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

Patrick Bolton, Bruce Kogut, Tano Santos
Professors, Columbia Business School
Presentation at the Conference

Preventing the Next Financial Crisis:
Lessons for a New Framework of Financial Market Stabilization
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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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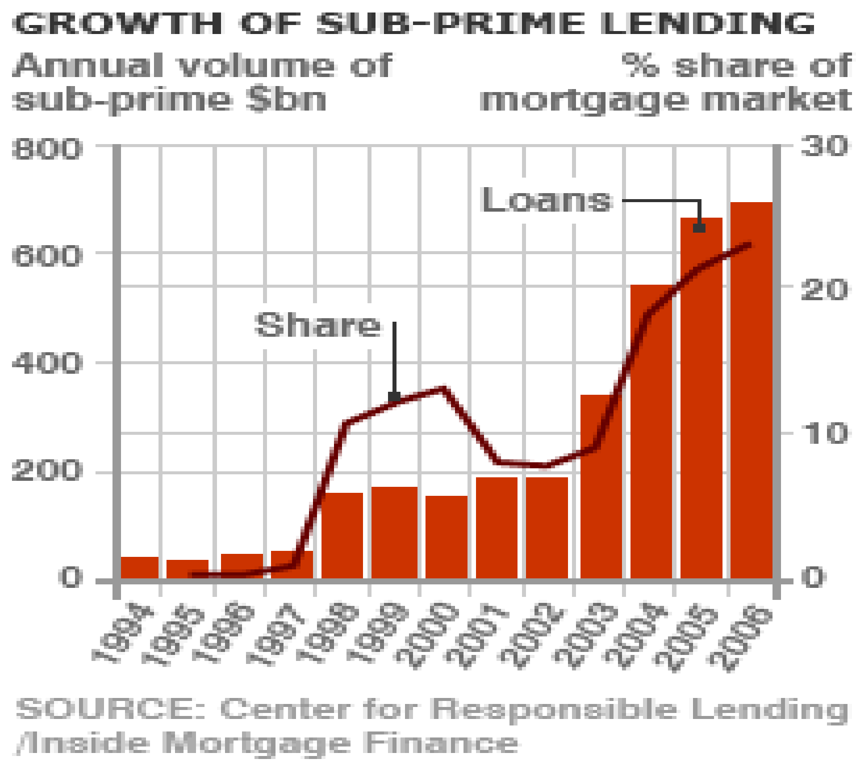
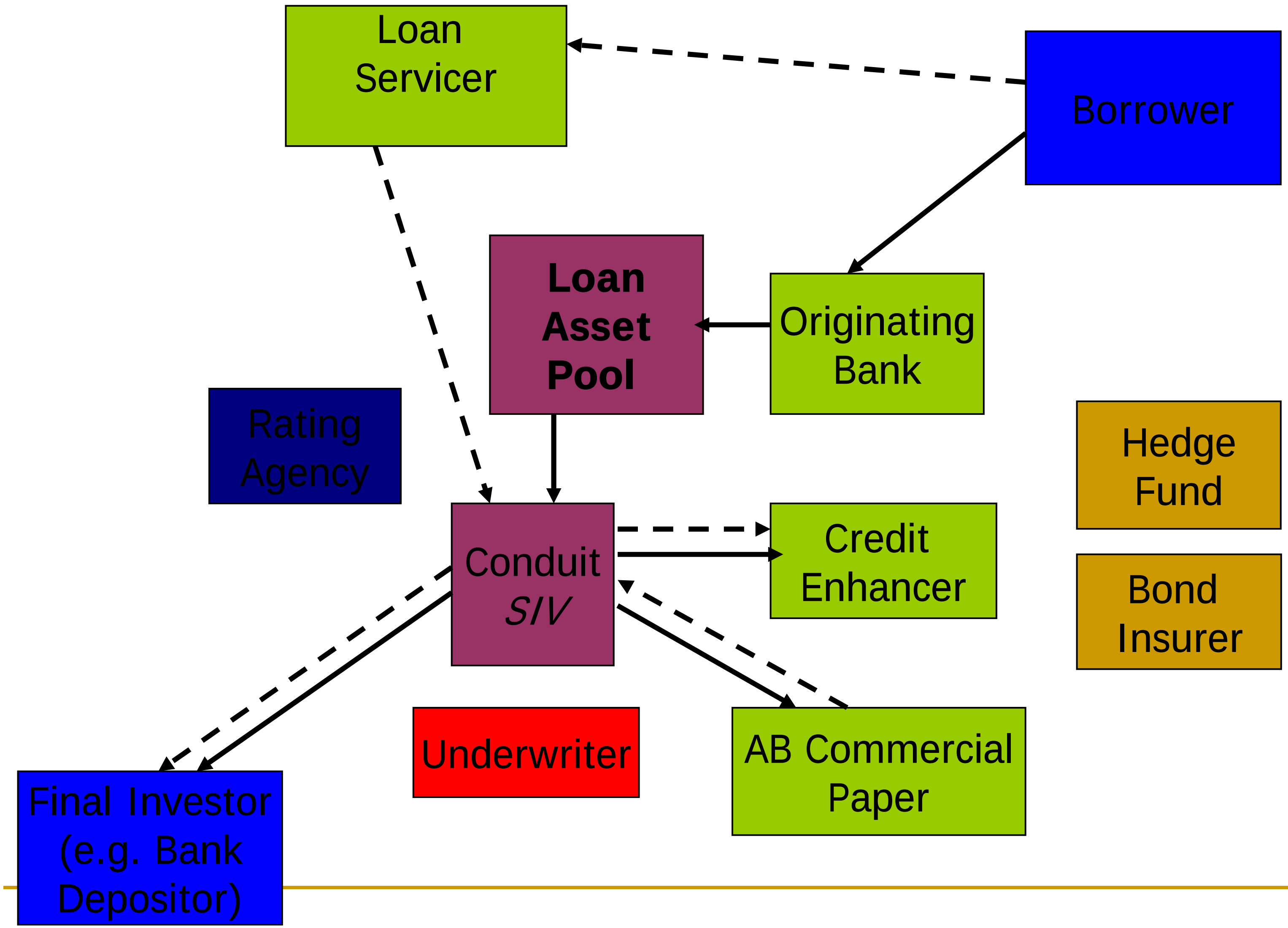
Origins of the crisis: Weak-link Propagation

