Responses to the Financial Crisis in the U.S.

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Outline

- The U.S. Origins of the Global Financial Crisis
- Immediate Legislative Response – TARP
- Subsequent Legislative Response – Dodd-Frank Act
- Roll-back of Dodd-Frank
- Future Concerns

The U.S. Origins of the Global Financial Crisis

- Multiple causes, including subprime mortgage loans and the bursting of the housing bubble
  - Mortgage-backed securities (MBS) – variety of tranches
  - Demand high and subprime mortgages originated to help satisfy demand
  - Disaster when housing bubble burst and subprime mortgages in MBS could not be refinanced and borrowers defaulted
- Credit default swaps (CDS) – used for hedging and for speculation
- Crisis of confidence
  - Runs on banks
  - Inability to rollover short-term debt
  - Credit crunch

The U.S. Origins of the Global Financial Crisis

- September 2008 – on the brink of devastation
  - 9/7: Fannie Mae and Freddie Mac placed into government conservatorship
  - 9/15: Bank of America announced its intent to buy Merrill Lynch (investment bank)
  - 9/15: Lehman Brothers (investment bank) does not get a bailout and files for bankruptcy
  - 9/16: Federal Reserve Bank of New York authorized by the FRB to lend up to $85 billion to AIG (provider of CDS)
  - 9/16: The Reserve Primary Money Market Fund “broke the buck”
  - 9/17: SEC imposed a temporary ban on short selling of stocks of companies in the financial sector
  - 9/18: Paulson (Treasury), Bernanke (Fed), and Cox (SEC) met with Congressional leaders
  - 9/21: FRB approved the applications of Morgan Stanley and Goldman Sachs (investment banks) to become Bank Holding Companies (BHCs)
  - 9/25: Washington Mutual closed and JP Morgan Chase acquired most of its assets with FDIC assistance
  - 9/29: FDIC announced that Citigroup would purchase Wachovia (with FDIC assistance); later rejected in favor of no assistance offer by Wells Fargo
  - 9/29: “Bailout bill” rejected by the House of Representatives

Immediate legislative response – TARP

- 10/3: Emergency Economic Stabilization Act
  - Temporary increase of deposit insurance from $100,000 to $250,000 (made permanent in 2010 Dodd-Frank Act)
  - Established the Troubled Asset Relief Program (TARP)
    - Interpreted to permit purchase of stock (versus purchase of troubled loans)
    - $250 billion in TARP used to buy nonvoting, preferred stock in banks/BHCs
      - Quarterly dividends of 5% per year for first 5 years and then increasing to 9% per year thereafter
      - Citigroup and Bank of America each identified as “systemically significant” and received additional TARP funds for a total of $45 billion per institution (30% of Citi’s equity and 19% of B of A’s equity)
    - Large push-back on this partial nationalization of banks – perceived as a bailout of banks whose own greed precipitated the financial crisis
    - Almost all TARP stock repurchased by financial institutions
    - Did not unfreeze credit as expected, but kept banks afloat with adequate capital

Subsequent Legislative Response – The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- Hundreds of pages long with many significant provisions
- No new TARP programs
  - TARP money that is repaid may not be used to buy more preferred stock or make additional loans
- Creation of the Financial Stability Oversight Council (FSOC)
  - Enhanced prudential standards (EPS) (stress testing, additional capital/Basel III, liquidity requirements, resolution plans) for systemically important institutions (SIFIs)
    - BHCs with assets > $500
    - Non-bank SIFIs identified by FSOC
      - AIG
      - Prudential
      - MetLife
      - GE Capital Corporation
  - Monitor systemic risks

Subsequent Legislative Response – The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

