YPFS Lessons Learned Oral History Project: An Interview with Clay Lowery

Clay Lowery

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Introduction:

The Yale Program on Financial Stability (YPFS) contacted Clay Lowery by email to request an interview regarding Lowery’s time as Assistant Secretary for International Affairs at the U.S. Treasury during the Global Financial Crisis. His department was responsible for economic and financial diplomacy, international monetary affairs, debt strategy, global financial services, and U.S. participation at the International Monetary Fund (IMF.)

Lowery also served as the finance deputy to the G20, G7, the IMF, and the Financial Stability Board, which has assumed a key role in the reform of international financial supervision and regulation following the crisis.

Lowery is currently the Executive Vice President at the Institute of International Finance. He was previously at Rock Creek Global Advisors LLC, where he acted as Vice President and Managing Director, advising multinational companies on international financial regulation, sovereign debt, investment policy, and budgetary issues.

Before joining the U.S. Treasury in 1994, Lowery served as Director of International Finance at the National Security Council and as Vice President at the Millennium Challenge Corporation.

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

Transcript


Lowery: A lot of things went wrong. There have been lots of studies over the last 10 or 11 years, some of them academic, some of them from policymakers, some of them from probably journalists and so forth, so I am not sure I can add much to that. In terms of how it became a global crisis, I think I would argue that in some respects it was a global crisis from the beginning. 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.

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 U.S.-based assets, again, mortgage-backed securities, the problems were actually starting within Europe. When people ask when the U.S. financial crisis turned into a global financial crisis, I would argue that it was on day one.

YPFS: **So, from the date that BNP Paribas said [it was stopping the redemptions] it became apparent that the crisis was global?**

Lowery: No, but as the fall of 2007 went on, we clearly saw that there was an obvious problem within the housing financing sector of the United States. The United States housing finance sector, and how it was being financed, had more international implications, and it was not just about U.S. entities. It turned out that it was about lots of entities that were purchasers of these securities. Some of them happened to be financial institutions in Europe, and some of them happened to be in the United States, and some of them happened to be elsewhere. That is what I mean when I say there were some global issues here. It was not just a U.S. problem.

That is point one. Then point two is that it started leading towards 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 U.S. 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.

YPFS: **What weakness were most apparent in the international financial system during the 2007-08 crisis? Do you still see these weaknesses existing? Are we still trying to deal with them, or are they over? Are those weaknesses gone, are we stronger now?**

Lowery: There were a number of weaknesses. I think that a fairly significant weakness in 2007-2008 was in the financial regulatory side and the way financial
institutions did their business. A lot of that has changed over the last 10 years. Partially because financial institutions realized that they had built up some of their own problems and were not doing as good a job on their own governance as they probably should have. Some of that is because the regulators needed to have stronger capital requirements and had to look more carefully at how derivative transactions were being put onto the books of financial institutions.

They also needed to figure out better coordination mechanisms between regulators and supervisors, so that there was a better discussion going on internationally. 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 towards a different type of financial stability problem in the future, one which 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.

So, those problems I think still do exist, and they are going to pop up in a different way than they did in 2007-2008. Obviously, this is something that the official sector is trying to work on, but that does not mean that they have solved it. I am not sure they probably ever will solve it, but it needs to be continuously watched.

YPFS: That is interesting, very interesting. So, we now have new weaknesses…

Lowery: Yes, and I think that it is the type of system you have. Vulnerabilities will always pop up. You try to address them as best as you possibly can. Others might pop up. So, the question is whether or not can you limit those vulnerabilities so that they do not become systemic. Any time anyone says to me, "We have done it, we have solved it," I am very skeptical about it. Not because those people are not smart, or they have not really tried very hard. I just think that it is because you do not know it until you are in the middle of a crisis, and then you do not know whether that crisis spills over or not. Obviously in 2007-2008, it spilled over in a very, very traumatic way, in an extensive way. 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.

YPFS: How was the international cooperation at the time when the crisis happened? Do you think it has improved since then so that we can prevent or remedy the situation faster?
Cooperation during the crisis was very good. There were probably some problems, but I thought that the G7 countries, and beyond the G7 countries, even working with China and the emerging market countries went well. From the official sector side and, as far as I can tell from the supervisor or regulatory side, cooperation seemed to be pretty strong. That is about crisis management. The issue is that whether there is strong crisis prevention.

