Lessons Learned: Matthew Kabaker

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Designing the correct solution requires, at the core, getting a handle on the real underlying issues and applying innovation and flexibility within the given constraints. And then, you still have to have a back-up plan.

On October 14, 2008, Treasury announced the Capital Purchase Program (CPP), which was funded by the recently enacted Troubled Assets Relief Program (TARP). Under the CPP (which was available to most banks), Treasury would invest capital into banks, which voluntarily agreed to participate, by purchasing up to $250 billion of preferred stock. Treasury announced that nine large financial institutions had already agreed to participate in the program. The CPP was designed to encourage banks to build capital (by encouraging private investment) and increase the flow of credit to businesses and household.

Kabaker shared that by December 2008, “it was increasingly clear, both from market signals and bank behavior, that we had a solvency, not a liquidity crisis, and that the solvency response which had occurred by that point [the initial TARP capital injections] was not having an effect on the perception of solvency.” The terms of that preferred stock, including certain behavioral restrictions and a step up interest, Kabaker explained, caused it to be “viewed by the bank and market as temporary capital at best,” more as a liability even though it was in the form of preferred stock.

This perception was significant, according to Kabaker, because it was a roadblock to the private sector investing in the banks. The private sector had more capital potential than the TARP budget and had the potential for its investment to be self-perpetuating if it participated in the recapitalization process; but this wasn’t happening. Therefore, Kabaker recalled, the first thing the policymakers did was to identify the reasons why the private sector was not already participating in the process:

There was a moment in the crisis, in the summer of 2008, where the private sector did participate in bank recapitalization, and many of those early investments were burned. They were premature and people lost money, and so the private sector was

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essentially on strike. Our conclusion was that this was principally as a result of uncertainty about the extent of losses of the banks themselves, and policy uncertainty around how the government would behave.

Uncertainty equals volatility, said Kabaker, so understanding this perception and the other underlying reasons why the private sector was reluctant to invest in the banks was key to the government being able to design a strategy that would mobilize private capital. These facts revealed a need to create clarity. Said Kabaker: “Our view was, if you could, one, create some clarity both of disclosure on what exposure the banks themselves had to the different credit assets, and two, create some policy certainty, you had the possibility that the private sector would provide capital for that recapitalization.”

So, said Kabaker, “we set about designing a series of policies that we felt would, with as little additional capital injection as possible from the government, create a situation where you could have a slightly more self-perpetuating positive cycle of the capital that was in the system from the initial preferred injections.”

These objectives were achieved by the bank “stress tests” that were implemented in early 2009 and simulated what bank losses were likely to be in various stress scenarios. Test results, which also identified any additional capital banks would need to raise to withstand the stress scenarios, were disclosed to the public. However, banks undergoing the stress tests were assured that, as long as they met certain requirements, the government would not fail, resolve, or nationalize them. The government would also provide capital if the bank could not raise needed capital from the private sector.

Kabaker said the stress-test regime was a successful one because of its dual elements: “I think the . . . combination of those two things, the private sector understanding that if they met the test, the bank would survive in its current form, and understanding what the bank’s losses were in tail scenarios, made the sector investable.” And just as important, said Kabaker, was the Treasury’s “providing an unlimited backstop to the purchase of common equity post stress test; there is no bigger volatility-reducing exercise than that. That is a very large put that was written by the federal government.”

In the end, said Kabaker, the stress tests helped the private sector regain confidence and get involved in the recapitalization process. He also thinks they shifted the environment in another important way: “Part of the nature of the ‘stress test,’ or the series of policies that surrounded the stress test, were designed so that we could get back control of that narrative, where there would be one set of policies and it would be clear.”

This was only achieved, Kabaker said, through collaboration among the different agencies and speaking with one voice. He described how one of the Treasury’s roles during the crisis was to make sure there was a shared voice between the regulators and that the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the Federal Reserve did not develop separate and different stress tests. He stated that it was important that Treasury communicated that,
There is one capital “bogey,” as we called it, and if the banks can meet it, then they will have met it, and they can continue to move forward as private companies.

