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Yale Program on Financial Stability Lessons Learned

Mark Van Der Weide

By Matthew A. Lieber

With more than two decades of continuing service at the Federal Reserve Board, Mark Van Der Weide brings a unique insider perspective on central bank policymaking before, during, and after the Global Financial Crisis (GFC), including the Fed's response to the COVID-19 pandemic in 2020. From 1998 to 2009, Van Der Weide served in the Fed's legal division. Detailed to the Treasury Department in 2009, he helped draft the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Back at the Fed in 2010, 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 policies. The Board of Governors appointed him general counsel in 2017. This "Lessons Learned" is based on an interview with Mr. Van Der Weide in September 2020.

Act fast—and with overwhelming force—to stop bank runs and asset fire sales.

Financial leaders at the Federal Reserve and the US Department of the Treasury learned a clear set of lessons from the crisis of 2007–09, according to Van Der Weide. As he put it:

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 third,] 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.

The emphasis on an immediate and forceful crisis response, Van Der Weide indicated, has been internalized equally by both newcomers and the remaining veteran Fed staff who served in 2007–08. He shared that he felt that Fed's response in 2020 to the COVID-19 crisis reflected operationalization of the lessons learned:

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. [...] 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.

By contrast, in 2007–08, the Federal Reserve’s response to the crisis was more drawn out, for several reasons. Market events occurred in at least three waves: with mortgage market tremors in 2007, the failure of Bear Stearns in March 2008, and spiking with the September 2008 respective collapse and near-collapse of Lehman Brothers and AIG, which pushed the financial system to the edge. Along the way, the Fed and the Treasury sought to contain the damage and insulate the broader economy from the mounting financial problems, intervening in commercial paper and repo financing markets, and attempting to resolve failing institutions.

In hindsight, one can see that earlier interventions by the Fed and the Treasury could have reduced the spread and damage of the financial crisis. The novel forms of the challenges called for extraordinary actions that were hard for these institutions to take at all, let alone rapidly and smoothly: to study precedents and craft interventions that would be feasible, efficacious, and legal—and then to line up the pieces and roll them out.

A major difficulty for the Fed was that its supervisory authority did not extend to many of the institutions where the problems were emerging. As Van Der Weide explained:

A lot of the most tumultuous events of the financial crisis of 2008 occurred outside the banking system that [the Fed regulated]—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.

As a result, continued Van Der Weide,

. . . At many 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.

Another challenge Van Der Weide related was addressing markets that the Fed had not traditionally regulated. For example, with commercial paper markets freezing up in October 2008, Fed leaders recognized a clear and present danger to the financial system. They had to respond, but they had a basic legal issue. Section 13(3) of the Federal Reserve Act makes clear that the Fed is to act as a liquidity provider and not a credit risk taker. This constraint had just prevented the Fed from rescuing Lehman Brothers. Van Der Weide described his due diligence to scrutinize the Fed’s emergency legal authorities in Section 13(3) which had not been invoked since the 1930s:

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 pretty quickly as we saw the strains increasing.

The Commercial Paper Funding Facility, which Van Der Weide considers the riskiest of the facilities the Fed did in 2007-08, successfully reintroduced liquidity to commercial paper

markets, using a novel design and narrow eligibility to ensure that the Fed's exposure was adequately secured.

Under-regulated pre-crisis, the banking system is sounder today thanks to updated capital and liquidity standards.

Addressing crisis prevention, Van Der Weide shared a basic takeaway from the 2007–09 crisis: “We had woefully underregulated the global banking system.” Before the GFC, the Fed and other bank regulators in the United States, as well as central banks around the world, had not regulated the banking system as strongly as they should have, he said. This was a contributing factor to the GFC. The crisis revealed some particular vulnerabilities across the banking system, Van Der Weide explained, namely that banks did not have enough capital and that they had too much liquidity risk.

