Minutes of the May 13, 2016 Financial Advisory Roundtable (FAR) Meeting

Present: FAR Members: Terry Belton, John Geanakoplos, Laurie Goodman, Gary Gorton, Darryll Hendricks, Charles Himmelberg, Bradford Hu, Deborah Lucas, Lynn Paquette, Manju Puri, Stephen Ryan, David Scharfstein, Antoinette Schoar
FRBNY: Tobias Adrian, Thomas Baxter, Dianne Dobbeck, William Dudley, Joyce Hansen, Beverly Hirtle, Lorie Logan, Antoine Martin, Jamie McAndrews, Meg McConnell, Kevin Stiroh, Michael Strine

This meeting of the Financial Advisory Roundtable (FAR) reconsidered the evidence from the financial crisis. Have regulators and market participants drawn the right lessons from the crisis? How have regulators incorporated these lessons? How have market participants incorporated these lessons? What lessons should regulators and market participants have learned? Were regulators behind the curve?

The role of lending standards and aggregate household leverage

FAR members discussed the view commonly proposed in the public domain that the housing crisis was mainly due to a deterioration in lending standards. This view was characterized as a combination of financial innovation and incentive problems leading to excessive real-estate lending in the run-up and then higher-than-expected defaults during the crisis, particularly among subprime borrowers. One FAR member proposed an alternative channel of over-leveraging (and later default) across the entire distribution of borrowers, fueled by expectation of continuously increasing house prices. This alternative channel emphasizes the role of churning and volume to existing borrowers for speculative purposes, with a lesser emphasis on the erosion of lending standards at origination.

In the discussion, FAR members argued that both channels are relevant for understanding the crisis and that there are important interactions between the two. For example, one FAR member pointed out that in an environment of potentially unsustainable house-price appreciation or increased house-price volatility, maintaining a constant LTV standard at origination is effectively a loosening of credit standards. However, FAR members pointed out that the two channels have distinct policy implications since loose lending standards at the individual level can be addressed with micro-prudential tools while systemic overleveraging—that doesn't violate micro-prudential standards at the individual level—has to be addressed with macro-prudential tools such as counter-cyclical LTVs and stress testing. Several FAR members argued that post-crisis reform had focused too much on micro-prudential tools, leaving a continuing need for a more macro-prudential approach focusing on systemic effects such as feedback between aggregate borrowing and house prices. FAR members also raised concerns about the dominant role of the GSEs in post-crisis housing markets and suggested that more analysis of the implied risks was necessary.

The crisis and its aftermath from a historical perspective

One FAR member reviewed the main lessons from the crisis from a historical perspective. First, the member noted that we learned that there can be major financial crises even among the most developed financial systems in the world. Second, the member highlighted the intrinsic differences between monetary policy and the financial stability framework. Changes to the monetary policy framework are likely to have consequences that can be observed in the short or medium run. On the other hand, the effects of changes to the financial stability framework are harder to evaluate because crises happen rarely. That is, the financial stability framework has less scope for experimentation and learning. Third, the member pointed out that even though crises happen rarely, there are some important features of the financial system that do not seem to change over time. For example, from 1950s to 2010s, the total amount of safe debt as percentage of total assets was roughly constant. On the other hand, the composition of private safe debt changed dramatically long before the 2007–2008 crisis. Starting from the 1970s, traditional bank debt (deposits) has decreased steadily, while shadow bank debt and other private safe debt have increased. Drawing from these historical considerations, the member emphasized that historical analogues can be very informative, especially for the cost–benefit analysis of new regulations and policies. For example, the liquidity coverage ratio introduced by Basel III might have a good analogue in the US National Banking Era, when national banks were allowed to issue their own notes by backing them with US Treasuries that had to be deposited at the US Treasury.

Members also discussed the topic of crisis prevention and resolution. The general consensus was that (1) there is more knowledge about the resolution of crises, and (2) it is hard to identify the specific trigger of a financial crisis because it will be different from one crisis to the next. On the other hand, most crises share common features in their development and resolution (e.g., the collapse of some form of short-term uninsured debt, the need for emergency lending facilities and capital injection in banks).

One member also stressed the importance of improving the expertise of the profession in dealing with financial crises. Specifically, the newly developed field of Macro-Finance is viewed as a critical toolkit for the new generation of central bankers. All FAR members agreed on the importance of doing more research on the details of the financial system and the need for researchers to have access to micro data.

Post-crisis regulation

FAR members discussed the effects of several changes to regulations after the financial crisis. One member noticed that there has been some progress in accounting standards dealing with balance sheet consolidation. For example, credit card securitization and ABCP vehicles are no longer classified as "qualifying special-purpose entities." However, this change in accounting standard does not affect mortgage and other term loan securitizations, and therefore problems may arise in "reps and warranties" of mortgages sold for securitization but later determined not to meet minimum underwriting standards.

One member also noted that the new regulations (in particular, stress testing) have had a beneficial effect on banks in that banks now have a better understanding of their own risk exposure and appetite at the aggregate level, comply more coherently with Basel rules, run more internal stress-tests, and make large investments in technology and data. However, other members noted that the post-crisis regulatory corrections (e.g., stricter micro-prudential lending standards and higher bank capital requirements) might have shifted some traditional banking activity from regulated banks to unregulated non-banks. Also, one member argued that more regulation increases fixed costs, and as a consequence, economies of scale might lead to more concentration. One member also emphasized that a large number of new regulations could increase the complexity of banks, making it more difficult to know which constraints are binding and the effects of regulation on banks' incentives. The member argued that the multitude of new regulations incentivized banks to take on riskier positions in the banking book. The group also discussed the benefits of some regulations in terms of reduced risk are sufficient to justify the cost to the firms that need to comply with them.