A SYMPOSIUM OF VIEWS

Defining the Financial Safety Net

The 2007–08 subprime crisis has heightened the policy world's interest in the makeup of financial markets. Financial institutions have set up off-balance-sheet vehicles as a means of disbursing and concealing risk, but to what extent do these off-balance-sheet vehicles during times of crisis fall under the central bank safety net? In the early stages of the subprime crisis, the Federal Reserve quickly made clear the off-balance-sheet vehicles of banks enjoyed safety net protection, but not those of non-bank financial institutions.

This brings up the issue of whether the collapse of a large American investment bank would be any less destructive to the macro economy than the failure of a commercial bank. In the United Kingdom, after initially refusing to bail out the mortgage bank Northern Rock, authorities now appear to have placed the safety net under all domestic financial institutions, which raises the question of why any U.S. non-bank financial institution wouldn't consider shifting its headquarters to London, given the promised protection by British taxpayers. Would the same taxpayers be willing to guarantee the entire world's non-bank financial institutions? Put another way, should U.S. taxpayers be asked to guarantee the financial activities of a Hong Kong trader using an American investment bank as a clearing broker?

How should the U.S. and global safety net be defined for the twenty-first century? Specifically, is the current system of off-balance-sheet vehicles inconsistent with the goal of greater financial transparency? Are reforms needed, and if so, which kind of reforms?

Two dozen experts weigh in.

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Central banks must take a more active role.

GUILLERMO ORTÍZ
Governor, Central Bank of Mexico, and Chairman, Bank for International Settlements Central Bank Governance Group

Central banks are last-resort lenders. Their role was pronounced by Walter Bagehot in his famous 1873 essay when he wrote that central banks should be prepared to lend freely against acceptable collateral but at penalty rates.

Central banks' options as last-resort lenders are influenced by each country's institutional arrangements. One size does not fit all. A central bank's lending procedures cannot be the same in a country with a faultily designed deposit insurance scheme as they are in one where depositors are less prone to panic runs.

The role of central banks has been changing through time. Their capacity to act covertly has been eroded by the widespread availability of information and the growing scrutiny of market participants. Their job as last-resort lenders has been further complicated by the stigma attached to borrowing from a central bank.

Central banks, as promoters of financial stability and managers of each country's ultimate settlement and clearing system, are also responsible for providing liquidity to financial markets. The aim is not to alleviate the situation of any particular institution, but rather to facilitate the normal functioning of markets when extraordinary events hinder operations.

Financial markets need certain amounts of liquidity to settle and clear operations. Under normal conditions, liquidity is provided by market participants themselves in the form of bilateral credit lines. These lines allow participants to settle their transactions without having to use large amounts of cash balances.

When certain shocks hit the markets, credit is usually squeezed. In this case, market participants need larger amounts of cash balances to settle their transactions, resulting in higher and more volatile interest rates. Under these circumstances, the role of a central bank, as manager of the ultimate settlement system, is to provide enough liquidity to prevent impairment of financial markets. Examples of extraordinary events abound, such as Black Monday in 1987, Y2K, and the terrorist attacks of September 11, 2001.

The fast growth of financial markets and the increasing number of participants with new and varying characteristics have exposed the former to a series of previously unknown shocks. Central banks have to take a more active role in mitigating liquidity squeezes, as recent events, which do not have a historic parallel, have shown.

It is important to distinguish between the two kinds of safety net instruments.

MALCOLM KNIGHT
General Manager and CEO, Bank for International Settlements, and former Senior Deputy Governor, Bank of Canada

A financial safety net is an instrument of public policy designed to mitigate the costs associated with stress in private-sector financial institutions. Intervention of this sort always involves some element of moral hazard but can be justified when the costs to society of an unmitigated outcome exceed those borne by participants in the financial system itself. The moral hazard induced by the safety net reinforces the need for financial regulation and supervision.

Some safety net instruments are put in place before evidence of stress emerges. These include explicit deposit insurance schemes or explicit criteria for closing down financial institutions. Prior arrangements to speedily transfer essential functions of troubled banks to other existing or specially established banks, although less common, are another example of this.

Other safety net instruments are used when financial stress is already evident. These can include emergency lending assistance to individual institutions and generalized liquidity infusions. In extreme situations, public-sector intervention has taken the form of wholesale government guarantees for certain private-sector liabilities, nationalization of elements of the financial system, supervisory forbearance, or an explicit easing of monetary policy.

The less-well-developed measures are before a problem arises, the greater the likelihood of measures needing to be devised under stress once the problem strikes. Such measures conceived *in extremis* are more vulnerable to moral hazard, can be costly to governments, and can have significant side effects. The possibility of easier monetary policies generating excessive credit creation and unwarranted asset price increases is a case in point.

These considerations have two implications. First, greater efforts are required to ensure a resilient *ex ante* safety net structure. Second, if recourse to other forms of public-sector intervention proves to be costly, the management and shareholders of the financial firms responsible should be made to bear an appropriate cost in order to mitigate moral hazard effects.

Put the investment banks under the safety net but have the Fed regulate their balance sheets.

BARTON BIGGS
Managing Partner, Traxis Partners

There is no question in my mind that the failure of a large American investment bank would rock the world's financial markets and would be very destructive to the macro economy. The world could certainly live with one less investment bank, but there would be malignant contagion. It is not well known, but under the U.S. bankruptcy laws, a failed investment bank would have to liquidate the securities it held in margin accounts for customers to meet its creditors' demands. An investment bank with a major prime brokerage business (which all of them have) would thus trigger a cataclysmic financial panic as it closed its hedge fund clients' positions. Just the thought of such indiscriminate selling would terrify markets. Considering these circumstances, U.S. investment banks logically should shift their headquarters to London, and the British taxpayers should rebel.

