General Discussion: The Subprime Turmoil: What's Old, What's New and What's Next

Chair: Martin Feldstein

Mr. Sinai: Charlie, I am puzzled by your logic of blaming the characteristics of crises on loose monetary policy. Chart 1 of Michael's remarks underscores the opposite. It shows that the federal funds rate just prior to a bust is high really ahead of it. I would argue that most crises in the modern era have occurred in the presence of tight money, principally in response to high inflation. This time I think it is a balance sheet crunch—more than a credit crunch—that is a part of the upper turning point of the business cycle. That is new in its extent.

Maybe you really mean that loose monetary policy helps create a later boom. Then the boom and higher inflation are part of the recession and bust in a crisis. This episode is different. You can't put this at the door of the Federal Reserve. It is the financial system itself, the innards of it that have created the crisis. Loose monetary policy would to me make more sense as a cause if it were a prior precondition in time. Tight money and tight credit most often definitely have been characteristics of business cycle upper turning points.

Mr. Blinder: Two questions for Charlie, although the first one will suggest an answer. The second one doesn't suggest an answer. It really is a question.

At the end of your paper—you didn't get there in your remarks—you talked about the prediction that stand-alone investment banks will wither away because of the superiority of raising money through deposits, which may be right. Ten or 12 pages earlier, you listed the establishment of deposit insurance in a list of changes "that are almost universally viewed by financial historians as mistaken reactions to the Depression."

First, I am not so sure how you square that. I am definitely sure it was a mistaken reaction to the Depression.

Second is just a question, which is, You raised very interesting points about the compensation of asset managers. There is a related criticism that has been leveled, and I wonder what you think about that, which is that many asset managers get rewarded—and this goes right up the line (it is not just the trader)—on returns rather than risk-adjusted returns. Wouldn't it be better if we could figure out a way to do it to reward them on risk-adjusted returns?

Mr. Makin: Both Michael and Charlie discussed the issues of liquidity as connected with the Bear Stearns episode. Charlie suggested Bear Stearns was far from insolvency when it failed.

I wanted to suggest a new concept—or maybe it's not new. The problem that arose on that March 16 Sunday night was one of incipient insolvency. That is, Bear Stearns was experiencing a severe shortage of liquidity. Our concern was that, if they tried to address their liquidity problem by selling assets, the value of the assets of course would collapse and they would very quickly be insolvent. That same process could spread to other investment banks. That would bring on the systemic risk that Chairman Bernanke was talking about.

I think it is a little dangerous to say, "Well, if we look at Bear ex post, they were far from insolvency."

They were going to be insolvent if there weren't some intervention. The kind of intervention that Michael suggested perhaps was either receivership, where you shut the process down, or perhaps direct purchase of those assets. Either one of you might want to comment on that.

Mr. Kashyap: Charlie, you implied the raising of equity can be viewed in isolation as something that is new in this crisis. Do you think if value-at-risk weren't embedded in the risk-management procedures, this would have happened? I think not. What is new is the risk-management procedures that mandate when you see value-at-risk (VaR) skyrocketing, you either shrink the assets or raise the equity. The equity was a consequence of the VaR, not something that just happened by accident. From here forward we are going to keep seeing this dynamic of either you sell the assets or raise the equity.

Mr. Hubbard: The principal point about the asset-management industry and compensation—of course, at Bear Stearns, there were already very high-powered incentives. The CEO lost $400 million in a month. My question for you is, Are you asking to change the 40 Act Rules for mutual funds? Is that what you had in mind? If so, are you trying to empower people to change structures, or do you want to regulate that? The issue is not just the rules for whatever mutual fund prices are, but the compensation of traders within an organization. Do you really want the Congress doing that?

The second piece of that question is, There are two ways of going at this and they are not mutually exclusive. One is the compensation reforms you mentioned, and the other is letting capital requirements on institutions on the other side of the market move over the cycle. Do you see those as good complements? Would you prefer the comp reforms?

Mr. Alexander: One of the questions I'd be interested in both the speaker and the commentator commenting on is, It seems to me one of the powerful sources of variation in this crisis is the fact that different institutions perform very differently. We think of this as something that was uniform but, even among large financial institutions like my own, perform differently than others. But also you have the different performance of hedge funds. I wondered what you make of that source of variation?

A second question relates to cycles of innovation. One of the insights from behavioral finance is that people overreact to small amounts of information. One of the things that is relevant to this cycle is you have this very rapid development of subprime and related structure

credit. To a certain extent, people extrapolated from a period of good returns. That, it seems to me, is a very common phenomenon with respect to cycles of innovation. I would be interested in reaction as to how you see that in the historical record.

