

2008 Financial Crisis: Five Years Later

Remarks of The Honorable Henry M. Paulson, Jr.

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In 2008 a huge credit bubble which had been building for years burst, pushing our capital markets to the brink of collapse.

I've done a good bit of soul searching since then, as I've watched the economy flounder and our citizens struggle with unpaid debts, foreclosed homes, ravaged nest eggs, lost jobs, and lost confidence—in themselves and in our system. Hindsight isn't always 20/20. Experts still debate the causes of the crisis and the effectiveness of our actions, and likely will do so for a good long while.

So while the actions we took were less popular than torture in some January 2009 polls, I remain convinced that on balance, we did the right things and that our decisions will stand the test of time.

We have come a long way in five years. The US economy is in much better shape. And while we need faster growth to fully recover, it is no small accomplishment that our economy has been growing at roughly 2% since late 2009 while consumers and financial institutions have been undergoing a massive and necessary deleveraging.

Our markets are functioning normally and the US financial system is the best in the world in terms of its breadth, depth, transparency and efficiency. It is a core strength and competitive advantage of the US economy.

So, "Are we in danger of another financial crisis?"

That's the question I've been asked most frequently since I left Treasury. The answer, I'm afraid, is yes. As long as there have been financial markets and humans who periodically experience bouts of panic, there have been financial crises. In recent history, we've tended to have crises every eight years or so. Historically they've been manageable; this crisis led to a deep and painful recession. The key is to avoid massive disruptions like 2008 or the Great Depression.

Every financial crisis has its roots in flawed government policies which create economic excesses or bubbles which are manifested in the financial system. To mitigate harm to the public it's necessary to identify the flawed policies, curb the excesses before the bubble grows too big, address vulnerabilities in the financial systems which have the potential to make the problem bigger and, when a crisis does come, act with force to limit it.

Enough time has passed that I believe we can learn from what we did right, understand where our efforts fell short, and act to stave off the financial threats that could imperil our economy in the future.

Looking back, our success in avoiding economic collapse was the combined result of presidential, executive and legislative courage and cooperation.

Ben Bernanke and Tim Geithner, then president of the Federal Reserve Bank of New York, were true partners. The three of us were united by a conviction that inaction was the biggest mistake we could make. So, although we debated tactics, we were unified in our resolve to avoid the failure of systemically important institutions, to stabilize key financial markets and to help restore the flow of credit to the economy. And our efforts benefitted from an extraordinary level of mutual trust and cooperation.

I underestimated how politically difficult it was for Congress to grant us extraordinary emergency powers — twice. That we were on the brink of collapse was so blindingly obvious to me, I found it enormously frustrating that Congress couldn't just act immediately. Now I realize how unusual it was for legislators to act as rapidly as they did just weeks before an election—and against their political interests.

President Bush's leadership was remarkable. For the better part of 18 months, I repeatedly brought him bad news. His response was always to buck me up, encourage and support me. When I was particularly discouraged that we had had to rescue Citigroup, just weeks after its initial capital injection, he told me: "Thank goodness the crisis happened when it did. Imagine if it had hit at the beginning of a new administration, when they were just learning how to work together."

I left office with mixed feelings. I was confident we had averted a financial meltdown and taken the necessary actions to thwart an economic collapse to rival, or surpass, the Great Depression. Indeed, excluding the Obama Administration's housing spending programs, we had initiated the programs that would account for 95% of all TARP investments, and had already committed 75% of the total TARP dollars that would be invested.

But I was also restless and dissatisfied. There was much unfinished work. In particular, I regretted having been unable to develop a more successful government housing program to limit the foreclosures that cost millions of Americans their homes. This goal eludes us today.

I felt certain the country was in good hands with Ben at the Fed and Tim set to succeed me at Treasury, but I also understood that a new president would inevitably make changes to put his own stamp on policy.

In the end, in no small part because he chose Tim for Treasury, the president ignored calls to change course and the continuity between administrations was extraordinary.

Tim and his team did a terrific job of creatively adapting the programs we left behind to meet changing market conditions, and they managed them well. The decision he and Ben made to subject systemically important banks to "stress tests" was a brilliant adaptation of TARP. The tests demonstrate to the market that the banks are adequately capitalized. They're a great confidence builder.