I write as an owner of the shares of a major investment bank and one whose hedge fund has it as a prime broker. From my biased viewpoint, it seems to me that the major U.S. investment banks are "too big to fail" and should be under the protection of the Fed. The degree of leverage of their balance sheets should also be subject to Fed regulation including the size of their Level Three assets as a percent of equity capital.

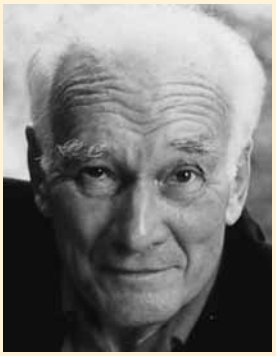
It is time for a longer-term approach.

SAMUEL BRITTAN
***Columnist,* Financial Times**

Why should there be a safety net for banks and not for the steel industry, textiles, or other victims of economic change? The cliché reply is that money, as the lubricant of the economic system, is "different." This might have had plausibility when there was a hard-and-fast line between banks and other financial institutions. Central bank safety nets could in principle be extended from deposit banks to investment banks. But there would be no shortage of other corporate bodies claiming similar services; and if we are not careful safety nets would be demanded for most of the economy, which would be either impossible or disastrous if attempted. As I write, the British authorities are trying to define their guarantee to Northern Rock depositors without a limitless spread of guarantees.

Ordinary citizens are entitled to a modern equivalent of keeping dollar bills or sterling notes under the mattress which avoids the physical hazards of such procedures. To this end Henry Simons, a Chicago economist writing in the 1930s and 1940s, proposed the creation of pure deposit-taking institutions ("hundred percent money") whose assets would have to be held in currency or Federal Reserve deposits ("A Positive Program for Laissez-Faire"). Other financial institutions, whether or not called banks, would carry on paying interest and looking for more profitable investments. Those using them would learn that higher returns came with higher risks. The idea is not as far-out as it seems, as it would be possible to build on the state-sponsored national savings institutions existing in several countries, for instance by providing for faster withdrawals and allowing checks to be written against them.

The immediate task for governments and central banks is to prevent a contraction of world demand without overdoing it and sowing the seeds of the next inflation. But this is also the time to take a longer-term look at the financial system to try to reduce the frequency and severity of monetary crunches.



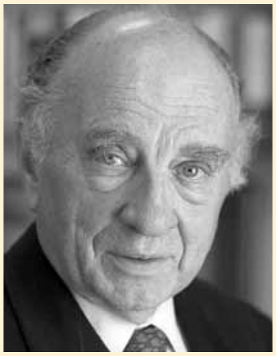
The strongest need is for regulatory attitude.

MARTIN MAYER
Nonresident Scholar in Economic Studies, Brookings Institution

I keep remembering Drexel Burnham in the late 1980s, when the glacier slid off the mountain and the water level didn't change at all. There was a lot of detail work to be done—the forcible "cave man clearing" of mortgage securities in the gym at the Federal Reserve Bank of New York, the complicated negotiations with the Portuguese government on gold trades, and so forth. But the markets stayed calm, and there can be no question today that Alan Greenspan at the Fed and Richard Breeden at the Securities and Exchange Commission made the right decision when they let a dominant Wall Street house go to the knackers.

Now all the "banks" are linked together in a worldwide web of poorly understood derivatives, instruments that can be generated at will and sold to anyone. And thanks to carelessly written legislation and ivory-tower economic theorizing, there is a dangerous confusion between commercial banks and investment banks. The two in fact do not go together very well. The commercial banker wants to know how you are going to pay him back; the investment banker wants to know how he can sell the paper. It is all very well to praise the benefits gained by securitization. The "subprime" mess illustrates the damage done when undisciplined lenders can originate risk to be borne by others.

The first remedy must be greatly enhanced transparency. "Conduits" that permit banks to hide loans should be compelled to list their assets and liabilities, and their relations with their sponsor. Registries of derivatives should reveal open interests; regulators could require the allocation of capital against risks in customized derivatives. Bank holding companies should report both on a consolidated and unconsolidated basis. But the strongest need is for regulatory attitude. For too long, our banking regulators have been willing to assume that these well-paid executives must know what they're doing. When it becomes obvious that they don't—and the Fed recognized the problematic nature of teaser rates on mortgages three years ago—the regulators must be willing and able to move.



Sharpen the sense of risk.

OTTO GRAF LAMBSDORFF
Former German Minister for Economics, and former Chairman, Friedrich Naumann Foundation

Off-balance-sheet vehicles must be regarded with mixed feelings. Since the majority of risk is "off-balance," an external analysis of the company's state can only be made with difficulty, mostly by scanning footnotes. Financial markets have experienced an increased loss of faith in financial disclosures; rightly so when we remember the Enron case. This development stands in contrast to a disclosure's purpose in helping investors make sound decisions.

The problem can mostly be found in the investors' greed for return. The fact that high returns come with high risks has largely been ignored. And the United Kingdom seems to have no interest in punishing such ignorance, but rather supports it with a financial safety net funded by British taxpayers for all financial institutions. Risk has been shifted to the wrong entity, not to mention the harm that would be done if the United States were about to copy this policy blunder.