Ms. Malmgren: I also have a question about the value-at-risk mathematical models, not in the aftermath but in the run-up to the crisis where essentially, because the models assume today's price information is more important than yesterday's, most of the catastrophic reference points had been knocked out of models, thus causing many institutions to say when volatility falls, we should double up the risk, and subsequent to the change in volatility, the lack of acquirement to update the volatility number. That is part of your agency risk. I wonder if you could comment on the relative contribution of this particular issue to the agency-risk picture?

Mr. Meltzer: First, I compliment the paper as a comprehensive and excellent summary of what we know and what we need to know. One addition I would make would be something about the lender-of-last-resort policy. The Fed has had 95 years without ever enunciating a lender-of-last-resort policy. Sometimes it does, and sometimes it doesn't. In the age of rational expectations, it is hard to justify allowing so much uncertainty about what its policy is going to be. Of course, one of the things that its lack of a stated and implicit policy encourages is the kind of intervention and pressures from Congress and Wall Street that have been so present in many, many crises and especially in the present crisis.

A second comment concerns the role of regulation. Most regulation violates the first law of regulation. That is, the first law of regulation says that lawyers and bureaucrats make regulation and markets decide how to circumvent them. That has to really be borne in mind carefully in thinking about new regulation. Investment banks, for example, mark to market every day by borrowing short term. If they can't borrow short term and they can't mark to market, then they should become subject to FDICIA without having to go into all the portfolio analysis and argumentation.

If you look at the history of regulation in the history of the Fed, regulating individual items just leads the Fed into wasting an enormous amount of time. For example, the implementation of Regulation Q got them involved in questions of whether the parking lots of banks should be counted as part of the interest payment that people receive, whether, if you gave the customer a safe deposit box, was that in lieu of interest and should you have to make a change for that, and there are just hundreds of these things which occupy the regulators all the time because they had a bad regulation and were having difficulty finding incentives that would make the regulation work.

I think this was an excellent summary. Those are just two suggestions for additions.

Mr. Goolsbee: The paper is pretty convincing in showing the ways that facilitated the speculation, but at two points I would caution you and ask you to justify a bit more of your argument.

One is the presumption made at several points in the paper in talking about the changing in compensation rules is that because you are getting paid as a share of the assets you automatically are changing the desire for risk. The insight of the mutual fund literature is that just having a share of the assets doesn't have any implication because the flows into and out of mutual funds are extremely performance sensitive. So it actually makes people more performance sensitive even though they are getting a share of the assets.

The second place I would caution you is your conclusion that the government's policies encouraging leverage have been somehow directly involved in this crisis. Almost all of the policies you cited are very long standing in origin. They are also, in many ways, not applicable to subprime. The mortgage interest deduction—a very large fraction of these people's income is low enough and the mortgages are not high enough, so they are not even itemizing, so they weren't even using that.

Several of the regulations on banks were such that two-thirds of the subprime mortgages weren't being made by banks, so the rules didn't even apply to them. I would just caution you on those two issues.

Mr. Calomiris: I think Mike is doing something useful by posing explicitly the counterfactual of, What if we hadn't used the discount window so much? My own view is, the surgical approach to targeting specific markets that have collapsed to prevent problems in those markets from spreading makes sense. That is the basic disagreement maybe that we have. That is, I start from the presumption that markets can collapse and stop functioning properly.

The second thing I would say with regard to the Drexel Burnham example is, the world has changed a lot since Drexel Burnham. The Fed is very appropriately focusing on the need to improve the clearing process and the infrastructure now, so that it can allow investment banks to fail. I don't want to paraphrase or try to say that is what I thought I heard the chairman saying, but that is certainly what I am arguing in this paper, and it is consistent with what the Fed is doing.

Dollar weakening. I didn't mean to say, if I did say, that the Fed should be targeting the dollar in some explicit sense. What I am saying is I am concerned that if there is a continuing loss in credibility for maintaining price stability that there could be a collapse of the dollar at some point in the future. I am less concerned about this than I was last month for a variety of reasons. But that would be a problem, because it would mean a collapse of consumption; it would mean a real recession; and it would also, of course, have dire implications for the stock and bond markets and for smoothing the effects of the credit crunch.

