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Yasemin Esmen

Rosalind Z. Wiggins
Yale University

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Yale Program on Financial Stability
Lessons Learned

Clay Lowery

By Yasemin Sim Esmen and Rosalind Z. Wiggins

Clay Lowery was assistant secretary for international affairs at the US Treasury during the Global Financial Crisis (GFC). His office was responsible for economic and financial diplomacy, international monetary affairs, debt strategy, global financial services, and US participation at the International Monetary Fund (IMF). This "Lessons Learned" is based on an interview with Lowery in September 2019. The full transcript can be accessed here.

Regulators should always consider the possible cross-border implications of what might at first look like a purely domestic problem.

The GFC began with a downturn in the US housing market, but it was global from the beginning, said Lowery. The way the US housing sector had been financed had broad international implications. US residential mortgages had been securitized and sold as bonds and derivatives not only to US banks and investors but also to banks and investors outside the country, and one of the first watershed moments occurred in Europe.

> The first event that we saw where we realized there was a pretty serious problem was back in August 2007, when a French financial institution [BNP Paribas] had basically stopped the redemptions on a couple of bond funds that were related to mortgage-backed securities. That they would just stop doing redemptions on this is something very rare. When that happened, it created a market shock.
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> From there, what happened was that the European Central Bank [ECB] put a lot of liquidity into the market as a sort of immediate reaction, in some respects surprising the Federal Reserve on how much liquidity they had put into the market. This was clearly indicating that there was a problem, and that the markets were not clearing at the rate that they would like them to. While the underlying assets were US-based assets—again, mortgage-backed securities—the problems were actually starting within Europe. When people ask when the US financial crisis turned into a Global Financial Crisis, I would argue that it was on Day One.
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> That is point one. Then point two is that it started leading toward the question of how much dollar liquidity was out there. The dollar, as everybody recognizes, is the most important currency in the world, and some of the financing mechanisms that had been created were very dollar based. So, if you could not get dollars, then it created other problems within the financial sector, not just for US firms, but also for European firms. That is why, again, it was clearly an international issue. Then the spillover to emerging markets and other countries started taking place probably in the early summer of 2008, and then became a huge issue in the fall of 2008.

Although the problems that existed in 2008 have been addressed, constant diligent monitoring of the financial system is needed, since new vulnerabilities can always arise.

Lowery expressed some skepticism about misreading the post-crisis era as a new prolonged period of calm in the markets:

> I think, in many respects, saying a lot of those problems have been "solved" is way too strong. I would say "addressed." And so, we probably don't have some of those similar issues today. However, that does not mean that other issues have not opened up. Whether those issues are more fragmented financial markets—including the regulation of the derivatives markets basically becoming more "Balkanized" in a way—if that is the case, and I think it could be, then that could lead toward a different type of financial stability problem in the future, one that would be based on a different coordination problem than what we saw in 2007–2008. Or you could see a rise in what is described as "ring fencing," which is basically regulators regulating their institutions nationally, whether those are foreign-based institutions in their jurisdictions or not and overlooking the global system.

According to Lowery, the question "is whether or not you can limit those vulnerabilities so that they do not become systemic." He continued, ". . . I think the hope out there is that when we do see crises that arise, they can hopefully be limited and not spread like wildfire." For these reasons, he stressed that regulators need to work on frameworks that will allow effective cross-border solutions. However, conceded Lowery, given the nature of the integrated financial system, "I am not sure they probably ever will solve it, but it needs to be continuously watched."

Cross-border cooperation among authorities is necessary when large systemic entities fail and can be helpful in a number of ways during a crisis.

Lowery was of the opinion that international cooperation was very good during the crisis and has improved since. This was his main focus as a representative of the Treasury, and international cooperation among countries had three major components, he said: bilateral communications coordination with different nations, coordination among the Group of Seven (G-7)/Group of 20 (G-20)–type of countries, and working with international financial institutions, such as the International Monetary Fund (IMF) and the World Bank.

Coordination involved the central banks and the finance ministries. During the crisis, said Lowery, these groups worked closely together and cooperated with one another, and they continue to do so today. Doing so, he pointed out, can bring added value to policy efforts:

> Secondly, we worked on the coordination among the G-7/G-20–type of countries. We worked on this subject a lot to make sure we understood where the different countries were coming from. You see that during the TARP [Troubled Assets Relief Program]: trying to find out and make sure that other countries were taking similar actions. By the way, sometimes the United States was taking actions similar to what other countries were doing. Remember that, while TARP was essentially an injection

> of public capital into a variety of financial institutions, it was something that actually had been done by other countries before we did it.

On the other hand, with respect to the regulators and supervisors, Lowery said that things have improved since the GFC, and they needed to. At the time, regulators and supervisors were not as quick to coordinate or agree on strategies as were the central banks or finance ministries but were key to reaching consensus on how to regulate large global financial institutions in many different jurisdictions. There has been a significant improvement in cooperation between regulators and supervisors about such entities. He said:

> On that front, things have improved over time, including questions such as how to regulate a big global financial institution that is in many different jurisdictions. Is there a better discussion among regulators and supervisors about such entities, and about such financial products or activities that could create problems? I think the answer on that is definitely yes, there has been an improvement. I do worry, however, about coordination and cooperation among central bank-type regulators and market-type regulators, as sometimes the international meetings have a bit more bias toward the outlook of those who do central banking for a living, who do have a different perspective than those that regulate capital markets.

Sometimes in a crisis, the biggest surprises are what you don't know: Pay attention to what you don't know.

When asked what his biggest surprise during the crisis was, Lowery answered: "I would say that, for me, some of the biggest surprises were some of the connections that were out there that I am not sure I totally understood. In fact, I am not sure I totally understand them today." He pointed to monoline insurers as an example:

> I did not know what a monoline insurer was. It turns out monoline insurers were important. There were connections between monoline insurers and sovereign borrowers and mortgage-backed securities that I just did not have a clue about. Seeing those unwind, and then seeing those institutions get into trouble, and then that creating a problem for whether or not securities could be issued, was something I probably just had not thought of.

His takeaway is that, in the crisis, "a number of very smart people from very important overseeing bodies did not really understand what was happening in different parts of the market." It is very important to pay attention to the micro issues as well as the macro issues, since either can have an impact.

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