In my view, political interference will not bring back the faith and the functioning of global financial markets. Regulatory authorities might fix parts of what the lack of transparency has broken. But why should the Federal Reserve or any other central bank or regulator know better than the involved investors which risks exist where at this moment?

This reform is needed: sharpen the sense of responsibility of all investors, American or European, and put the burden of their actions back on their shoulders. No political or financial rationality might otherwise overcome blind greed for high return. If the risks need to be put back "on balance sheet," they would truly be carried by those who benefit from the advantages of a certain investment. Or do you think all British taxpayers want to invest in Enron's knock-out assets such as energy derivatives? Forcing investors to put up an amount of equity higher than the expected losses could result in enhanced market transparency, increased competition, and the sound functioning of financial markets.

The financial turmoil provides an opportunity to act.

STEFAN INGVES
Governor, Central Bank of Sweden

Developments in finance have fundamentally changed the operations of financial intermediaries in recent years. Banks are moving to an "originate-to-distribute" approach. Risks are transferred, for example, by derivatives or by securitization. Also, bank funding relies less on core depositors, more on market liquidity. Thus, financial stability depends to a larger degree on financial markets and their efficiency and liquidity.

In the recent financial turmoil, illiquidity was a major concern. Markets dried up. Some institutions lost market confidence and access to funding due to credit losses or simply to uncertainty about their asset valuations. The turmoil linked credit exposures in the United States to liquidity squeezes in Europe. Financial contagion increased both due to greater reliance on markets and to the proliferation of cross-border banking.

The developments in finance pose challenges for the traditional safety nets which assume a system where banks originate loans and then hold them to maturity, and where banks are funded by core depositors. Also, in such safety nets, other intermediaries and markets play separate roles from those of banks, and cross-border banking is limited.

The financial turmoil has presented many of the vulnerabilities of the present system in a clear light. Awareness among policymakers and banks is currently high. We should use this window of opportunity to act. Banks need to strengthen their liquidity risk management and contingency planning, since shortcomings may lead to unnecessary activation of the financial safety net. Authorities should evaluate the need for changes to the regulatory framework, both in terms of liquidity supervision and central bank activities. Authorities also need to harmonize international arrangements to achieve swift resolutions of cross-border crises.

Keep the current arrangement but close the loopholes.

SUSAN M. PHILLIPS
Dean and Professor of Finance, School of Business, George Washington University; and Member, Board of Governors of the Federal Reserve System, 1991–98

A significant strength of the U.S. financial system is its breadth and diversity of financial institutions, instruments, and markets, only some of which fall under the central bank safety net. Commercial banks which are under the safety net face regulatory costs including federal supervision, required reserves, and capital and disclosure requirements. While financial market participants such as broker-dealers fall outside the safety net, thereby not incurring these costs, they have traditionally produced many innovative instruments for management of financial risks and financing needs.

If all broker-dealers were to come under the federal financial safety net, they too would become subject to the same requirements as commercial banks, which in turn may significantly stifle innovation and raise costs of financial services unnecessarily. I think the U.S. financial system is best served by having some financial institutions and transactions fall under the safety net and others outside to encourage innovation and competition. Thus market participants can choose whether they want the cost and protection of the federal safety net or whether they want to manage that risk themselves. Nevertheless, the burden is on all regulators to assure maintenance of capital commensurate with risk and appropriate disclosure. If banks carry off-balance-sheet entities, but have contingent commitments to those entities, bank capital and financial statements should reflect these commitments. In addition, bankruptcy laws and deposit insurance must be adequately disclosed and robust to allow entities outside the safety net to fail in an orderly fashion. I expect that the recent problems in the financial markets will encourage financial regulators to re-examine regulatory systems to assure closure of loopholes. The United States has benefited over the years from a diverse financial system and I hope that vibrancy and leadership can be maintained.

Needed: A divinely guided genius.

L. WILLIAM SEIDMAN
Chief Commentator, CNBC, and former Chairman, Federal Deposit Insurance Corporation

The U.S. financial safety net should provide protection against the collapse of the financial system that would endanger the entire U.S. economy. A safety net (under the free market) would provide protection against the occasional but recurring tendency of the system to panic and freeze.

Such a net is provided now mainly by FDIC insurance, the Fed's discount window, and potentially the U.S. Treasury's intervention (for example, the Resolution Trust Corporation in the savings and loan problem of the late 1980s). Such a net is and should be designed primarily for the banking system, but also should be available for the entire system. This would include funds, trusts, investment funds, investment banks, life insurance companies, and others whose failure might bring down the economic system as a whole.

It should never be allowed to aid in any way equity owners, management, market lenders, or off-balance-sheet entities.

A determination of the appropriate use of the safety net should be made jointly by the U.S. Treasury and the federal and state regulators (maybe by a super majority).

Remembering always that the moral hazard of intervention in the financial system is a very real danger, the safety net should be operated only by a divinely guided genius who hates the whole idea of government interference in the marketplace.

The problems must be attacked before they erupt.

HORST SIEBERT
Heinz Nixdorf Professor in European Integration and Economic Policy, Johns Hopkins University

Remember the discussion on Basel II and its capital adequacy requirements in order to make the international financial system more robust and to prevent financial crises? What a contrast to the structured investment vehicles which banks have invented to take credit risks off their balance sheets when they "securitize" loan packages. As the subprime crisis has shown, banks actually no longer know how much credit risk they have hidden in their books. Nor are markets informed on these risks.

