A Perspective on Recent Financial Disruptions

I am delighted to contribute to this important volume sponsored by the National Bureau of Economic Research on *Reducing the Risk of Economic Crisis* if for no other reason than to find that I am not alone in my worries about the vulnerabilities of the economic and financial system I should also say at the outset that the three background papers prepared by Ben Friedman, Larry Summers, and Paul Krugman have bolstered my confidence in work being done by academic economists. All three papers are first rate, they are readable, coherent, and institutionally sensitive, but most of all, they offer pragmatic guidance to someone like myself who must bridge the gap between theory and practice What is also striking about the three papers is that none dismisses the possibility that a serious financial disruption could occur, although each comes to that view from a somewhat different vantage point.

Overview

My task, as I understand it, is to add something of my own personal perspective to the discussion as a whole. With that in mind, let me start with several general comments:

First, all three of the background papers grapple with the definition of "crisis," and to varying degrees they attempt to distinguish between types of crises While I have great difficulty coming up with neat definitions in this area, some useful distinctions can be made For example, "financial disruptions" can be distinguished from "financial crises" by means of the extent of the damage they inflict on the real economy. That is, the term "crises" should be reserved for those episodes that cause clear and significant damage to the real economy However, even that distinction may be misleading in that it may ignore or unduly downplay the extent to which a financial disruption has the potential to inflict serious damage on the real economy if left unattended or if handled irresponsibly.

Second, with the above distinction in mind, my personal perspective is one that is tempered by direct experience in dealing with quite a few financial disruptions, but no financial crises, since even the 1987 stock market disruption seems to have had little or no effect on the real economy

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Paper prepared by E Gerald Corrigan, President of the Federal Reserve Bank of New York, for the National Bureau of Economic Research (NBER) Conference on Reducing the Risk of Economic Crisis The conference was held in October 1989 In January 1990, the paper was submitted to the NBER for publication fifteen years could have tripped into the category of "crises." Indeed, I can readily think of a number of examples of "financial disruptions" that clearly had at least the potential for causing serious if not systemic damage.

Some might feel that this is an exaggeration Perhaps so, but the hard fact is that when the phone rings, informed judgments have to be made and often they have to be made very quickly in the face of limited and conflicting information. Those initial judgments almost always center on an assessment of whether a given situation has systemic implications and, if so, the nature and extent of such implications Those initial assessments are also always made in a context in which you know that losses and even failures provide a necessary element of discipline to the system Thus, efforts to protect the system should not protect those whose miscalculations or misdeeds caused the problem in the first instance

Third, as I see it, the past fifteen years have witnessed a greater number of financial disruptions with potential systemic implications than was the case over the postwar period prior to 1974 And if we divide the 1974-89 period roughly in half, the latter half of that interval has seen more disruptions than the former, especially in a context in which the last seven years have been characterized by uninterrupted economic expan-

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sion — a point Ben Friedman stresses in his paper. At the risk of oversimplification, I believe there are three reasons that the past fifteen years have seen such a high incidence of financial disruptions First, macroeconomic policies and performance — perhaps especially the tacit acceptance of deficits, debt, and inflation — have contributed both directly and indirectly to elements of volatility and risk taking in financial markets and in other elements of economic activity. Second, financial innovation and technological advances in the financial markets are two-edged swords These developments clearly provide important new choices and benefits to savers and investors alike, but they are also the source of new elements of risk and volatility Finally, there is far, far too much emphasis on short-term returns and rewards, surely here in the United States but elsewhere as well

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The *last* general point I would make is that I believe that, looking forward, the risks of financial crises — as distinct from financial disruptions, which are sure to occur — are something more than zero. Since that may be interpreted as a provocative statement, allow me to elaborate It is probably fair to say that automatic stabilizers and other institutional changes have — as suggested in all three background papers — reduced the statistical probabilities of a financial disruption turning into a crisis But, and this is a very big but, if a crisis were to develop, I believe its capacity to generate major damage to the real economy may be greater today than it was in the past The fundamental reason for this is the nature, speed, and complexity of the operational, liquidity, and credit interdependencies that bind together all major financial institutions and markets in the world In Bagehot's day, and long before, the first precept in banking and finance was "know your counterparty." Today, that's not nearly good enough.

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Indeed, in Bagehot's day, the managers of financial institutions understood very well the nature of the transactions that were generating income and profits, today, that is often not the case. That, of course, raises the question whether financial management has fully caught up with today's incredibly complex financial marketplace.

