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YPFS Lessons Learned Oral History Project: An Interview with Mark Van Der Weide

Mark Van Der Weide

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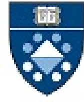

Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Mark Van Der Weide[1] General Counsel to the Board of Governors of the US Federal Reserve System
Interviewer Name	Matthew Lieber Yale Program on Financial Stability
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Introduction:

The Yale Program on Financial Stability (YPFS) contacted Mark Van Der Weide by email to request an interview regarding Van Der Weide's experience as a staffer for the Board of Governors of the US Federal Reserve System[2]. From 1998 to 2009, Van Der Weide served in the Legal Division of the Fed. In 2009-10, he served at the US Treasury Department as a Fed detailee, where he helped draft the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Back at the Fed, Van Der Weide served for eight years in the Division of Supervision and Regulation, where he was made Deputy Director, helping to implement the Dodd-Frank Act and the Basel III Accord, among other things, before the Board of Governors appointed him General Counsel in 2017.

In this interview, Van Der Weide discusses the 13(3) emergency lending facilities of 2008 and 2020, the way that the Fed tried to devise a solution for Lehman Brothers before it failed, interagency cooperation and relations with Congress, improvements to the soundness of the US banking system along with continuing areas of improvement, the issue of shadow banking in 2020, US capacities to address distress in the real economy, and the concern about moral hazard from the second massive intervention in 12 years.

This transcript of a telephone interview has been edited for accuracy and clarity.

Transcript:

YPFS: **On behalf of YPFS, welcome, Mark Van Der Weide, and thank you for your time and your attention this morning. Our questions fall into three main categories: crisis response; post-crisis reform; and then COVID. Feel free to weave in COVID, the third piece, as we go along.**

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[1] The opinions expressed during this interview are those of Mr. Van Der Weide, and not those of any of the institutions for which the interview subject is affiliated.

[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Van Der Weide is available in the Yale Program on Financial Stability's Journal of Financial Crises.

First, turning to the Global Financial Crisis of 2007-2009, when and how did you and your colleagues at the Federal Reserve Legal Division first become aware of the crisis?

Van der Weide: That's a complicated question to answer. And my memory has faded a little bit about the tick-tock of all the events that occurred back in 2007, '08 and '09. One of the reasons why it's a complicated question to answer is that the financial crisis of 2008 - different from the financial crisis of 2020 - had many different phases. I usually date the start of it to August of 2007 when the first strains in the interbank funding markets occurred and the Fed lowered its discount rate for lending to banks.

But there were many phases that occurred along the way, Bear Stearns in March of 2008, the GSEs' failing in early September, Lehman mid-September and on and on. So, there wasn't a single event. And our realization of the extent of the crisis evolved with the events that were evolving through 2007, 2008.

The Legal Division at the Fed is a little bit different, I would say, than other government agencies. It's profoundly integrated into the decision making of the organization. So, as soon as anybody at the Fed knew something was going on with Bear Stearns, for example, the Legal Division was in the know and was a part of the process of analyzing the incoming information and trying to decide whether the Fed should do something about it, and if so, what? But there were multiple phases of the crisis and it's a little bit hard to say when we were brought in at particular points.

One more reflection—in general, I would say because a lot of the most tumultuous events of the financial crisis of 2008 occurred outside the banking system that we regulate–Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, Goldman Sachs, AIG–all of these were companies that we did not regulate and that we did not supervise; we did not have perfect visibility into those organizations. So, at many of the distress points in the crisis—Bear Stearns, for example, and AIG, for example—we got very little notice of the deep nature of the problems at those firms. Days, not weeks, for Bear Stearns and AIG.

YPFS: **Right. And if you had to break it into different temporal pieces in your awareness, is it accurate to say there are two major crises—building points—before it blows up in September 2008? First, the S&L thrift real estate (lenders) in 2007 and then Bear Stearns in March?**

Van Der Weide: I think that's about right. I would carve up the 2008 financial crisis in the same way, with the first phase being the mortgage market tremors in 2007. Because of the way mortgages had been originated and distributed and securitized and purchased by a variety of investors around the world, many of which were funded through short-term wholesale funding, the mortgage market tremors spread quickly through the financial system throughout the back half of 2007. So, you did see some mortgage company failures and distresses, non-bank mortgage company failures and distresses. But the shocks from the

mortgage markets spread quickly into the broader financial markets. You saw strains in the interbank funding markets appearing in the back half of 2007. And you saw lots of difficulties in some of the asset-backed commercial paper programs and structured investment vehicles.

So, I think that's right. The pre-Bear Stearns period was phase one. And then the Bear Stearns' failure to the Lehman failure was phase two. And then Lehman and the post-Lehman failure was phase three.

YPFS: **Throughout 2007-08, we see the adoption of new tools and responses in the Fed's innovations. One of those is the establishment of the funding facilities. We've looked at this Commercial Paper Funding Facility (CPFF) as particularly innovative. Case study researchers at Yale found that it was the one that most pushed the envelope of what was legal under the Federal Reserve Act, section 13(3). From your vantage point inside the Legal Division, what were the concerns and why?**

Van Der Weide: Yeah. Let me just do 30 seconds on the 13(3) facilities more generally, and then discuss the CPFF. I would say that the most novel of the Fed's responses to the crisis in 2008 was our uncorking of various different 13(3) lending facilities. The Fed had not used that authority in the Federal Reserve Act since the 1930s, so it had been 70 plus years since we had used that authority.