When a crisis breaks out it is too late for the central banks to differentiate between commercial banks and investment banks. Instead the problem must be attacked before it erupts. First, the International Financial Reporting Standards must make absolutely clear that balance sheets of banks have to be consolidated and must include all risks that a bank has. Admittedly, this is difficult if the risk allocation between the credit guarantor—that is, the sponsor—and the vehicle company is found in a sentence on page 92 of a 400-page contract (as was the case with IKB, the German Industrie Kredit Bank, the first to be hit by the subprime crisis), and if this risk allocation is worded in such a way that it is difficult even for legal experts to understand what it means.

Second, financial supervision has to sharpen the rules for the consolidation of off-balance-sheet vehicles and their associated risks. Transparency has to be improved.

We need to know which part of the credit remains with the sponsor and which part is taken over by the vehicle company or by secondary or tertiary banks to whom the assets have been sold. Bank managers violating these rules have to go.

Third, rating agencies have to improve the quality of their ratings. Financial supervision should compare after-the-fact the quality of ratings. I personally will not at all be surprised if in the future similar problems as with the subprime credits arise in the case of derivatives.

Put every financial firm on a level playing field.

ARTHUR LAFFER
Founder and Chairman, Laffer Associates

The goal of accounting rule FIN-46(R) was to increase transparency so shareholders could see a firm's true risks through its obligations. As fate would have it, five years later commercial banks are now being allowed to prop up their books during this "subprime" meltdown with structured investment vehicles (SIVs) backed by commercial paper.

For all intents and purposes, these SIVs are just glorified special purpose entities that stand in direct conflict with the goal of transparency. Estimates put the amount of assets being held by commercial banks through SIVs at $400 billion. Commercial banks, it would seem, are skirting FIN-46(R) by not calling themselves the primary beneficiary, even though a company like Citigroup (with $83 billion in SIVs) may have implicit obligations to support these vehicles.

Banks obviously want to keep as much of the recent damage as possible off of their balance sheets because of reserve and write-down requirements that affect their ability to lend. Yet the answer is not to bail out any institution that makes a risky bet on credit derivatives. The U.S. Treasury's backing of the planned Superfund is not a public bail-out like the United Kingdom's, but it does conflict with the notion that we are supposed to be moving towards greater transparency. While the Bank of England did bail out one non-bank financial institution when they rescued Northern Rock, this is not a practice to be relied upon.

A safety net does affect corporate decision-making. If the value of these SIVs were to skyrocket, U.S. taxpayers would not see the returns. Thus reforms need to be implemented to make firms more accountable for their actions. The goal should not be to punish corporations but to put every firm on a level playing field so that investors instead of taxpayers are the ones accountable for the actions of the corporation. Yet a bailout does just the opposite, reducing the downside risks facing the corporation while transferring that risk to taxpayers.

The safety net no longer assures full functionality of the credit markets.

HARALD MALMGREN
President, Malmgren Global LLC

The existing financial safety net was devised to protect depositors and assure continued ability of banks to provide credit in times of distress. This safety net no longer assures full functionality of credit markets. By adopting the "originate to distribute" model, major banks, less reliant on deposits, generate earnings from processing and trading loans, passing on risks to institutional investors. Thus, many banks have become non-bank financial institutions, competing directly with other non-banks.

To the extent that banks wished to participate in trading and holding collateralized debt, they escaped regulatory and shareholder scrutiny by creating off-balance-sheet, special-purpose entities such as SIVs. The financial market is no longer limited by borders, so banks have found themselves able to exploit differing regulatory regimes and central bank policies. In response, regulatory officials abandoned efforts to monitor credit quality, replacing traditional tools with admonitions that banks adopt "appropriate risk management techniques." In response, each bank devised its own independent risk management model.

Not surprisingly, chaos erupted during the subprime mortgage debacle and the subsequent wider 2007 global credit crunch as broad segments of debt markets became illiquid. International negotiation of reforms and measures to align regulatory policies will take years. Additional safety nets may protect depositors, but not the huge array of institutional investors that now are the primary source of capital for credit markets.

Restoring trust and functionality of credit markets requires new rules assuring transparency of complex debt securities. Securitized, repackaged debt should be standardized, with clarity about its DNA and a serial number allowing investors and traders to trace the origins. Issuers of collateralized debt securities should be required to retain at least partial risk when such securities fail to perform as marketed, or become "illiquid." Rating agencies should be barred from providing advisory services to issuers of debt securities—and new types of rating services should be encouraged, such as consultancies in forensic market analysis and shareholder advisory services. To protect the investing public, the true leverage of financial institutions, whether bank or non-bank, should be visible. Off-balance-sheet activities should not be permitted. Regulators should focus on restoring credible "mark-to-market" valuations on published timetables—ruling out dodgy proposals to postpone realistic re-pricing of assets.

What matters is the preservation of confidence.

GERD HAÜSLER
Vice Chairman, Lazard International

Recent developments in financial markets yet again demonstrate that the U.S.-style differentiation between banks and non-banks has outlived its purpose. Modern financial engineering, with investment banks providing credit to clients and commercial banks thriving on the archetype investment banking business model—originate to distribute—renders the above distinction largely irrelevant. What matters, however, is the preservation of confidence in the system: Anything falling short of complete protection for retail investors up to a relatively high ceiling will potentially generate or at least fuel a bank run. The United Kingdom has tried with less than complete protection and failed. Investment banking is wholesale banking par excellence; hence rules could and should be more onerous for their counterparties. *Caveat emptor* has served as our response to information asymmetries.