Some diagnostics of recent financial disruptions

Against that general background, let me now turn to some diagnostics of the financial disruptions I have had some direct exposure to over the past fifteen years to see what common denominators — if any — may be present. Such an exercise may be helpful in identifying approaches and policies that, at the least, can help check problems when they arise but maybe — just maybe — can also help in the formulation of approaches that reduce the incidence of such disruptions.

The *first* factor I want to cite in this regard I have already touched on, and that, of course, is macroeconomic policy and performance. There is no question in my mind that the seeds of many of the financial disruptions we have seen in recent years were sown in the decade between 1969 and 1979, when attitudes about inflation were all too sanguine. More recently, we have made the implicit decision that we can live with huge internal and external deficits and correspondingly high levels of public and private debt. Directly and indirectly, the resulting economic and financial environment produces patterns of behavior and expectations that surely work to increase risk and fragility in the financial system.

There is another phenomenon, which I call the "illusion of liquidity." That is the belief — obviously unfounded — by many market participants that they are that much smarter or that much quicker, or that their stop-loss strategy is that much better, so as to permit them to take profits and get out when markets turn while others take the losses.

The *second* factor I would cite is concentrations of activities or exposures by financial institutions. Concentrations take many forms: exposures to a single borrower, exposures to a single industry, exposures to a single instrument, exposures to a single class of borrower, or exposures to a single commodity. However concentration is defined, I am hard pressed to think of a single episode of financial disruption in recent years that did not entail some element of concentration on the part of the institution or institutions that got into trouble.

The *third* factor I would cite is what Paul Krugman calls the "bandwagon" effect. Beyond its obvious forms, there is a curious twist on this phenomenon Namely, financial innovations (new instruments, trading strategies, etc.) that initially produce high rates of return for the innovator tend to be very short-lived in the financial sector because they are so easy to duplicate However, the "bandwagon" effect, reinforced by the illusion of permanent high rates of returns, tends to draw relatively unsophisticated players into such activities at just the wrong time. As a further extension of the "bandwagon" effect, there is another phenomenon, which I call the "illusion of liquidity" That is the belief — obviously unfounded — by many market participants that they are that much smarter or that much quicker, or that their stop-loss strategy is that much better, so as to permit them to take profits and get out when markets turn while others take the losses

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A *fourth* factor that has been present in most financial disruptions of the past fifteen years is the threat of dislocation in payment, settlement, or clearing systems. This has been reasonably well documented in the case of the stock market crash, but very difficult and potentially very serious problems with payment and settlement systems have also been encountered in other episodes over the past fifteen years. For example, both the Herstatt situation in 1974 and the silver market disruption in 1980 presented major problems of this nature. Needless to say, payment and settlement systems are of special importance because such systems can be the vehicle through which a localized problem can very quickly be transmitted to others, thereby taking on systemic

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A *fifth* factor I would cite, but with some trepidation, is the possibility that financial markets—or at least some segments of financial markets—may be characterized by a condition of overcrowding such that spreads and returns do not fully compensate for risks In saying this, I know full well that the textbooks would say this condition cannot exist for long. The textbooks would also say that the solution to overcrowding is exit—graceful or otherwise. That is, of course, one of the things I worry about. Namely, if the overcrowding hypothesis is correct, can the implied shrinkage and consolidation occur in an orderly way, recognizing that financial institutions are not gas stations?

A *sixth* factor that must be cited is plain old-fashioned greed, which in all too many cases has given rise to fraud and other elements of criminal activity. Indeed, we have seen cases in which widespread violations of criminal statutes have occurred and numerous other examples of reckless and irresponsible behavior that I find utterly shocking. Needless to say, the problem of blatantly excessive risk taking is more likely to be a problem in the case of thinly capitalized institutions since the owners have so little to lose if things go sour.

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A *seventh* and final factor that must be cited relates to supervisory gaps or, even worse, breakdowns in the supervisory process. The worst example of this, by far, is to be found in the thrift industry situation, which saw not only a breakdown in the supervisory process but a public sector "bailout" of incredible proportions. However, the silver market disruption, the Ohio thrift problem, and the stock market crash all revealed at least some troubling elements of supervisory gaps or shortcomings in the supervisory process itself. Even today, I regard the absence of any form of consolidated oversight of major securities companies as a defect in the supervisory framework in the United States.