- 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*



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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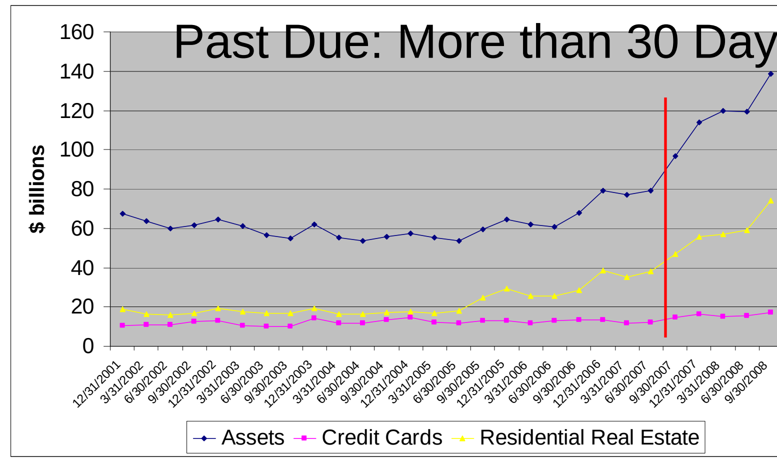
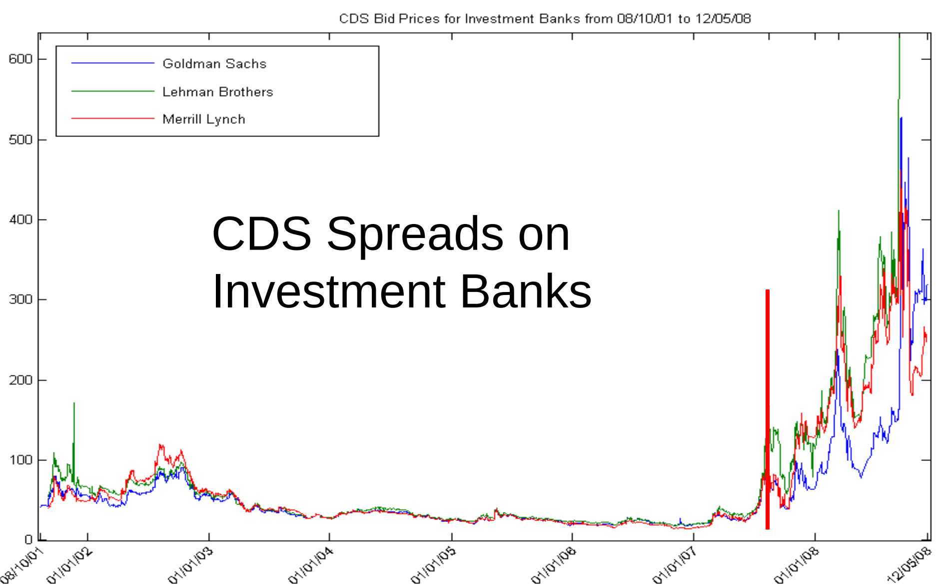
Regulatory Responses

