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QUESTIONING THE LEGALITY AND LEGITIMACY OF RESPONSES TO THE 2008 FINANCIAL CRISIS

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P R O C E E D I N G S

MR. WESSEL: Simon Johnson will be here in a moment, but I'm just going to start with the preliminaries, since he's already heard them. I'm David Wessel. I'm director of the Hutchins Center on Fiscal and Monetary Policy here at Brookings, and we welcome you all.

We're here to get really, a preview and a discussion of a new book my colleague, Phil Wallach from Government Studies. It's called *Legality, Legitimacy, and the Responses to the 2008 Financial Crisis: To the Edge*, a quote from Paul Volker, who very early on in the government's response to the financial crisis, around the time of Bear Stearns, said that the fed had judged itself necessary to take actions that extend to the very edge of its lawful and implied powers.

And it's an important topic. What Phil has done is talk about the questions of legality, but the more interesting and harder to define questions of legitimacy that may help us understand why something which, in retrospect, looks reasonably successful, has turned out to be so controversial.

Phil is going to talk for a minutes about his book, and then, we're going to have responses from Simon Johnson, who is the Ronald A. Kurtz professor of entrepreneurship at the MIT Sloan School and a senior fellow at the Peterson Institute, across the street, and Andy Levin, who was for a long time, a staffer at the Federal Reserve, an advisor to Ben Bernanke and Janet Yellen, is now at the IMF and will soon be a professor at Dartmouth. And he speaks neither for the IMF, nor for the Fed, and probably not for Dartmouth, so we want to liberate him to say what he really thinks.

And then after that, we'll have time for some questions from you and some discussion up here. So Phil, why don't you take it away?

MR. WALLACH: All right. Thanks, David, and thanks to all of the

Brookings staff who helped me with the book and to set up today's event. I am truly humbled to have such a distinguished panel here, and such a great audience, as well.

I wrote this book, because like many others, I got hooked on following the developments of the financial crisis beginning in 2008, first just reading the news, then one blog, three blogs, 10 blogs, then the slew of books that came out over the years, including David's class, *In Fed We Trust.*

So, we now had many dozens of books focusing on the questions of how and why the financial crisis happened in the first place; your standard old fashioned seven fat cows, seven skinny cows kind of thing. Fair enough. Those matters are clearly of paramount importance.

But none of these directly focused on what concerned me the most, which was that it seemed like our processes of government were being short-circuited, that we were improvising rescues for private corporations without proper respect for the rule of law. And so here we are. I wrote this book.

And for what it's worth in researching and writing the book, my own sense of outrage somewhat subsided. Studying historical responses to other crises, both financial and military and U.S. history lessened my sense that what happened in 2008 was truly unprecedented, and it made me realize that some of the legal rationales offered were less implausible than they seemed on first impression.

Our legislature passed a number of really large, expansive, empowering enabling acts, most famously, TARP, which gave vast discretionary power to the Treasury Department and also, to the fed and FDIC Other Acts. And those government actors aggressively made use of that aggressive. But that sort of fits the standard picture for 20th century American government crisis response.

So, it's fair to say that I've somewhat lowered my expectations for what

the rule of law will actually mean in practice in the heart of a crisis. But that doesn't mean that there's nothing to see here. Indeed, I hope there's a lot to see here, and you should read the book to see it all. I can't really cover the whole field, because there's dozens and dozens of actions and decisions that warrant close investigation that I give in the book.

Even on close inspection, many of the actions taken by the government were truly audacious, as Paul Volker said, right up to the edge of their legal authority, and sometimes, arguably over it. Regular process was displaced by what I call adhocracy. Even if that is a somewhat predictable occurrence in crises, it lasted a remarkably long time in the wake of this crisis, and at least in some cases, it sort of stretches all the way into the present day.

And it isn't clear that following the playbook of adhocracy really was capable of a creating a sense of legitimacy that the public would accept, given our current distrustful political environment. So as David said, we've had a number of crisis responses that look better than most people expected them to, in retrospect, but nevertheless, an enduring sense of distrust and diminished government legitimacy. We continue to have polls seeing the government at historic nadirs of trust from the citizens, and I think that financial crisis responses have a lot to do with that.

So, what struck me as I wrote this book was a disconnect between legality and legitimacy, so to oversimplify a little bit, the actions that were most legally outlandish inspired very little public outrage, and where public outrage was the strongest, the government could justly claim that it was merely following the low and had no other viable options. So, legality is neither necessary or sufficient to achieve legitimacy.

One of the book's central ambitions is to figure out how legality and legitimacy are linked to each other in a crisis, and what we can reasonably expect from

the law in helping to ensure crisis responses are accepted as legitimate, and what we can do apart from the law to think about how to produce legitimacy. So, rather than trying to work through any of the book's more abstract answers to those questions, in my remarks here, I just want to turn to a few key, concrete examples and briefly turn to the question of what I see as lessons for the future.

So, the first one I'd like to discuss is the Treasury Department's rescue of the money market mutual funds in the middle of September, 2008. So, money markets were $3.5 trillion in assets, a key source of funding for commercial paper markets, and therefore, sort of the life blood of funding in corporate America. And they looked like they could be the next domino to fall in the middle of September, 2008.

Famously, the single oldest money market fund held enough Lehman Brothers debt that it broke the buck. The shares in its fund fell below a dollar. What looked like a risk-free asset before, suddenly looked like a distinctly risky asset now, and we had a 21st century bank run in motion. So, that would have been quite disastrous, and our government officials, understandably, decided that they needed to take action to stop that from developing.

So, Hank Paulson's treasury department was up to that task. They found the $50 billion Exchange Stabilization Fund, which is an obscure pot of money with hard to discern purposes in the modern world, and they said the best thing about this is that we can use this money without going to Congress. We can get it done much faster because of that.

So, they took that money and used it to guarantee the money market funds. The best you can say about the legal explanation that they provided for that is that it was a fig leaf. You could say, well, really important things are going to happen to the U.S. economy if the money markets fail, and that will affect international exchange rates,

therefore, the Exchange Stabilization Fund is an appropriate instrument to use.

You can't really make that argument with a straight face, but you could at least sort of put it out there. The real argument was, we need to do something really badly, right now, and this is going to make a huge difference. And sure enough, it did. They announced the program right away, as soon as they saw the money markets were in trouble.

That calmed people's fears considerably. They stood up the program just a couple of weeks later, and for the medium term, in fact, got firms that enrolled in it to pay insurance fees so that they actually brought some money into the fund, and they never paid out a cent, because they had stopped the bank run, effectively. They managed to keep money markets from going further into crisis.

So, this episode gets a lot less attention than many of the rescues that you can attach proper nouns to; the Bear Stearns, the AIG. It didn't make the cut for inclusion into HBO's version of the crisis, for instance (Laughter). It certainly didn't generate much in the way of widespread outrage, in spite of its very poor legal justification. So, the lesson is, nothing succeeds like success.

Where the government pulls off some trick that helps many people without incurring significant costs for the taxpayer, there's not going to be a backlash, period, whatever the law says. Similar versions of this story, although less extreme, can be told in relation to the Federal Reserve's commercial paper funding facility, or the FDIC's Temporary Liquidity Guarantee Program, both of which look fairly successful, and in spite of their legal difficulties, really didn't generate too much in the way of heated political controversy.

Now, let's turn to the converse case, where law does prove decisive, but the result is a government decision regarded as illegitimate. The best example comes

from March, 2009, what most people seem to regard as the peak of crisis outrage, which attached to the paying out of hundreds of millions of dollars in retention bonuses at AIG, which was in many ways, an epicenter of the financial crisis.

It's not at all hard to understand why people found that so intolerable. Here were a bunch of people high on the list of people who seem to have made the financial crisis as bad as it was. By that point, their firm had gotten something like $180 billion of aid from the federal government, and here we were passing money through and out the door to pay retention bonuses, so that we should show our gratitude to the employees who were staying in their jobs that the federal government had helped to save.

Surely, that can't be right. People, naturally, feel outraged, even more so because Congress seemed to be on the case. They seemed to know that executive compensation was a hot issue for people, and they had taken actions to restrict the payment of bonuses from TARP recipients in the February, 2009 Stimulus Act.

But there was an exception for bonuses already legally obligated before the act was passed. That was probably necessary to comply with the contract laws of the United States Constitution, and the AIG bonuses fell into that category, so they were legally obligatory.

There was lots of rending of garments at that point. President Obama took to the airwaves to say that people were right to be angry, and hinted that some kind of remedy would be in the works. The House of Representatives actively considered a bill titled End Greed Act, and actually passed a 90 percent confiscatory tax on bonuses for firms that more or less fit the description of AIG.

