't hold.** It didn't hold effectively. They were more exposed to risks, and to systemic risks, because of how complicated they got. We thought they would self-regulate. We missed how hard that was to do when they got complicated.
- I think compensation abuses are part also evidence of the monitoring problems of complicated firms. And the lack of market discipline associated with those firms. Compensation is something shareholders are supposed to care about.
- [Over time, they became more aligned with equity prices. But if equity owners don't have the information and aren't disciplining firms, we have no reason to believe the equity price incorporates all information.] Does that mean you intervene directly in compensation structure, or do you ask, what are the barriers that make equity holders not assert discipline?
- I think that housing was an important trigger because it went to the heart of the credit problems. We had a significant destruction of wealth when the tech bubble burst but we didn't have a financial crisis because the equity in the tech industry wasn't critical collateral in the leverage process. The housing assets were critical collateral in the leverage process. It's possible to see a crisis amplified by leverage. The initiating shocks were more important when it involves housing in the collateral.

- As a nation, we over-subsidize housing, we want housing to be important, we made housing an important sector, we subsidize the GSEs, and we're happy about securitization of housing-related products because it seemed to further foster that national goal. What you also want to remember is the international context. The Asian crisis in 1998. There was a massive demand for reserves in the Pacific Rim. Added to by the Middle East. The massive increase in reserves took the form of US dollars, and riskless assets denominated in dollars, namely government securities. We were running a surplus. If the foreign official sector wanted government securities, and we weren't making government securities, they were pulling government securities out of private hands. The ratings on government securities had a specific advantage at Basel. Rocket scientists filled the void by tranching asset-backed securities. One of the reasons that housing collateral became so important as collateral in finance is that the foreign institutions were buying the best AAA securities, leaving a void for constructed AAA securities.
- [You meant?] The mortgage is what makes possible your buying the house, but it is also the collateral for securities. If something happens to house prices, it impairs the value of the collateral in these securities.
- [The credit bubble isn't so important for homeowners as it is on financial markets?] Obviously they intersect. **The increasing reliance on mortgages as collateral made the financial sector vulnerable to a financial shock.**
- [Monetary policy? Describe your views on the steepness of the yield curve and why it mattered to the crisis?] How much were the seeds of this sown in 2002, 2003, 2004. On one hand I don't take the criticisms of someone like John Taylor very seriously. We're talking about Fed Funds Rates but what matters in financial markets is longer-term securities. It probably has some impact on the value of homes. If you look at the correlation of the monthly change in the Funds Rate with the 10-year Treasury rate, or the fixed-year mortgage, it was zero or slightly negative. Rates are set in capital markets.
The tightening in 2004 was exactly predicted in markets and reflected in market rates.
- There was jobless recovery. Rates were impaired. Monetary policy had no major role in creating the housing bubble. It was supportive. Congress told the Fed, maximize employment. In retrospect, policy gradualism was a problem. By raising the rates slowly, as suggested in many macro models, policy gradualism is an anomaly. You should make your policies a random walk. **By raising the fund rates 25 bps quarterly for two years, the Fed kept the yield curve steeper... that encouraged short-termism, the carry trade, adjustable rate mortgages, that helped create the credit bubble.**
- [One argument is the Fed had the wrong view on inflation because it wasn't putting enough weight on asset prices.] Asset prices and monetary policy, the debate goes back a long time. **The Fed at that time had a fascination with the PCE price index, and in fact, the concerns**

about disinflation in 2003 and 2004, in part got revised away. The inflation rate they were looking at in real time subsequently got revised, so there was less inflation pressure than was understood.

- At the time the Fed really did believe, or senior officials believed, in the syllogisms that you make monetary policy based on where you think asset prices are headed, but you don't move your policy rate more than macro conditions warrant based on a concern about asset prices. You have other methods, supervision and regulation, and presumably moral suasion.
- [Go back to 2004 or 2005, and let's say the Fed has a crystal ball, and says house prices are really going to crash. Would the Fed have done anything differently?] **In 2007, Mishkin said a 25% decline in housing prices could be handled by lowering the funds rate faster. It's not clear knowing prices would have gone down a lot would have changed the policy.** It would have increased the pressure on sup and reg, and on the President's Working Group, to make sure institutions were more resilient.
- **If you believe in the Great Moderation, and attribute it in part to policy makers, you believe you can take more risk, uncertainty is lower, and you need less capital.** In 1997, Greenspan said, rates were low, and would be remembered as too low. What's the alternative? It doesn't seem to be to jiggle the Fed Funds rate so people appreciate risk. The appropriate thing is to pair the tranquility with effective supervision and regulation. When times are good, it's very tough to make that case.
- [Greenspan looked at a number of these innovations and said, these help to diversify risk.] That goes back earlier, what are the two things that intersected...
- [Was the Fed looking hard enough for risks? Was there a culture at the Fed to be concerned?] Yes. I think that Alan Blinder's characterization when he was vice chair that all of the Divisions were siloed and there wasn't enough communication was probably true. Monetary policy, research, supervision, didn't really interact that much. Ferguson, Bernanke really did try to change the culture. One of the lessons learned from September 11 was the sense that the Fed needed a better understanding of systemic risk and risks to nondepository institutions, and risks that cut across markets. **It was basically responding to a real threat. It was the question that the failure in one node would threaten the system. One of the results of the Ferguson task force was, try to understand systemic risk. The Board did create a section to do that. To focus on systemically important nondepository institutions. That was pushing against the culture at the Fed.**
- I was there during the era of deregulation, that was the prevailing view: market instruments were helping shed risks. We could use those instruments to shed risks.

- [Deregulation atmosphere – was it deregulating, or not challenging the industry on innovations?] It’s a question of not challenging the industry. The SEC did have low capital. It was a matter of, where there was an issue of drawing lines, it’s not in my shop.
- Ferguson report: “Lessons Learned from the Events Of September 11:” It was discussed in the budget documents because it was one reason the Fed got bigger. Most of the lessons were about infrastructure. That’s when the Fed started doubling down on its provision of Fed funds. More redundancy. The Board did create a new section. **The FOMC did have in one of the two day meetings did have presentations on the housing market, probably in 2005. You can figure it out from the minutes. There were issues about what were the risks from securitizations, what would happen if house prices went down, that sort of thing.**
- [One of the things Greenspan said was, whatever the Federal Reserve may have thought about the housing market, there was no way he could have gone to Congress and asked for more regulation. Did the Fed feel pressure either on the housing front or otherwise?] No question about it. **The easiest thing is to look at the questions in the Chairman’s semiannual monetary policy testimonies. In the early part of the 2000s, a minority of the questions were about monetary policy. They were about regulation – ILCs, Fannie and Freddie, CEA, TILA regulations.** The Fed got thousands of comments when it wanted to make a modest change in disclosures. It would be brave to get in front of the committee and say, there are too many houses, prices are too high.