In this context, I am mindful that questions have also been raised about the effectiveness of the bank supervisory process in cases such as the Continental Illinois failure and the major Texas bank failures. More specifically, the question is often asked as to why the bank supervisors were not able to identify and stop the patterns of behavior that gave rise to these problems before they reached the proportions that ultimately caused failures and the large costs to the deposit insurance fund.

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While each of the financial disruptions of the past fifteen years was very distinct, every episode I can think of had elements of most of the seven factors cited above associated with it. Having said that, allow me to stress that the diagnostics of financial disruption is useful only up to a point What may be even more important is the traits of firms or markets that have generally avoided problems or the patterns of behavior that have permitted firms to overcome problems without reliance on public funds or other forms of public support Here it is clear that comfortable margins of capital and liquidity, combined with diversification of activities and exposures and strong management and control systems, are the keys to success in avoiding problems and overcoming them when they arise.

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Some myths about financial disruptions

Having shed some light on common denominators that have been present in most if not all of the financial disruptions of the past fifteen years, I would now like to turn my attention to several of what I regard as popular myths that tend to be associated with the folklore of financial disruptions. I will cite seven such myths.

First, there is the view that systemic concerns are uniquely associated with large financial institutions or, more particularly, with large banks. That is simply not true on two counts: first, large securities houses present many of the same systemic issues that arise with large banks, and second, troubled institutions need not be large *or* be banks to raise systemic concerns. The best illustration of this is to be found in the chain of events triggered in 1985 by the failure of E S M., a small government securities firm in Florida. That seemingly inconsequential failure triggered the Ohio and Maryland thrift problems and the failure of Bevill, Bressler, and Schulman, a small government securities dealer in New Jersey, placed in jeopardy several insurance companies, and came very close to producing full-scale gridlock in the entire mortgage-backed securities market. This sequence of events produced headlines in newspapers throughout the world, uncovered hundreds of millions of dollars in losses for the affected institutions, and resulted in a number of individuals being convicted of criminal violations However, none of the institutions involved was "large," none was a bank, and none had federal deposit insurance. Yet by any definition, the sequence of events had the clear potential to produce systemic damage

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The *second* myth I want to touch on is the bank "bailout" myth in general and, more specifically, the "too big to fail" myth For these purposes I want to draw a sharp distinction between banks and thrifts because I believe it important that the banking sector not be penalized unjustly by virtue of the problems in the thrift industry and the extraordinary blend of circumstances that gave rise to those problems.

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In banking, as historically defined, the term "bailout" is a misnomer, and I believe there is more to the distinction than semantics. In point of fact, banks—including large banks—have failed, and in the process the shareholders and management have not been bailed out To be sure, the process of closing, merging, and/or recapitalizing problem or failed banks has cost money, but the funds used for these purposes have, virtually without exception, been provided out of the deposit insurance fund that is funded by the banking industry itself

Having said that, there is no question that large financially troubled institutions present special difficulties simply because they, by definition, carry with them greater systemic risk and greater threats to public confidence For these reasons, governments at all times and in all places have been reluctant to run the risk of the sudden and uncontrolled failure of large depository institutions—a pattern we see even in countries that have no formal deposit insurance system. The problem, however, is not so much that large institutions are too large to fail, for large institutions have failed. Rather, the problem is that authorities are reluctant to tolerate the sudden and uncontrolled failure of large institutions and therefore generally opt for managed shrinkage, merger, or recapitalization in a context in which shareholders and management are generally wiped out

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Looked at in that light, neither equity holders nor senior managers of failed institutions—including large institutions—have any reason to believe they will be bailed out Yet, we are all acutely sensitive to the so-called moral hazard problem, which in effect postulates that banking and financial market participants take on undue elements of risk in the belief that public authorities will somehow protect them from the risks of loss and/or failure

There can be no doubt that the moral hazard problem is quite real, just as there can be no doubt that the failure of large institutions presents special problems for the authorities. However, neither of these considerations need imply that any institution is too large to fail or that owners and managers—at the least—of such institutions will not be severely penalized by virtue of such failures. Perhaps the balance of risks and rewards is somewhat out of kilter — at least at the margin — but even if this were true, it does not justify the all too widely held view that the authorities in this country — to say nothing about other countries — systematically and irresponsibly bail out financial institutions, small or large. That is not to say, however, that there is not greater room in the process for market discipline, for surely there is.