All told, the TARP bank and insurance company capital programs put in place by the Bush Administration and carried out by the Obama team have returned \$32 billion in addition to the original investment.

For all the progress that has been made, however, there are a number of issues that trouble and in some cases flabbergast me. Five years after the financial crisis, we have made no progress on GSE reform, we have not fixed the shadow banking market and we are still debating whether we have solved the dilemma of “too big to fail” banks.

I believe the single most important step we took to stem the financial crisis was putting Fannie Mae and Freddie Mac in conservatorship and backstopping their debt and mortgage-backed securities.

The GSEs were the dominant players in the housing market, which was at the vortex of the crisis. With \$5.4 trillion in debt and mortgage-backed securities outstanding, those institutions together were nine times the size of Lehman Brothers. Borrowing more than \$20 billion a week, they ranked as one of the world’s largest issuers and guarantors of securities. They were central to our financial system, and their failure would have dealt a devastating blow to our economy.

By almost any measure, our GSE actions were successful. We staved off an imminent catastrophe and ensured that mortgage financing would be available throughout the crisis. This prevented a much steeper decline in housing prices and reduced home foreclosures.

But our actions were meant to be a “time out” while the government decided how to restructure GSEs.

Today, Fannie and Freddie not only remain in conservatorship, they are more dominant than ever. As the housing market recovers, they are making big money – reporting a combined \$28 billion in net income in 2012. The Obama administration’s new budget projects that if the GSEs remain in current form, they will repay in the coming decade all of the \$187 billion invested in them and return dividends of \$50 billion more. That’s welcome news, but it comes with a downside: Now, any attempt to reform the GSEs will appear to cost the Treasury. Thus, ironically, as the market heals, the government has a disincentive to make changes in the very system that brought us to near ruin.

Conservatorship of Fannie and Freddie worked – it got us through the night. It’s now time to tackle GSE reform and phase out the agencies that were at the center of the crisis.

Any organizations which replace the GSEs should have a reduced mission with limits on the mortgages that the government can insure. This can be done by restricting the size of qualifying mortgages, limiting the income of qualifying borrowers, or limiting government insurance to first time homeowners or some combination of all three.

Today, about 90% of new residential mortgages are supported by a government guarantee, which means the government – not the marketplace – is setting the price and terms of home mortgages. Without the discipline provided by a private mortgage market, we will be at risk of another binge with government-provided incentives leading to yet another housing bubble. A major objective

of reform should be a new system where private market participants bear significant risk and government insurance is purchased at a price which is sufficiently large to allow a robust private mortgage market.

Most of the public and political dialogue has focused on the risks of large banks. But some of the most serious problems in the US financial markets lie in the so-called shadow banking market which supplies wholesale short-term lending to financial institutions and industrial corporations.

Banks and other financial institutions rely on short-term funding to make long-term loans and other commitments. To the extent this funding is from retail deposits, which are backed by federal deposit insurance, the risk is minimal. But many banks rely on non-deposit short-term funding. They borrow from institutional investors and use their securities as collateral. Lenders feel safe, because if the bank can't make good on the loan, the lender can keep the security. This wholesale lending – or “repo” – market stands at more than \$2.5 trillion.

The crisis exposed structural flaws, slack lending standards, and inadequate regulatory oversight and transparency in this market.

Some of these issues are being, or have been, addressed, but more needs to be done to fix the repo market. Regulators should do contingency planning to determine how they would use emergency resolution authorities to deal with a failed dealer and ensure that the securities collateral is disposed of in an orderly manner so as not to initiate or magnify a liquidity crisis. The market would also benefit from margin requirements that would provide greater financial cushion in a liquidity crisis and higher capital charges for firms that rely too much on wholesale funding.

Structural problems around money market funds have also generated debate. After the Lehman failure, it took an emergency guarantee by Treasury to prevent a run on money markets where in 2008, 30 million Americans held deposits of \$3.5 trillion, often with the mistaken perception that these deposits were as safe as an insured bank deposit. A collapse of these money market funds would have devastated the savings of American families, led to failures of businesses on Main Street and across the country – which relied on them for short-term financing – and put millions of Americans out of work.