- Limitation of some of crisis tools -- Section 13(3) of the Federal Reserve Act – ability of Fed to lend to nonbanks in “unusual and exigent circumstances”
  - Used during the crisis to
    - Lend to specific institutions
      - JP Morgan Chase to facilitate acquisition of Bear Stearns
      - AIG
    - To establish broad-based credit facilities, such as the Commercial Paper Funding Facility (CPFF) – bought unsecured commercial paper from corporate issuers through a special purpose vehicle
  - DFA limited 13(3) lending to programs with “broad-based eligibility” so that liquidity can be provided to the financial system but not to a specific failing company
- Orderly liquidation authority
  - To apply resolution authority for insolvent banks through the FDIC potentially to insolvent financial companies (BHCs, investment banks, insurance firms)

Roll-back of Dodd-Frank

- Passage of Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018
  - Increased BHC SIFI threshold from $50 billion in assets (45 companies) to $250 billion in assets (14 companies)
    - In effect as of May 24, 2018 for BHC with assets < $100 billion
    - In effect for BHCs with assets between $100 and $250 billion in November 2019
      - FRB still has authority to apply enhanced prudential standards (EPS) on a tailored basis if necessary, based on certain risk-related factors
    - Institutions identified as G-SIBs subject to EPS even if less than $250 billion in assets (29 G-SIBs identified by the Financial Stability Board in conjunction with the Basel Committee on Bank Supervision)

Roll-back of Dodd-Frank

- FSOC de-designation of nonbank SIFIs – and now there are none
  - FSOC proposed interpretive guidance on designating nonbank SIFIs criticized by two former Treasury Secretaries/FSOC chairs (Lew, Geithner) and two former FRB Chairs (Yellen, Bernanke)
    - Proposed procedures for designation would take too long
    - Likelihood of failure should not be a factor
      - Assessing a firm's distress would send a signal about financial health and could lead to market reaction that would send the firm into failure
    - Off-ramp negotiations between FSOC and company would be contentious and inappropriate for FSOC to engage in
- Regulatory relaxation both in terms of new regulations and changes in focus by various agencies. Former FRB Governor Daniel Tarullo called this "a kind of low-intensity deregulation, consisting of an accumulation of non-headline-grabbing changes and an opaque relaxation of supervisory rigor"
  - Stress tests less stressful (i.e., more predictable) and could reduce capital buffers-
  - Consumer Financial Protection Bureau's (a creation of Dodd-Frank) focus in the Trump Administration has been on reducing burden on providers of consumer financial products and services rather than protection of consumers

Concern for the Future -- Shadow banking is alive and well and are CLOs the new MBS?

- Increased regulation in banking pushes activities into the shadow system
- Estimated at almost $15 trillion in assets (about the same size as British banking industry)
  - Mortgage lending (9% of market in 2009; 52% today)
    - Monitored by states, CFPB, Fannie and Freddie guidelines
    - But not subject to capital requirements
- Leveraged loans ($1.2 trillion) to businesses
  - About 80% of leveraged loans are “covenant-lite”
  - Banking regulators issued updated “guidance” about leveraged loans in 2013
    - Need for meaningful covenants
    - Concern about excessive leverage if debt exceeds 6 times earnings
    - September 2018 clarification said that enforcement actions would not be based on the guidance leading to more aggressive lending by banks, although guidance does factor into supervision
    - Shadow banks not subject at all to guidance
  - Leveraged loans sold into collateralized loan obligations (CLOs). CLOs biggest buyers of leveraged loans with record $128 billion issued in 2018
    - $750 billion in CLOs outstanding globally, with one-third or so held by banks
    - In US, $600 billion U.S. CLOs outstanding, and U.S. banks own about 14%; U.S. insurers own about 9%, public pension funds also hold

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MBS v. CLOs

- Originate to distribute model means loan originator does not bear risk for bad loans
- Dodd-Frank Act risk retention rule (originator retains 5% of loan risk when loan sold) found not applicable to CLOs
- Continuing reliance on rating agencies to evaluate CLO loan pools

“Those who do not learn history are doomed to repeat it.”

- *George Santayana*

Questions?

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