I personally spent quite a bit of time in late 2007, early 2008, in the Federal Reserve Board legal division's library, poring through all the different precedents that we had on 13(3). There weren't a whole lot, but we became expert on that quickly as we saw the strains increasing.

We did launch a large number of facilities. I would agree with your assessment that of all the facilities that we launched, the CPFF was the most challenging. There was a very strong view by our economists and our policymakers that the US financial system needed a facility like the CPFF. We had been successful a few weeks earlier through another one of our facilities, the AMLF, and through a Treasury guarantee program, at stanching the run on the money fund industry back in September.

But the commercial paper markets remained pretty broken, remained pretty frozen, and the non-functioning commercial paper market definitely posed a clear and present threat to the stability of the US financial system. So, we needed to do something to provide a backstop for the commercial paper market. But the legal risk was above average for that facility, I would say. We are required under the law to be secured to our satisfaction on any lending facilities we do under 13(3).

It's a vague standard, but we are clearly meant to have a very low risk of loss on all of our 13(3) facilities. We're supposed to be a liquidity provider but not a credit risk taker. So, we structured the CPFF in a way that we felt we could

get secured to our satisfaction. We set up a special purpose vehicle to purchase commercial paper, newly issued commercial paper, from a variety of issuers.

The Fed lent to the special purpose vehicle. So, technically our loans to the special purpose vehicle were fully secured by the commercial paper that the vehicle bought, but the commercial paper was mostly unsecured commercial paper. But we lawyers authorized the CPFF because of the high quality of the issuers–we only bought the top quality commercial paper, A1/P1 rated commercial paper–because it was very short term commercial paper (generally 90 days), and because we required issuers to pay an upfront fee to help give us some initial protection. Put that whole cluster together and we got comfortable that the CPFF was secured to our satisfaction. But, in my view, I think that was the most risky of the facilities that we did.

YPFS: That's interesting with regard to precedent. Today 12 years later, the CPFF is an important precedent, isn't it? When we look at the concerns and discussions you had inside the central bank and the initiatives in the post-COVID response package, how do you assess the concerns then vis-a-vis now? Obviously, 2010 you came out well on that. The due diligence you did protected the Federal Reserve.

Van Der Weide: Yeah. The facilities were quite successful back in 2008, both at stabilizing the financial markets, but also in that no taxpayer money was lost, not even on the CPFF, our most risky facility. Every facility that we did earned a profit. So, I think we do consider those facilities to be a success.

One of the sad parts of the COVID crisis of 2020 is that we saw similar breakdowns in some of the same financial markets in March of 2020 that we saw in the fall of 2008. Money funds and the commercial paper markets in particular.

But the Fed had a tried and true set of 13(3) facilities that we had deployed in 2008 that were quite successful in preventing those dislocations from metastasizing. And with some interesting tweaks here and there, when we saw these same financial markets destabilizing in very similar ways in 2020, we had on the shelf a suite of facilities that we could launch to make sure that the short term funding markets in the US didn't collapse.

And so, we were able to launch in very short order updated versions of the Primary Dealer Credit Facility, the money market fund liquidity facility and the Commercial Paper Funding Facility to make sure that the short term funding markets keep operating. In some respects, I'm happier with the facilities that we were able to launch in 2020 in that they were less risky for taxpayers in significant part because this time around we got a treasury equity injection for the commercial paper funding facility and for the money market liquidity facility, which we did not have back in 2008. So, at least from a Fed central bank lending perspective, our loans were even safer in those programs 2020 versus 2008.

YPFS: **Right. You mentioned tweaks that you made in this 2020 crisis including the Treasury capitalization. What were the other tweaks you were referring to? Because it was a learning that occurred, right? You were able to launch these programs rapidly based on the prior experience, but they were tweaked. Could you fully describe that?**

Van Der Weide: Yes. One difference, which I can't really call a tweak to the program, was more of a tweak to the rollout. The commercial paper funding facility in particular took us quite a while to devise back in 2008. We'd never done something like this before. So, it took quite a bit of work to figure that out and move from an initial term sheet to an operational lending facility; it was the same with some of the other facilities. But having already built them once and having kept them on the shelf relatively fresh over the last 12 years, we were able to launch all of our short term funding market facilities very quickly in 2020. We were at least able to announce them very quickly. It took us some time to get some of them actually up and running and making loans. But we were able to announce them all together as a package up front in early days of the coronavirus crisis.

And that was quite critical to restoring confidence. We were able to act a lot faster because of what we learned from 2008.

But there were two tweaks that I think were most important on the short term funding facilities. The first I mentioned was that we were able to get a Treasury equity injection into the money fund facility and the commercial paper facility, which we did not have in 2008.

But that also allowed us to make another tweak which I think magnified the efficacy of one of those two programs, the money markets liquidity facility. The 2008 version could only purchase asset-backed commercial paper from money funds, which was a thin slice of the assets of money funds. It was a very valuable program, and combined with the Treasury guarantee for money funds, it worked.

But the Fed was able to take more risk in that program in 2020, because we had the Treasury equity injection, the. We were able to purchase a very wide variety of assets out of the money funds, not just asset-backed commercial paper, but also unsecured commercial paper and certificates of deposit and some other securities.

