The Crisis of 2007-08

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What caused the crisis?

• Some of the usual causes that are given in the press are:
  – Ratings agencies
  – Lack of transparency
  – Poor incentives
  – Inadequate risk management systems
The main cause...

• The Federal Reserve held interest rates too low for too long and this caused a bubble in property prices
  – Without the significant drop in property prices there would not have been a problem

• Subprime mortgages as tax arbitrage
Lesson 1

Central banks need to think carefully about the effects of monetary policy on asset prices, particularly property prices.

In the past very few central banks have done this. For example, the Federal Reserve argued this was not possible and focused solely on consumer price indices of inflation.
Why didn’t regulation prevent the crisis?

• Banking regulation is different from other kinds of regulation in that there is no wide agreement on the market failures it is designed to correct.

• It is backward looking in the sense that it was put in place to prevent the recurrence of past types of crises.
Current regulation did not prevent the crisis

The important elements of the crisis:

• Role of liquidity in this crisis – cash-in-the-market pricing

• The effects on interbank markets and collateralized markets

• Fear of contagion
Lesson 2

Banking regulation needs to be designed to solve market failures rather than imposed piecemeal as a reaction to crises.

Many banks focus on satisfying current regulations rather than thinking ahead.
Incentives

• Why has Goldman Sachs been able to avoid the worst effects of the crisis while other financial institutions such as Merrill Lynch did not?
  – Goldman has a long run incentive system while firms such as Merrill Lynch do not

• Financial institutions need to reform the way they reward executives and base compensation on long run performance not annual performance
Lesson 3

Incentives of bankers need to be reformed but this should be a matter for the private sector and not regulated.

Financial institutions need to be ready to fire executives that underperform and make sure they are not compensated in such situations.
Cross-border cooperation

One of the most worrying aspects of the current crisis is the possibility for contagion across borders.

UBS and the “too big to save” problem

The international community needs to do much more to coordinate crisis management.

Société Générale problem provides an example of how not to do it.
Lesson 4

Put in place a system of burden sharing so that crisis management can be effective in case a large multinational bank is faced with bankruptcy

Particularly important for the EU with its goal of a single market in financial services

A role for the IMF or BIS?
Importance of focus on financial stability

• After the crises in Norway and Sweden the Norges Bank and Riksbank started publishing Financial Stability Reviews and now many central banks do it
  – It would be helpful if the Federal Reserve did this

• The governance of the regional banks, and in particular the New York Fed, needs to be reformed to avoid conflicts of interest in crisis situations, e.g. Lehman Brothers
Lesson 5

The Federal Reserve System needs to place more emphasis on financial stability

This may not have helped them to avoid the current crisis but on the other hand it may have led them to think through many of the issues that they are now faced with more carefully
Concluding remarks

Many remaining issues

• Provision of liquidity at quarter-end and year-end and window dressing

• Mark-to-market accounting in financial institutions has severe drawbacks in times of crisis and needs to be reformed

• Fed view versus the ECB view and problems caused by exchange rate movements