There were a lot of rather dark threats about what would happen to bonus recipients, law or not, and many of them gave their bonuses back as a result of

that. But perhaps, predictably, since there was nothing legal to be done, nothing legal was done in the end, which people, nevertheless, found outrageous.

People's instinct was to say that justice ought to have been done, legality be damned. What good was it to be a de facto nationalizer of failing firms if a bunch of legal impediments kept you from stopping them from doing outrageous things? So, you see a similar kind of tension in many of the government's most protracted involvements during the crisis.

We have the sense under the rule of law that government should be acting in some kind of neutral, non-arbitrary way by conforming to the law. It should keep its hands clean in that way. But at the same time, people want the government to get its hands dirty, both in heading off the crisis and in helping the interest groups that they think are worthy. The result is a government that tries to have things both ways, saying that it is doing as the law says, even as it starts to use its crisis response powers to serve favored interests.

I tell that story in the book as it relates to the Chrysler bankruptcy, and also, in the context of the treatment of shareholders of AIG and Fannie Mae and Freddie Mac. People have strongly conflicting opinions about who should be helped and who's ox should be gored, and naturally, when decisions were finally made, they made many people unhappy.

Some of the decisions that were made are truly hard to understand as being either legal or necessary in terms of fighting the crisis, such as the third amendment for Fannie Mae and Freddie Mac, made all the way in 2012. At the same time, Fannie Mae and Freddie Mac shareholders are not exactly the most sympathetic interest group. We don't exactly see much of political Washington lamenting the damages to them.

So, I want to conclude with just a few thoughts about what the government should think about going forward, as it tries to produce legitimacy in future crises. So, the book has a number of suggestions about ways to produce legitimacy from simply investing more resources in that purpose during the crisis, which -- and relying on the GAO. Simple, straightforward things of that nature.

It also suggests that institutions like the fed need to more forthrightly engage with their critics at many points; that they had missed a lot of opportunities to educate the public about the rationales for their decision by acting as if they didn't really need to respond to criticism. I then also have a complementary pair of suggestions that tries to reckon with the potential of the law to constructively shape crisis responses and the limitations of the law.

So first off, when Congress really knows what it doesn't want to happen, it can effectively enact statutory prescriptions that say so. Oftentimes, those are invisible in larger political debates because they're so effective. So, one of the examples I give in the book is the anti-deficiency act, which says that the treasury cannot spend money that has not been appropriated, or cannot commit money that has not been appropriated.

That forms part of the legal landscape that was never seriously questioned, even in the darkest hours of the crisis. The reason that the treasury had to go and tap the Exchange Stabilization Fund in the legally dubious way that I discussed before, is that it was committed to the proposition that it couldn't simply take taxpayer money and put it out in the world without any kind of legal backing.

When Congress speaks clearly enough about what it does not want to happen, it really can set boundaries. Now, we have to be careful, because we don't want constraint for its own sake. There are good reasons to want our crisis responders to have quite a lot of flexibility, and Congress needs to act carefully in saying exactly what

shouldn't happen.

At the same time, Congress should be more honest about its own inability to direct a crisis response, especially in the early and fast moving stages. So, the suggestion I make at the end of the book, meant to spark some discussion, is that basically, we should have a financial crisis slush fund. Now, slush funds have a bad name. We think of them as pots of money that allow officials to do somewhat nefarious things in the dark of night.

But slush funds don't have to be that way. By slush fund, I just mean something that has very little in the way of limitations in how it can be used, and my idea is that we should essentially have a form of targeted national savings. We should put aside $50 billion or $100 billion into this pot of money, and then allow the treasury secretary, probably in concert with the president, to say we have a way of using this money to stop a financial crisis in its early stages. That would more than repay itself in terms of our fiscal situation going forward. That money should be available.

Now, it shouldn't be an unaccountable slush fund. As soon as the money gets used, it should trigger all sorts of accountability and reporting requirements. Congress should know exactly what's happening with the money, and be given, perhaps, a chance to fast track some kind of resolution that would stop the money from being paid out.

And ultimately, it should be time limited and with a very hard cap on how much money should go out. Perhaps with some additional provisions to make sure that it isn't leveraged in any kind of way. But if we had this pot of money, we would sort of limit the executives' truly discretionary actions to this -- we would cabinet it off within this area, and it would be less likely that the treasury would need to come up with legally dubious interpretations of its other powers.

We have clear limits to when law does apply and when it doesn't, and that allows us to better shape our responses to the financial crisis in a way that is understandable to the American people and accepted by them as legitimate. So, I'll leave it at that and look forward to the discussion.

MR. WESSEL: Thank you. We're going to turn to Simon now. Let me just say that there are some seats down in the front here, and if you want to come sit down, feel free to come down. I promise not to call on you (Laughter) unless you raise your hand.

Since Phil was kind of enough to plug my book, I want to return the favor for Simon, who has done a couple -- at least two books; at least only two I've read. One is called *13 / The Wall Street Takeover and the Next Financial Meltdown,* which came out very early in the crisis and talked about Simon's views on how well we did or didn't do in getting the banks to be reformed after the crisis. And then, a very good book on fiscal policy, *White House Burning: The Founding Fathers, Our National Debt, and Why it Matters to You.* So, with that introduction, Simon.

MR. JOHNSON: Thanks very much, David, for those kind words. Thanks to Phil for the invitation, and thanks for writing such a really interesting book. It is a topic that has been worked over by a few people, it's true, but I think that the book adds a lot of interesting dimensions, and I highly recommend it to everyone.

Now, Philip asked us by way of response to be forward looking, and I think taking up this issue of legitimacy, all of our system of our crisis response apparatus and thinking about what could happen next, I think that's a very fair question. It's certainly one that I got a lot of ideas about from reading the book.

And I'd like to talk about three dimensions of that. The New York Fed, Congress and then, I'll come back to the Board of Governors of the Federal Reserve

System. Now, any crisis, and I've lived and worked through about a dozen -- any crisis, I think, has one basic feature, which is there are some concerns about solvency; you don't know who suffered what kinds of losses.

That becomes concerns about liquidity. Perhaps, I should withdraw my money from this bank or that money market fund, and that can become self-fulfilling and spread. And crises -- not at all to belittle them -- they are immense and traumatic events -- but crises end when the government decides who is going to be supported and on what basis, who is going to actually suffer the losses on their equity or on their credit, and who is going to be protected more completely.

The nature of the guarantee. And the nature of that guarantee is absolutely about the political legitimacy of the people making that decision. Can they make that decision stick? Can they actually implement it? And that's something that you'll see blow by blow very nicely laid out the last time around in Philip's book.

But I think there are three things we have to worry about going forward, and the first and absolute foremost is the New York Fed. What is the Federal Reserve in the United States? Well, we talk about it as the central bank, our central bank, but actually, it's a bit more complicated. It's a strange hybrid left over from political compromise of the Federal Reserve Act in 1913, which includes a set of people working in Washington who I want to come back to later, the Board of Governors, who are, I think for all intents and purposes, a form of government agency, along with 12 regional feds that are actually not government agencies, and the presidents of those feds are not appointed by the president of the United States, and they're not confirmed by the U.S. Senate.

Now, we can talk for a long time about the details of this system. The piece that really, I think, has come through and bothered many people, and continues to

bother people on the left and on the right, including on Capitol Hill now is the New York Fed. The president of the New York Fed is a very powerful person. This person is the vice chair of the Federal Open Market Committee, perhaps the second or third most important economic decision maker in the country, and somebody who historically prior to Dodd-Frank, was appointed by the board of the New York Fed in a board structure, where the bankers, the member banks directly and through people they appointed indirectly, had a majority of the votes.

So, the banks would choose the president of the New York Fed. Now, it's a little bit more complicated after Dodd-Frank, and we could talk about that, if you want. But a lot of questions have been raised about the New York Fed, because I think it's precisely in this central role in the problem, as Philip lays it out, which is, as I said, some people are insolvent, and some people have a liquidity problem. But how do you know which is which? How do you make sense of all this very complex data coming at you? How do you decide where to put the guarantee and who should be let go?

Now again, the Federal Reserve system has changed since the crisis, and in part, because of Dodd-Frank. So, it's not exactly the same situation as it was before, but the New York Fed still has an enormous amount of power, perhaps we call it soft power. I think that's the term you used in the book; influential power.

And the largest banks, the largest bank holding companies and the largest non-banks in the United States have long held positions of influence relative to decision-making and sense making at the New York Fed. It is absolutely incredible that when the Federal Reserve System with the New York Fed in point position, provided financial assistance to JPMorgan Chase to buy Bear Stearns in early 2008.

