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Lessons Learned: Patricia Mosser

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Lessons Learned

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During the 2007–2009 Global Financial Crisis (GFC), Patricia Mosser was senior vice president in the Markets Group at the Federal Reserve Bank of New York. Mosser oversaw market analysis, monetary policy implementation, many crisis-related liquidity facilities, foreign exchange operations, and analysis of financial stability and reform. She was also responsible for the analytical work of the Markets Group on global financial conditions. Currently, Mosser is the director of the masters of public administration program in economic policy management and senior research scholar of international and public affairs at the Columbia School of International and Public Affairs. She leads the school's initiative on central banking and financial policy. This Lessons Learned is based on an interview with Mosser held February 14, 2018; the full transcript can be accessed here.

The systemic risks to the financial system need thorough and continuous attention.

Before the GFC, the Federal Reserve and other financial regulators largely concentrated on monitoring the stability of individual banks. Not much attention was focused on the interconnections between financial institutions or on the stability of the system as a whole. The Fed didn't foresee the systemic risks early enough to prevent the crisis. Mosser said, "We didn't think about risks across the system as carefully as we should have, and what the cascading effects could be."

Fed officials knew there was the possibility of bank runs and panics—they are endemic to financial systems. However, the United States had not suffered a crisis of similar magnitude since the 1930s, during the Great Depression. "I think we were complacent in thinking we figured out how not to have those anymore, which wasn't true," Mosser said.

She explained that the most important change needed was for regulators to think about the financial system much more holistically: "It's not just banks, or insurance, or asset managers, or AIG, or Lehman—it is how the entire system works together and how it can break." This logic, Mosser continued, has to be extended beyond institutions to markets and instruments:

> We need more thinking through carefully about what the risks are when you look in a market and say, "That's risky; what is this new instrument?" But one also has to think through carefully all of the instrument's interconnections to other markets, the economy, and other institutional players and then imagine how a cascade of good things could happen and how a cascade of bad things could happen.

Fortunately, Mosser said, there has been a "sea change" in how central bankers and regulators all around the world analyze financial risks and financial stability. Now, far more attention is paid to systemic risks and interconnections between institutions and the threat of contagion, and these matters are discussed on an ongoing basis.

However, Mosser pointed out that, as valuable as the heightened focus on systemic risk is, a related problem still needs more work. She pointed out that not enough attention was paid to nonbanking segments of the financial system. Mosser explained, "It didn't take a genius to know that only about one-third of the US financial system had direct access to the Federal Reserve for lender of last resort." For large bank holding companies like Citigroup and JPMorgan, only parts of their organizations had, and have, standing access to the Fed as lender of last resort. For the standalone investment banks, like Bear Stearns and Lehman Brothers, there wasn't any access.

> The United States is extremely peculiar. This is a legal/regulatory structure problem. It is different from the vast majority of countries, certainly large, advanced countries with international dealer banks—those firms that make global capital flow go. Except for the US, countries all have universal banking models, which means you'll have different subsidiaries, one focused on retail, one focused on investment banking, etc. The European model works like this. Japan works like this. The retail deposit subsidiary has deposit insurance, just like the United States. The difference is that the entire company has access to a lender of last resort. It doesn't matter whether the asset sits in the retail bank or in the investment bank; it's a single entity. But in the United States, only the deposit-taking bank subsidiary, not the bank holding company, has access to the discount window.

Mosser believes that this problem has not really been fixed, and that it is a continuing legal restriction that can be "very damaging" in a systemic crisis.

Planning and testing emergency tools regularly will pay off during a crisis.

During a crisis, time is extremely valuable. Some of the Fed's emergency programs took weeks or even months to become operational, and some had never been tested. But, Mosser said, policy makers "were well aware of the limitations of the Federal Reserve to provide liquidity to the entire financial system." The Fed had been thinking about what could be done in a crisis and had designed some initial proposals for using its emergency and non-emergency authorities.

> The problem was not a lack of imagination about what could go wrong; it was either not enough urgency or not enough hours in the day to actually put together a fully formed emergency facility that might be ready to truly pick up and operationalize off the shelf.

Mosser asserted that preparation is key, and early implementation of emergency facilities can decrease the likelihood of runs and panics. One of the biggest lessons learned is "to have more of [these emergency programs] sitting on the shelf and go out and test" them, even if they are not going to be used right away. That way, people know how to use them when needed.

Mosser believes that these tools can be tested without alarming the markets, by explaining "very forthrightly and very publicly" that it is a test and asking firms to participate. This will provide valuable knowledge and minimize the risk associated with deploying untested tools in the midst of a crisis.

Credible government guarantees are particularly potent, even relative to other forceful interventions.

Mosser explained that credible government guarantees are extremely effective tools and will trump even very well designed lender-of-last-resort programs. Mosser said, "Ultimately, what stopped the run and truly slowed down the panic in the fall of 2008 were government guarantees; it was not the lender-of-last-resort actions."

Guarantees support liabilities, which allow the firms to raise funding from market channels and not just rely on government-provided liquidity to prop up the institution. Guarantees, such as the US Department of the Treasury's guarantee of money market mutual funds, were tremendously valuable in stemming the crisis, said Mosser. Another US government guarantee program that received little attention but was even more effective was the Temporary Liquidity Guarantee Program (TLGP) from the Federal Deposit Insurance Corporation (FDIC). According to Mosser, it was basically deposit insurance for the entire liability side of any financial institution that chose to participate. The FDIC used its systemic risk exception provision to guarantee debt for any financial institution, for a fee. The program guaranteed enormous amounts of debt, for up to three years. It was "an unbelievable guarantee," Mosser said. "It stopped the run. Full stop. Because it was a credible US government guarantee."

The challenge of providing an effective, broad international lender of last resort still hasn't been resolved.

One significant element of the crisis was that the liquidity shortage in US dollars outside the United States was probably greater than inside the country. The Fed provided some lending in US dollars through swap lines with other central banks, as well as some to US arms of foreign banking firms. Between the swap lines and lending to domestic banks with a foreign parent, Mosser estimated that three-quarters of the dollars lent through the Fed's programs were borrowed by foreign institutions. The Fed was able to manage risk of lending outside the United States by lending only to select central banks, which then lent to their domestic banks. This helped the Fed get comfortable with providing dollars abroad to private financial institutions the US did not regulate—only indirectly, through foreign central banks that in most cases did regulate such institutions. But it's not a perfect solution, according to Mosser, because the Fed doesn't know that the central banks are all applying the same standard of stability for assessing their banks, and some emerging and unstable economies are not good candidates for swaps because of underlying economic or political factors. The International Monetary Fund helps, but can't totally fill the gap, said Mosser.

> If you're going to have a global financial system with global banks in different countries, then they're going to have to be able to borrow from several different

central banks, not just their home central bank. You better have some assurance if you're the host country that this institution coming to you is playing by the same rules of the game that your local banks are playing by, otherwise you're going to be more reluctant to lend to them.

The problem is in practice, in a crisis, it's really hard to do. If you think it's hard for regulators to be honest within their country, it's even harder for them to be when it's an international conversation. That's another issue that hasn't really been resolved completely. It's better with the swap lines. The swap lines are a big step in the right direction. It could stand some more work at the international level**.**

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