And although the stress-test strategy succeeded, Kabaker said that there was no way of knowing that it would. His team also had a backup plan just in case. To cover all bases, explained Kabaker, a placeholder was put in the initial Obama budget to allow policy makers to ask for an additional $700 billion for bank resolutions, a strategy which had been considered and rejected. The additional funds were never requested because the stress tests did the job. According to Kabaker:

I do not know if that would have been the right policy, but the decision not to pursue very large scale bank resolution was, in part, due to the budget constraint. In hindsight, the policy that we implemented [broad-based capital injections into banks] was probably a lot more efficient than full-scale bank resolution, which is what a number of other countries did, such as the U.K. and Ireland.

The innovation really happened, said Kabaker, “in designing around the constraints. In this case, we did have, to some degree, a budget constraint that was, relative to the size of the U.S. financial system, modest.” In hindsight, it led to a very effective solution.

**During a crisis, it is important to consider all possible outcomes when deciding on intervention policies.**

Kabaker discussed how, in the midst of a crisis, actions that may seem credible may not really be and may come with unintended consequences. One example he pointed to from the Global Financial Crisis (GFC) was the question of whether the government should seek to compromise creditors’ claims when providing assistance to companies. The administration was criticized for not requiring creditors of companies receiving assistance to take haircuts. However, Kabaker emphasized that the policymakers thought it was important to keep all possible results in mind, consider practicalities, and choose the best possible outcome for the long-term, not just what might look the best in the short-term:

If, in the middle of a crisis, you are going to impose losses on someone without creating a broader-run dynamic, you have to be able to have a very clear and crisp explanation of who is losing and how you can differentiate between different creditors and the losses that they take. That was basically an impossible task, because the type of creditors in banks, from derivative counterparties to senior lenders, were essentially undifferentiated. You would have almost had to create a new legal regime in the midst of the crisis, publish it in a way that was easily understood, and be able to do that in a way that was not run-accelerating.

Kabaker said the team thought that task to be “highly impossible” relative to the alternative policy they pursued. Remarking on the government’s total response, in which haircuts were not required, Kabaker sees a positive: “If you think about it, the U.S. financial crisis response was budget positive, meaning it was not only costless, it actually contributed a positive surplus.”
Managing the politics of crisis response can be extremely demanding because perceptions often outweigh practicalities and constraints.

Kabaker admitted that one perception of the government’s crisis response was that some of the “worst offenders” were rescued, which in his opinion was necessary because of the unique nature of the U.S. financial system. In the U.S. economy, he explained, instead of a central bank or a similar institution, the private financial sector has the job of intermediation; it leverages the savings of the economy to drive credit formation and drive macroeconomic activity. By the time of the GFC, he explained, half of the U.S. financial sector was operated by nonbanks, which were lightly regulated or unregulated. The fact that the markets could decide whether or not to engage in financial intermediation, said Kabaker, made the intermediation activity unstable, and during the GFC much of this intermediation had stopped, resulting in a credit freeze.

This created a vexing situation, as Kabaker explained:

Your challenge is how to maintain some level of credit intermediation or lending to families and businesses when half of your entire intermediation sector just went on strike. They are gone and all you are left with are these banks. Your issue is that these are the very institutions whose mistakes caused the financial crisis, and yet, now that your markets-based intermediation is gone, all you have are these institutions.

... So, my best strategy, absolutely, as politically unpopular and noxious as it is, is to make those institutions work. The need of the many, which is the need for credit intermediation activity, ends up causing you to have to “bail out” or support these institutions. You could let them all fail, but then you have nothing. You have no system. You cannot recreate financial intermediation in the middle of a crisis, so you have to work with what you have.

Supporting the country’s financial system as a whole required that those financial institutions that did the worst deeds in leading up to the crisis also needed to be supported, said Kabaker, who acknowledged the inherent irony:

... it is oftentimes the financial intermediary who did the worst [deeds] who is going to be the one that is in the worst trouble. If you need to support the financial sector as a whole, by definition, the greatest amount of your support is going to go to the institution that did the worst deeds leading into the crisis. It is like some terrible cycle of political pain, where the most efficient, best financial crisis response becomes assisting the worst offender. A lot of the challenge of financial crisis management is managing the politics of that basic reality.