The head CEO of JPMorgan Chase, Jamie Diamond, who was on the board of the New York Fed, did not resign from that position. Now, we can talk for a long

time about why he did and didn't resign, and believe me, I've been through these arguments, including with lawyers at the Federal Reserve.

But can you name any other place or organization in American society where someone would remain in a position of such apparent, apparent conflict of interest? I don't know anyone in the private sector, in the non-profit sector, in a university, in a company who would remain on the board of directors in that setting.

If you ask the New York -- the New York Fed is not a government agency. The New York Fed is not subject to the Freedom of Information Act. The Federal Reserve doesn't like the Freedom of Information Act and will fight you, if you want information -- and Philip's got a nice case about that, their fight with Bloomberg, which I agree with him, that they made many mistakes, at least from a public relations point of view.

But the New York Fed -- if you ask the New York Fed for access to their archives with regard to any of the issues that are front and center going forward; relationship with the big banks, how do they make sense of a crisis; how do they -- it's a fascinating speech given by Mr. Baxter, who was general counsel of the New York Fed in early 2009, talking about why they went into help Bear Stearns.

And he has paragraphs, you know, this is his language -- and I'm quoting, "Bear was ranked number one in private label mortgage-backed security securitization. Bear was also a major derivatives dealer. And of course, Bear was also a major source of inter-connectedness with other market participants."

Where is the list? The list of banks or non-banks or anything else that would get that level of support? Do they have written down criteria, or are they just making this up on the fly? If you want access to anything, anything to do with -- not just this crisis, anything historical that the New York Fed has done, the answer is, they will

not, generally speaking, open their archives to you after 1960. Nothing after 1960.

Now, imagine if we tried to make monetary policy on that basis, with that level of secrecy and non-disclosure. The legitimacy of monetary policy, I think we would agree, would be heavily compromised, and you wouldn't even consider proposing it these days, but that's what the New York Fed does today.

Congress. Now, Congress obviously gets a lot of criticism from many corners, and I think you know, Philip is careful in what he says in the book. But I think Congress played the role that it's supposed to play. I think if you want to spend taxpayers' money, you need to go to Congress. There are certain authorities that are absolutely delegated to a well functioning central bank, and that includes the provision of liquidity.

But, as Mr. Bernanke, I think recognized, and this is David's book -- early on -- well, early relative to some of the more traumatic events, there were potential solvency needs, there was a need -- there were potential losses. The central bank shouldn't be in a position to take those losses, and they wanted to go to Congress.

And frankly, the first proposal that treasury put before Congress in TARP was not satisfactory in terms of lack of oversight. Seven hundred billion dollars in small, unmarked bills outside Mr. Paulson's office (Laughter). It's not going to fly, and it shouldn't fly.

And I think Philip's also very good, by the way, in laying out the various oversight mechanisms that were put in place, that yes, didn't uncover major scandals, but that in itself, was part of the outcome. I think the special inspector general for TARP, I think the correctional oversight panel for TARP -- these did what they were supposed to do. This is a very important part of our system.

Did Congress react too slowly? I don't think so. The House didn't pass

TARP. A revised version passed the Senate, and the House voted again the same week. That's how the system is supposed to work. That's the design of the system, and I don't think that you or they (Laughter), more to the point, will want to support the slush fund idea, and I don't think I would support the slush fund idea.

MR. WESSEL: That's bracket the slush fund. Get to the Board of Governors and we'll come back.

MR. JOHNSON: The Board of Governors. So, the Board of Governors has the following responsibility right now, and this goes straight to the legitimacy point. Under Dodd-Frank, there is a much discussed Title II resolution authority, where the Fed and the FDIC would help wind down or otherwise, deal with a failing large, complex financial institution. But that's a backup authority.

Title I of Dodd-Frank says that the relevant authorities, again, with the Board of Governors of the Fed on point for this one, those authorities need to determine that every financial company in the United States of any kind, be able to fail through ordinary bankruptcy without any intervention from the government. Title II is there just in case they get it wrong.

Now, this is the so-called living wills that the Fed and the FDIC supervise, and the Board of Governors of the Federal Reserve has to be aware that if they fail to deliver credible public, clear, legitimate results on Title I, nobody is going to be particularly believing them or supporting them down the road when they say, hey, whoa, this is a surprise. We thought this couldn't happen. Or, I believe this is completely about liquidity and not about solvency.

The credibility of the Fed on regulation, on supervision, on crisis response, which is I think the really key resource that Philip is identifying for us, that still hangs in the balance. It is completely about, at this stage -- a little bit about some other

things, but massively about the living wills process.

And so far, I'm afraid what we've seen from the Board of Governors is not satisfactory and not convincing. And that should be a great worry to everyone who's taking up Philip's challenge of thinking -- being forward looking and thinking about our ability to handle future difficulties. Thank you.

MR. WESSEL: Thank you. Andy?

MR. LEVIN: Well, thank you, David. I'm actually very excited about this kind of event. I think there's a need for economists to be interacting more with people from other disciplines, political science, history, sociology. And David, actually, I think has been playing an important role in starting this process.

A month ago, I went to a similar event where it was someone who's written in history, and I just last night, finished Philip's book, except I haven't finished all of the footnotes. I was starting to check some of those today (Laughter).

MR. WESSEL: Okay.

MR. LEVIN: It's a great book. I do recommend it to people. But I'm an economist, so let me just tell you kind of how I think about these problems, and sort of a frame that I was able to try to sort through, because the book is very rich, and a lot of details.

So, economists think about principle agent problems. In this case, we can think of the principle as the public and the agent, let's say, as one of these agencies. It could be the Fed or the FDIC. Generically, a principle agent problem is something like a manager or an employee. And so, I think in the interaction between political scientists and economists trying to think, you know, more systematically and rigorously, what do we mean by legitimacy -- I mean, you have a chapter in the book I thought was, you know, important and helpful.

One of the problems us economists have is, we try to put everything in mathematical equations. That's probably going too far. But a principle agent problem, what I think about legitimacy generically is -- you know, does the principle have confidence in the agent? And you know, are they willing to retain that agent? Will they fire them or you know, replace them or just change the institution of the arrangements altogether?

So now, to be more specific, let's go through this. First, you have to design the institution. You design the arrangement. I think that one of the things I was dissatisfied with the book is that it kind of takes the crisis itself for granted. The pretty much starts with Bear Stearns.

Now, one of the benefits, I think, of the broader literature of many other books that have been written is, I don't think we should be taking that for granted. And I was just refreshing my memory about the big (Inaudible), where it was very clear that some important people in the financial markets did understand in 2005 and 2006, what was coming.

Another book I was looking at recently -- it was clear to the loan committees at Lehman and a couple other investment banks in late 2007, that they were technically insolvent. And I wonder to what extent that information was conveyed or apparent to some key agencies, including the New York Fed.

And we could go through the details of this, but I think that when we're thinking about design of institutions, this comes to Simon's point. We ought to be talking to design institutions, where the possibility of a crisis is as close to zero as we can make it. And we know that after the Great Depression, we succeeded as a country in designing a set of institutions that from more or less the mid '30s or you know, the late '90s or early 2000s was pretty effective. But there were, of course, financial events, but nothing like a

Great Recession.

And so, the question is, what do we need to do now in order to prevent a crisis from happening? And part of the legitimacy, I think, is the fact that the public was reassured for many years that everything is fine, we're in great moderations. We've kind of solved you know, the kind of classic problems of financial crises and depressions. And then, the public discovers that's not true.

I think if you had a doctor who was reassuring you all the time, and then you had suddenly had a very serious illness, you would be pretty upset with your doctor. So, this gets to legitimacy.

Two, you have to select the agent. And I think one of the problems I've seen perennially is, it's a bad idea to have one person in charge with too much power. I think that Allan Greenspan acknowledged in the Financial Crisis Commission that you know, his own views were informed by a working assumption that executives of a financial institution work in the interest of the shareholders.

Now, many other economists have known for a long time, that we can't make that working assumption. Stiglitz and Akerlof and others won Nobel Prizes about this. Okay? The Federal Reserve Board needs to be a real board. This is one of the challenges, I think, going forward, to make sure that it's not just a single chairman dominating things. There needs to be a real board. And likewise, with each of the other agencies that have various responsibilities.

Diversity it crucial here; getting a real diversity of views, and not just PhD economists from top universities. I think bringing in people from other backgrounds and disciplines of all sorts helps make an institution more robust and builds the public confidence, the resilience and the legitimacy. The decisions are being made by a wide range of people without any brain think or brain meld or whatever you want to call it.