So, we were able to provide much more powerful liquidity support for money funds in 2020 because of that treasury equity injection. And in part, because of that, we didn't need the Treasury guarantee of money funds like we had in 2008. So, I think those are the two main innovations in the short term funding facilities.

YPFS: **There have been several different ramifications, no? I've written them down, seen them on the website, seen reference to them. There have**

been several of these, and some have been taken up more than others, no?

Van der Weide: Yeah. My count of the facilities in 2020 is 13. A lot more facilities than we had in 2008. And most of them have some kind of a Treasury first loss position and equity piece to support the Fed's risk taking on the program.

YPFS: In hindsight, looking back in 2008 from your point of view, are there any decisions or actions that were taken by the institutions that you served in that you wish had been handled differently? With 20-20 hindsight, knowing what you know now.

Van Der Weide: I would say, in general, I have few regrets. True of most of my colleagues too. I think it is fair to say, and this is maybe changing the question a little bit or answering a slightly different question, but I do think it's pretty obvious in hindsight that the Fed, other bank regulators in the United States, and other bank regulators and central banks around the world had not regulated the banking system as strongly as it should have been regulated. And that certainly was a contributor to the crisis back in 2008.

So that's a fair indictment of bank regulators around the world in the decade leading up to the financial crisis. As I said before, many of the most destabilizing collapses back in the 2008 crisis were not of banks, they were of non-bank financial institutions. And I don't think the Fed could be held responsible for that—AIG and the standalone investment banks, Bear Stearns, Lehman, et cetera. But I think it's fair to criticize the Fed for insufficiently tough bank regulation before the crisis.

The actual crisis response, once it started breaking out in '07, '08, I think it was really on the whole quite good. Lots of questions have been raised, and you've raised it again here today, about whether we should have saved Lehman Brothers. In the end, I don't think we had the legal authority to do it. If we had been able to do it, would the financial crisis have transpired in a less damaging way? Probably. But we tried hard to find a way to prevent Lehman from crashing.

I still remember quite vividly the leadup to Lehman's failure, just the short-term leadup in the week before its failure. The government had three different plans to try to deal with Lehman. One was to try to find a consortium of private sector entities that would provide support to Lehman collectively. The second was to try to do a Bear Stearns/JP Morgan type deal, where you find a single acquirer for Lehman and the Fed would maybe provide liquidity support for some of the troubled assets like we did for Bear Stearns.

And then there was a third workstream, plan C, which was, if we fail and Lehman failed, what can we do to mitigate the damage to the US and global financial systems? This was the "foam on the runway" workstream. And I remember I was assigned to the third workstream, the "foam on the runway" workstream. And I remember being unhappy about that because I didn't think

a Lehman failure was going to happen. I thought we would find a way to prevent Lehman's bankruptcy.

YPFS: **We phrase the question carefully—"should we have found a way (to save Lehman?)"—as in, "couldn't you have devised a legal way?" By pushing the envelope and poring over the authorities in the laws of the Federal Reserve Act or the authorization legislation. Please describe that part.**

Van Der Weide: Yes, absolutely. And when we did that work, that helped us to concoct the three work streams that I just described. We found two very legal ways for us to potentially help Lehman avoid failure. One was through this private sector consortium. The other one was to replicate a JP Morgan/Bear Stearns style transaction. And that's what we worked on. Until late in the game, we thought sticking to that second plan might work, but in the end, it didn't.

We were left with a situation where Lehman was facing a gigantic run and it didn't really have enough collateral, and the Fed's not supposed to be a credit risk taker, and we did not feel comfortable that legally we had the ability to go in and lend into that run and potentially lose a tremendous amount of money for taxpayers.

YPFS: **Yeah, clear enough there. All accounts point to the leadership that proved strong in terms of coordination and crisis response between the Fed, White House and Congress and the politicians responding appropriately, the leaders of the institutions working together. Could you describe that experience? It's not like normal government time, is it?**

Van Der Weide: No, it definitely wasn't. I would say the relationship between the Fed and the Treasury Department was quite close back in 2008. We had less contact with the White House folks. The Treasury Department was our main liaison to the administration. We kept in very close touch with them about all the things that we were doing.

In particular, when we were launching all of those different 13(3) emergency lending facilities, we always got the Treasury's informal consent before we launched them. We weren't required to by law, but we felt that given the emergency nature of those programs, the potential risk to the taxpayers, it was the right thing to do to get part of the elected branch of government onboard with the programs.

So, we had quite a few conversations with them before launching any of the 13(3) facilities. The relationship with Congress was a little more challenging. In the end, eventually, Congress was willing to pass the TARP legislation, which was also quite critical in preventing the financial crisis from getting worse and to moving us into the recovery phase.

So, in the end, I think the relationship with Treasury was close and intimate and very cooperative. The relationship with the legislative branches was a little more difficult and a little more hostile. There wasn't a lot of love in Congress

for all the different “bailouts,” as they were called. And so, there was some acrimony and a lot of tension in the relationship between Congress, on the one hand, and the executive branch and the Fed, on the other hand.

YPFS: **And how does that compare to the coordination nature and characteristics responding to the different but in some ways similar current situation, the COVID shutdown and the economic lockdown and the financial slide that occurred?**

Van Der Weide: Yeah, the 2020 experience was different. It's different in interesting ways. Let me start with just the Fed/Treasury relationship. On the whole I would say also in 2020 the Fed/Treasury relationship has been very good. I would say it's been even tighter than it was in 2008. Part of that is because the Dodd-Frank Act now requires the Treasury to officially formally preapprove any emergency lending facility that we do under 13(3). Another part of the closeness was because we did so many more 13(3) facilities with Treasury in 2020 versus 2008.