Allen Sinai's comment. I do explicitly mean what the papers I cite show, which is when interest rates are very low, you see credit standards deteriorating. And there is now a lot of microeconomic evidence for this direct link between times of very low interest rates and boom periods and the relaxation of credit standards. That is the point I am making. It was, I think, the way you interpreted it.

Alan Blinder asked a lot of interesting questions. On stand-alone investment banks, I am simply suggesting the cost-benefit analysis has shifted. It is hard to predict. On deposit insurance, I would refer you to the paper Eugene White and I wrote and remind you all that

the Treasury, the Fed, and President Roosevelt were very strongly opposed to deposit insurance, which was perceived at the time as special interest legislation being pushed by Henry Steagall, the Barney Frank of his time. It was an unnecessary innovation and very much a politically driven one. That doesn't mean I am trying to get rid of deposit insurance now, which is not politically realistic.

As far as long-term risk-reward tradeoffs, my view would be that this is exactly the topic we should be talking about in a whole conference. That is, how can we think about reforming risk-return tradeoffs?

And Glenn's question: Do I want to regulate this or deregulate it? I am mainly pushing, initially at least, in the direction of thinking that hedge fund incentives, which are more long-term directed toward value-maximization (which is the same as a risk-return tradeoff), would be good to introduce more into the management of non-hedge fund investments. So it is a deregulation suggestion, not a new regulation. I recognize that I don't have all the answers. There are some complicated issues there. Hedge fund incentives aren't perfect either.

I liked John Makin's point, so I won't comment more, except to say I'll try to incorporate those. I also liked Anil's point. I tried to make a version of that point, but maybe not as clearly.

Moving to Lew Alexander, I would say that is the empirical paper I would next like to write, which is looking at how the different loss experiences in different financial institutions might reflect different incentives within those institutions. Also, Glenn raised an interesting point related to this, which is, How much do we need to worry about incentives—not just at the top like the Bear Stearns CEO—but incentives all the way down to the asset managers? That is where I am focusing.

I liked Pippa's question. I don't have a good answer to this question about measuring volatility. Of course, that was crucial for the quantitative equity trading that I didn't talk much about. I didn't think it was such a big deal actually, which is why I didn't talk about it. Obviously, risk managers have to look beyond the current marked-to-market volatility, particularly in an environment where the current pricing in the market might reflect asset management agency

problems. So you have to use your brain, not just mechanically plug in what the asset volatilities are that you are getting.

Allan Meltzer made some great points. My hearing of Ben Bernanke's comments was very sympathetic to this idea that we need to have a lender-of-last-resort policy, partly because it will reduce the problems of moral hazard. It sounded to me like there is a wonderful symphony of views on that idea.

First law of regulation circumvention—absolutely! What is my suggestion? Subordinated debt requirements, of course, focus on market discipline in creating credible signals, forward-looking signals of risk, that might be more proactive. That is a big part of why I think they are a useful component.

As far as Fed involvement, I basically agree with Secretary Paulson on this. The Fed needs to be a macro-prudential supervisor, but it needs to get out of the day-to-day supervision and regulation business like every other developed country in the world—other than New Zealand, which doesn't have its own financial system after all. The Fed shouldn't be deciding whether real estate brokerage is a financial activity, for example. That only weakens the Fed by politicizing it.

Goolsbee's point is the last one. Of course, it is relative performance that matters. The important point and the first point here is my Keynes' quote that begins the paper by suggesting the following thinking may have been in operation, If you are a mutual fund manager and you know that all the others are taking the same bet you are taking, then you are not really at risk of a major relative performance problem, because you are all rising and falling together.

In terms of leverage policies, I agree that in subprime the interest rate deduction is not an important incentive for risk taking—in fact, I even have a footnote saying it is not clear that we want to call the interest rate deduction a subsidy. But the other ones clearly are. Community Reinvestment Act pushes since the 1977 legislation, of course, have been a contributor to that problem.

Mr. Bordo: Charlie basically discussed my main point, which is the counterfactual. I would really like to see what the counterfactual would have been had the Fed not did what it did with Bear Stearns and also with creating these special facilities. What if they had done what they had done before? What if they had used open market operations and used the discount window as it existed, given the legal mandate in the Federal Reserve Act, which does allow them and has allowed them to lend on the basis of many different kinds of collateral? So I wanted to know more about this assumption by everybody that the Fed did the right thing, that they were forced to do the right thing; and that if they hadn't it would have been a disaster. I would like to see what the alternative counterfactual would have been. I am just not 100 percent convinced that counterfactual would show you that what the Fed did was the right thing. That is my reaction.