Was the cooperation before the crisis strong and good? I think the answer is probably yes, except for, of course, most people missed that the crisis was going to happen in the first place. Now, has that improved? I would think the answer is “yes,” but that is because you have different groups out there trying to think through the vulnerabilities in the system. How do I see around a corner? In other words, I can see right down the street, and I can see where some crisis might come from but what about the thing that is on the side street that I have not thought about before?

In 2007, it turns out a significant part of that was subprime housing markets, and the way the system had been built up around that, and this almost fantasy that housing prices will always and continuously go up. That is obviously just one of the things that caused the crisis, but it is an important thing. It turns out that it was not something that everybody was focused on. There were some people obviously, but they were outliers.

How do we look at that now, and do we see a buildup of vulnerabilities based on an activity that looks like it might not be that big of a deal? I think that at least the official sector has done a much better job of trying to think through those problems, so that they see the concerns that could come up. I could be proven wrong very easily, because something might happen that we are not ready for.

YPFS: Can we say that, in general, countries, the G7, the G20, are working together more, cooperating a bit more in financial issues?

Lowery: Well, there is a problem with saying that, only in that it suggests that they were not cooperating back then. I do not think that it is accurate. Let’s break it down a little. There are three major players in the government sector for countries in terms of financial markets. One, are central banks, two, are finance ministries, and three, are market and financial regulators, and the central banks are often the regulators but not always.

If you break that down, central banks back in 2007-2008, and today as far as I can tell, work pretty closely together and try to work with each other. That does not mean they do not have divergences now and then, but they seem to work close together. I would not say that there has been some major, gigantic
improvement on that front, but then again, I would not say that it was a problem in the first place.

I think finance ministries also worked semi-closely together during 2007-2008, and probably are working so today. I do not think that this is as much of a vulnerability, and I did not think it was really the creation of the vulnerability back then.

Then it is really about, “What do you think about regulators and supervisors?” I would think, 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.

Now, one thing I would say is that I do not think it was a lack of cooperation that was the catalyst for what became a giant financial crisis back in 2007-2008. While I think there has been improvements on cooperation and I think it is helpful, I do not know how much of it is done for the safety of the system, mainly because I was not convinced that it was a big problem back in 2007-2008. YPFS: For the record, how were you involved in finding a resolution to the crisis?

Lowery: The U.S. Treasury was involved in almost all aspects of the crisis management. Obviously, the bigger issues during that time were domestically here in the United States, such as the different types of transactional bailouts that were put together: Bear Stearns, Fannie Mae, and Freddie Mac, and then finally, the more aggregated methods such as the Troubled Asset Relief Program (TARP).

Internationally, which is obviously the mandate that was more my responsibility, we were involved in working very carefully on a few different things.

One, bilateral communications coordination with lots of different countries, whether in the official sector or at times in the private sector, but mainly the official sector. Everything from the more famous stories of [Treasury Secretary] Hank Paulson dealing with China, to the smaller things like having conversations with the central banks in Japan or South Korea or other countries who held a lot of Fannie Mae and Freddie Mac debt. We had to make sure that they understood how we were creating a system to protect that debt
when Fannie and Freddie essentially had to be taken over by the U.S. government.

Secondly, we worked on the coordination among the G7/G20 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: 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.

Then three, was working with the international financial institutions, of which we usually think of the International Monetary Fund (IMF,) though you can also think about the World Bank and some others. In the fall of 2008, the IMF actually did a series of financial lending to countries, particularly in Eastern Europe, that had humongous financial difficulties, although nobody really talks about that. This IMF lending actually was bigger and greater than what had been done in 1997 during the Asian financial crisis, when the IMF had stepped up in a major way and everybody, including Time Magazine, which had “the committee to save the world” on its front cover, and talked about all the IMF bailouts and so forth. In 2008, the IMF actually did more [than what it did in 1997,] but it didn’t grab those type of headlines because, of course, we were busy fighting lots of other issues. The U.S. Treasury was involved in all aspects of these efforts.

YPFS: You were doing this at a time that some country heads were claiming this was basically an American crisis. If I am not mistaken, there was a person calling it “an American cancer.” Was it difficult to actually go to the G7 and G20, and tell them, "No, it is everyone's doing”? How was that experience?

Lowery: I think the person that probably made that statement most famous was the Chancellor of the Exchequer of the United Kingdom, who was quoted as saying when they were trying to see whether or not Barclays could buy Lehman Brothers--"We don’t want you, the United States, to export this American cancer to our shores." I think it was something along those lines.

I sat in a lot of international meetings, G7, G20, lots of different types of meetings, bilateral meetings with countries that are in the emerging markets, developing markets and so forth. There was some feeling that this was only a U.S. problem.

