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Yale Program on Financial Stability
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By Lynnley Browning

During the Global Financial Crisis of 2007–09, Tim Clark was senior adviser in the Division of Banking Supervision and Regulation at the Board of Governors of the Federal Reserve System. Clark was a chief architect of the Federal Reserve's capital and liquidity stress tests that helped to stabilize the banks. He was also one of the leaders behind the implementation of the Dodd-Frank Act and other reforms at the Federal Reserve, and ultimately served as deputy director of the Division for Supervision and Regulation. This abstract is based on an interview with Clark that occurred on December 13, 2019; the full transcript may be accessed here.

During a crisis, managing the market's beliefs and expectations about government action is very important. Get it wrong, and the private sector will withdraw even further, which can make things much worse.

Before working on the Fed stress test, Clark assisted in the rescue of Fannie Mae and Freddie Mac, the two giant quasi-governmental mortgage entities. The government's actions putting them into conservatorships provided a moment of calm, which unfortunately didn't last—Lehman Brothers failed shortly thereafter.

Clark remembers the moment he learned of that event and that some of his peers were very concerned that "the markets and the public would be concerned that there wasn't enough government support at that point to keep things stable." Yet, Clark said, it was very important to try and maintain the confidence of the markets because the government wanted the markets to participate in the recovery. At the time, this was a very novel idea, but it would be a powerful way to demonstrate confidence in the government's response. "One way to restore broader confidence is to show that there are private investors who have enough confidence that they're willing to put billions of dollars at risk," said Clark. Although the crisis was well underway in September 2008, he said:

> Things were very bad, but there was still a lot of wealth existing in the world. Quite a bit of capital came from outside this country at various points in the crisis, and a lot of the major shareholders and the biggest banks hadn't gone bust—they still had available money. The question was whether they wanted to throw good money after bad if the banks were just going to collapse or get nationalized.

But to make that happen, explained Clark, the government had to chip away at the "confidence deficit."

According to Clark, attacking that confidence deficit was very challenging because of a number of factors. One was that known information was very uncertain; "there was a very wide range of estimates of the size of the losses in the system, an extremely broad range," said Clark:

> I don't remember them exactly, but there were some that were like, "It's a few hundred billion," and there were some that said it could be "as high as two trillion." So, when you have a range of estimated losses by people who are acting with massively less than complete information, and that range stretches from not really being much of a problem to possibly wiping out the entire capital base of the banking system, that puts you in a pretty precarious position, in terms of certainty.

According to Clark, understanding this quandary was crucial to the government's strategy to stabilize the system: It came down to employing more than one tool, and above all, ensuring that its efforts were credible.

In a crisis, the government may not have all the information it needs, and still it will have to craft solutions relying on the incomplete and imperfect information it does have. Do not be afraid to try several different tools; it may take a combination to get the right result.

Because of the many unknowns that were present, Clark said, the government tried multiple tools, hoping that the combination would be effective, which thankfully it was. One of the most effective tools that the government implemented was the Supervisory Capital Assessment Program (SCAP), or stress test for banks, in whose development Clark was deeply involved. He said:

> It was far from a foregone conclusion that it was going to actually inspire confidence, because we at the Federal Reserve were very clear that it had to be a real stress test. So, quite frankly, we didn't know what the outcome was going to be. And if we had tried to predetermine the outcome with a positive happy ending for the banks, that would obviously have massively undermined the credibility. So, we literally, I would say, did not know that that was going to work.

The test did work in part because of the rigor of its terms and partly because of the Treasury's commitment under the Capital Assistance Program (CAP) to provide capital to those banks the tests showed to be in need of capital.

> . . . if it had not been for the Treasury and the Capital Assistance Program (CAP), where they basically said, "We will provide any capital needs the stress test finds using convertible mandatory preferred," then I also think the stress test's credibility would have been massively undermined, because it would have been much harder to just let the chips fall if we didn't know what they were going to fall into. But at least we knew for sure that the worst thing that was going to happen here—and that's not to say it's a good outcome—was that the government would have to pump a bunch of money into the banks. From the supervisory perspective, it was not like we had to go into this as we did, appropriately uncertain at the outcome and also uncertain of what would happen to the banks if we exposed them as being overly weak and the private sector didn't provide capital.

The crisis was in many ways an event of first impression—there was no way to really predict how it would evolve or what would successfully arrest it. In this environment, and given the challenge of limited reliable information, Clark says the government considered and tried a lot of remedies—"a lot of different things that could have been done a lot of different ways"—in hopes of arriving at the right mix of solutions. For example, recalled Clark, the original plan for the Troubled Assets Relief Program was to buy the assets off the banks' balance sheets, which didn't happen. Other responses in the mix included the Public Private Investment Program (PIPP), which according to Clark, "was never very big; I think it was $30 billion at its top peak. But they did set up the PPIP, and then we did the stress test and the push for private capital injections."

According to Clark, the combination of tools eventually produced results that began to turn the situation around:

> There was some reduction in uncertainty that was coming out of the stress test, there was some reduction in uncertainty coming out of the CAP program, being the government's standing behind the banks and not nationalizing them. There was some reduction in uncertainty just as time was going by. While some things were getting worse, not everything was.

According to Clark, these small reductions in uncertainty combined with "some positive activity in the markets and some positive indicators in the economy before the final [stress test] results came out," helped to eat away at the confidence deficit and point to a brighter direction.

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