Third is the transparency issue. And I think Simon underscored this. I totally agree with some of the things that you said in the book. I just want to flag the fact that is very much connected to this, that you did a FOIA request for the legal rationales of the New York Fed, and I guess your footnote -- footnote 80, I think it is (Laughter), says you were denied the FOIA request.

Larry Ball, who is a professor at Johns Hopkins did a FOIA request, similarly got rejected, but he convinced a public interest law firm to take this to court. And unfortunately, last week, the federal court requested the FOIA request. Why? It's exactly what Simon said. Basically, a lot of the fundamental part of it was the New York Fed is a private institution that's actually regulated by the Board of Governors, and therefore, not subject to FOIA.

Another part of it was that there's an exemption in FOIA about pre-decisional deliberative matters where things can basically be kept secret for decades. So, I think if we want the public to have confidence in the decisions, and even if you're in an emergency crisis and you don't have time to explain it very carefully at the time, at a minimum, it has to be made transparent afterwards.

And here we are, this is now seven years ago, in some cases eight years ago that some of these decisions were made. I think it's very difficult to explain why that information cannot be revealed, and the chair of the fed could do this with a stroke of a pen. Just make all of the --

And by the way, the FMC transcripts and all the staff analysis is revealed after five years. The Federal Reserve could have a similar rule of decisions of the Board of Governors, including the legal decisions, that everything would be made available after five years or seven or ten, but something, so that there would be the transparency.

And finally, the accountability. I just want to make a comment here. I

don't think it's fair to do 20/20 hindsight, and I think your book is very helpful in this. I'm not accusing you. I'm saying that a lot of the people who have made comments, it's easy to judge 20/20 hindsight.

I think the judgments and the accountability should be what you know, economist would call ex ante, which means that part of what you expect from an institution or an agency is scenario analysis; what could go wrong, and contingency plans. What we would if that happened?

And so, what you call adhocracy, I think the solution to it, as far as I'm concerned isn't so much slush funds as it is stress tests. And in the same way that a stress test proved to be very helpful for many of the private financial institutions, I think the public and the Congress should be starting to require agencies to do stress tests themselves.

What could go wrong, and what would you do about it? What tools would you need? You know? Do there need to be changes in the law? And not the day before the crisis or the day after the crisis, but months or years before, and that's why I come back to the point that much of this, if you'd had a more diverse group of policymakers and staff working for them in 2005, in 2006 and certainly, early 2007, and then even in the end of 2007, scenario analysis and contingency planning could have helped alleviate the crisis or possibly even prevent it. And so, I think part of the lessons learned for the future is we need to have more of that kind of accountability, not just criticizing afterwards, but trying to plan ahead.

MR. WESSEL: Thank you. We know -- I totally agree, Andy, that -- no one would argue that we had even close to optimal regulation, supervision and policy before the crisis. There are differences of views about the adequacy of the response to the crisis; what might have happened differently. And maybe we'll talk about that.

But Phil, in his remarks, asked us to take a look at where we are now. It seems to me that one hypothesis is that the public and the politicians were not happy with the inventiveness of the authorities; whether it's the stuff that the pros know about -- you know, how the Exchange Stabilization Fund was used, or the way they bought assets and called it a loan, or the commercial paper facility where they kind of seemed to stretch what was collateral.

And because they didn't like how inventive they were Dodd-Frank attempts to put some restraints on the authorities, the fed, and to some extent, the other authorities. And I think the question I have is, did they overreact in a way that will make it hard to handle the next crisis? That is, have they tried to pre-decide a lot of issues and not given the authorities enough flexibility to deal with a crisis, which surely will come, even if we did everything you recommend?

This is sort of the essence of the slush fund. Right? They should have some fire extinguisher that they control, and I think both Andy and Simon are a bit resistant to this, and I think that the Congress has shown itself too resistant. Am I summarizing your point right, that -- don't tie their hands too much?

MR. WALLACH: Well to me, I'm not sure exactly what it's so much of an either/or decision. It's a matter of creating redundancies in the system, almost, so that there's different ways of addressing problems.

As I was listening to your remarks, one of the things from the book that came into my trade is that there's sort of a substitutability between trust and accountability. And usually, I'm thinking of ex ante trust; ways that we can make the system function ex ante, such that we can be happy giving discretionary power to our agents, because we trust them to do the right thing.

But to the extent that we're able to produce that entirely, we also want to

have systems of ex post accountability that then allow -- that can sort of take the place, so that we can convince people that the actions that have been taken are not nefarious, and you really want to scrutinize them as much as possible, so that people can be really sure that that's the case; that you're not putting over a fast one on them.

I think we are currently in a very low trust environment, which of course, makes it unlikely that Congress is going to want to create a slush fund --

MR. WESSEL: But do you think that Congress has gone too far with Dodd-Frank and tying the hands?

MR. WALLACH: Well, I think there's the changes to Section 13.3 that would stop them, at least on the face of things, from doing something like Bear Stearns or AIG rescues again. Instead, they'd have to gin up the wide access facility. To me, that doesn't seem too troublesome, although I would be quick to recognize the limits of my own ability to judge that.

But you know, I think one change that makes Don Cohen here at Brookings uncomfortable, for example, is now the fed has to act in concert with the treasury secretary. That's now an explicit requirement for creating 13.3 facilities put in place by Dodd-Frank. Now, as it happened, Bernanke and Paulson were working hand in glove during the last crisis. That wouldn't have changed much.

But you could imagine a situation in which the fed would want to go in one direction and the treasury secretary would pull in the other. To me, I would like that requirement put in place, because the treasury secretary is -- sort of seems closer to elected officials because his boss is the president, than the fed does. And that adds some amount of political legitimacy.

The president really ought to have to more or less, directly give his blessing to these kinds of extraordinary measures. Now, President Bush did so very,

very quietly, because he probably, rightly, sensed that he wasn't in a position to play the role of legitimizer in 2008 with some -- you know with (Inaudible) --

(Simultaneous discussion)

MR. WESSEL: So, I'm hearing you say you don't think Congress went too far in tying the hands.

MR. WALLACH: I think that's right.

MR. WESSEL: Okay. Simon?

MR. JOHNSON: I don't think Congress went too far. And by the way, 13.3 is not -- the renewed 13.3 is not yet written. There was a -- it's been proposed, and there is bipartisan pushback on what the fed has proposed.

I think that, though, the key issue is inconsistency or perceived inconsistency. And Phil's very good about this in the book, taking you through these very situations. But I would summarize it this way: By what legal authority did the government remove the head of General Motors? None. There's none.

However, he left as a counterpart to the government's rescue or support of General Motors. The head, for example, of Citigroup did not leave. Why? Well, you can't say it's lack of legal authority, because you pushed out the head of General Motors. So, I think that Congress is calling for more consistency, and they are certainly, absolutely calling for an end to the specific so-called open bank assistance or open non-bank assistance.

So, you cannot -- and certainly, the spirit of Dodd-Frank is that -- and current letter is that you cannot exactly do a Bear Stearns or an AIG while you're supporting a particular open firm. Now, if it goes into resolution and you're in a Title II where the FDIC is running as a resolution and they need a credit in order to make that work, in order to prevent final disruption, for example, then they can access a line of

credit from the treasury.

So, that's not a slush fund. You've got to be very careful with that. But there is a pre-funding for the FDIC's use of the resolutional authority, which is supposed to be a last resort.

MR. WESSEL: And what about the -- during the crisis, with some reluctance, Sheila Bair at the Federal Deposit Insurance Corporation agreed to guarantee the liabilities of the banking system; their debts. And that's harder under Dodd-Frank now. It requires some intervention from Congress.

And his book, Tim Geithner says that's the one that worries him, because in a crisis, you might have to act more quickly than Congress would, and he thinks that authority should have remained where it was. Do you have a view on that?

MR. JOHNSON: I think that limiting the availability of those blanket guarantees for banks and for money market funds is sensible. You do have a very powerful central bank. If you trust that central bank, and if that central bank is believed when it says this is different; we require some additional authority here, then I think you have very -- and they're going to talk to treasury, anyway.

MR. WESSEL: Right.

MR. JOHNSON: That's not I think, a real constraint.

But can they go to Congress? Can they persuade congressional leadership? If they are trusted and believed and legitimate, absolutely. And they can decide very quickly. But I think it's very good that they have to go to Congress.

MR. WESSEL: Andy?

MR. LEVIN: Well, I think my -- as I said, my concern about Dodd-Frank is mostly the question mark, still, of whether that will give us a 40 or 50 year period with no major financial crisis like we had. Okay?