To rectify these flaws, US bank regulators engaged with their global counterparts at the Basel Committee in Switzerland to harmonize domestic reforms. Like many of the world's major economies, and under the Fed's direction, the US implemented the Basel III accord, which significantly strengthened the capital requirements for banks and implemented new liquidity requirements. The Basel reforms have “made banks tremendously safer,” Van Der Weide explained, noting that “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.” According to Van Der Weide, estimating conservatively, “we tripled the strength of bank capital requirements versus pre-crisis.”

Regarding liquidity levels, there previously had been much more limited regulations. Indeed, the 2008 crisis stemmed in large part from banks holding long-term mortgage securities that they funded excessively with short-term liabilities. The Basel Committee's standards require banks reliant on short-term funding to hold very liquid assets on their balance sheets.

Crisis-borne capabilities and greater political support boosted the Fed's 2020 crisis response.

Empowered by new lessons and post-crisis tools, the Fed responded much more rapidly and effectively to the pandemic crisis of March 2020. Van Der Weide considered the COVID-19 response “a validation of the strength of government's toolkit to deal with crises.”

Within weeks, the Fed rolled out emergency lending programs that had taken a year to deploy in the GFC. Among others, updated versions of the Primary Dealer Credit Facility (PDCF), the money market mutual fund facility, and the Commercial Paper Funding Facility (CPFF) kept the short-term funding markets operating.

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.

In addition, the Fed was able to tweak the programs to expand their impact thanks to greater congressional support for the interventions. Van Der Weide noted, “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.” This contrasted greatly with 2008, when according to Van Der Weide, the relationship “was a little more difficult and a little more hostile.”

The Fed’s crisis response in 2020 also saw even tighter coordination with the Treasury Department because the Dodd-Frank Act required Treasury to formally pre-approve any Fed 13(3) emergency lending facility. The Fed also did more facilities with Treasury funding in 2020 than it did in the GFC. The Treasury’s first-loss position supported the Fed’s risk taking on these programs, which enabled them to be broader than they might have been without it. For example, the Fed expanded the CPFF to include a wider set of assets. Overall, the speed and scale of the Fed’s 2020 crisis response, in Van Der Weide’s view “was quite critical to restoring confidence.”

There is more work to be done on the shadow banking system.

While generally emphasizing the increased soundness of the US banking system, Van Der Weide recognized that regulators have done less work on monitoring and reforming the shadow banking system. Its heterogeneity complicates efforts to establish and oversee the sector in a single regulatory framework; there is still much to be done. He noted that, perhaps partially as a result of post-GFC banking reforms, there had been some movement of activity from regulated banks to shadow banks, highlighting the need for greater scrutiny.

Van Der Weide identified three trends in shadow banking activities that the Fed is monitoring:

Mortgage origination 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.

[. . .]

Leveraged lending is something [else] to keep an eye on. It was a business the banks got burned on in 2008 . . . A lot more leveraged loans are being held on the balance sheets of securitization vehicles like CLOs – collateralized loan obligations – and loan mutual funds.

Still, he pointed to some key successes regarding shadow banking—tightening regulation of derivatives markets, authorizing the Financial Stability Oversight Council to designate individual shadow banks that become systemic, and pushing for more disclosure. In addition, Van Der Weide explained that the crisis revealed three particular vulnerabilities across the financial system:

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.

He credits Title II of Dodd-Frank, specifically its Orderly Liquidation Authority, for establishing a process to resolve large nonbank financial institutions. Although the framework has not yet been tested by a systemically important institution's failure, it does give regulators a powerful new tool that they did not have in 2008. Van Der Weide commented: "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."

The Fed's broader crisis-fighting role raises questions for its independence.

Of note during the GFC, the Fed maintained a close alignment with the Treasury Department, which Van Der Weide said was its main liaison to the executive branch. The Fed had several conversations with the Treasury before launching any of its 13(3) facilities. "We always got the Treasury's informal consent," Van Der Weide explained, noting that, "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."

The GFC and COVID-19 crises have seen the Fed deploy its authorities in novel and broader ways, which according to Van Der Weide, presented certain new concerns for Fed independence that should be carefully watched:

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 did not 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.

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.

Dated: June 2022

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