However, in between unsophisticated retail investors and highly sophisticated investment banks, we increasingly find "half-sophisticated" second-tier banks that badly need checks and balances to keep them from flying first-class to Las Vegas and returning empty-handed. There is no magic bullet but only a mixture of higher standards for the selection of key officers, including board members, and the elimination, through Basel II, of further loopholes such as off-balance-sheet SIVs. Auditors and rating agencies will have to look at their conflicts of interest, take a less narrow and technical approach to assessing new structures, and avoid confusion by using the same rating scale for diverse products. Regulators and supervisors need to impose more onerous liquidity stress tests for our brave new capital markets world where "warehousing" of risk has been largely replaced by "originate to distribute." Finally, the industry needs to better balance risks and rewards. The time lag between bonus payments for new products and the potential emergence of risks later is just too long to qualify as deterrent.

No bailout, only emergency support.

NORBERT WALTER
Chief Economist, Deutsche Bank Group

Regulatory and supervisory regimes often change radically after a crisis. This is understandable but not good. Many of the financial innovations of the recent past have considerably improved the functioning of the modern financial markets. To kick out "originate (or repackage) and distribute" is too simple, and in my view simply stupid.

On the other hand, to claim that only the bad (risk) management of a few less-capable people caused the trouble, meaning that consolidation and professionalization of the market would do the trick to fix it, is too naive an approach. We learned that mark-to-market valuation has its limits when it comes to a breakdown of confidence. We learned that resorting to mark-to-model under such circumstances might enable participating institutions to design the balance sheet according to subjectively meaningful principles put forward by the eggheads in their quant groups. This, however, did not bring back transparency and mutual trust, not even between the two handfuls of truly important global players. It certainly did not make central banks and regulators/supervisors any more certain about the size of the trouble and/or the needs (in terms of instruments) for corrective action, including the needs as lenders of last resort. There is a need for international agreement on accounting rules in case of market failure. There is a need for transparent structured products. And there is a need for constant exchanges of information between important supervisory authorities. Scrutiny is needed for off-balance-sheet, contingent, and hard-to-value liabilities.

What should become very clear as well, however, is that no bail-out is to be offered, but only emergency support for the stability of the system. Shareholders and management are to be held responsible. Risk managers need to learn about the reality of probability distribution being anything but normal. Fat tails are going to stay with us.

No need yet for a new safety net.

JIM O'NEILL
Head of Global Economic Research, Goldman Sachs International

Every time there is a period of financial trauma, there is a question about the need for a major overhaul of the system, but somehow, it always seems to recover! In terms of the current crisis, there are two key underlying causes, which need to be remembered before anyone wants to give too much "prescriptive" advice.

First, the U.S. housing market has entered a period of declining prices nationally for probably the first time in modern U.S. history, and this is after a period of sustained house price appreciation. As a result, there are bound to be consequences for many in the United States and the rest of the world.

Second, and possibly linked to the Basel II requirements, we have gone though an era where there was considerable desire to remove things from balance sheets. Given the huge growth of derivative instruments also, they constitute a core "shock" to the system which the decline in U.S. housing prices represents, to which the banking system then has to adjust. Until U.S. housing prices return to a normal equilibrium, I am not sure there is much point in devising any new safety nets.

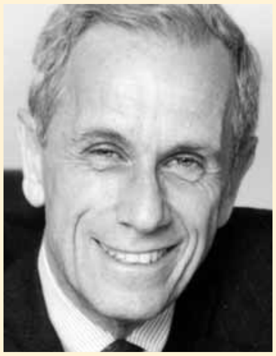
The demand is for pragmatism.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

So far as I am aware, British taxpayer support to financial institutions applies only to those that serve the domestic market, operating in sterling. It does not extend to the numerous foreign-owned institutions operating in London for the world market, mainly in currencies other than sterling. So financial institutions are not likely to rush to London because Northern Rock has received some support.

Dealing with any financial crisis requires an on-the-spot judgement as to its severity, its threat to the broader system, and what precise actions can best mitigate it. Crises cannot be approached exclusively by applying formal rules; they demand a degree of pragmatism which will always be criticized afterward on one ground or another.

However, off-balance-sheet entities are problematic, not least because they may involve self-dealing, that is, loans or guarantees to entities beneficially owned by banks or their officers. All such entities should at a minimum be required to be publicly disclosed by the beneficial owners, they presumptively should not be covered by a central bank safety net, and some should probably be prohibited. Banks after all lend the money of their depositors, which is the main reason they are regulated.



The safety net can't be defined in advance.

STEPHEN AXILROD
Former Staff Director for Monetary and Financial Policy, Federal Reserve Board; and former Vice Chairman, Nikko Securities Company International

I do not believe the nature of the financial safety net can, or should, be defined in advance for conditions of the twenty-first century. Circumstances change unexpectedly, and central banks, the government, and the private sector necessarily must adapt in ways they never anticipated. In today's circumstances, the safety net may have to be stretched a bit beyond the traditional banking system, but it remains extremely important to avoid the so-called moral hazard problem. I would argue that even the Fed's indirect role in the late 1990s LTCM situation and the Bank of England's awkward and rather embarrassing handling of Northern Rock were instances where official actions created the image of a safety net stretched too far.

