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Lessons Learned: Michael Silva

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Lessons Learned

Michael Silva

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Michael Silva was chief of staff to then-President of the Federal Reserve Bank of New York (FRBNY) Timothy Geithner from 2006 to 2009, including the early stages of the Global Financial Crisis (GFC). As such, Silva was critical in the coordination of personnel and information during the GFC, specifically during the period when the FRBNY was addressing liquidity stresses in the bank sector, including the bailout of Bear Stearns, the failure of Lehman Brothers, and the rescue of American International Group. When Geithner became President Barack Obama's Treasury Secretary in 2009, Silva became chief of staff to his successor at the FRBNY, William Dudley, until 2013. Since leaving the FRBNY, Silva has been in the private sector as a regulatory and compliance officer at GE Capital, DLA Piper, and most recently UBS. This "Lessons Learned" is based on an interview with Mr. Silva in September 2020.

Don't be afraid to question the experts.

Timothy Geithner, then heading the FRBNY, was concerned about the danger signs of the housing bubble as early as mid-2007, but it wasn't until the collapse of Bear Stearns in March 2008 that the market at large had to reckon with the implications of the housing market collapse, recalled Silva.

"My common sense was telling me that which cannot continue forever will come to a stop," said Silva. As a lawyer by training, not an economist or bank examiner, Silva says he deferred to the economists advising the Fed, and in retrospect, wishes he had pushed back more.

Even after Bear Stearns and Lehman Brothers failed, it wasn't until the Reserve Primary Fund dropped below $1 a share that the markets spiraled. According to Silva, the losses weren't big enough to bother economists, but a money market fund "breaking the buck" was a signal that set off panic among investors. Silva said:

> If your gut tells you that this doesn't make sense, have the courage to keep pushing back. With all due respect to my economist friends who I have great respect for, economics is based on a lot of theory that goes out the window when people get scared. The economic theory doesn't account for fear and stupidity and greed.
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> When the Reserve Fund broke the buck, the economists thought, "Well, that's not going to be such a big deal because it's just one small little fund." Well, guess what? That small, little fund that lost $38 million dollars turned out to be when the dyke almost broke. That was tiny, little. So again, they were wrong. So, Number One: Don't be intimidated by the experts.

Trust, but verify and push to do what has to be done.

The initial scramble to react to the fast-moving collapse of Bear Stearns exposed weaknesses in the knowledge base among the regulatory bodies, some of which have since been corrected and some which haven't, said Silva.

> I called the equivalent of the [FRBNY's] supervision group chief operating officer, and I said, "Hey, it looks like Bear Stearns is not going to be able to open in the morning. I think you're going to need to scramble a team to get over there to give us a viability assessment and an assessment as to whether they have anything to lend against." And he said, "Sure, where's Bear Stearns?" And I said, "I don't know. Google it."

At midnight, with Asian markets already trading and smelling blood on the water, the staff had to assess Bear's situation before the markets imploded and they couldn't even find the company address. "This was a direct result of how gerrymandered our regulatory system was prior to [2008], and unfortunately, still is," said Silva. "Before the crisis, it was a big problem. After the crisis, it got better because fear will do that; a near-disaster will do that."

Prior to the crisis, agencies such as the Securities and Exchange Commission (SEC) and Federal Deposit Insurance Corporation (FDIC) were "very territorial," said Silva. The SEC, as the securities regulator, didn't like the Fed's prying into the safety and stability of investment banks "and the investment banks certainly didn't like that." But the SEC was not a prudential regulator empowered to look into the liquidity and controls within financial institutions to ensure their safety. This limitation had serious impacts, as Silva described:

> A good example of that was that evening, when we were asking the SEC officials, "What's Bear Stearns' liquidity?" They handed us a report, and they said, "Here it is." We looked at it, and it was a report prepared by Bear Stearns.
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> Now, we were a little taken aback by that, because as prudential regulators, we never rely on what the firm says. We rely on doing our own work.

This left the Fed without the insight it needed during the overnight scramble to prevent Bear's collapse. So, the Fed sent its own people into the bank in the post-midnight hours to sort out how much Bear would owe counterparties when the markets opened in the morning and to determine if it had enough collateral to cover a loan to get it through the day. Armed with that information, the Fed was able to provide Bear a bridge loan and then facilitate its sale to JP Morgan.

> Sometime later that morning, Tim [Geithner] told me: "Mike, I'm not going to get surprised like this again. I'm not going to rely on the SEC anymore to tell me the condition of these investment banks. I want our own people in these investment banks right now." And I had to say to him, "Sir, we don't have any authority over the investment banks. We can't put our people in the investment banks."