If people had confidence that Dodd-Frank was like Glass Steagall, you know, and that maybe someday, 50 years from now, it would have to be revisited. And you know, maybe sometime in the next hundred years -- of course, there's never anything -- you can't guarantee -- people who I listen to and take seriously their views worry that we could have another major financial crisis, you know, in a number of years that's counted on two hands or even one hand, and that the kind of institutional changes that were made in Dodd-Frank with the FSOC -- people that I listen to and take seriously are very concerned that FSOC itself isn't able to make the decisions that need to be made, nor is it a body that could act very effectively in a crisis.

So, again, rather than focusing so much, which is, I think, what the book does -- that's its purpose, but I think broader we need to think (sic) -- is not just what are we going to do in the next crisis, is -- I think to be fair to the public, and there's a few bits of this in the book -- not enough, as far as I'm concerned, because most of it is about the banks and the money market funds, and you know, really, the things that were relevant for a relatively small slice of the public.

There's two pages about the homeowner's assistance programs, and almost nothing about small businesses or you know, the many ways that the average Americans were devastated by this crisis; people thrown out of their houses, people having to live in their cars, millions of people having to go onto food stamps.

This was a terrible crisis, as bad, in many ways, as the Great Depression; maybe not quite as bad, but pretty darn bad. And we need to make sure it doesn't happen again.

MR. WESSEL: Let me take -- that's a good point. So, let me ask you about that. So, as you point out, there are lots of things that give heartburn to lawyers and financial policy experts, and you identify a number of them where they appear to

have stretched the law. And of course, there's the one that seems, on the other side, that they didn't stretch the law enough to save Lehman Brothers.

But when you think about legitimacy and what people at large found acceptable, it seems to me that Andy has put his finger something, that there is a narrative out there that basically somewhere, the banks got bailed out and Main Street didn't, and everything else is detail. So, every one of the examples is, it falls into that category.

The counterparties at AIG, they got a hundred cents on the dollar. Hope and homeowner's and this and that didn't actually do very much; that even today, a lot of people have mortgages that are worth more than the value of their house, and even today, as Andy and Danny (Inaudible) have pointed out, there are lots of people who aren't working or aren't working at full-time jobs and would like to.

So, a lot of this is about results, and the narrative is that the economy got screwed and Wall Street didn't, and that -- do you think that there's something to that, that that's what made people angry, rather than some you know, Neil Barosky says that in chapter 13 and this, that and the other thing?

MR. WALLACH: Right. Well, I do think in the book, I talk about -- the mortgage stuff is a big disappointment. That's the part of TARP that ordinary people thought was going to most relate to them, and give them some help. And Paulson, as Treasury Secretary, was just pretty much a hundred percent against TARP for anything like that, because he thought that arrested the financial crisis in its financial sense was the most important thing, and that's what he was going to spend a hundred percent of his resources on. And he was very, very dogmatic about that.

But okay, he got out in January, 2009, and the Obama administration has had to deal with this question for many years now. And I think there's a very strong

case to be made that they, in terms of restoring the political legitimacy of this system, they made a very bad mistake by not throwing their weight more strongly into helping homeowners.

Like regardless of whether they thought that that was so important for the big picture economy, they missed their chance to show the ordinary people that they were really on their side.

MR. JOHNSON: So, I was in a discussion last week where somebody said, and he thought he was being radical and crazy and out there. He said, I think in the next crisis, the fed should support more than just the banks. (Laughter) And I said, well, this crisis they support a lot of people who weren't banks (Laughter). You know? The non-bank sector, the shadow banking sector.

And I complete agree with and want to associate myself with what Andy said. And the answer to your question is yes. A lot of this is about the following; that certainly, when you have a central bank that has influence over the price level and which can move, also asset prices over some period of time, including through qualitative easing, then in any crisis where asset prices have fallen and you have some debts, the key issue is, can you finance that holding? Can you roll over your debts? Can you meet your payments long enough to get back from being under water.

You're right. Of course, some mortgages -- some people are still under water on their homes, but a lot of asset prices have come back. But that credit was not available to many individuals. It was available to many banks and to non-banks, and it was available as capital infusions as well as credit. Right? So they're different forms of financial support.

But most homeowners were not able to finance their positions; their underwater positions. And at the end of the day, they had to sell out, and they didn't just

go down and come back.

(Simultaneous discussion)

MR. WESSEL: Not most. Some, not most.

MR. JOHNSON: Many.

MR. WESSEL: A lot of people --

MR. JOHNSON: Millions.

MR. WESSEL: Okay. A lot of people --

MR. JOHNSON: Millions (Laughter).

MR. WESSEL: -- basically stayed in their houses and --

MR. JOHNSON: Yeah, so if you could afford that and you could make the payments --

MR. WESSEL: Right.

MR. JOHNSON: -- then you may be okay now.

MR. WESSEL: So, but why do you think that -- so some parts of the rescue, arguably are a success. Alan Krueger has a paper with Austan Goolsbee talking about the auto bailout. And he relates that one point, Larry Summers asked for a show of hands. How many people think Chrysler is going to survive this thing? And Goolsbee and Krueger said, we don't think Chrysler will survive. The auto industry is doing reasonably well.

The TARP, by most accounting, cost less money to taxpayers than many people, myself included, anticipated at the time. I'm not sympathetic to the idea that it was a great investment or something like that. The banking system in the United States, for all the problems it continues to have, is clearly in better shape than Europe's. Right?

But there doesn't seem to be -- there seems to be very little sense that some parts of this worked well. And I'm just puzzled as to why you think that might be.

MR. LEVIN: I guess I want to come back -- because I do think about this a lot. And again, I loved the book. It's just there were certain pieces of it (Laughter) where I --

(Simultaneous discussion)

MR. WALLACH: You don't have to keep apologizing (Inaudible) --

MR. LEVIN: That's all right. I still want people to go out and read it.

MR. WALLACH: Well, they have to go read the footnotes that you say are interesting.

MR. LEVIN: Well, (Laughter) okay. So ante versus ex post -- okay? Accountability. So, if I take a really risky decision and it works out, and maybe I even make money on it -- okay -- you still can ask the question, was that an appropriate decision? And this comes to what Simon said about liquidity versus solvency. Okay?

And honestly, there were policymakers in late 2007, at the time that the term auction facility was launched, who said this is just a liquidity problem. Okay? I think at the time, John Williams and John Taylor actually wrote a very interesting paper. It was called *The Black Swan*, at a time when that phrase was just coming into common usage, where they said wait a minute. The credit default swabs and the spreads on bank debt are widening in ways that seem like there's real solvency here.

And policymakers were very dismissive of that. Oh, come on. How could that possibly be? I mean, that would mean that there's risk that a major financial institution could fail in the next year, and we all know that can't be. Well then of course, you fast forward to March, and Bear is rescued, and everyone realized, oh, I guess this was a solvency problem. But the truth is, there were people in the markets ahead who knew that all along.

Now, the point here is, we cannot just judge TARP and TALF and all the

other facilities by the fact that everything -- or Chrysler and the auto bailouts by the fact that ex post, they worked out. I think the question here is why Congress and the treasury department needs to be involved in these things, if there is another -- God forbid, another crisis, is because ex ante, you have to say how much risk are the taxpayers willing to take on.

At what point is it better just to nationalize and close out the shareholders, or even let some of the bond holders take losses, okay, in order to reduce the maximum level of risk that the taxpayers are taking on. So again, I think part of the answer I would give to you -- I'm not sure if this is about why the public doesn't have faith in all those rescues, but I think what I would say as an economist is, you have to make ex ante assessments of risk.

MR. WALLACH: Just a small thought. So, legitimacy is needed precisely when things aren't going well. Right? That's what I meant to get at with my, nothing succeeds like success. To the extent that these programs work out, that's not where you're -- the resilience of your political system is getting tested. Right? It's where things go wrong.

And I think we got incredibly lucky in many ways, that our system wasn't tested more in 2009 and 2010. You can imagine many things that would have made the global situation much worse. And when kind of political resources the system had in late 2009, 2010, it's a very upsetting scenario to play out in your mind.

I mean, part of what I think about when I think about the public not getting it or not getting the successes is, I go back to Roosevelt's fireside chats. You know, he was able to sort of involve the American people, in the sense that they were fighting back and would eventually triumph, even through many years when they weren't triumphing. Right? Things weren't working out. They were trying wrong things.

There really wasn't anything vaguely comparable to that this time around, and the public has no idea about -- you know, a normal person doesn't have any idea about most of what the fed did or what the treasury did. They know TARP sounded like a big giveaway, and there was never a narrative that really made them feel like they were in it together.