The Treasury was a really close, intimate joint venture partner for the Fed in all of our work on the facility design. So, very powerful, very strong relationship between Mnuchin and Powell, between Treasury staff and Fed staff. Lots and lots and lots of calls together, lots and lots of work together and a positive relationship.

But I would say, the main difference 2020 versus 2008 is that the interactions between Congress, on the one hand, and the administration and the Fed, on the other hand, were a lot more positive. The Congress acted.

YPFS: **Which were more positive?**

Van Der Weide: The Fed’s relationship with Congress was quite a bit more positive in 2020. Congress acted quite quickly to provide all sorts of stimulus to the economy. I think that was a very beneficial thing to do. And they were willing to be proactively supportive of the Fed's emergency lending programs. And in the CARES Act that they passed, they gave Treasury a very large sum of money to make investments in Fed emergency lending programs. So, they positively promoted the establishment of our programs.

And just all in all, the relationship with Congress was a lot better. In part, I would say that's because some in Congress blamed the Fed back in 2008 for causing the crisis, either through excessively lax monetary policy or excessively lax bank regulation. No one in 2020 is blaming the Fed for the crisis. I think it's generally recognized that there was an asteroid that struck and no one's really at fault, I'd say. We're all just trying to solve the problem.

But we've also had a more positive relationship with Congress this time because we're not doing any “bailouts” of any individual, imprudent financial firm and we're also not primarily focused on preventing an implosion of Wall

Street. We're providing facilities that are directed at a wider variety of firms and economic actors.

The other interesting contrast is that the Congress was only reluctantly willing to do TARP in 2008. They were very unhappy about it and spent most of the rest of 2008 and 2009 and 2010 being deeply skeptical of what the Fed did back in 2008. That is just not the situation in 2020. Congress affirmatively and by large margins passed all of the stimulus legislation like the CARES Act, et cetera.

But they've also been steadily encouraging us to do more. And it's not only one party. It's Democrats and Republicans. It's not every single member of Congress, but the pretty loud and clear message that we're getting from both houses, both parties in Congress is, "Thank you very much for all you've done. See if you can do more. There are people hurting out there and businesses hurting out there, and see if you can do more facilities and broader facilities." And so quite a different environment in 2020 than 2008.

YPFS: Interesting - to your point about no single institution, I don't know if that's been commented on a lot. So, when you look back now at 2007/8 in that crisis response, and now you have two big (crises). What do you consider to be the main lessons learned from crisis response?

Van Der Weide: There was a clear set of lessons that were learned from the 2008 crisis response. And many of the folks at the Fed in 2020, like myself, were also there in 2008, so we had a direct, first-person recollection of events. But even those at the Fed and Treasury that weren't around in 2008 took some lessons learned from the financial crisis of 2008. And I think that made our response better.

The main lessons we learned were number one, act fast, don't dilly dally. When you see a financial system heading toward the abyss, do something about it rapidly; don't waste time trying to figure out what the perfect solution is. Just start acting to quell the panic. Second and related, you need to act with overwhelming force using your full arsenal of tools.

And we certainly did that in 2020. Already in March we were cutting interest rates to zero, launching very large asset purchase programs, setting up central bank swap lines, beginning the launch of our 13(3) facilities, and starting to issue regulatory flexibility statements. So, overwhelming force is the second lesson learned.

Third lesson learned was: a prime directive in a time of financial instability is that the central bank needs to stop runs and fire sales of assets. That's the thing that can really collapse your economy. So, one of the key functions of our financial system is maturity transformation: banks and other financial entities take short-term deposits and make long-term less-liquid loans.

And in a time of stress, those kinds of entities can face runs, and runs can cause failures of organizations, and they can cause massive fire sales of assets, which can cause asset prices to decline considerably and have strong destabilizing effects. The prime directive of the Fed in that kind of a situation has got to be to prevent the financial system from imploding in a contagious chain reaction of runs.

So, we did this in stages back in 2008, over maybe a six to nine month period between Bear Stearns and the end of the year. But in 2020, we launched all of our "save the short term wholesale funding markets" facilities in a matter of a few weeks as we talked about before. We were able to borrow the templates from our 2008 facilities and make a few changes. But it was quite useful to be able to pull those facilities off the shelf, make a few changes, put them in place, and see similar, rapid healing in those markets as a result.

YPFS: Turning to the reform where you've worked on a lot in the implementation, what was the relationship between crisis response and reform? Did you see, one, 'OK, this is ending, we realize what reforms we're going to do'? How did the crisis experience affect the reform consensus, the reform politics after the crisis?

Van Der Weide: Yeah. On a personal note, I was with the Fed during the 2008 crisis, but I was detailed over to the Obama Treasury department in early 2009 to get to work on the legislative financial reform part of the package. I was one of many detailees from the Fed to the Treasury to help the new Administration figure out where to go on financial reform.

But, in early 2009, I did view the financial crisis as fading. It wasn't quite over yet, but it was about over, and I could see that the next phase of important work was really helping to redesign the financial system architecture in the United States based on lessons learned from the crisis. And so, I, and a few other Fed staffers, moved over to Treasury to help them out on what became the Dodd-Frank Act.

