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Advice, Not Consent: A Case for a Systemic Risk Adviser and against a Systemic Risk Regulator

By Alex J. Pollock

Financial crises keep happening. Could a systemic risk regulator prevent them? Not if that means it would have to predict the financial future correctly. But a "systemic risk adviser" might be useful and is worth a try—provided it is independent enough to point out the systemic risks being created by the government's financial actions and policies, in addition to those of private financial actors.

"The [banking] failures for the current year have been numerous, many having been characterized by gross mismanagement and some by criminality. . . . The unfavorable conditions were greatly aggravated by the collapse of unwise speculation in real estate, especially in city and suburban property."[1] This quotation comes from the report of the Comptroller of the Currency—in 1891.

In 1912, soon-to-be-president Woodrow Wilson said, "Waiting to be solved . . . lurks the great question of banking reform."[2] Nearly a hundred years later, it still seems to be lurking.

With the creation of the Federal Reserve System, "financial or commercial crises seem to be mathematically impossible."[3] At least, that was what the Comptroller of the Currency thought in 1914.

In 1922, then–secretary of commerce Herbert Hoover launched the government's "Own Your Own Home" campaign. In 1927, the McFadden Act significantly liberalized the terms on which national banks could make real estate loans. By 1932, as Jesse Jones, the formidable head of the Reconstruction Finance Corporation, observed: "Strewn all over was the wreckage of the banks which had become entangled in the financing of real estate promotions and had died of exposure to optimism."[4]

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It is the professional duty of bankers and debt investors to be skeptical, not optimistic, but this seems to be forgotten in each financial cycle. As economist Abram Piatt Andrew wrote in 1908: "The American panic of 1907 . . . gave the lie directly to those who in recent years have contended that we should never again witness the experiences like those remarkable years 1837, 1857, 1873, and 1893."[5]

Financial crises keep happening. My banking career began during the credit crunch of 1969. This was followed shortly afterward by the bankruptcy of the Penn Central railroad—clearly a "systemically important" railroad—and panic in the commercial paper market, which was bailed out by the Fed in actions that were controversial at the time, while Penn Central was nationalized.

Key points in this *Outlook*:

- U.S. financial history is marked by bubbles, busts, and calls for banking reform.
- If expert market participants and regulators fail to foresee the future, how would a systemic risk regulator do any better?
- The Fed is an especially bad choice for this role, given its contributions to systemic risk.
- A better idea is an independent systemic risk advisory body steeped in history's lessons.

In 1974, for the first time, unimproved land was allowed as collateral for national bank lending. In 1975–76, there was a massive real estate bust. About two-thirds of bank loans to real estate investment trusts—the enthusiasm of the day—were nonperforming. The Senate Banking Committee held hearings on what its then-chairman called an “inordinate risk to the banking system,” which was likely insolvent if it had been marked to market—but it was not marked to market.

Less than a decade later was the financial crisis of the 1980s; it reached a crescendo in 1989–91, featuring the final collapse of the savings and loan industry, another terrific commercial real estate bust, and severe insolvency problems for the highly regulated commercial banks, of which more than 1,400 failed in the decade ending in 1991. Citibank was in trouble, and it was not alone. “Banks Entering Era of Painful Change—More Bailouts, Bankruptcies, Layoffs Likely.” This headline, seemingly taken from today’s papers, was published in July 1991.[6] That same month, a Wall Street author penned this remarkable line: “Lenders are unlikely to repeat their past mistakes.”

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Major regulatory reforms and reorganization—the normal political reaction—marked the time. Notable among them were these acts of Congress: the Financial Institution Reform, Recovery and Enforcement Act of 1989; the Federal Deposit Insurance Corporation Improvement Act of 1991; and the Housing and Community Development Act of 1992. Such actions would ensure that such financial crises would happen—in then–secretary of the treasury Nicholas Brady’s words—“never again.”[7]

It Happens Again: Leveraged Real Estate

It might seem that lenders would not repeat their past mistakes, at least for a long time, and that governments would avoid them, too. But in 1994, the Clinton administration’s National Homeownership Strategy advocated “financing strategies, fueled by creativity” to help homebuyers who “lack [the] cash available to accumulate the required down payment” or “do not have sufficient available income to make the monthly payments.”[8] A good deal of “creativity” was indeed applied and such strategies were implemented, albeit with a rather different outcome than intended.

In the twenty-first century, surrounded by computers, databases, mathematical models, and internationally agreed-upon capital standards, we have experienced another great bubble and bust, based once again largely on leveraged real estate. Real estate speculation is as American as apple pie, going back to the Founding Fathers, and, this time, Chinese savings helped us carry out this national tradition.

Martin Baily of the Brookings Institution observed at a recent AEI conference that systemic risk arises when a lot of people hold the same asset.[9] According to the FDIC, as of December 31, 2008, 60 percent of all the loans of all insured depositories were real estate loans: $4.7 trillion in real estate loans out of total loans of $7.88 trillion. For the 7,600 banks and thrifts with assets of $1 billion or less each, the proportion of real estate loans rises to a remarkable 77 percent of loans.[10] This concentration of real estate rot in the entire banking system poses systemic risk, which cannot be understood without considering the government deposit insurance which makes it possible.

