Lessons Learned: Daniela Klingebiel

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Daniela Klingebiel was principal portfolio manager with the World Bank's Pension and Endowment Department, Hedge Funds, during the Global Financial Crisis. Throughout her career, she has written many papers on financial crises, comparing various governments’ attempts to manage them and dissecting what has worked and why. This Lessons Learned summary is based on an interview with Klingebiel held on February 4 and March 3, 2021; the full transcript may be accessed here.

When dealing with a financial crisis, it is very important for the government to signal to the markets what they should expect and to be consistent in its messages.

In March 2008, the United States government had helped coordinate the sale of failing investment bank Bear Stearns to JPMorgan Chase for $2 per share with a $30 billion guarantee of its mortgage-backed securities from the Federal Reserve. According to Klingebiel, this sent a clear and credible message to the markets. By contrast, a few months later, when the government did not prevent the bankruptcy of Lehman Brothers, another failing investment bank, confusion reigned, and this sparked a global contagion.

She elaborated:

During 2008, policymakers in the US further complicated and compounded the crisis by behaving inconsistently and adopting an initial piecemeal approach to solving or mitigating the crisis. (If you look at historical crises, this is what often happens. There often appears to be a period of denial of the extent of the crisis and the hope that the crisis can be contained by small measures.)

So, a downgrade by one of the credit agencies of Bear Stearns’s mortgage-backed securities triggered a run on the bank. After initially saying that they would not intervene, policymakers stepped in with liquidity support and sold the bank to JPMorgan. This “bailout” seemed to suggest to market participants that there is a lender of last resort or a provider of solvency of last resort and that they do not really have to be that concerned . . . .

And then in September of the same year, the regulators and policymakers decided to allow Lehman to fail, suggesting that they simply lacked the right tools and mechanisms to prevent Lehman from going into bankruptcy. . . .

If you looked at positioning, leverage, etc.—at any indicators—there was a lot of leverage in the system and financial products with significant implied leverage.

Allowing Lehman to go bankrupt without providing initial support and guidance on what Lehman’s bankruptcy means for markets and other institutions led to a panic
among market participants, given the importance of Lehman as credit counterparty and globally operating financial institution.

Klingebiel posited (as have many others) that the mixed signals resulting from the way the US government handled Bear Stearns and Lehman Brothers were a disaster. After that failure, said Klingebiel, US authorities became much smarter about addressing the financial crises more comprehensively and signaling to market participants that there was a backstop to the system.

Providing longer-term fiscal support after a crisis may result in more equitable outcomes across injured parties.

Klingebiel asserted that the outcomes of the GFC would have been more equitable if the US government had offered more help to individuals who suffered as a result of the crisis. This could have been achievable by not cutting back fiscal aid early. She noted:

In the end, the government bailed out Wall Street and protected the financial institutions given their critical importance for a functioning economy. But, by not thinking through the support for those whose mortgages were underwater due to the significant fall in house prices, many people not only lost their houses but had to go into bankruptcy and sell their own homes at fire sale prices. From an equity perspective, they could have handled it a bit better.

On fiscal policy, there is enough evidence now that suggests that the Obama administration and Congress should have been much more aggressive on supporting the economy through fiscal measures. They should not have cut back fiscal support so early, especially for those individuals that suffered the most because of the financial crisis. It took very long for the low-income, low-skilled workers to recover their losses.

When creating a crisis response tool kit, seek to achieve a balance between flexible ad hoc processes that can be implemented with speed and dexterity and preestablished bureaucratic processes that are more rigid and seek to maintain fairness.

Strong systems and an absence of corruption lead to a clear understanding of what can be done in a crisis and allow policymakers to move quickly to respond to the crisis. Klingebiel advised that the cleaner the process, the lesser the influence, the cheaper the outcome. She also noted that while some may consider it optimal to design processes that will treat all parties fairly, speed is also important when it comes to crisis resolution.

From my experience, it is important to design a clear and relatively simple process that determines which institutions are allowed to continue to operate and which will be closed. A clear and transparent process which is based on objective valuations is also the best protection against pressure from politicians and influence groups.

Klingebiel also pointed out that effective programs to battle financial crises require strong judicial and regulatory systems. When adopting policies for a specific country, she suggested
thinking through what is available in that country in terms of talent, processes, systems, and the like to understand its needs and constraints while designing processes that are easy to understand and implement.

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