Regardless, it is the image that counts. And in that context a broad moral hazard risk is more easily brought into play if monetary policy makes it cheap enough for market participants to undertake huge risks—such as did the Fed's policy for about three years following the recession of 2001. Of course, the central bank in monetary policy is not in the business of protecting the market from itself; that is mainly the job of bank and other regulators.

But it is the job of a central bank to employ its monetary policy instruments to avert an overall moral hazard problem in markets that leads to the build-up of destructive financial imbalances. In today's world of markets that are closely connected both domestically and internationally, market bubbles appear to be as potentially disruptive to the economy as imbalances from excessive overall inflationary pressures.

A safety net should be used mainly to assure the public that the payments system will continue to function smoothly and that core savings will remain essentially inviolate, a resolutely old-fashioned view complicated in today's world because core savings may placed in securities as well as deposits. A central bank should be able and willing to lend on an emergency basis to both depository and other financial institutions (the line between which has unfortunately become increasingly blurred). But such emergency lending should be very rare indeed to keep the central bank's balance sheet itself from becoming part of the problem and also raising more pointed moral hazard issues. As to off-balance-sheet items, it is not whether they should have safety net protection, but a matter of oversight and decisions about how they should be handled in measuring, and publishing, bank capital positions, so that financial transparency helps tone down the excesses of the ever-greedy market.

Finally, in this globalizing world, it has become increasingly clear that central banks need to look even more seriously into the question of who lends to whom when push comes to shove. When should a troubled institution be considered primarily American or European, and which central bank should be the emergency lender of last resort? Over time, national markets will become increasingly irrelevant entities much as did regional markets in the United States, making the regional structure of the Federal Reserve system anachronistic, especially insofar as regional differences in interest rates and use of the discount window were contemplated, almost before it was set in law.

Britain should fight any anti-Anglo-Saxon framework.

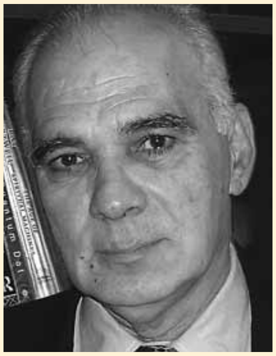
BERNARD CONNOLLY
Global Strategist, Banque AIG

Any government will, in the end, always feel politically compelled to provide protection for domestic depositors in banks, whether domestic or foreign (this could very easily become a major problem for the governments of the Baltic republics, for instance). Because fiscal support is a national responsibility, home country supervision, as opposed to host country supervision, of cross-border banks is unlikely to be acceptable—the host country will not trust a home country supervisor.

But protection should not extend to unsponsored off-balance-sheet vehicles, whose investors must understand they are on their own. Limiting moral hazard requires bank-sponsored off-balance-sheet vehicles to be brought within the regulatory net. The bigger problem is the valuation of bank-sponsored vehicles' assets. Marking-to-market on the basis of indexes, such as ABX, which are subject to violent swings as prop desks and hedge funds necessarily use them both for hedging and for speculation, is not the right answer. Marking-to-model is probably preferable, but regulators must be prepared to enforce modelling that does not confuse what are in effect tail events—the credit bubble of the past few years—with "normal" experience.

Both regulation and supervision should remain national, at least where countries have national monetary policy autonomy, with financial institutions left free to trade off "regulatory arbitrage" against counterparty suspicion.

Within European monetary union, the difficulties are clearly insuperable, with gold-standard era slumps inevitable for some countries. What is essential is that any international cooperation in financial supervision should be framed primarily by those with the biggest stakes in the financial sector—the United States and Britain. New York and London are joined at the hip, and if the European Union attempts to force Britain into a specifically European (and, equivalently, anti-"Anglo-Saxon") framework, Britain must resist—even if that means leaving the European Union.



It is important not to damage the market's price discovery function.

CRITON M. ZOAKOS
President, Leto Research

The purpose of any financial safety net is to preserve overall general market function without damage to the market's particular price-discovery function for a financial asset. Implicitly, this precludes any protection for non-balance-sheet assets of non-bank financial institutions such as investment banks that are also the market-makers or brokers for financial assets.

To extend safety net protection to complex marked-to-model assets so often found in the off-balance-sheet vehicles of large financial institutions would not merely subvert the market's price-discovery function—it would annihilate it.

The present crisis in the credit/bond markets cannot be resolved by extending the safety net to non-bank financial institutions. Nor is it likely to have a major negative impact on the real economy as long as the accelerated growth of loans from depository banks to the real economy continue to fill the gap created by the seizure in the credit/bond markets. Given this absence of any "clear and present danger" to the real economy, any talk about reforming or extending the safety net should be avoided.

Market discipline, more vigilant counterparty surveillance among consenting adults, and better stress-testing of financial engineering models should do the trick, along with a sensible resignation to the fact that serious people pay for their mistaken investment decisions.

Unlike large, complex, non-bank institutions, the off-balance-sheet assets of depositary banks are largely assets that have already been marked to market and, therefore, their continued protection under existing safety net arrangements does not impair the market's price-discovery function. There is no reason why these arrangements should not continue.

We've learned nothing from history.

EUGENE DATTEL
Wall Street veteran and author of* Cotton and Race in America: The Human Price of Economic Growth *(2008)

The subprime crisis is yet another episode in the continuing historical saga of financial debacles. Each crisis occurs in a different context and time, but is a variation on the same theme. Financial institutions chase a relatively high yield without regard to risk until a real or anticipated default happens. Then the extent of the problem dribbles out and governments assess the possibility of a more generalized impact upon their respective economies.