It was interesting. It was an almost entirely different set of people that were working on financial reform versus the ones that were working on crisis response. And there was an entirely new Treasury Department coming on-line in early 2009. A presidential election had occurred, and there was a new president, and he was bringing in all his new people. So, at Treasury, there was a complete overhaul of the personnel.

Even at the Fed, I would say there was not a lot of people like me that worked both on the crisis response and in important ways on the financial reform project. There was a handful of us. But, in general, it's a different set of people that worked on the regulatory and legislative reform versus the crisis response.

The design of the financial reform package definitely drew very importantly from lessons learned from the financial crisis. I will say that the financial reform effort in 2009-10 was directed primarily at removing the causes of the crisis, addressing the causes of the crisis, and making a financial crisis less likely in the future. The effort wasn't addressed as much at the crisis response toolkit.

Tim Geithner, who was the Secretary of the Treasury, did, as part of the financial reform package try to strengthen the government's tools for dealing with a crisis. And he had one major success – a new resolution regime for nonbank financial firms. But I would say his other efforts were unsuccessful.

YPFS: Which was that (crisis-fighting) plank that Secretary Geithner was pushing for (in Dodd-Frank) that you're referring to?

Van Der Weide: A number of things. The signature element was probably: he was a big fan of the TLGP, which was an FDIC program that guaranteed bank and bank holding company debt back in the fall of 2008. Tim wanted to create a clear legal authority that would enable those sorts of guarantees of financial company debts in a time of crisis. And Congress was pretty uninterested in giving the FDIC or any other government agency that ability.

Geithner also tried in the resolution framework for nonbanks, what became Title II of Dodd-Frank, to enable the government to provide substantial open bank assistance to failing large financial institutions. And again, Congress was uninterested in providing that authority.

'No more bailouts, no more bailouts,' was the mantra of just about everybody in Congress. So, those efforts were not successful. In fact, Congress clipped some of the crisis management tools that were in place in 2008. The Fed was prohibited from making loans to individual companies under its 13(3) authority. We were only allowed to do broad facilities going forward.

And the FDIC's ability to provide open bank assistance was written out of the law. So, by the time Dodd-Frank passed, the crisis management tools of the government had actually been constricted in some material ways.

YPFS: It's remarkable the extent of that reform nonetheless. Reviewing Dodd-Frank, the Volcker rule has gotten a lot of attention. But at the high level, you helped write the reform, and later were Deputy Director of Supervision and Regulation at the Fed, before your present position. Could you give a roadmap of Dodd-Frank implementation?

Van Der Weide: Yeah. Happy to do that. I started my career at the Fed in 1998. So, I was at the Fed from 1998 to early 2009. Then I did that temporary detail to the Treasury Department for a little over a year to work on Dodd-Frank. And I came back to the Fed in 2010 into the Supervision division.

After I spent that year at Treasury helping them put together Dodd-Frank, I spent the next eight years of my life back at the Fed designing and implementing all the post-crisis reform rules. It was a decade-long project.

I would say Dodd-Frank has been fairly effective. But, if I had to say, what was the more important set of reforms after the crisis? Was it the Dodd-Frank Act, or was it the stiffening of bank regulation that was done by central banks around the world through the Basel Committee and the Financial Stability Board? I would say it was the latter.

The key lesson learned from the crisis was that we had woefully underregulated the global banking system. And so, all the work that was done at the Basel Committee to significantly increase capital levels for banks and introduce liquidity regulation for banks was really the key set of reforms.

And the Dodd-Frank Act was secondary in its importance. But I do think it was effective. I do think it was a good law. To me, the key bits of the Dodd-Frank Act that were most important from a financial stability perspective were, number one, the new resolution framework for financial companies that was put into Title II.

In addition to banks not having enough capital and having way too much liquidity risk, the other thing we learned—at the top of the lessons learned list— was, we didn't really have a very good failure framework to deal with large financial institutions. We had the bankruptcy code and that works pretty well for most companies, but it really does not work at all for large financial entities. So, when faced with a failure of a Bear Stearns or a Lehman Brothers or an AIG, we did not have a good set of options.

But we now have a new Orderly Liquidation Authority (OLA), Title II of Dodd-Frank. It has not yet been used, but I think at least on paper it looks like it's an effective way to allow the failure of the next Bear Stearns that comes along.

YPFS: **Sometimes things are not used, and then they're considered having had an effect, like the (lack of) take up on certain lending facilities. Is the OLA something you think that's having an effect, or it's just waiting around for a bank to really get in bad shape and doesn't have an effect until that happens?**

Van Der Weide: Yeah, I think it probably has two effects. I think it has an ex-ante effect and an ex post effect. First, there is an ex-ante effect; there's an effect today. The fact that the government now does have a nice way of taking down a failed financial firm without destroying the financial system should reduce the moral hazard and too-big-to-fail subsidies that large financial institutions have.

Many financial market participants were expecting a bailout in 2008 and '09. They should be much less optimistic that they're going to get a bailout on a big scale in 2025 because the OLA is there. The government has a mechanism now

to take a failing firm down, destroy the shareholders and haircut significantly the bond holders and deal with the firm that way.

