Recovery from Financial Crisis

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Introduction

I am pleased to be at this meeting and to discuss efforts to strengthen the financial system on a global basis. This has certainly been a challenging period for bank supervisors who took a variety of ad hoc steps during the crisis to deal with troubled institutions and markets, worked to maintain core financial services and public confidence, and are now issuing and implementing a long list of reforms.

Despite these well-intentioned efforts, we should consider whether the regulatory reforms reflect an effective response to the issues that surfaced in the recent financial crisis. Further, we should look to lessons from the past to understand to what extent the approaches used during the financial crisis may at least partially explain why many countries around the world are experiencing an economic recovery that has been agonizingly slow.

To illustrate this point, I will first look at the policy approaches taken in previous crisis periods and examine what worked best and what did not. Then I will compare the response to the recent financial collapse with successful approaches from the past. Finally, I will discuss my view that there are policy shortcomings that still need to be addressed and ways that we can provide for a stronger recovery.

Lessons from Previous Crises

As the side effects of the 2008 crisis have lingered and turned into a very slow recovery process, several reasons have been given as possible explanations for this experience. One idea, for example, is that financial crises are unique and it takes much longer to recover from them than other economic downturns. Similarly, some contend that asset price bubbles produce a "balance sheet recession." As a result, people must first try to pay down debt and increase savings, thus leaving monetary policy and low interest rates less effective in encouraging borrowing and expansion. Another contention is that banks must first work off their bad assets and restore capital before they are in position to help promote a recovery.

While all of these carry some truth, we have had major financial crises in the past. In a number of cases, the outcomes have been better, setting the stage for relatively faster recoveries while also limiting any moral hazard problems that might be carried forward.

United States, Sweden and Japan

What the United States did to address the banking panic of the 1930s became the model for much of what was done in Sweden and eventually in Japan. The banking crisis of the 1930s was the most severe in U.S. history, with the total number of commercial banks declining by 9,000, or nearly 40 percent, from the beginning of 1930 to the end of 1933. About 4,000 banks failed in 1933 alone.

After a one-week banking holiday was declared in March 1933, the Reconstruction Finance Corporation (RFC), which was a public entity established in the 1930s to provide support to ailing banks and businesses, joined with the banking authorities to quickly assess the condition of every U.S. bank. Each bank was then placed into one of three categories. The first category included sound banks that were generally thought to have adequate capital. A second group included banks that had lost most of their capital but still had the resources and ability to protect depositors and remain viable, and a third group consisted of failing banks that had lost all of their capital and would not be able to pay off their depositors in full. Notably, in making these evaluations, the RFC established a policy that every bad asset in a bank must first be written down to its realistic economic value.

The banks in the first group were then reopened promptly after the bank holiday, and banks in the second group were reopened after raising new capital privately or by selling preferred stock to the RFC. Banks in the third category were placed into conservatorships. The RFC also insisted that any needed changes be made in a bank's management before RFC funds were injected.

Overall, the RFC was highly successful in promptly restructuring, recapitalizing and restoring public confidence in a U.S. banking system that had been in a sharp downward spiral. Nearly all of the RFC funds were eventually repaid with virtually no loss to taxpayers. Also, the RFC's insistence that bad assets be written down to realistic values and poor management be replaced helped to minimize moral hazard issues. The economy continued to remain weak in the years after 1933 due to a variety of factors, such as the substantial disruption in financial intermediation from bank failures, zero interest rates and extreme caution on the part of businesses to expand their operations by making new investments and hiring new workers. Despite the soft recovery, the banking sector encountered few problems after 1933.

In Sweden, a speculative boom in real estate and bank credit, along with unsustainable exchange rate policies, led to a severe economic downturn and banking crisis in the early 1990s. Actions by Swedish authorities closely followed what the RFC did in the United States. Swedish banks were classified into three categories that were patterned after the RFC approach. This analysis led to a governmental takeover of two of Sweden's six largest banks, with a third bank needing to raise additional capital. To restore confidence during the crisis, the Swedish government instituted temporary guarantees for bank depositors and creditors but left stockholders at risk.

One additional element employed in Sweden was the use of asset management corporations to acquire and resolve the bad assets of the two banks that were taken over. Thus, two healthy banking operations were returned to private ownership without significant delay. As a result of these steps and a strong economic recovery, the Swedish banking crisis was resolved more quickly than generally expected and at little or no cost to taxpayers.

In contrast to Sweden, Japanese authorities were slow to address the banking problems that arose after Japan's real estate crash in the early 1990s. Japanese banks became swamped with substantial volumes of bad assets and had little real capital to support their operations. As a result, Japan suffered through a series of severe credit crunches for much of the 1990s—the so-called "Lost Decade."

Japanese authorities finally took action beginning in 1998 to deal with bank insolvency issues and to inject capital into the remainder of the banking system, using the RFC model as a guide for these actions. These capital injections largely ended the credit crunch and were later paid back without loss to taxpayers.

A final example is the thrift crisis in the United States in the 1980s. This crisis arose from thrift institutions holding 30-year, fixed-rate mortgage loans during a period of rapidly rising interest rates in the early 1980s. As market rates jumped well above the contractual rates on many of these loans, a significant number of thrifts were faced with both funding and insolvency issues. However, there was little public commitment to deal with these issues, given an inadequate amount in the thrift insurance fund and little support in Congress for allocating money to clean up the industry.