MR. JOHNSON: So the U.S. has, as you know, David, enormous fiscal capacity. And with that fiscal capacity, you can address almost any, certainly domestic crisis, perhaps almost at any scale. But the distributional consequences of that vary massively, and I'm with Andy in worrying about going forward. Are you going to ride the cycle in such a way that you repeatedly crush people relatively low down the income scale?

For example, while relatively benefiting people who are doing fine anyway, and who are at the top, who happen to be central figures in the financial system. I think that's the big fear here, and I think that's the trajectory we're in.

MR. WESSEL: So, I think before we turn to the audience, let me ask you for one policy recommendation you would make, either to the fed or the banking agencies or the Congress that would make you feel better than you feel today, Andy?

MR. LEVIN: Oh, I'll just pick the one that I already said, then.

MR. WESSEL: Yes.

MR. LEVIN: I think that -- no. No, the simplest one with a stroke of a pen that would have, you know, given Philip what he wanted to see in writing his book, and Simon what he would like to see and Larry Ball what he would like to see, and a bunch of others who are trying to understand. Lessons learned are for the Federal Reserve just to say no more 1960. Okay?

From now on, on everything, it's five years or seven. Okay? Just pick a

year, but a reasonable year and say, you know, from that point backward in time, it's open. Open archives. That should be done.

MR. WESSEL: Both the New York Fed and the Board of Governors.

MR. LEVIN: I mean, the whole -- not just the Federal Reserve System. I think frankly, the U.S. government could -- I would suggest actually, that the Congress changes FOIA to say that the pre-decisional deliberative exemption and some of these others should also have a five year clock on them, or a seven year clock or something reasonable, so that after something like five or seven years, even things that were pre-decisional deliberative should be made available to the public, so that there's accountability and transparency. And if the decisions that were made -- well, then that should increase the confidence and the legitimacy.

And it's like an investment. I agree with Philip on this. It's an investment for the future. And if it wasn't done, well, then you do lessons learned. Well, what could we do better next time around?

MR. WESSEL: It's kind of hard to imagine Hillary Clinton signing this bill. But okay (Laughter).

MR. JOHNSON: I would just broaden that to include these living wills. So the living wills have a public part and a private part, and the private part will never currently appear. Why not have that appear with, let's say, a 10 year lag?

Now, supposedly the longest living will at the moment is a hundred thousand pages. One former official said it's 200,000 pages. I don't even know what that looks like (Laughter). I mean, how is that a serious submission or helpful to officials? But anyway, show it to us with a lag, and it's going to have the same effect as what Andy is saying, which is, oh my goodness, people are going to be looking at this one day? We're going to have to take this seriously. It has the same positive effect, and 10 years is fine

for that kind of lag.

MR. WESSEL: Okay. Phil?

MR. WALLACH: Well, I --

MR. WESSEL: Something different.

MR. WALLACH: Well, I guess I would talk about something Andy said. The intellectual diversity of the fed is minimal (Laughter). But the broader point is that there is a sense, an us and them divide, an elites and normal people problem where normal people feel that their voices essentially don't get heard at the highlight ranks of government.

Having more people involved that have a background in retail politics, you know, one would hope would partially -- you know, Hank Paulson was an investment banker, not somebody known for his common touch. But I think figuring out ways to make the public feel like these are their institutions, I mean, that's sort of the riddle for American democracy at large, but I think it's an especially acute problem in this context.

MR. WESSEL: Okay. Let's turn to questions. There's a mic. So, wait for a mic and tell us who you are. Why don't you stop right there? We'll start in the back. Tell us who you are and ask a question. Don't make a speech.

MR. PASTRONK: I'm Bobby Pastronk. Am I correct that you all believe that the response could have been designed so as to better support those on fixed incomes for whom the current low interest rate environment produced by the solution has been harmful, or those found underwater on mortgages? And if so, what would the decisions have been to have produced those outcomes?

MR. WALLACH: I think the fixed income and low interest one, that's sort of a whole different discussion. I think that's sort of part of the pain of the crisis, rather than necessarily so much ramifying from the decisions. Underwater mortgage owners --

an extra word on that.

You know, part of what Paulson said, which made him so reluctant is he thinks that money would have gone out the door and never come back, unless some of the other TARP money that went out the door and came back with interest. Whether you think it was a generous rate or whatever, it did, in fact, come back to the treasury.

I think you know, the policy decisions that would have needed to be made to really send a strong signal that this is where we want to be channeling our money, and we don't care if it comes back, that would have needed to have been made by Congress. I think Congress did not speak clearly enough. A lot of people hoped that somehow, the TARP money would have served that purpose, but they didn't really give it teeth in the law to make sure that would happen.

MR. WESSEL: Well, I think many people in Congress were under the impression that some of the TARP money would go.

MR. WALLACH: Yeah.

MR. WESSEL: I think in the Obama administration, their answer is two-fold. One is, you say that giving money to people who are underwater would have made this more popular, and they say the tea party with Rick Santelli screaming about, the government is going to bail out your mortgage -- your neighbor who took too much money.

And the second thing is, they say that it's a lot harder to come up with a plan that actually works, that will have the desired result. I think there's evidence that there was a lot of angst in the administration with this. That's a slightly -- do you want to take the fixed income -- are we screwing savers here?

MR. LEVIN: Not really. (Laughter)

What I'd like to do is just first respond to what you said, which is, I think

that if the government had taken this problem seriously -- and I agree with -- you know, the point here was, you have to do it in a way that's fair.

MR. WESSEL: Right.

MR. LEVIN: That's part of legitimacy. They might have said, we're going to treat people who didn't (Inaudible) loans differently than ones who went through a regular process, and where there was income verification. I think that would have been at least a starting point, even for the tea party to say you know --

And frankly, go back and just check the loan documents. If the person committed fraud, you know, either the broker or the applicant, then they don't get the assistance. Okay? There would have been ways to even be responsive to the tea party concerns.

Secondly, and this comes back to this problem of sort of the extent to which the agencies were so focused on the financial markets and not on Main Street. The problem with the people being underwater homeowners and the tightening of mortgage standards and credit card standards, that has hit very hard on business startups.

The business startup rate has been abysmal now for the last -- it was not great even before the crisis, but it's been abysmal. Business startups are important for employment. They're important for income distribution. They're important for productivity. That's where a lot of innovation comes from.

And so, I think there's a very strong argument -- and this was not just ex post. This is ex ante, because I was making those arguments at the time, (Laughter) and couldn't get people to listen, was that the government, whether it was Congress or the Treasury Department or some of the other agencies including the fed, could have made much more effort to try to promote business startups, which are part of a usual recovery,

and we might now, six, seven, eight years later have better employment outcomes, better income distribution outcomes and better productivity, which has also been pretty bad.

So, now that still doesn't solve the fixed income problem, but frankly, if we'd had a better recovery, we might not be constrained by the zero bound anymore.

MR. JOHNSON: And so, I was just going to speak to the savers point, because we haven't addressed that. Okay, I think the savers are going to have a problem in any situation, because you're going to cut interest rates, make credit cheaper, for the reasons that Andy said. And the counterpart of that is going to be lower rates of interest on simple fixed interest paying instruments.

I think though, the best that can be said is that the Federal Reserve did what it could to preserve the principle value of many of those investments, and the policies they took that pushed up asset prices did help some kinds of fixed income investments. But without question, if you go through this kind of problem again, people holding that kind of financial investment are going to be hurt in the same way.

MR. WALLACH: Wouldn't you also agree that if we had had a different mix of fiscal monetary policy, if we had had more stimulus sustained, we might have had less need for monetary?

MR. JOHNSON: Well, I think perhaps. I supported more fiscal at the time. But I think there's a limit to how much fiscal --

MR. WALLACH: Right.

MR. JOHNSON: -- stimulus you can put into any economy. I think what Andy said is right. If you get a better, faster recovery, that's going to help everyone. But massive financial crises are usually not followed by rapid economic recoveries. They're usually followed by debt overhang problems of the kinds you articulated.

MR. WESSEL: Question out here in the front.

SPEAKER: Well, I --

MR. WESSEL: Why don't you wait for the mic, because it's easier to hear?

SPEAKER: Okay.

MR. WESSEL: And tell us who you are.

MR. BROWN: I'm Stuart Brown with Warren Capital.

So, following some of what you were just saying, my disappointment with quantitative easing was that it parked a lot of money with the banks. We were buying lots of bonds and mortgages, and that money went to the banks but didn't go out into Main Street.

Was there something to keep the fed from saying, we'll buy $18 billion of infrastructure bonds? We'll buy all the water and sewer bonds, all the Port Authority bonds, all the highway bonds, all the higher education bonds you guys can come up with, and get the money actually out there? If people have jobs, they can pay their mortgage.