Our view was two-fold: (i) “we recognize that the problem emanated from the U.S.” and (ii) "No, it is not solely a U.S. problem. It is a bigger problem than that and you need to know about this." We were clearly right on the second point, unfortunately. I wish that we had not been right, but we were.
So, there were sometimes discussion around, "This is not just a U.S. problem". But most of the time it was not a problematic conversation. It was not along the lines of: "Oh, it is your cancer, and just stay away from me." It was more like, "Okay, you guys have cancer, but you are also the biggest player in the world. So, what do we do about it? What are you doing about it?" It was a very open conversation, of which many of the countries, I think, were very appreciative. And not just appreciative of the hard work and the efforts of U.S. officials, but the fact that we were very willing to discuss it and explain exactly what we were trying to do.

By the way, that does not mean we got it all right. We certainly did not. At least, we were not trying to hide the ball, so to speak. We were trying to make sure we explained our strategy so that these international players could have confidence in what the United States was trying to do to save, not just our system, but potentially save our global system.

Yes, there were comments. Look, we could not have had a better relationship than with the U.K. The comment about the American cancer was made not as a joke or as a slap at the United States. It was much more along the lines of: “I am concerned because a big financial institution in my country could catch some of the problems or could inherit some of the problems that are happening in your country.”

They had their own set of problems. So, I did not see it as a negative. Now, were there people that were trying to be negative and say, "The United States does not know what it is doing. The capitalist system is corrupt," et cetera. I am sure there were people like that, but I did not hear that in the main conversations.

In terms of “How was it?”, it was a lot of hard work, but I do not remember ever thinking. "Boy, I cannot stand those guys because they think that we are the problem."

YPFS: Now, looking back 10 years later, do you feel that there could have been a difference in the U.S. response that would have made things easier or resolved the crisis quicker?

Lowery: I am sure that there are, but it is hard for me to say. People have written books on this and I am not one of those people. I thought that we had a lot of people working really hard that tried to do the best they could under extraordinarily difficult circumstances. Led by, whether it was [Treasury Secretary] Hank Paulson or [Chairman of the Board of Governors] Ben Bernanke at the Federal Reserve or Tim Geithner at the New York Federal Reserve Bank [Chief Executive Officer and President] and eventually at the Treasury [as Treasury Secretary]. And not just them but some of the political leaders as well: both President Bush and President Obama, as well as the congressional leaders in the United States, and that is just in the United States.
All of these people were working really hard and trying to do the best they could. Sometimes solutions worked, and sometimes they did not. Were there better ways of doing things? Probably, but it was an extraordinary time, as well as extraordinary events that were not necessarily that predictable. There are those who did predict it and made money on it. We all saw the movie *The Big Short*, but they were the outliers within the financial markets, and it turned out they were right. That does not mean there were not a lot of people out there who are extremely smart and just as smart as they are, and have made just as much money, that got it wrong.

**YPFS:** Now that we know the results, are there things that you would have done differently? I guess it would not have made so much of a difference, and we do not know how it will have turned out unless we tried that way?

**Lowery:** Right, that is the problem. Everybody can say they have a solution set. One, you had to do it in real time, as opposed to three years later, five years later, 10 years later. You are still not sure whether it would have worked. It could have failed for a reason that you had not even thought of. For all of the actions that take place, there are counter reactions and there are consequences. Some of them are intended, a lot of them are unintended. Do not get me wrong: I think that people should study this problem, I think that people should come up with different solution sets, and I also think that those same folks need to be very open to the idea that they may be wrong, too.

**YPFS:** What was the biggest surprise for you in how the global markets were affected, and how they reacted in 2007 to 2010? And later as well?

**Lowery:** The biggest surprise? 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. 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.

I guess the lengths that were involved were sometimes surprising to me. The thing that I have always thought about from back then, and still do today, is: You never know. For instance, I don’t know how many times I’ve read or even written "Markets think this," or "Markets think that..." Frankly, I really do not know what the markets are saying. There is no such thing as “markets.” Markets are basically a lot of inter-linkages that are hard to understand in their entirety.
It was interesting to me to find out that a number of very smart people from very important overseeing bodies did not really understand what was happening in different parts of the market. In that respect, that is not surprising to me, because I always expected it. However, when you break it down into the individual parts, like the monoline link I just mentioned, that is when I started getting surprised. I thought, "Boy, I did not even know that was important." The macro side did not surprise me, but on the micro side, I am very surprised. It was some of the micro linkages that surprised me the most.