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Opinion

What We Need to Fight the Next Financial Crisis

Congress has taken away some of the tools that were crucial to us during the 2008 panic. It's time to bring them back.

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In September 2008, regulators faced the end of Lehman Brothers and the beginning of a global financial crisis. *CreditCredit: Andrew Winning/Reuters*

Ten years ago, the global economy teetered in the face of a classic financial panic, the most dangerous type of financial crisis. In a financial panic, investors lose confidence in all forms of credit, retreating to the safest and most liquid assets, like Treasury bills. The prices of risky assets collapse, and new credit becomes unavailable, with dire consequences for workers, homeowners and savers.

The seeds of the panic were sown over decades, as the American financial system outgrew the protections against panics that were put in place after the Great

Depression. Depression-era safeguards, like deposit insurance, were aimed at ensuring that the banking system remained stable, but by 2007 more than half of all credit flowed outside banks. Financial innovations, like subprime mortgages and automated credit scoring, helped millions to buy homes, but they also facilitated unwise risk-taking by lenders and investors.

Most dangerously, trillions of dollars of risky credit were financed by uninsured, short-term funding. This made the financial system vulnerable to runs — not by ordinary bank depositors, as in the 1930s, but by pension funds, life insurance companies, and other investors. A Balkanized and antiquated regulatory system made identifying these risks difficult and provided policymakers with limited authority to respond when the panic erupted.

The underlying performance of the broader economy before the crisis was troubling as well. Productivity growth was slowing, wages were stagnating, and the share of Americans who were working was shrinking. That put pressure on family incomes even as inequality rose and upward social mobility declined. The desire to maintain relative living standards no doubt contributed to a surge in household borrowing before the crisis.

Henry Paulson, Ben Bernanke and Timothy Geithner worked with regulators and other officials to stabilize the American economy during the 2008 financial crisis.

Credit: Matthew Cavanaugh/European Pressphoto Agency

Although we and other financial regulators did not foresee the crisis, we moved aggressively to stop it. Acting in its traditional role as lender of last resort, the Federal Reserve provided massive quantities of short-term loans to financial institutions facing runs, while cutting interest rates nearly to zero. The Treasury Department stopped a run on money market funds by providing a backstop for investors. The Treasury also managed the takeover of the mortgage giants Fannie Mae and Freddie Mac, and worked with the Fed to try to prevent the collapse of large, systemically important financial firms. The Federal Deposit Insurance Corporation guaranteed bank debt and protected depositors.

But the powers of the regulators alone proved inadequate. Congressional action made it possible for two presidents, one Republican and one Democratic, working with regulators, to prevent the collapse of the financial system and avoid another Great Depression. Most importantly, Congress provided capital to the banking system, allowing for the normalization of credit flows. Congress also provided support for housing and mortgage markets and authorized a powerful fiscal stimulus. The economy began to grow again in mid-2009, and the funds deployed by Congress were recovered with substantial profit to the taxpayer. Policymakers certainly didn't get everything right. But compared to most other countries, America's post-2008 recovery started sooner, was completed faster and was built on healthier foundations.

Are we ready for the next crisis? In some respects, yes. Reforms of financial regulation have helped make the system more resilient, making a crisis less likely to occur. Banks and other key financial institutions are financially stronger, and the gaps in regulatory oversight have largely been closed. Regulators are more attuned to systemwide risks. Our main concern is that these defenses will erode over time and risk-taking will emerge in corners of the financial system that are less constrained by regulation.

Even if a financial crisis is now less likely, one will occur eventually. To contain the damage, the Treasury and financial regulators need adequate firefighting tools. After the crisis, Congress gave regulators some promising new authorities to help them manage the failure of an individual financial institution, tools we did not have in the fall of 2008 when we faced the collapse of the investment bank Lehman Brothers. The so-called orderly liquidation authority, for example, which was passed as part of the Dodd-Frank Act in 2010, could help regulators unwind a failing firm in a manner that could be less damaging to the system as a whole.

But in its post-crisis reforms, Congress also took away some of the most powerful tools used by the FDIC, the Fed and the Treasury. Among these changes, the FDIC can no longer issue blanket guarantees of bank debt as it did in the crisis, the Fed's emergency lending powers have been constrained, and the Treasury would not be able to repeat its guarantee of the money market funds. These powers were critical in stopping the 2008 panic.

From a political perspective, Congress's decision to limit these crisis-fighting tools was predictable. Many of the actions necessary to stem the crisis, including the provision of loans and capital to financial institutions, were controversial and unpopular. To us, as to the public, the responses often seemed unjust, helping some of the very people and firms who had caused the damage. Those reactions are completely understandable, particularly since the economic pain from the panic was devastating for many.

The paradox of any financial crisis is that the policies necessary to stop it are always politically unpopular. But if that unpopularity delays or prevents a strong response, the costs to the economy become greater. We need to make sure that future generations of financial firefighters have the emergency powers they need to prevent the next fire from becoming a conflagration. We must also resist calls to eliminate safeguards as the memory of the crisis fades. For those working to keep our financial system resilient, the enemy is forgetting.

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