So, I think it would have that ex-ante effect. And then the ex-post effect. In a time of stress, OLA will be able to provide a mechanism for the government to resolve a failing financial firm with less contagion effects through the financial system. So, I think that's good on both fronts.

YPFS: To your prior note about the primary importance of the bank standards through the Basel Committee, could you go into that more fully, Mark – beginning with just how that works. Basel is off in Switzerland somewhere, right? The international world of banks. Is it binding in US law that banks have to do this? If you could talk about A) how this works practically, and then B) how it affects the system, and has this primary importance.

Van Der Weide: Yeah, happy to. So, the Basel Committee on Banking Supervision is an international committee of central banks and bank regulators. They meet in Basel, Switzerland three or four times a year, and they negotiate and design international bank regulatory standards. The standards are not binding in the United States; they're not binding in any country until that country goes through whatever kind of rulemaking process they have.

In the US, that means, the Fed sits on the committee, the other US banking agencies sit on the committee. When the committee adopts a new standard, we generally will propose it in the US through standard rulemaking procedures, take public comment, and then finalize it.

But the Basel standards are not binding in the US until they go through the American regulatory processes. The Basel Committee adopted a series of different reforms of bank regulation in 2009, 2010 and the succeeding years.

The main achievement of the Committee was a very significant strengthening of capital requirements for global banks. Mark Carney has claimed that the Basel Committee and other regulators increased bank capital requirements to levels 10 times higher than the pre-crisis levels. I think that's an exaggeration. I think maybe we tripled the strength of bank capital requirements versus pre-crisis. But, however you measure it, we effected a very significant strengthening of capital requirements for global banks.

And the Basel Committee also introduced for the first time liquidity requirements for global banks. There really wasn't any kind of liquidity regulation before the 2008 crisis, but now banks are required, to the extent that they have short-term wholesale funding or other runnable liabilities, to hold very liquid assets.

So, that's also made banks tremendously safer, and the combination of much higher capital requirements and decently strict liquidity requirements has left the global banking system and the US banking system a lot stronger.

YPFS: **How many years did this take to be implemented, the rulemaking in the US? When was the bulk of that put into place?**

Van Der Weide: Basel did most of its work quite quickly. It had almost the entire reform kit done by the end of 2010. And it took us many years to implement it in the United States. We had some of the core capital provisions in place by 2013. But we haven't finished yet actually implementing the 2010 Basel reforms. There's one important liquidity standard that we haven't yet finished. So, it's taken us nearly a decade to implement all of those reforms.

YPFS: **One of our other interviewees from the Fed commented that the US has one of the more fragmented financial systems. I think part of Dodd-Frank was to try to deal with that. How would you describe it from the bird's eye view, broad strokes, the architecture of the US financial system in 2017 - after the US had put these reforms into effect, ten years from the crisis, compared to the pre-crisis US financial system?**

Van Der Weide: One way to answer that is to say the architecture six months ago was very similar to the architecture in 2007. The reforms that we made to the financial system, whether they were through Dodd-Frank domestically, or whether through the international negotiations, did not radically reshape the architecture of the global financial system. They were not reforms that were put together by revolutionaries.

Even though the architecture, I would say, did not change in major ways, don't take from that any view that the financial system is the same as it was in 2007. It is much safer in many ways, even though the architecture has not changed in a significant way. One way to think about it is the basic shape of the castle in which we live has not changed, but instead of the walls being one foot thick, the walls are now 10 feet thick. It's now much better able to protect against cannonballs coming in from the outside.

And, to put a little more flavor around it: what you see today versus 10 years ago is, as I said before, that the banking system is much safer. Large banks in particular are much more resilient and much more resolvable if they fail. And they're required to be that way by rules that we have put in place. We see small banks and medium-sized banks that are somewhat more resilient than they were back before the financial crisis. And we see foreign bank operations in the United States that are smaller and much safer.

We no longer have five giant standalone investment banks that are effectively unregulated prudentially. All of those firms have either failed, been absorbed by US commercial banks, or otherwise come under the Fed's supervisory umbrella. We see a securities brokerage industry that is much smaller than it was in 2007 and much less leveraged. We see a set of prime money funds, which were key contributors to the destabilization in 2008, that are still around, but they're a lot smaller as well.

So, I think you do see quite a bit more safety in the financial system, even if the architecture has not changed in a radical way.

YPFS: Okay. Thinking about the regulatory picture and fragmentation, Dodd-Frank changed the layout somewhat and brought the thrifts under the umbrella of the Federal Reserve— would you say that's minor in terms of a regulatory framework change?

Van Der Weide: Yeah, I would say minor. I know that's not the answer that you were expecting, but no, I don't view the Dodd-Frank Act or any of the post-crisis reforms as having a significant impact on the still relatively fragmented nature of oversight of the US financial system. I think this was an opportunity missed. One of the possible responses to the 2008 crisis would have been a significant simplification, streamlining, consolidation of the US financial agencies, but that really did not happen.

One agency was destroyed—the Office of Thrift Supervision—and its functions were effectively rolled into the OCC and the Fed. But, two or three new agencies got created: the Consumer Financial Protection Bureau, the Financial Stability Oversight Council, and the Office of Financial Research. So, net-net, we wound up with more agencies supervising the financial system after the crisis than we had before.

