A Conversation about Key Conclusions

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What are the main conclusions and policy recommendations that emerge from this book? During the final session of the conference at which the chapters were presented, we discussed this question.

GPS: So, John, what would you say is the main conclusion from all this interesting analysis and discussion?

JBT: I am struck that so many issues raised here are not being addressed in the financial reform legislation now being considered by Congress. To put it bluntly, the legislation does not deal with the underlying causes of the financial crisis. So my top recommendation, based on what we learned here, would be for the Congress to return to the strategy it set out when it established the Financial Crisis Inquiry Commission (FCIC). Let the FCIC complete its congressional mandate to investigate the causes of the financial crisis, explain the causes clearly to the American people, and then, only then, pass a reform plan designed to address these
causes. Nick Brady put it well: “You can’t fix what you can’t explain”; as did Kimberly Summe: “Let us hope that our policy makers choose not to legislate based on the caprice of public sentiment” but rather based on a sound assessment of the problem. I know that some say the crisis was too complex to explain in simple understandable terms, but the short background essay distributed by Ken Scott (which is the appendix to this book) suggests otherwise. What would be your main takeaway, George?

GPS: I am more convinced than ever that we have to define and measure systemic risk operationally if we are going to make any progress. Without an operational definition the bailout mentality will continue. I said this at the opening of the conference, and your essay and Monika Piazzesi’s discussion of it confirmed this. I heard no one disagree. It’s clear that we do not have a workable definition yet, despite much discussion and research over the past year. As Paul Volcker says, it is “a fuzzy concept.” There is even disagreement about whether systemic risk in the recent crisis was due to government or the private sector. Defining and measuring systemic risk is a very big project and will require a concentrated effort by economists, lawyers, and financial market participants using data on loans and counterparty relationships and experience. That should be the priority now.

JBT: I agree, and my next point follows directly. Once systemic risk has been defined and measured clearly enough that it can be applied to a particular situation or firm, we should develop a framework to deal with the systemic risk in ways other than bailout. The framework should be highly credible, accountable, and transparent. The goal of the
framework would be to determine whether a failing firm creates a systemic risk and, if so, what can be done about it. The framework would include the “preparation” proposal stressed by Gary Stern in his commentary. After a decision is made about how to deal with the situation, a detailed report should be published and released publicly. The report would explain why the decision was made, what alternatives to bailout were considered, and why they would or would not work. Such a framework will help government officials avoid the bailout.

GPS: I think the essays and the discussions represent substantial progress on finding a credible alternative to bailouts. The hours of work and frequent Saturday meetings of Ken Scott’s Resolution Project have really paid off. Tom Jackson’s Chapter 11F bankruptcy proposal shows us how to deal with many of the criticisms that skeptics had made about the slowness of bankruptcy or about the lack of financial expertise in the bankruptcy courts. In addition, Darrell Duffie explained how new types of contingent convertible debt and mandatory rights offerings can be deployed without “relying on the backstop of a government bailout.” Peter Wallison and David Skeel were in agreement with Tom on bankruptcy, as were most who commented from the floor. So I say let's write Chapter 11F into the law so that we have a credible alternative to bailouts in practice. We can then be ready to use a rules-based bankruptcy process to allow financial firms to fail without causing financial disruption.

JBT: A recurring message here is that government should do no harm. This is the message of Paul Volcker
when he warns that “zero interest rates may be necessary at the moment, but they themselves lead to some dangerous possibilities in terms of breeding more speculative excesses.” The reason that Tom Hoenig, Chuck Morris, and Ken Spong place so much emphasis on rules-based process in their Kansas City resolution plan is that they want to limit discretion and avoid the harm that can come from government interventions. As Bill Kroener has stressed, any new resolution process must prevent government agencies from interventions that could cause further panic. Let us not forget also that the sequence of events in the fall of 2008 suggests that government statements and interventions may well cause or exacerbate panics. My conclusion from all this is that we recognize that government actions can cause panics, and set a high priority on preventing such action in financial reform legislation.

**GPS:** Paul Volcker and Nick Brady argued strongly that we constrain financial institutions that have access to Federal Reserve loans and federal guarantees more than other financial service organizations. I agree. To be clear, we should not prevent innovative financial products, but neither should we allow financial structures to put taxpayer funds at risk because of such products. Separating proprietary trading from banking is one means of prevention, and this does not mean going back to Glass-Steagall and taking underwriting out of banks. Other financial institutions can establish separate “mutual funds” if they want to engage in such activity, and make clear that the funds are not guaranteed by the parent organization. As Nick Brady told us, “Safety and soundness is a categorical imperative.
If we don’t start there, we’ll find ourselves back in the same situation.”

**JBT:** Various people mentioned how we need to improve regulation. We heard that regulators and supervisors can’t keep up with rapid financial innovation or that they need more access to data. Dick Herring explained the complexity that arises in the international context as different countries have different regulations, which causes firms to change their behavior in ways that increase risk. Joe Grundfest points to the ways that government agencies can change laws and regulations retroactively, and how skilled lawyers can assist in creating this unpredictability. Conflicts of interest may also arise as people move in and out of government. In my view, the most important lesson is that we should make regulations simpler and easier to administer. A regulatory system cannot be based on complicated formulas. International cooperation is essential for reducing complexity, as Dick Herring has shown, and can be encouraged through the sharing of wind-down plans for firms operating across national regulatory agencies. As Nick Brady tells us, “Either the investment bankers will outwit the regulators, or the regulators will overreact.”

**GPS:** Remember that markets work.

There is a narrative about the financial crisis that states the problem was a failure of the market system. That narrative is wrong. A long period of easy money led to excessive risk taking, and government pressure to make questionable loans triggered a housing bubble.

Yes, many financial institutions went wild, so let’s fix the problem of financial institutions and hope that government
will behave better in the future. Government should set the rules of the game, implement them credibly, and then get out of the way. The rules should be clearly stated and stable over time so that people understand them and make decisions based on them. Then we can let markets work.

**JBT**: Well, that’s a good note to end on. So we have eight main concluding recommendations:

- Let the Financial Crisis Inquiry Commission complete its congressional mandate to investigate the causes of the financial crisis, explain the causes clearly to the American people, and then, only then, pass a reform plan.
- Define and measure systemic risk operationally.
- Develop a framework to deal with the systemic risk in ways other than bailout.
- Write Chapter 11F into the law so that we have a credible alternative to bailouts in practice.
- Recognize that government actions can cause panics, and set a high priority on preventing such actions in financial reform legislation.
- Constrain financial institutions that have access to Federal Reserve loans and federal guarantees more than other financial service organizations.
- Make regulations simpler and easier to administer.
- Remember that markets work.