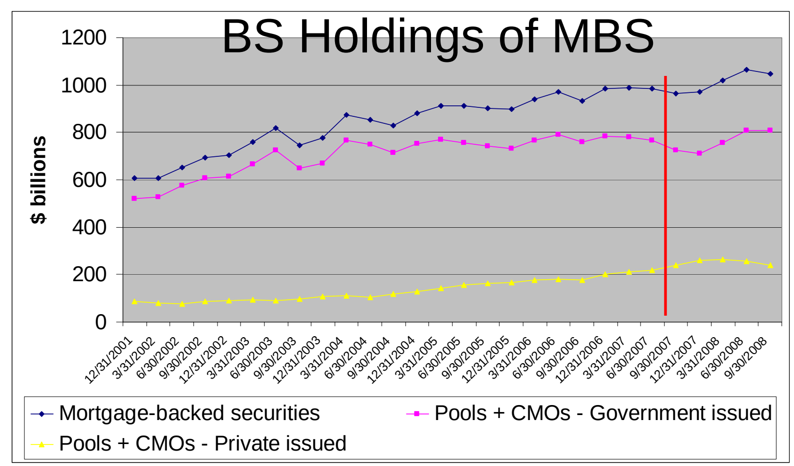
- The Fed acted as ***liquidity*** provider and Lender of Last Resort
- The Treasury became the Actor of Last Resort to address *insolvency, e.g.* TARP, TARL
- Some key regulators were largely absent, e.g. SEC as regulator of Investment Banks

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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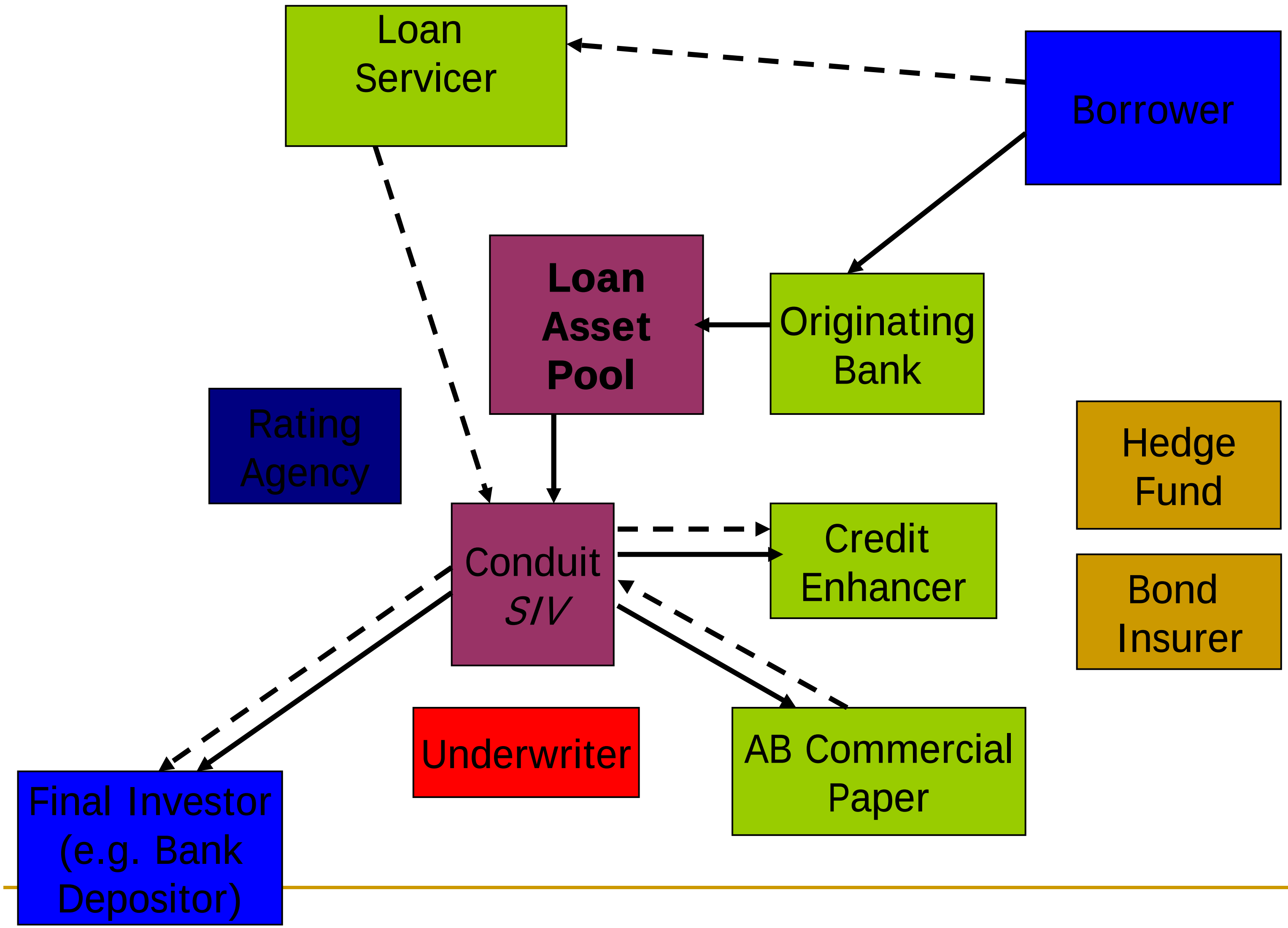