As we move into the summer of 2009, the “great question of banking reform” once again being debated, we are now in the political reaction phase—a lagging indicator of the financial cycle. There is an overpowering desire by politicians to show that they can Do Something: punish offenders, humiliate those who fail, increase regulation, create new regulatory bodies, reorganize existing ones, or, the latest idea, create a systemic risk regulator.

A Systemic Risk Regulator? The Fed?

To begin with, it is essential to distinguish between a systemic risk *regulator*, which I oppose, and a systemic risk *adviser*, which I favor. The creation of a National Institute of Finance, proposed by Allan Mendelowitz and John Liechty,[11] is an idea consistent with the advisory approach.

Consider this summary of our dilemma by Loyola University Chicago professor George Kaufman: “Everybody knows Santayana’s line that those who fail to study the past are condemned to repeat it. When it comes to financial history, those who do study it are condemned to recognize the patterns they see developing, and then repeat them anyway!”[12] This witty statement poses a

disturbing and profound question. Part of the answer is that the force of the government, including and particularly the Federal Reserve, is itself a key source of systemic risk.

Therefore, any meaningful systemic risk adviser has to be distant enough from the government and central bank power structures to be able to speak freely and forcefully about the systemic risk that the *government*'s actions may be creating. That is why, even if one correctly prefers an adviser to a regulator, a council of government agency heads is not the answer.

My opinion on two questions by now is obvious: (1) Should there be a systemic risk regulator? No. (2) If there is one anyway, should it be the Federal Reserve? No.

"Economic forecasting was invented to make astrology look respectable," John Kenneth Galbraith is said to have remarked, and, as Alan Greenspan recently said at AEI, "Regulation which fails is that which requires forecasting the future."[13] Putting these two thoughts together, what hope is there that a systemic risk regulator could operate successfully? To forecast the financial future correctly—let alone to control it!—is impossible. This is because of the exceptionally complex and rapid recursiveness of financial markets and the resultant uncertainty. This Uncertainty—with a capital "U"—means, according to the classic discussion by Frank Knight, that not only do you not know the odds of events, you *cannot* know the odds.[14] This is partially because beliefs about the odds by market actors, central bankers, and regulators change the odds. Hence Moore's Law of Finance: the model works until it doesn't.

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We may summarize these problems with the experience of the transcendent mathematical genius Isaac Newton in the mania and panic of his day, the South Sea Bubble. Newton invested early in the bubble, sold out as the price rose, and made a very large profit. But when prices continued to rise, he apparently experienced seller's remorse and went back in, was caught in the collapse, and lost even more. Afterward, he wrote in disgust, "I can calculate the motions of the heavenly bodies, but not the madness of people."

You can apply mathematics to economics and finance, but that does not make them science. Using Newton's laws, the courses of the planets can be predicted with accuracy and complete agreement among experts hundreds of years into the future, but the course of financial markets cannot be reliably predicted for the next six, or even three, months. And financial forecasts always display marked disagreement among experts. What we need to deal with systemic risk is much less models than memory.

As for the Federal Reserve, its history has been marked by periods of severe economic and financial stress and disaster, after which its policies have been revealed as deflationary or inflationary blunders—well-meaning mistakes, subject to huge uncertainty as decisions were made in the midst of complexity and crisis. Among these mistakes: the roller coaster of inflation and deflation in 1919–21; the collapse of the financial system and the Great Depression, including the Fed's 1937 "tragic mistake" of pushing the economy back into contraction; and the Great Inflation and stagflation of the 1970s.[15]

With the twenty-first-century bubble turned to bust, we have a fourth instance in which the Fed is widely perceived to have made big mistakes. "The U.S. crisis was actually made by the Fed," argues Columbia University professor Jeffrey Sachs.[16] An additional assignment as the systemic risk regulator would make the Fed too conflicted when combined with its role as monetary manager—and history does not make us too confident about the Fed's performance as the latter. Why would we reward with even more power the same agency whose monetary policy stoked the housing excesses in the first place? To paraphrase Senator Jim Bunning (R-Ky.) at a congressional hearing last year: how can you regulate systemic risk when you *are* the systemic risk?

Another source of systemic risk is federal deposit insurance, which makes possible the high leverage of the banking system. A highly levered financial system—one with assets of ten, fifteen, or twenty, let alone twenty-five or more, times its equity—will always bust from time to time. Running the system at high leverage means you will periodically have crashes.

How low would leverage have to go to have a financial system with no busts? No one knows the answer for sure, but it may require leverage of as little as four or five times equity, which would mean capital ratios of 20–25 percent, as opposed to 6–7 percent. Since we cannot get there from here, I expect that the financial system will continue to run, even after what-

ever reforms may occur, at high leverage—a key systemic risk.