Monetary easing and targeted bailouts present the only available responses. It makes no difference whether a troubled institution is a commercial or investment bank. Even a manufacturer may be a rescue candidate if its difficulties are deemed sufficiently threatening to the economy. The bailouts of Continental Illinois and Chrysler were political decisions that did not consider the business category of the government aid recipient.

It should be remembered that the U.S. taxpayer is also an enabler in the process for he is an investor, either personally or through a pension fund, and cheers loudly as long as equity prices rise.

Each crisis is proof of John Kenneth Galbraith's observation of the "brevity of financial memory." The current market participants are either too young to remember these destabilizing events or old enough to understand that the culprits may receive institutional, but rarely individual, punishment. The dictum that financial institutions do not tamper with a revenue stream is generally alive and well. Alas, "We learn from history that we learn nothing from history."

In America, legislation that provides for adequate disclosure and protection against fraud exists. Additional regulation specifically designed to prevent the reoccurrence of financial folly has been generally ineffective in curbing aggressive behavior or stupidity. As for off-balance-sheet financing, an capable analyst should be able to evaluate publicly available data and avoid the hazards of investing in a company or asset that is too complicated to understand.

Reform recommendations may serve as an outlet for righteous indignation, but the really important response can be seen in how quickly a nation recognizes its problems, understands the extent of the damage, and courageously and painfully revalues and disposes of the questionable assets. Unfortunately, this is a messy, ruthless, but necessary process.

The dangers of moral hazard.

ALLEN SINAI
Chief Global Economist, Strategist, and President, Decision Economics

The current credit crisis encompasses a wide range of bank and nonbank financial intermediaries, all of which provide credit and invest in the U.S. and global economies. Indeed, the traditional major sources of credit—commercial banks—no longer are so, with a wide range of nonbank financial intermediaries that have grown in size and number now taking up the lion's share of credit. These include investment bank/brokerage firms, hedge funds, private equity funds, venture capital, insurance, and the mutual funds that now provide a totality of credit and finance that dwarfs that of traditional banks.

But the U.S. and international regulatory and supervisory systems do not extend to these institutions. Regulation, supervision, and transparency vary across them and the lack of these functions has contributed to the current crisis. And increasingly, leveraged balance sheet expansion has funded the provision of credit through a wide range of securitized and derivative securities, which may be originated by any of the institutions and then sold, directly or in packages, to investors. The packages often are legally in the form of trusts with ownership ambiguous and the risk of loss mainly residing with the investors. Incentives for underwriting, performance, accountability, and transparency thus are diffused or non-existent.

The U.S. and global safety net, or potential central bank, finance ministry, or Treasury support functions when there are systemic failures, should extend to all these bank-like institutions, but only on certain conditions.

First, transparency, supervision, and regulation require uniformity—including the types of securities, derivatives and structure of them, amounts that can be held, legal structure, and the ability to track and estimate values. Credit ratings need to be performed by a quasi-public organization, not a private-sector for-profit company.

Second, regular visitations by supervisory agencies are needed, as is the case in commercial banking, and open provision of information on the types of investments, conditions, and exposures in a public reporting format, at least to investors, similar to that used in financial accounting.

And last, the possibility of extending reserve requirements to an asset, or balance sheet, base that includes the nonbank financial intermediaries should be examined. If in effect, this would limit the extension of leveraged credit and help keep monetary policy in control.

A global financial safety net to cushion the collapse of a large investment bank, commercial bank, or some other financial institution under these conditions would increase investor confidence and help prevent the kind of freezing-up in credit and negative credit shock we are seeing now.

But, for such a safety net to be even-handed and not an instrument of increased moral hazard and unsustainable risk-taking, a more open transparency for the activities of all the institutions "protected" by the safety net needs to be in place and brought into the framework of monetary policy. This has been loosened, if not made irrelevant, by globalization, financial innovations, and the growth of the nonbank financial intermediaries.

I'd prefer the Fed's approach over the United Kingdom's role.

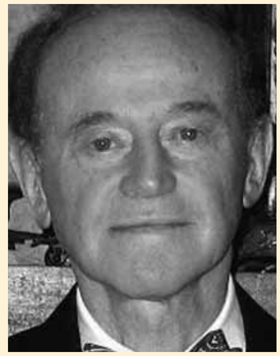
DAVID M. JONES
Chairman of the Board, Investors' Security Trust Company

Regarding how the U.S. and global safety net should be defined for the twenty-first century, I offer the following essential points. Most importantly, the Federal Reserve and other central banks are responsible for financial stability as well as for the pursuit of stable prices, and in the case of the U.S. central bank, the dual objectives of stable prices and maximum employment.

In the latest credit crisis, the Fed as well as other central banks sought to reestablish the orderly functioning of the credit markets by injecting emergency liquidity into the financial system. Since the Fed discount window was used to inject part of this emergency liquidity, it seemed natural that the banks and other depository institutions that have access for the discount window would be favored by the monetary officials. The purpose of the Fed's discount window actions was to assure depository institutions of the ready availability of a backstop source of liquidity.