Unfortunately, the primary response was to give thrifts a wider range of powers in the hope of providing a new way out of their problems while allowing them to continue operating on little, if any, capital base. This framework led to serious moral hazard issues and a surge in commercial real estate lending by problem thrifts. By the end of the 1980s, a greatly expanded federal bailout was needed for the thrift industry.

The lessons from these previous financial crises are clear. First, the quickest way to restore prosperity and financial stability is to identify the losses in the financial system and take timely and concerted action to address them. A guiding rule for supervisors should be that once a loss in the financial system is incurred, it will not go away on its own and will only delay the chances for recovery and increase the eventual costs.

Second, supervisors must be in a position to identify which institutions are viable and capable of surviving a crisis. Supervisors also need to determine which institutions are insolvent and must be resolved while providing a chance to bring them back to private ownership under new and more capable management.

Third, moral hazard issues must be considered in the steps taken. Whenever possible, regulators should pursue actions that force the responsible parties to take losses and minimize future problems.

Recovering from the Recent Crisis

Faced with uncertainty and urgency, the United States and many other countries did not turn to these lessons or the crisis resolution model that was used in the United States in the 1930s and later adopted in Sweden and eventually in Japan. In the United States, for instance, public authorities provided significant liquidity assistance and debt guarantees during the recent financial crisis, but did little to pursue corrective measures when granting this assistance.

For example, the Troubled Asset Relief Program (TARP), which was used to inject public capital into U.S. banks, did not follow the key principles that were used by the RFC in 1930s to strengthen banks and avoid moral hazard problems. Unlike the RFC, TARP injected funds indiscriminately into all the major U.S. banks. No attempt was made to put these banks into different categories based on their condition and viability. Neither were they required to first write down their problem assets to gain a perspective into capital needs and to force a balance sheet cleanup and minimize moral hazard concerns. Equally important, there was no effort to assess the quality of management and to insist on changes when needed. Instead, attention and restrictions were tied to limiting executive compensation and bonuses after the fact and not to the more critical question of management capability.

Perhaps one could argue that the 2008 crisis was different and did not lend itself well to the type of actions taken in previous crises. For example, many claim that today's financial instruments are less transparent and are harder to evaluate and price. Another factor may be the systemic nature of many of the institutions involved in this crisis and the global nature of the crisis itself.

These and other characteristics certainly merit consideration. However, the slow nature of this recovery, the limited amount of new lending after more than four years and the continuation of banking issues in some countries may suggest that the actions we took left unresolved problems. In addition, we must consider whether what we are doing is sustainable in the long run or whether it only increases the chance of future crises.

We should first ask ourselves if we have corrected the misaligned incentives that were behind this crisis. Quite clearly, a major issue in the United States and many other countries during the crisis was the public assistance and protection that was given to banks deemed "too big to fail." We cannot expect to have a sound financial system if the key players in it are not held fully responsible for the choices they make.

The traditional safety nets in most countries already provide incentives for added risk-taking that we all attempt to address, albeit imperfectly, through regulation and supervision. Adding too-big-to-fail protections into our safety nets not only further distorts these risk-taking incentives but also puts a much greater degree of pressure on the supervisory framework. Enhanced supervision and the related steps many of us are taking now are unlikely to work well as long as major institutions still have incentives to take on added risk.

Another incentive problem we should think about is the Basel risk weights. Regulators have spent a great deal of effort trying to construct a quantitative system for linking capital needs to risk levels. Yet the financial crisis has clearly demonstrated that mortgage loans, mortgage-backed securities and sovereign debt were not the low-risk assets as designated under the Basel standards. We have also seen that institutions have a remarkable ability to circumvent standards as long as they have an incentive to do so.

Regulatory capital measures undoubtedly gave us a misleading picture during the crisis—in part because we were reluctant to require that bank holdings be written down to their actual values, but also because these capital measures failed to pick up the steep decline in capital that became evident in market capitalization figures and other market-based measures of capital. To me, all these issues imply that we must have a strong leverage constraint to counteract any shortcomings that may exist in risk-based capital standards.

Along with strong leverage ratios, we must have the correct supervisory focus, particularly since we have not carefully followed some of the lessons of previous crises. For instance, do we still need to clean up the banks and insist on better management? In previous crises, the first step to a successful recovery was to admit that some banks had failed and could only be brought back to life with better management and a clean balance sheet.

With regard to other aspects of supervisory focus, I am especially concerned that we may forget the importance of our traditional supervisory tools—microprudential supervision, careful examiner assessments of credit and other banking risks and our evaluations of the quality of bank management. Today we are focused on enhanced supervision of the systemically important financial institutions, stress tests, macroprudential supervision and many other reforms. These steps will not get us very far if we don't first address the incentive problems in our financial institutions, insist on better bank management wherever needed and emphasize our traditional supervisory framework.

Enhanced supervision and stress tests, for instance, are likely to draw many resources away from traditional supervision. While these new supervisory tools have been useful exercises, in the end they may become little more than routine, repetitive steps in satisfying regulatory requirements—much like the Basel risk weights—without contributing to a more effective supervisory process.

Conclusion

It is said that regulators come in after the battle is over and shoot the wounded. In this case, many issues remain as we seek to put our respective economies in position for a strong recovery and a more resilient financial system. I believe we must first identify and correct the shortcomings discovered in this crisis. Previous crises provide an excellent guide of what works well in re-establishing a strong banking system, as well as what does not work. Because each crisis is different, we must diagnosis carefully the risks and outcomes within our financial system as a foundation for a stronger economic recovery.