And you're right, certain additional powers were given to all financial agencies to better enable them to be tough regulators and tough enforcement cops on the beat. Maybe the Fed got a little more power and authority than the rest. But all in all, Dodd-Frank focused mostly on the effort to strengthen private sector financial firms and making sure they were more resilient, and not a lot of attention was put on trying to rationalize the agency structure.

I think the US agency structure works. It is remarkably fragmented—that's a good word for it. But I think it still works reasonably well. So, in my view, revamping all of the agency structures in the US was a war of choice after the crisis of '08. It was a war of choice that people decided not to take on because there were more important things to do like making sure bank capital levels got increased and that sort of thing.

YPFS: Given the reforms taken in terms of the Basel Capital Accords and capital strengthening across the system, what specific areas of financial activity, what parts of the framework give you concern for the system today?

Van Der Weide: There are still some things to worry about. I do think the structure of the financial system, the overall regulation of the financial system, is much stronger today than it was a decade ago. But there are some pieces of unfinished business from 2008. And some of the events of 2020 reinforced some of the longstanding views that many of us have had about the residual infirmities in the financial system.

I'll just point to a couple of places. One is while the collective global regulatory and central bank community did a nice job re-regulating the banking system after the 2008 crisis, a lot less work was done on the shadow banking system. Some things were done on the shadow banking system, the non-bank financial intermediation system, but less was done there.

YPFS: **Shadow banking is a term that was in use before the global financial crisis of 07-08, and then it's come back into use. I don't know if it ever left. Wasn't it supposed to be brought into the daylight? What does it mean? Some people reject that term. What does that mean when you say shadow banking at the government level, at the policy level?**

Van Der Weide: A lot of different people have a lot of different definitions of shadow banking. In my mind, shadow banking is credit intermediation, lending, usually accompanied by leverage or maturity transformation and having no government backstop.

The simple way to think about it, although there's intense heterogeneity in the shadow banking system, is that a shadow bank is like a bank in that: it's a significantly leveraged entity, it engages in maturity transformation (so it often borrows short-term and lends long), and it's engaged in credit provision. So that's my basic definition of it.

The term has become a little less popular in recent years. The Financial Stability Board has moved to using the term "non-bank financial intermediation" or "non-bank credit intermediation," rather than shadow banking. But some of us old grizzled veterans still use the phrase "shadow bank."

YPFS: **And the reforms that we've discussed, why have they proven insufficient to cast daylight onto this? What would be needed to bring these into a regulated position?**

Van Der Weide: I should start by saying that some things were done. Some of the most scary bits and pieces of the shadow banking system were addressed in the reforms over the last decade. For example, the accounting rules have been changed, so it's harder for a bank to sponsor a shadow bank off balance sheet when it's providing tremendous amounts of credit support to the vehicle.

We're better now at regulating how banks connect themselves to shadow banks. We've tightened regulation of the derivatives markets, which are important markets in which shadow banks acted in the United States. The new Financial Stability Oversight Council (FSOC) has an ability to designate individual shadow banks that become systemic [as systemically important nonbank financial institutions ("nonbank SIFIs") subject to monitoring by the Federal Reserve]. And there's a lot more disclosure around shadow bank activity and some of the big markets that shadow banks operate in. But shadow banking is still not comprehensively regulated like the banking system is. I think one of the reasons why it's not regulated like the banking system today

is that it's pretty hard to figure out the right set of regulatory frameworks to wrap around the shadow banking system.

And it goes importantly to what I said before: there's just a very significant amount of heterogeneity in the different kinds of vehicles out there that engage in a banking business but don't have a bank charter. And so, trying to figure out how to regulate these very different types of firms is hard to do. And the other important thing is there's just not a lot of tradition of tough regulation of shadow banks, of non-bank financial entities. And so, the inertial low-regulation forces are a little stronger behind some of those vehicles like money market mutual funds.

YPFS: The Volcker rule was cited as pushing certain activities out of regulated spheres, which you've been working to adjust. Is shadow banking something that has grown as an unintended consequence of any of the post-crisis reform?

Van Der Weide: A little bit, I think that's probably right. There has been some amount of movement of financial activity away from the banking system in the wake of all the reforms that were put in place after the crisis in 2008. You see that in a few targeted areas in particular. Mortgage origination, for example, has moved significantly away from the banking system. You've seen a significant decline in the size of the trading books of the big US banks and movements of some of that trading activity into smaller proprietary trading firms, hedge funds, and some other kinds of fund vehicles.

You have seen a little flow of activity from the banking system to the shadow banking system over the last decade in part as a result of the regulatory framework. Net-net, I think that's okay. As a general matter, you do want to make sure that that the core of the financial system, which includes the banking system, is very safe and sound and if that means some of the more risky activities migrate out to other parts of the financial system, net-net, other things equal, that's going to be a good thing.

But you're right to say that the tough bank regulation that we've put in place and the less tough set of reforms we've put in place for the shadow banking system has resulted in some migration of activity to the shadow banking system.

YPFS: Private leveraged loan companies, I guess, would be one shadow banking category. They're under the SEC, they're doing everything you said. Do we have the capability to regulate them appropriately?

Van Der Weide: Leveraged lending is a very good example of migration. Leveraged lending was a business the banks got burned on in 2008. There's been quite a bit of change in that market in the succeeding decade.

And it's definitely led to a smaller role for banks as a lot fewer leveraged loans are being held on bank balance sheets these days and a lot more leveraged

loans are being held on the balance sheets of securitization vehicles, like CLOs – collateralized loan obligations – and loan mutual funds.