Clearly, the Fed was using the banking system as a point of contact to eventually restore the orderly functioning of credit markets that had seized up, including the most severely impacted asset-backed commercial paper market, the high-yield corporate bond market, and the highly leveraged loan market. Unquestionably, the Fed was drawing a distinction between commercial banks on one hand and investment banks, finance companies, and off-balance-sheet conduits such as collateralized debt obligations which might be considered part of a "shadow" banking system on the other hand. In a credit crisis in which risk is being repriced and deleveraged, it is appropriate that the "shadow" banking system would be hit the hardest. Until investor confidence is rebuilt, the commercial bank share of credit extended temporarily rises while the "shadow" banking system's share of credit extended temporarily declines.

In my view, the Fed's commercial bank-centered approach to restoring the orderly functioning of credit markets, which seems to be showing hints of working, is preferable to the "stop-go" approach of the U.K. authorities. The U.K. authorities inappropriately lurched from one extreme, that of standing on the principle of no bailouts for investors taking on too much risk, to the opposite extreme of guaranteeing the deposits of all financial institutions, a burden that U.K. taxpayers will be reluctant to sustain.



Above all, save the capital markets.

ALFRED H. KINGON
Chairman, MuniMac Capital Trust, former U.S. Ambassador to the European Union, and former Assistant Secretary of the Treasury

How should the U.S. and global financial safety net be defined for the twenty-first century, and what kind of reforms are needed to address the current system of off-balance-sheet items? What comes immediately to mind are the credit difficulties in the late 1980s and early 1990s, the tech stock bubble in the late 1990s, and of course the current housing bubble with the accompanying subprime crisis.

To look at this appropriately I believe you have to stand far above current events and observe the transformation of the entire financial world—indeed the entire world—in the last few decades as the Industrial Age is supplanted by the Information Age.

Many economic manifestations of this vast secular transformation can be seen but the relevant one is the almost inconceivable massive increase in liquidity. Look at the explosion in equity trading via electronics, the mind-boggling increases in commodities and forex trading, and even in world trade itself. It is not hard to comprehend how the system was unworkable under institutions and rules devised for a previous age. Now, add to this the explosion in leverage and one can understand the difficulties we are now in.

The surge in liquidity is manifest in non-bank instruments, primarily in various types of bonds and other debt securities. Moreover, this liquidity came mostly from the newly emerging countries looking for a place for their surpluses. The flow was massive, the instruments were new, corners were cut, and the rating agencies, to be kind, were flummoxed. Looking back, you have to ask why Enron's off-balance-sheet items were illegal and why, say, Citibank's were not.

So what is to be done? First, certainly do not bail out the imprudent speculators. Yes, that may mean a major U.S. investment bank fails. Would that have deleterious effects? Most certainly, but to bail it out to would strike a serious blow to our free market system and begin compromising it. Additionally, to enact massive new regulations would stifle capital flows and seriously endanger the free-market system that has built this country.

Second, an improved transparency system is required for this new age especially to cover the new types of debt instruments. And yes, the rating agencies must also change their practices to be able to monitor money flows in this new world. Marking to markets must be done rigorously and regularly and be applied to all special-purpose obligations as well as all bank-to-bank flows.

But above all we do not want to destroy our financial markets in the corrective process. The free flow of capital must remain in this new globalized world along with the free flow of goods, services, labor, and enterprise. More discipline and more transparency in the new products are the keys. To try and somehow reduce or limit risks to those who can afford them would, I believe, destroy the market system that has built the wealth of this country and is now building the world.

Beware the unscrupulous salesman peddling unsuitable financial products.

HANNES ANDROSCH
Former Minister of Finance and Vice Chancellor of Austria

Although we are lectured periodically on the inability of pump-priming economic policy to ensure economic development, stability, and prosperity, this is nevertheless the policy diet we have been served and have come to expect. The low-interest-rate policy has never been properly justified, based as it was on an artificial concept of "core inflation" which enabled us to ignore the above-average increases in several key commodity prices, chiefly food and energy. And this interest-rate orientation provided highly combustible fuel for the flames of financial excesses by creating powerful incentives to engage in "irrational exuberance" as well as ignore the risks of moral hazard.

The dot-com bubble was an early warning and a crisis from which we got off relatively lightly. Rather than learn from our mistakes, we took it as a sign that we had developed immunity to, or at least a cure for, bubble-induced crises.

As long ago as the 1990s, prescient voices raised the alarm that unscrupulous salesmen were peddling unsuitable financial products to unsuspecting customers whose deeper interests could not be served by the induced sales. The financial products in question were subprime mortgages. The warnings and calls for controls were brushed aside, or ignored, right up to the pinnacle of our financial system. Perhaps this deaf-ear syndrome was attributable to an even greater fear of economic recession, or even deflation. No matter. In consequence, moral responsibility for the resultant fiasco is widely distributed.

Debt securitization, including collateralized mortgage obligations, collateralized debt obligations, and a plethora of other instruments, represent enhanced methods of financial intermediation, even if less understood and less transparent than traditional methods. They were welcomed in their day as the ultimate free lunch—higher return at lower risk—and it is only now that the bill is being presented. One way or another, the taxpayer will pick up the tab and this should be kept as low as possible.

This means first of all that the stability of the financial system must be preserved—the safety net must hold. Any protection of shareholders and investors should be set at a low level to ensure that those who had most to gain should contribute proportionately to the loss. Furthermore, there is nothing obvious to be gained by window-dressing measures to postpone the inevitable correction. In this context, the current spectacle of the perpetrators of the orgy of avarice being allowed to depart the scene of crime with grossly inflated severance payments, rather than stand trial, is most counterproductive as a signal to those who will now bear the effective burden of the crisis and as an incentive to their successors.