Preventing the Next Financial Crisis: Who Should be the Actor of Last Resort

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Presentation at the Conference

Preventing the Next Financial Crisis:
Lessons for a New Framework of Financial Market Stabilization
December 11, 2008

A conference organized by the Sanford C. Bernstein & Co. Center
For Leadership and Ethics
The Conference

1. What were the origins?

2. What were the policy responses?

3. What are the recommendations for preventing the next crisis?
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Origins of the crisis: Weak-link Propagation

- Cumulative bank crises: S&L to Asian crisis
- Growth in foreign reserves and rising global liquidity
- Rapid expansion of highly leveraged new instruments in unregulated markets e.g. the CMOs and CDS market
- Weak-links in the chain of securitization due to the deterioration in ‘quality’ of underlying assets: mortgages
The Production of Securitization and the *loan-chain*

Diagram:
- **Borrower**
- **Originating Bank**
- **Credit Enhancer**
- **Conduit S/I/V**
- **Rating Agency**
- **Loan Servicer**
- **Final Investor (e.g. Bank Depositor)**
- **AB Commercial Paper**
- **Underwriter**
- **Hedge Fund**
- **Bond Insurer**
The weak links in the *loan-chain*

- Loan origination → *breakdown of screening*
- Loan servicing → *breakdown of renegotiation*
- Rating Agencies → *conflict of interest, pressure towards rating inflation, misuse of credit risk models*
- Credit Enhancement by originator → *regulatory arbitrage*
- *Excessive leverage* by investment banks and commercial banks
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Regulatory Responses

- The Fed acted as *liquidity* provider and *Lender of Last Resort*
- The Treasury became the *Actor of Last Resort* to address *insolvency*, e.g. TARP, TARL
- Some key regulators were largely absent, e.g. SEC as regulator of Investment Banks
What the Fed Could See in September 2007

- Fed Cut the Federal Funds Rate in September 2007
- Commercial Banks already seeing rising past due payments
- CDS market already worried about Investment Banks

Joint with Sid Balanchandran
Summary of the Crisis

- Too much liquidity chasing too few opportunities
- Massive new markets for volatile instruments were unregulated.
  - Financial innovations move more quickly than regulatory renovation
- Failure to distinguish systemic risk due to a common shock and systemic risk due to adverse feedback
- Regulators had insufficient knowledge of new products to be able to foresee and forestall the crisis
  - Early warning signals, such as formal models of credit risk default, failed, as did more conventional rating systems.
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The Production of Securitization and the loan-chain

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Cautionary Words

We can prevent this financial crisis from occurring…but we will not be able to prevent a next financial crisis.

To paraphrase Floyd Norris....
From Principles to Mechanisms

1. **The new FSA**
   1. Lender and Actor of Last Resort are independent
   2. New organization for coordination of regulatory bodies
   3. Essentially, a *tripartite system*

2. **Rule based regulation**
   1. ‘*Skin in the game*’ must be mandatory for
   
      - loan originators
   
      - Underwriters
   
      - Rating agencies?

3. **Adaptive regulators & regulations**
   1. **Breaking the pro-cyclicality accelerators in bubbles**
      2. Counter-cyclical reserve requirements and loan loss provisions as in Spain (hard to implement in downturns – market pressures)
New Principles of Regulation

4. **Industrial Organization of Finance**
   1. Financial markets are often dominated by a few players – the crisis has made this worse. Reduce concentration to avoid too-big-to-fail
   2. Align incentives of a few key players
   3. Increase “shock-absorbers” for key players to reduce systemic risk
   4. Regulating credit rating agencies (the precedent of regulation of auditors)

5. **Financial Innovation and OTC markets**
   1. OTC contracts a source of innovation, but also a source of systemic risk
   2. Regulatory intervention when systemic risk increases → organize centralized clearing

6. **Financial democracy**
   1. Consumer protection and financial illiteracy
   2. Principles of access to market innovations
   3. Promoting innovation in hybrid social enterprises and new markets for raising capital and equity for social ventures.
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