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Robert Feinberg: Cato Experts Discuss Avoiding Next Financial Crisis

By Robert Feinberg – November 26th, 2012

At a panel of the 30th Annual Monetary Conference of the Cato Institute, moderator Zanny Minton Beddoes, economics editor of The Economist, acknowledged that the United States is still climbing out of the last crisis and asked whether the right lessons have been learned and the right policies have been put in place or whether today's monetary policy contains the seeds of tomorrow's problems.

Tom Hoenig, former president of the Federal Reserve Bank of Kansas City and current vice chairman of the FDIC, immediately responded that, yes, this country is sowing the seeds for the next crisis. He expressed skepticism "that the financial system has been reformed, that Too Big To Fail [TBTF] has been addressed."

It has been said for many years that new laws, new resolutions schemes and enhanced supervision would enable more effective handling of future crises. Hoenig recalled that in 1991, the FDIC Improvement Act (FDICIA) was enacted "to end public bailouts, in particular of banks TBTF." According to the Treasury Department, $5 billion had been spent bailing out the biggest banks that year. Hoenig mused that he wished the bailout cost had been so low in the most recent crisis.

He observed that the incentives affecting the largest banks "remain basically unchanged from the pre-crisis times. Despite Dodd-Frank, they continue to be incented to leverage." According to Hoenig, this makes the financial system more fragile.

Assuming that the safety net for financial institutions cannot be eliminated, or would be difficult to eliminate, Hoenig offered three recommendations:

1. Given the availability of the banking safety net, including the discount window, it is necessary to address the problem of moral hazard, so FDIC insurance was established and investment-banking activities were forced out of the safety net. When those barriers were taken down, the safety net was established to cover riskier activities.

Therefore, the safety net should only cover narrow banking activities, by moving trading activities out of banks and into separate entities, and he refuted the notion that banks didn't cause the 2008 episode, citing Lehman Brothers and the largest banks that received Troubled Asset Relief Program (TARP) assistance.

2. As an opponent of Basel III, Hoenig found that the largest banks had only 3 percent tangible capital in 2008, so the industry had no choice but to shrink balance sheets in order to survive.

Therefore, he insists that global capital requirements should focus solely on tangible capital. He estimated that the largest banks would have 6 percent, whereas before the Great Depression, the market demanded 13 percent to 16 percent.

3. Bank supervision needs to be re-established as a tool to identify risk by putting more emphasis on examining the quality of assets.

Jeff Miron, senior fellow at the Cato Institute and director of undergraduate studies in economics at Harvard University, approached the subject as a libertarian contrarian, asking whether policy should seek to prevent crises, because the policies adopted in pursuit of this goal "typically fail to avoid crises and are counterproductive from a broader, long-term perspective."

Miron gave four reasons for this:

1. Avoiding crises is not the right goal for policy.

2. Theory holds that the necessary effects of financial crises are not necessarily large.

3. Evidence confirms that the effects of financial crises may be limited.

4. Whatever the effects of crises, the treatment is almost certainly worse.

Rather, Miron argued that the primary goal of policy should be to promote a high rate of economic growth per capita. He questioned whether crises are more than a symptom and not a cause of diminished economic growth, whereas the policy responses in monetary, trade and fiscal policies contributed to long, slow, severe downturns, and he pointed to misallocations of resources toward, for example, housing.

Lawrence White, a professor of economics at George Mason University, introduced the term "anti-fragility," which is the property of getting stronger in response to moderate stress, from a forthcoming book by Nassim Taleb. White suggested that the way to do this is to "peel back" various supports and guarantees, including even the FDIC, because deposit guarantees have contributed to moral hazard and hence to fragility.

He disagrees with those who contend that the banking system is "naturally fragile in the absence of government guarantees." Rather, he insists that the process of natural selection will weed out fragile institutions, and to argue otherwise misses the fact that the industry has survived for many centuries, because financial systems emerged from crises "chastened and stronger." Such a system would accommodate the failure of a Lehman Brothers, because a system that cannot allow such a failure is too fragile, and he finds that "the Dodd-Frank Act does not credibly end TBTF."

Edward Kane has found that deposit insurance subsidizes bad banking and risk taking, according to White, and Taleb criticizes the practice of optimizing banks to a limited set of activities that are not adequately diversified. It is the system that would be made "anti-fragile" by allowing diverse strategies to be followed by banks.

Robert Hetzel, senior economist of the Federal Reserve Bank of Richmond, concluded the panel with a pessimistic view that crises can be avoided, and he referred to the insistence of John Taylor, an economics professor at Stanford, that causation, rather than correlation, has to be the basis of analysis. Hetzel quoted Washington Irving's observations about the financial crises of 1818-19 regarding the course of delusive bubbles, and he criticized central banks as being unable to control economic variables in a way that doesn't contribute to economic instability.

On the whole, the most grounded presentation was that of Hoenig, who went straight to the issue of capital and why its quality needs to be strengthened. The other panelists provided useful references but little in the way of insight as to how the next episode of the crisis is likely to unfold.

Robert Feinberg served on the staff of the House Banking Committee for the 10 years that encompassed the savings-and-loan debacle and the beginning of its migration to the banking sector. Subsequently, he has consulted on issues related to the crisis for law firms, accounting firms, securities firms and trade associations.

Feinberg holds a BS.E. from the Wharton School and a J.D. from the Law School of the University of Pennsylvania. He has drafted dissenting views on landmark banking legislation, contributed to a financial blog and written hundreds of reports for clients to document the course of the financial crisis as it has unfolded over the past three decades