A Conversation with **Richard W. Fisher**

Working Our Way Through the Financial Crisis

Dallas Fed President Richard W. Fisher looks at the causes of the current financial troubles and examines the policies aimed at restoring the system to good working order.

Q. What's going on in the nation's financial markets right now?

A. The financial industry is facing many headwinds. Even the more heavily regulated commercial banks and thrifts are now looking at some major challenges. We are all well aware of how the bursting housing bubble impacted banks' balance sheets and spilled over into what banks once regarded as off-balance-sheet activities.

Earnings suffer as writedowns continue, leaving some banks and other financial firms in dire need of capital. The FDIC's list of problem banks continues to grow, and we are beginning to see a rise in bank failures, though to a lesser degree than many would have expected.

The federal government now possesses a majority stake in one of the country's largest insurance firms, acts as conservator for two of the biggest players in the nation's mortgage markets and is actively injecting capital into financial institutions across the country. An ancient Chinese curse condemns one to live in interesting times. I think we can all agree that a little boredom would be a welcome relief right now.

Q. So, what went wrong?

A. Most everyone agrees that risk appetites, fed by innovations in ways to measure, calibrate, repackage and sell risk, became excessive during the boom years. These innovations—otherwise known as "securitization" and the "originate-to-distribute" model of banking—are by no means new, but they certainly took on some new and uncharted dimensions in this decade.

Structured credit products became all the rage and gave us an alphabet soup of new acronyms like ABS, CDS, CLO and CMO. These new instruments allowed financiers to slice and dice the risk associated with mortgages and other credits, presumably reducing risk by spreading it around to those most

willing to hold it. In retrospect, they compounded risk to the financial system.

New and sophisticated statistical models, made possible in part by advances in computer technology, assured us that all this new risk was being properly and accurately measured. And the ratings agencies further comforted us by giving many of the new securities their seal of approval—often, their highest triple-A seal.

I am firm in my view that financial markets remain prone to risk overshooting, and we see an elevated level of risk aversion when the inevitable correction comes. That is what happened in the summer of 2007, when willingness to take on risk seemed to dry up overnight, leading to significant liquidity squeezes and funding pressures at banks and other creditors.

Q. At first, it seemed that the largest losses occurred in the U.S. Why was that?

A. Our country's financial system is the most advanced in the world. One reason the most advanced financial system may not necessarily be the safest, or most stable, is that innovation and structural advancement yield additional byproducts besides stability. To illustrate this point, let me refer to another banking phenomenon: diversification.

Suppose a bank's ability to diversify its loan portfolio suddenly increases. How does it react? Does it simply enjoy its newfound stability? Not necessarily. Experience tells us that such a bank will typically increase its lending activity or hold less capital. As a result, financial stability, originally enhanced by greater diversification, will fall back to its previous level. What has changed is that more lending is possible, or less capital is required. Neither reduces risk.

Often, the most innovative and advanced financial systems are also the boldest. They expand more aggressively than their less advanced peers into new products and areas. As a result, they may also find themselves exposed to greater losses once global risk appetites decline.

Q. This particular financial episode seems unique. Is it?

A. After all that has happened since the summer of 2007, it seems fair to ask whether the so-called new financial system—despite its emphasis on securitization, structured credit products, value-at-risk statistical modeling, credit derivatives and off-balance sheet activity—is really all that new and different.

In the end, commercial banks suffered losses because of errors in judgment. Some financial institutions attempted to reduce required capital and shield activity from regulators' view. Poor judgment compounded by capital arbitrage and accounting gimmickry has been the cause of innumerable financial crises throughout history.

Q. So, there is nothing fundamentally new or different this time?

A. One of the issues at the heart of this particular episode is the interconnected nature of financial market participants. Unfortunately, while everyone knows that interconnectedness is important, it is difficult to tell exactly how and to what extent things are woven together—sort of like the "butterfly effect."

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A butterfly's wings disturb the air around it, setting off a chain of events that ends with a major storm in some remote part of the world. A small catalyst results in large—and sometimes catastrophic—consequences.