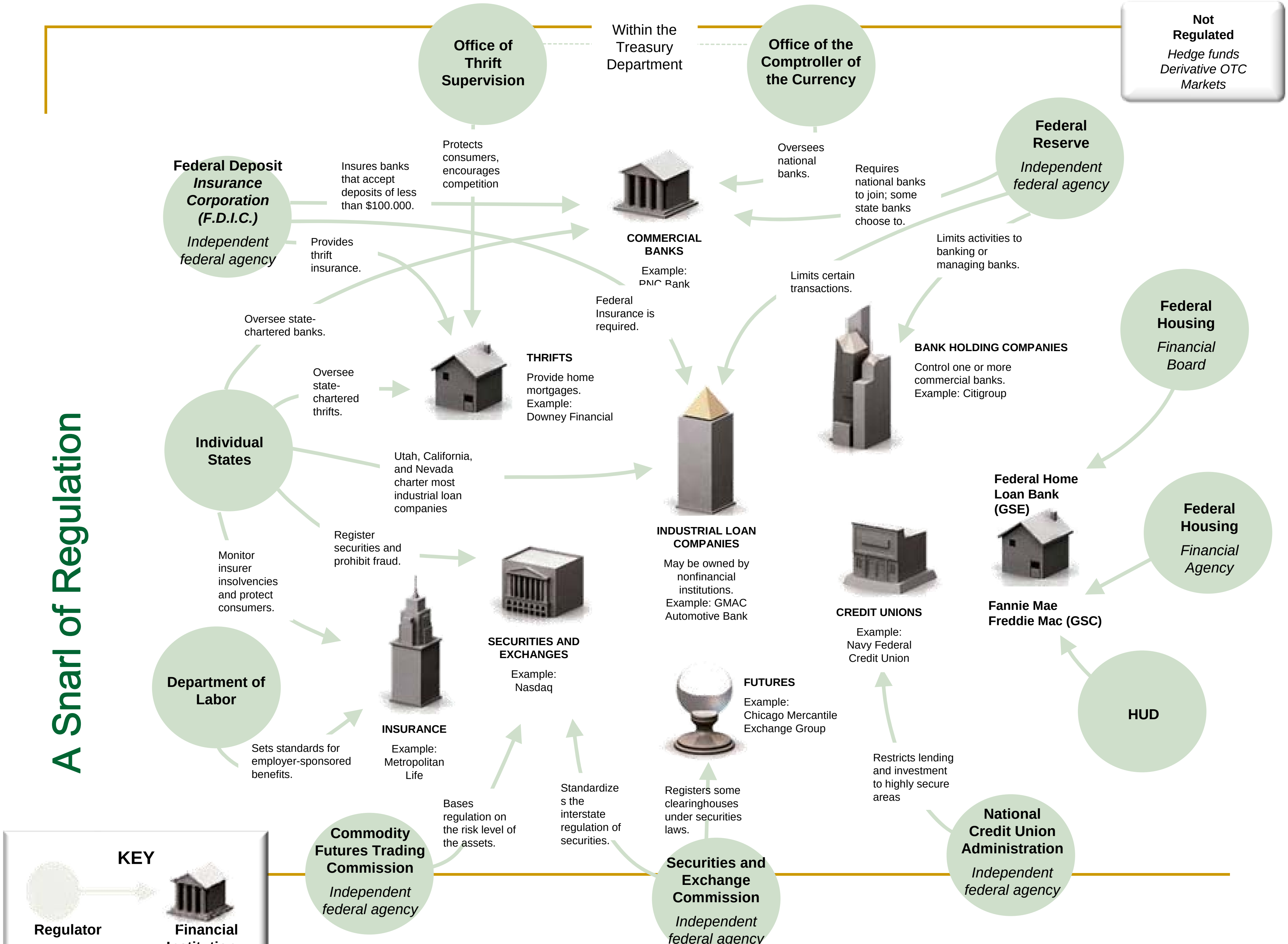

Modified from The New York Times - October 4, 2008

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
        1. Strengthening off-balance sheet vehicles.
        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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