MR. LEVIN: Okay, this comes back also to your monetary fiscal thing. And what I said earlier about scenario planning and contingency planning. I was very frustrated in 2009 about the idea that we were looking for shovel ready projects. Okay? You probably remember that. That was a big constrain on the design of the fiscal program.

Why? Because there was a lot of confidence that we were going to have a quick recovery and be back to normal within a couple of years. I think if that -- what I wished, even at the time, and certainly in retrospect, is that a fiscal package had been designed where there's a scenario where the economy has a quick recovery, and maybe the fiscal thing is -- you know, tapered off pretty fast, and another one where (Laughter) you've got 5 and 10 years to find plenty of not shovel ready projects that are going to be

useful over a 5 or 10 year period, and where maybe, you're willing to commit a lot more, because interest rates are low and the economy still isn't satisfactory.

Okay? So, likewise, on the monetary policy side, you can't do a lot of in terms of purchasing securities, because the Federal Reserve Act puts tight limits on it. We could talk about that over coffee afterwards. You would have had to probably go to the 13.3 type authorities, and probably would have required consultation with Congress.

But the Bank of England did this, and the ECB is trying to do it now, what they call Funding for Lending, where it's a more explicit arrangement, where the bank makes a loan, and then in effect, the central bank funds part of that loan, and you make sure that you're actually promoting, you know, new lending to small businesses, business startups, or to households that are under water, whatever it is. And that wasn't really done.

The sense of the 13.3 was, we're over the worst of it by you know, summer of 2009, and then the 13.3 all went off the scene, even though from Main Street's point of view, a lot of them are still not through the worst of it.

MR. WESSEL: The woman here. Stand up. Oh, pass the mic to her. Thank you.

MS. BACHRACH: I'm Eleanor Bachrach. I worked on the Senate Banking Committee staff some time ago. In fact, I handled the Chrysler loan guarantee. So, my continuing interest.

First, the comment -- I think your slush fund presents a huge moral hazard in an industry that already has shown that it's willing to take huge risks and figure it will be bailed out. Also, I'd like you to address, I guess what I would call generally the too big to fail problem, and particularly, it seems to me that Geithner, who of course, came from the New York Fed, did some pretty -- it was a pretty terrible choice.

He ignored the direct decision to work on breaking up the banks, particularly Citibank, which would address that problem. And he also just generally, which I find hard to fathom from the book of the special inspector general, went out of his way to say, oh, we can't do this or that. We've got to keep the banks in, whether they want the money or not, which seems strange.

And of course, on the issue of the homeowners, which I do think is a huge scandal, it wasn't just giving the money. It was getting the banks, which had profited, to give some concessions. So, I wondered generally, how you would address this whole problem, because --

MR. WESSEL: Okay, so let's talk --

MS. BACHRACH: -- I think -- okay.

(Simultaneous discussion)

MR. WESSEL: Before you finish indicting Tim Geithner, who isn't here, let's focus on the two big to fail thing, because I know Simon has strong feelings on this.

MS. BACHRACH: Well, if I -- you know, okay. I just wanted to finish by saying I think Dodd-Frank, in fact, is a weak read, because there's always going to be more money for lobbying --

(Simultaneous discussion)

MR. WESSEL: Pick one thing you'd like the panel to answer.

MS. BACHRACH: Too big to fail.

MR. WESSEL: Thank you. Simon, you want to defend Tim Geithner?

MR. JOHNSON: (Laughter) Perhaps over coffee. So, that was a joke (Laughter). Too big to fail is the key big issue remaining, and I think the Federal Reserve, as I said, has an opportunity with the living wills to confront that, because the spirit, and I believe, the letter of Dodd-Frank says that no one should be too big to fail,

which means that every financial firm should be able to fail through the ordinary bankruptcy process without provoking any kind of government intervention.

Now, we recognize that there can be liquidity problems, there can be spillover problems. There are attempts to mitigate that, but you should still be able to fail. And I don't think that's currently possible.

MR. WESSEL: So, let me ask you to distinguish between two things. So, you argue that we have not changed the system enough yet so that we have banks that we can allow to fail. Right? Does that mean you think they should have let more big banks fail in 2008 and 2009?

MR. JOHNSON: Well, I think that's a very good question, and it's the kind of question that Philip's book absolutely grapples with. I think -- and I said at the time -- by the way, I like the footnotes. I read the footnotes, all of them (Laughter). Best part of the book (Laughter). And what I liked about it --

MR. WESSEL: Should have just stopped at I read the footnotes (Laughter).

MR. JOHNSON: Well, what I like about it is that Philip takes you through -- you know, he talks about a lot of blogs, including my blog, which I appreciate.

MR. WESSEL: Right.

MR. JOHNSON: But other people's blogs, as well. And so, he takes you through the real time debate. What were people actually arguing about at the time? And I think that when you get into the middle of a financial crisis, there is a very strong argument for trying to stop the fires and for trying to prevent various kinds of runs, and that's why you need a central bank, for example, that you trust.

And when they say, well, look, we're building this fire break. And sorry, your house is on that side? That's unfortunately. This is where I'm parking the fire

engine. That's where the hydrant is. So, you've got to believe them and you have to trust them you have to support them, including at the level of Congress.

So actually, as a matter of fact, and this is what I did say, and this is what Philip catches me saying, and other saying at various points, I think it was good to support and prevent for the failures. I would have attached more strings. I would have had more changes in management. And I like -- I proposed, in my mind, at the time, something that's very consistent with what we got in this Title I and Title II combination.

So, an FDIC type of resolution process in which you go out of business -- your contracts are broken, because we transfer everything to the new company, but then, we get you back on your feet, and we try to limit the damage to the credit system. That I think, is the right approach.

MR. WESSEL: Do you want to say anything?

SPEAKER: Yeah.

MR. WESSEL: Then bring the mic down here to this gentleman in the front.

SPEAKER: So, I feel like the too big to fail thing is a question of political commitment. I mean, a lot of the criticism about -- I mean, Dodd-Frank, unfortunately, in my mind is still something that generates pretty stark partisan discussions, and Republicans sort of question the legitimacy of the whole thing and suggest that maybe it'll disappear at some point.

And that makes me worried about the future of Title 1 and Title II, just in the sense that the credibility around those things really is key. And so, you know, the people -- the policymakers who are in charge of pulling the trigger, should the time come to do so, they really need to think about their legitimacy in advance, so when that moment comes, people will believe that they can go through with it.

SPEAKER: (Inaudible) -- I'm just here as an individual. I'm curious why you think that the banks got too much money, and that the individual homeowners were shortchanged. I mean, after all, they were the people who borrowed all the money. They had all the money. And the fact that they couldn't return it to the banks was the reason that the banks needed the bailout. So, it seems like, Andy, you were saying that they might be -- should have been entitled to two helpings, in a sense.

MR. WESSEL: Pass it to the gentleman in the aisle.

MR. LEVIN: No, I think it's not accurate, though. I mean, in fact, most of the people even today, who are underwater homeowners have -- they've kept their commitments. They're still paying their loans, even though the house isn't worth as much as the debt that they have on it. So, anyway, I recognize these problems are complex. And so my only complaint would be that I think simply, that there wasn't enough effort made to try to find solutions.

SPEAKER: In the --

MR. WESSEL: Tell us who you are, please.

MR. SHUTLEY: Pete Shutley, retired from Brookings. In the 1990 savings and loan crisis, a number of senior executives went to jail. Nobody went to jail in this major, major financial crisis. Doesn't that really damage the legitimacy of the whole thing?

MR. WALLACH: Well, I was waiting for that question to come from somebody (Laughter). I don't address that in the book. I find it a very, very hard question to grapple with, not having sat in the SEC's shoes and in the Department of Justice and trying to understand exactly why it is that they haven't brought the prosecutions that people would have wanted.

I mean, it seems to me that it would have been very, very easy to

prosecute a lot of low level mortgage applicant preparers, and that would have satisfied very few people. You know, there's a desire to see Angela Mozilla or someone perp walked and sent away. And it's hard for me to know how one judges whether they didn't bring those cases because they were just pretty sure they couldn't make them; whether that was a mistake, even if they were right. Maybe they should have just let the cards fall where they would.

But I think you're right. That is a source of lingering dissatisfaction, and it's very -- someone else has to write a different book to answer whether that's justifiable or not.