The crisis spreading through the global financial system can be thought of as a butterfly effect. Take credit default swaps, for example. These instruments and the institutions they connect are quite complex. In principle, though, these swaps provide a fairly simple service: Properly utilized, they are a form of insurance against the risk of the default of an underlying asset.

While that might sound appealing, the value of the insurance is only as good as the person providing the guarantee. When that individual's viability is called into question—when heightened uncertainty enters the mix—the whole network will suffer the consequences. It all comes down to what we say all the time—what is really common sense, but is nevertheless often ignored—"know your counterparty."

The most striking and truly new part of the recent financial cycle was the mistake of replacing sound judgment with the mathematization of risk. An immense array of statistical gadgetry wielded by a new generation of quantitative minds, themselves emboldened by unprecedented computer power, managed to squelch the wisdom of longtime bankers and seasoned financiers. Our problems are not new. But they have been magnified by a certain type of hubris that viewed statistical modeling as infallible.

Q. What sort of changes do you see for banking in the aftermath of our current difficulties?

A. I think we can expect to see a more back-to-basics approach to banking, one that relies on a stable, core deposit base with ample capital. Here in Texas, we have witnessed how such a basic approach can be quite profitable as a banking business model. In part reflecting our strong economy, Texas banks continue to outperform their counterparts across the country. However you measure it—whether by return on assets, noncurrent loans or charge-offs—Texas banks, while experiencing their own recent setbacks, remain a notch above many of their national peers.

Q. What about the Fed's response?

A. We have responded to the current crisis in both traditional and fairly innovative ways. In addition to lowering the federal funds rate, the Fed has also introduced several new facilities that represent a brand new approach to addressing liquidity problems.

Our term auction facility was introduced in December 2007 as a market-oriented mechanism that allows banks to bid for longer-term funds. In March 2008, we established the term securities lending facility and primary dealer credit facility to further enhance liquidity for primary dealers and investment banks.

In September and October 2008, we established backstops for commercial paper issuance and money market mutual funds through the creation of the asset-backed commercial paper money market mutual fund liquidity facility, the commercial paper funding facility and the money market investor funding facility. We entered into swap agreements with 14 other central banks to provide dollars in international lending markets. And, on Nov. 25, we began supporting the issuance of various consumer lending instruments with the introduction of the term asset-backed securities loan facility.

The expectation is that this innovative packaging of liquidity support and backstops, combined with additional capital provided by the U.S. Treasury's Troubled Asset Relief Program, or TARP, plus regulatory oversight, should reinforce financial stability and set the stage for a recovery of the credit markets.

Q. Are these responses enough?

A. In the near future, we will have to consider more fundamental reform of our financial infrastructure. In addition to the usual calls for greater transparency and accountability, policymakers would do well to establish and follow several main principles of reform.

For example, they should seek to avoid situations that privatize profits and socialize losses. Institutions and investors that are free to make money in the financial system should also be free to lose it. That is the only way to maintain some degree of market discipline in the system. In addition, policymakers should continue to stress the importance of capital adequacy at financial institutions. To be blunt, leverage got out of hand. It certainly is not an easy job, but supervision and regulation needs to make capital levels reflect the risks taken by an institution.

Q. Will we be able to resolve our current difficulties?

A. If financial markets are prone to overshooting and undershooting, we may find ourselves wondering what we have to be optimistic about. In the fearful and uncertain aftermath of bursting bubbles, we too soon forget the euphoric booms that fund our purchases, expand our businesses and generally afford us the rich opportunities we enjoy in this country.

We should always be mindful that this dynamic system—or, as the economist Joseph Schumpeter called it, this "creative gale of destruction"—has given us the highest standard of living in recorded history. Something must be right about it.

But, make no mistake: We have been here before. Corrections from periods of excess are painful and disruptive. Our present difficulties may be trying, but they present us with a host of opportunities. I think we will use those opportunities wisely.