> Tim is a lovely guy. Nicest guy in the world, and generally very easy to deal with, but this is one of the few times he got short with me. He said: "Mike, what part of 'I want our people in every investment bank' do you not understand?" And I said, "Okay."
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> So, I called the bank supervision group, and I said, "You've got to put people in every investment bank." And they said, "Mike, we can't put our people in investment banks." And I said, "What part of 'I want people in every investment bank' do you not..." I said, "Listen, Tim wants them."
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> And here's what happened: We sent our people to Goldman [Sachs] and to Morgan [Stanley] and to the other investment banks in the early morning. And guess what? They were welcomed with open arms. And that told us these people were nervous themselves.

On the same day of the Bear save, the Fed established the Primary Dealer Credit Facility (PDCF) to stand ready to lend to other investment banks. Unfortunately, when Lehman Brothers became critical in September 2008, it did not meet the requirements.

Don't be afraid to move fast and hard but beware of politics.

When a crisis looms, it's best to use "overwhelming firepower to nip everything in the bud," said Silva. "Don't take chances because things can get out of control real fast."

> I think I would have pushed harder now, not that I had a big vote, but I did have a good seat. I would have said, "Are we sure that the markets will survive Lehman going down? Are we absolutely sure?" Because our economists thought yeah, the markets will survive this, and they were right, right up to the moment the Reserve Fund broke the buck.
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> Don't play with fire, I guess is what I'm saying. We're playing with fire again right now, with respect to COVID. We're not just playing with fire, we're playing with Napalm now, between the public health crisis and the public tensions, potential constitutional tension, contested election. It's really just an immensely dangerous situation.

The difficulties in fashioning relief for homeowners after the 2008 crisis were in part a political factor, said Silva. Financial regulations and support facilities such as those that supported the financial system are "blunt instruments," while homeowners assistance is more a nuanced and complicated effort.

> Coming up with a fair program for homeowners that protected those that needed and deserved to be protected, without rewarding those that shouldn't be rewarded, that was all in the political realm, and Congress is a very blunt instrument. It does not come up with finesse.

Crisis response should also include long-term efforts.

The 2008 crisis left both more economic inequality and more resentment among those affected, said Silva. "Unfortunately, to prevent the financial crisis from becoming worse, we had to rescue the very people who started the thing," he said. "That was tremendously unfair, in one sense, even though it protected the greater good. But I think it did start to highlight this increasing inequality in America that's only gotten worse since."

The effects of the 2008 crisis echo in the response to the COVID-19 pandemic, said Silva. The main difference in this case is that the triggering event is far more severe and uncontrollable, but the response has benefited from the experience of 2008, said Silva:

> Fortunately, the Fed had a playbook from the 2008 crisis; 2008, it turns out, was batting practice for 2020. Because all the facilities you see the Fed right now operating to support markets, are all basically modeled on the facilities that were developed in 2008. So, a lot of this stuff was right off the shelf.

But that alone won't be a long-term solution, said Silva: "You can't use monetary policy indefinitely as a tool for this. You have to get fiscal policy involved." Generally, when the US is facing a shock that causes a wave of small-business defaults that could then trigger a full-scale economic crash, Congress has to pass a real stimulus legislation to put some "real spending" behind the monetary policy. Silva and other practitioners of monetary policy know that the response to a crisis level event requires a staying power obtained only through the process of lawmaking. Silva explained:

> Congress better get their act together soon because this economy, I call it the zombie economy. It's dead, but it's still walking around because it's propped up by the Fed market support facilities and the fiscal stimulus that the Congress has provided so far but is rapidly lapsing. If we don't get people back to work soon, this whole thing could collapse in something worse than the Great Depression, possibly.

Don't underestimate human nature.

"Economists like to think people invest rationally," Silva said. "No, that's not the case at all." Profit pressure and competition can blind players from seeing the dangers ahead, or even reacting to those they see. Silva cautioned that we shouldn't underestimate the effect of greed and stupidity. He recalled an often-repeated quotation by former Citigroup CEO Chuck Prince—"When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing"—as an example of the cavalier attitude that persisted at the time. "I was very disappointed at that," he said.

That focus doomed Lehman and made conditions worse in the market, said Silva. In 2008, Geithner and then–Treasury Secretary Henry M. Paulson, Jr., convened the leaders of the big financial houses and asked them to pool resources and support Lehman's $100 billion in debt to avoid its collapse, but they refused. Silva opined, I was very disappointed that our financial leaders didn't support Lehman Brothers. These were a bunch of American financial leaders who didn't step up, and I bet now they wish they had. Because for just about $80 billion, no more than $100 billion, spread among the 20 of them, they could have come out of this looking like heroes and avoided Dodd-Frank, and avoided all this extra capital.

But instead, they looked at their very short-term interests, and guess what happened? The whole thing blew up, they lost a lot of money, they had to raise a lot more capital. It's cost them trillions of dollars all together because they didn't want to spend $80 billion or $100 billion that night.

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