MR. LEVIN: David, can I just make one comment about this? Because I think even though everyone talks about too big to fail, my own view is that the real -- a big part of the problem is too complex to fail. And this is related to this question, because I think that when you have an organization that's very complex, where some people in the corner like at AIG, are doing things that you know, the people running the institution don't even completely understand themselves.

It becomes harder and harder and harder to figure out who is accountable and to charge anyone with any kind of crime, you know, civil or criminal penalties. And so, I think that again -- what I think probably in the longer run will make the U.S. economy and financial system more robust and resilient and safe is probably to reorient things towards simpler, you know, organizations.

MR. WESSEL: There's a gentleman here, and then a gentleman here.

SPEAKER: Yes, I'm (Inaudible). The U.S. is a signatory of the Basel Accord which sets bank regulations all around the world. In April, 2006, the Security Exchange Commission approved investment banks like Lehman Brothers to be able to leverage directly with over 60 times the one with triple A rated securities, even though

banks could only leverage about 12 to 1 lending to small businesses.

In Dodd-Frank, there is not one single reference to the Basel Committee in the original Dodd-Frank. How can two different worlds live sort of Basel Intel linked and live so far apart, and no one really even asks these types of questions?

MR. JOHNSON: Well, you ask these questions all the time, Peter --

SPEAKER: I do that. I do that.

(Simultaneous discussion)

MR. JOHNSON: (Inaudible) and I appreciate it.

SPEAKER: I do, and I --

MR. JOHNSON: And I think these are very good questions, and the answer is awkward, that these things are not closely enough connected. One is in the area of the technocrats, and I think that that's become problematic.

SPEAKER: Problematic.

MR. JOHNSON: Dodd-Frank -- there was a decision made not to legislate capital requirements in Dodd-Frank, and I think that the Federal Reserve has to push further in terms of going far beyond what was in Basel III with regard to requiring higher capital equity at the largest banks -- at the very large banks. I'm not advocating higher capital at the community banks.

MR. WESSEL: But they have raised capital.

MR. JOHNSON: Yeah, I think they should go further. Further.

MR. WESSEL: Right.

MR. JOHNSON: Further is what I'm saying. Much further.

MR. WESSEL: But in terms of legitimacy, it does seem to me this kind of awkwardness -- Paul Tucker, formally the Bank of England has pointed out that the Basel Committee of bank supervisors and the Financial Stability Board seem to have some

influence, but they're not -- there's no treaty that sets them up. There's no recourse and stuff.

Do you think that this -- but on the other hand, if you had every country in the world making their own rules, that we'd have all sorts of arbitrage and bad things would happen. So, do you think this is an element of the legitimacy, or is this just -- only a few former Brookings people worry about this?

MR. WALLACH: No, I think it contributes to the sense that these policies sort of emanate from very smart people who caused the whole thing to blow up the last time. Right (Laughter)?

MR. WESSEL: Right.

MR. WALLACH: And that causes people to be distrustful. But I think you're right. Given -- I mean, part of the difficulty in breaking up the banks or something, making banking simpler, part of the problem is that the U.S. is actually not strong enough on its own to just impose that solution on these global financial institutions. There's a lot of very hard --

And Simon has made some I saw Simon debate about breaking up the banks once, and there's just a whole lot of technical questions about how the U.S. sort of -- could wield its power to do so effectively in the global realm. So I think there's a really tension there.

MR. JOHNSON: Well, just a point of information. We do, absolutely, have the authority to regulate the bank's domicile in the United States, including very large global bank holding companies -- JPMorgan Chase, Bank of America, and if the fed, Board of Governors decided they could make them smaller and they could make them simpler. That's absolutely in their authority.

Now, I think that would be a good move from the point of view of

strengthening our international competitiveness, among things. Other people disagree. But just as a matter of legal authority, and I think it does go to David's point of legitimacy, that is absolutely a possibility under current law.

SPEAKER: Yes, hi. Thank you. In regard to David's first question, did Dodd-Frank go too far -- so I sort of hear your answer. Right? It probably didn't, because there's still a lot of wiggle room and whatever (Laughter). And I see the political implications of that and everything.

But my question is that, as a society is the best thing that we can do, really to impose constraints, to limit the ability of the institutions that are best positioned to act quickly, and therefore mitigate -- at least mitigate the consequence of the crisis, or are we just preventing them from doing their job? Is this the best thing that we can do?

I mean, I agree with Andy. The best thing is to prevent the next crisis from happening, but conditional on the crisis happening, are you or anybody else even a little bit more concerned that because of Dodd-Frank, things may be a little bit harder to manage?

MR. WALLACH: Well, remember that they -- I think a lot of people at the fed or at the FDIC would say that they have -- their position has been considerably strengthened by Dodd-Frank in many ways, in terms of actually having explicit legal authorities to deal with non-banks. That's not a trivial matter. They had to do all of these crazy legal workarounds back in 2008, precisely because the law didn't give them any very well directed powers for that.

So, I think it sets them up to deal with some of the problems using more discretion. I mean, I think the other thing -- the FSOC -- part of what worries a lot of people about it is that it seems so unconstricted, undefined in exactly how it will work. So, I don't see the central problem from Dodd-Frank being too much constriction.

MR. JOHNSON: Yeah, the treasury secretary in the leadership of the fed insisted in September, 2008, they lacked legal authority to do various things, including prevent the failure of Lehman -- the spillover of Lehman. I didn't quite pick out your accent, but there was an op-ed written by a member of the board of the European Central Bank in October of 2008, Lorenzo (Inaudible). It basically said what civilized country could possibly let Lehman Brothers fail? Right?

There's some big breakdown in governance and mature decision making in the United States, and implying it couldn't possibly happen in Europe. Well, that was 2008. There's a lot of water under that bridge. But I think Dodd-Frank absolutely tries to clarify and tries to strength the ability of the fed and treasury to make decisions in these very difficult situations.

But, it does also stipulate limits on that power, and that's, I think, an important part of how you get legitimacy. And then, you have to go back to Congress. I really do not think if it's a genuine crisis, and they believe the people who are coming before them, they believe in their competence and their expertise and their impartiality, Congress will grant them additional authority, including use of fiscal authority at very short notice.

MR. LEVIN: The part of this that I'm most familiar with is the 13.3 authority changes. I actually was interested in reading Philip's book about the changes of the FDIC, which I hadn't been as much aware of.

So, just to be clear, there are changes in 13.3 under Dodd-Frank. Basically, the most important change is now the fed can do things, but within seven days, basically has to get a sign-off from the secretary of the treasury. And I think one reason for that which you didn't emphasize much in the book, Philip, but you know, is the fact that these have fiscal consequences; that we can't tell in real time whether it's liquidity or

solvency, and therefore, it's appropriate that the secretary of the treasury says yes, we're willing to take on this risk; that it ultimately could affect the U.S. taxpayer, and that's why the president needs to sign off on it.

MR. WESSEL: It also limits them, as in they can't lend to individual institutions. They can only lend to --

MR. LEVIN: Yeah, although I think that is -- as Philip points out in the book, that part actually probably won't ever be a binding constraint. President Lacker has explained why, so we can do that over coffee. Okay?

(Simultaneous discussion)

MR. WESSEL: A long coffee (Laughter).

MR. LEVIN: A long coffee. Or a beer. Whatever.

But I think that the constrain on the cooperation with the secretary of the treasury is right.

MR. WESSEL: And what about the FDIC loan guarantees? Do you have a view on that?

MR. LEVIN: I read Philip's description. I think Simon, maybe you should weigh in on that one.

MR. WESSEL: Simon thinks that in a pinch, Congress will do the right thing. Now, whether you could get a majority of people in Washington to agree on that proposition --

MR. LEVIN: All right.

MR. WESSEL: -- is debatable, but Simon's point is, it's a democracy, and if you can't convince Congress --

MR. LEVIN: Okay, so then what I think --

MR. WESSEL: -- then, you (Inaudible) --

(Simultaneous discussion)

MR. LEVIN: -- is actually a helpful direction it seems like policymakers are starting to head toward is having debt that can convert into equity in certain contexts.

MR. WESSEL: Right.

MR. LEVIN: And so, those are the sort of things that would again, be a workaround to this. Rather than providing a blanket guarantee on the debt of the banks, make it into something that's convertible.

MR. WESSEL: So, I think we're going to have to cut it off here, but as you know, there will be an extended coffee hour afterwards (Laughter). And there are two things to remember. One is, copies of Philip's book are in the back, and even though he hasn't authorized me to say this, I'm sure he'd be happy to sign it. I never met an author who wasn't.

And secondly, look at your feet, an if there's paper or coffee cups, pick them up and put them in the garbage can in the back. Our staff would appreciate it. And thank you to Phil and our panelists. (Applause)

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