The SEC is attempting to fix the money market fund problem by requiring institutional prime money market funds which hold corporate securities to regularly publish the value of their assets or take other steps so that the public will understand that their investments are not guaranteed. I support this action but believe these measures should be extended to all money market funds.

Some are also calling to break up big banks. Big banks are difficult to manage, and the mergers during the crisis exacerbated the concentration. The phenomenon of “too big to fail” is unacceptable and must end. The best approach is to reduce the advantages of being large with more stringent capital and liquidity requirements. Tough regulation, including imposing limits on size or forcing divestitures if a bank is unable to manage its risk, could make failure less likely.

Dodd-Frank and the Basel III capital standards introduce capital surcharges for the biggest institutions and US banking regulators have recently proposed rules to do just that. More may eventually need to be done, particularly with regard to setting minimum liquidity standards, but this is a good first step.

“Too big to fail” is a misnomer in any case. Complexity and interconnectedness matter as much as size in assessing risk. No bank should be too big or too complex to fail, but almost any bank of size is too big to liquidate quickly, particularly during a crisis.

The Dodd-Frank Orderly Liquidation Authority (OLA) comes as close as possible to traditional bankruptcy while acknowledging that winding down a financial institution must be managed carefully to protect the public. It gives regulators emergency authorities to avert a disorderly wind-down of institutions whose failure would threaten the country’s financial stability, including the ability to issue guarantees and make capital injections, and it gives regulators the tools so that no bank needs to be too big to fail. We sorely needed such powers during the financial crisis and could have used them to avoid the disruptive Lehman Brothers bankruptcy.

But Dodd-Frank falls short in other areas. It fails to streamline our ungainly financial regulatory structure and leaves multiple regulators in overlapping jurisdictions, feeding uncertainty and delay. We had five main financial regulators before the crisis. And we have five today. This is a big problem. Indeed, the rule writing process for Dodd-Frank has been plagued by dysfunctional competition, paralysis, confusion and uncertainty.

I don’t underestimate that it will be difficult to address these remaining challenges – but it is critical that we do so – lest we sow the seeds of tomorrow’s crisis.

Many of the actions we took—seizing control of Fannie and Freddie and injecting capital into the banks through the TARP—were deeply distasteful to me. But today I believe more than ever that they were absolutely necessary. I can only imagine how much more suffering there would have been had we not acted so decisively. Indeed, it was the prospect of imminent economic catastrophe that drove me to act over and over again.

Looking back, I wish that we had done a better job communicating our decisions. Part of the problem was a familiar dilemma for regulators. You want to be transparent, but you don’t want to trigger or compound the problems you’re trying to avoid. This was particularly true in dealing with the weakness and subsequent failure of Lehman Brothers.

I didn’t want to be the Treasury secretary who presided over the onset of another depression. I believe we would have faced just that had our efforts fallen short. Unemployment levels that hit 10 percent in October of 2009 could easily have risen to 25 percent.

The legacy of public outrage that greeted some of our measures and further poisoned the political atmosphere will make the job of policy makers who follow us more difficult. I am concerned that our successors will be hamstrung by the fallout from this bitterness and may, when confronted by intense criticism, hesitate or fail to act precisely when leadership and courage are called for.

Big, messy problems rarely have perfect solutions. Inevitably, you must work with inadequate information to make difficult decisions that almost certainly will have unintended, and frequently bad, consequences. The alternative is not to act at all, which is far worse.

So as we look to avoid the next financial crisis we must finish cleaning up our messes and repairing our flaws. And we need to look around the corners. Lurking there are big, hard issues.

Our focus today should be answering the question: What are the best policies to promote sustainable economic growth? These will also be the best policies to ensure generational fairness, national security, and continued global leadership. Without policy fixes, our children and grandchildren will pay a steep price in diminished opportunity, lower living standards, and Medicare and Social Security systems that can't make good on their promises.

No nation can remain a global power if it doesn't have sustainable fiscal policies. For the United States, the challenge is to gain control of our long-run finances, without cutting so much or increasing taxes so much in the very near term that we endanger our fledgling recovery.