In general, leveraged lending is something to keep an eye on. I would say I'm not excessively worried about the trend, in significant part because whatever pieces of these loans banks do hold on their balance sheet, they're having to hold a lot more capital against them today than they did years ago. They're also managing the pipeline and origination risks of those transactions a lot better. And most leveraged loans that are no longer being held by banks are being held by CLOs. And CLOs are generally stably funded vehicles. They don't really engage in maturity transformation, they're not borrowing short and lending long. Because of that more stable funding structure, I don't feel like there's a large amount of financial stability risk in this particular migration of the leveraged loan business from bank balance sheets to CLO balance sheets.

YPFS: **Turning to the COVID response, so much has been done at the Federal Reserve as mentioned, and lessons learned were applied. Still COVID-19 has revealed gaps in US capacities to respond. What lessons are you learning based on your experience on the COVID response about gaps in US capacities to support businesses and individuals in the real economy?**

Van Der Weide: I would say at a high level that the Fed's response to the COVID crisis of 2020 has been good. We learned the lessons of 2008 quite well, lessons we talked about before—the need to act fast, to act with power, to stop the runs, and to be creative in responding to the unfolding events. We've used every tool that we had, and I think we've been quite successful in preventing the financial markets from dislocating.

There were a lot of worries by a lot of commentators after the Dodd-Frank Act passed that the government's crisis management toolkit was not up to task for the next crisis. But, one of my takeaways from the COVID event of 2020, is that at least for this particular financial crisis, the government's toolkit worked quite well.

The Fed's tools worked even though there wasn't a lot of room for interest rate cuts and even though some of our 13(3) powers had been constrained. We were still able to have a tremendously positive impact on restoring financial markets. A fundamental takeaway from the 2020 event is—and maybe it'll be different for a different kind of financial crisis—it's mostly a validation of the strength of the government's toolkit to deal with crises.

Going forward, let me mention one place maybe where our tools have not been as successful. I think our tools were very successful in healing the short-term funding markets, in healing the corporate bond markets, and in healing the municipal securities markets. But we've collectively had less of a positive impact on small and medium-sized business lending.

And there, the story is a little more complicated, but I would not attribute the additional struggles there to the toolkit not being good enough. Congress and the Cares Act did the PPP, the Paycheck Protection Program. That was a very powerful fiscal move for small businesses. But the Fed's facilities weren't able, in a very powerful way, to provide a lot of liquidity support to small and medium sized businesses.

But that's really a task that's just too difficult for a central bank, and we shouldn't have any expectation that a central bank is going to be able to dive in and replace the small business lending infrastructure for an economy or the consumer lending infrastructure for an economy.

I think those sorts of things really require broader fiscal action by Congress. And at least in 2020, in early days, Congress acted pretty vigorously on both of those fronts. We'll see whether they can get together a second stimulus package or another stimulus package here in the fall, but all in all, I think the early government economic response to the COVID event has been pretty good.

YPFS: We really appreciate your coming on here and going a few minutes longer. Let me give you the chance to add any last words. If there's any question I haven't asked or any comment you want to add or reiterate.

Van Der Weide: Let me just make some closing remarks about the path forward from here. The government has now acted quite powerfully two different times in the last 12 years to avert a financial crisis, and a lot of people worry about what the long-term consequences might be of the central bank, of Congress, stepping in and intervening very powerfully in the financial markets to prevent them from collapsing.

This is something that we don't have time to think about in situations like September 2008 or March 2020, but which are very important public policy issues for us all to keep in mind. There certainly are long-term risks of those sorts of interventions from a central banking perspective. Obviously, when we have low interest rates and are doing massive asset purchases, there are certainly risks of asset bubbles in financial markets and potentially inflation. Now, the low interest rates from 2008 to 2020 didn't generate any scary asset bubbles or excessive inflation, in my view, but past is not always prologue. And these are things we need to watch.

On the financial market intervention side, there's definitely a risk of moral hazard. We effectively addressed the moral hazard created by our 2008 interventions through erecting a new tough bank regulatory and resolution framework over the last decade, but as we've talked about, less has been done on shadow banking. And another thing we'll need to carefully attend to going forward is potentially increased moral hazard over time from some of the new facilities we did in 2020, such as the Corporate Credit Facilities and the Municipal Liquidity Facility.

And then the last thing I wanted to flag, is that we also need to be very careful about potential threats to central bank independence as the Fed acts more frequently and in broader ways to avert financial crises. The more that the central bank is relied upon to solve non-traditional problems, the more the central bank is taking risks with taxpayer money, and the more that we're viewed as allocating credit or picking winners and losers, the less independence that Congress and the executive branch will be willing to give the Fed. And independence is critically important to the success of a central bank. So, that's a third thing that I would watch going forward.

YPFS: **That was a really important point. Yeah. Thank you, Mark, for adding those, that's wonderful. It's really valuable to our program to have your time and insights.**

Van Der Weide: All right. Thank you, too.

Van Der Weide, Mark, 2022. "Lessons Learned Interview." Interview by Matt Lieber. Yale Program on Financial Stability Lessons Learned Oral History Project. September 14, 2020. Transcript. https://ypfs.som.yale.edu/library/ypfs-lesson-learned-oral-history-project-interview-mark-van-der-weide

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