A Systemic Risk Adviser

Instead of creating a systemic risk regulator, I favor creating a very senior systemic risk advisory function, which would supply institutional memory of the outcomes of past financial patterns. This advisory body should have a heavyweight board, an insightful and articulate executive director, and a small staff of top talent. It must be free to speak its mind to Congress; the administration; foreign official bodies; and financial actors, domestic and international. It must be free to address the government's contribution to systemic risk, in addition to that of private actors. In other words, I favor a philosopher, but not a philosopher-king.

The systemic risk adviser should look first of all for the build-up of leverage, hidden as well as stated, and for accelerating short-term funding of long and potentially illiquid positions that is increasingly considered "normal" and safe. Its purview should be global. Its thinking and analysis should be deeply informed by the financial mistakes and travails, private and governmental, of recent years, decades, and centuries.

The advisory body should be skeptical about "new era" rationalizations but aware of its own limitations in the face of fundamental uncertainty. It should remember that losses often turn out to be, as they have been in the current bubble and bust, vastly greater than anyone thought possible; it should also remember that risk-taking is essential and that the failure of individual firms is not only necessary, but, in the systemic sense, desirable. As my AEI colleague Allan H. Meltzer says, "Capitalism without failure is like religion without sin—it doesn't work." The systemic risk adviser must also remember that the main point is to keep our long-term growth trend—Adam Smith's "natural progress of opulence"—intact, while we cycle around it, with a hoped-for moderation in illusory enthusiasms and destructive panics.

Our adviser must seek to identify concentrated points of vulnerability to system failure. If such points develop, sooner or later, they are likely to fail. Good examples of such concentrated points of possible failure, which indeed failed at enormous cost, are the government-mandated use of the dominant credit rating agencies, with their mistaken ratings of mortgage securities; Fannie Mae and Freddie Mac, which, under government sponsorship, made the housing and mortgage bubble much worse; and the overdependence of credit default swap counterparties on AAA-rated AIG, or, more precisely, on a subsidiary of AIG speculating by using the parent company's AAA-rated credit.

Would a systemic risk adviser, if we had had one, have caught such concentrated vulnerabilities? Perhaps. Could its voice and focus have served to reduce the systemic risk? Maybe. Given the huge potential benefit if it did, an independent systemic risk adviser is worth a try.

We should not be too optimistic, however. Even the best adviser will not foresee all future problems or prevent all future bubbles and busts. Everybody—no matter how intelligent, diligent, and knowledgeable; no matter how many economists and computers are employed—makes mistakes when it comes to predicting the future, including the future results of their own actions. Because uncertainty is fundamental in financial markets, entrepreneurs, borrowers, central bankers, government agencies, speculators, and politicians alike will continue to make mistakes.

Nonetheless, a systemic risk adviser is distinctly worth a try, and, if it is properly structured, we should try it.

Notes

1. Quoted in John Jay Knox et al., *A History of Banking in the United States* (New York: Bradford Rhodes, 1903), 194.

2. Quoted in Alex J. Pollock, "Collateralized Money: An Idea Whose Time Has Come Again," *Challenge* 35 (September/October 1992): 62–64.

3. *Report of the Comptroller of the Currency*, 1914.

4. Jesse H. Jones with Edward Angly, *Fifty Billion Dollars: My Thirteen Years with the RFC (1932–1945)* (New York: Macmillan, 1951).

5. Abram Piatt Andrew, "Hoarding in the Panic of 1907," *Quarterly Journal of Economics* 22, no. 4 (1908): 497–516.

6. Jerry Knight, "Banks Entering Era of Painful Change—More Bailouts, Bankruptcies, Layoffs Likely," *Washington Post*, July 22, 1991.

7. Nicholas Brady, quoted in *Treasury News*, February 6, 1989.

8. Quoted in Peter Coy, "Bill Clinton's Drive to Increase Homeownership Went Way Too Far," BusinessWeek Hot Property, February 27, 2008, available at www.businessweek.com/the_thread/hotproperty/archives/2008/02/clintons_drive.html (accessed June 12, 2009).

9. Martin Baily (remarks, American Enterprise Institute, Washington, DC, June 3, 2009), available in audio or video through www.aei.org/event/100061.

10. Data are aggregated from the Federal Deposit Insurance Corporation's Statistics on Depository Institutions, available at www2.fdic.gov/sdi/main.asp (accessed June 15, 2009).

11. See Allan I. Mendelowitz and John C. Liechty, "Financial Regulators Need Better Data," *American Banker*, March 25, 2009.

12. George G. Kaufman (remarks, Enterprise Risk Management Symposium, Chicago, IL, April 15, 2008).

13. Alan Greenspan, "Addressing Systemic Risk" (remarks, American Enterprise Institute, Washington, DC, June 3, 2009), available at www.aei.org/speech/100052.

14. Frank H. Knight, *Risk, Uncertainty and Profit* (Boston: Houghton Mifflin, 1921).

15. Bernard Shull, *The Fourth Branch: The Federal Reserve's Unlikely Rise to Power and Influence* (Westport, CT: Praeger, 2005).

16. Jeffrey D. Sachs, "The Roots of America's Financial Crisis," Project Syndicate, March 21, 2008, available at www.project-syndicate.org/commentary/sachs139 (accessed June 10, 2009).