The *third* myth I want to comment on is the one that says disclosure — or more disclosure — is something of a panacea that can solve the market discipline problem While I am obviously all in favor of disclosure, I think it is sheer fantasy to assume that individual investors and depositors — and perhaps even large and relatively sophisticated investors and depositors — can make truly informed credit judgments about highly complex financial instruments and institutions Even now

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we may have a condition of information overload in a setting in which even the professional rating agencies have their problems. Continental Illinois and the major Texas banks were investment grade rated during the time interval in which they were acquiring the assets and the concentrations that led to their demise Once again, this is not to say that disclosure and/or better forms of disclosure cannot play a useful and constructive role in helping the market discipline process along, but only to suggest that the benefits of even the most optimal forms of disclosure are not as great as is assumed by many commentators.

Fourth, there is the view that firewalls are fail-safe and can fully insulate the insured depository or the registered broker-dealer from the misfortunes of its parent or affiliated companies. Not only is that view highly questionable in practice but, in the extreme, firewalls can increase risk rather than contain it That is, to the extent we depend excessively on legislative or regulatory firewalls, we may encourage riskier types of behavior or construct barriers that stand in the way of prudent intracompany flows of liquidity or of capital that can, in particular circumstances, help to minimize problems. Because of this, I believe strongly in the principle of consolidated supervision and resist the combinations of banking and commercial firms Finally, while firewalls may work the wrong way on safety and soundness grounds, I do believe they play a very necessary and useful role in limiting conflicts of interest and unfair competition.

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While on the subject of firewalls, I should also acknowledge that in the eyes of many practitioners, the presence of complex regulatory firewalls in the context of the bank holding company structure places U S. firms at a significant disadvantage in relation to their international competitors While there is something to this view, it is very difficult to judge how important this factor may be in competitive terms. What is clear, however, is that the differences in structure do introduce political tensions in the application of national treatment principles to banking and securities firms operating in foreign markets

The next myth, the *fifth,* is that market participants, or even the central bank, can readily distinguish liquidity problems from terminal financial problems in the very short run. This is simply not always the case. This reality has enormous implications for the way market participants will behave in the face of uncertainty For example, had it been clear from the outset that the stock market crash of 1987 would not result in any solvency problems of consequence, the near gridlock conditions that prevailed in financial markets at times in the days after October 19 would not have occurred. However, in the face of uncer-

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tainty, market participants tend to hold back on credit extensions, delay payments, or hold back on the delivery of securities or collateral, as is suggested in Larry Summers' October 1991 scenario. Unfortunately, in these circumstances, what may start out as a liquidity problem can all too easily become a far more serious problem, ultimately giving rise to the risk of failures or insolvencies.

The inability to distinguish liquidity from solvency problems in the very short run can also have implications for the supervisor and the lender of last resort. For the supervisor, the problem can be the legal and policy ramifications of closing or taking over a troubled institution in a context in which it may be clearly capital deficient but not so clearly insolvent. For the lender of last resort, there is the danger of violating Bagehot's first principle of "never lending to unsound people." I might add in this context that the problem of distinguishing between liquidity and solvency becomes all the more difficult in a globally integrated financial system in which large institutions may have dozens, if not hundreds, of branches, subsidiaries, and affiliates scattered throughout the world.

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The *sixth* myth I want to discuss is the view that there is something fatally and irreversibly flawed with the U.S. system of deposit insurance that in turn seriously complicates the moral hazard problem. Here again, I want to focus particularly on commercial and bank deposit insurance. The argument is rather straightforward: namely, the mere presence of a system of officially supported deposit insurance — but especially one that has gravitated towards full insurance of all deposits — largely eliminates market discipline and promotes excessive risk taking.

It seems to me that at least in its extreme form, this argument can be challenged on several grounds. First, in a number of other countries, even where there is no system of deposit insurance, the authorities are generally no more willing to allow depositors to incur losses than they are in this country, and if anything, in many cases they may tend to be more cautious with respect to their willingness to permit banks or other financial firms to fail in a disorderly manner. Second, in every case of a severely troubled bank — including those that have overcome problems — we have seen significant deposit outflows. This of course suggests that at least some depositors — typically large and/or overseas depositors — do not fully accept the notion of full insurance. Finally, as noted earlier, shareholders and managers of failed banks have in fact been systematically and seriously penalized for their mistakes.

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These remarks should not be construed to imply that I believe that there are no constructive opportunities to strengthen the workings of the deposit insurance system. Rather, the point is that we should be careful in approaching the task of reform. For example, the suggestion of subjecting offshore deposits in branches of U.S. banks to insurance premiums — whatever its merits on other grounds — runs the clear risk of further broadening the appearance of de facto full insurance and thereby changing the behavior of the one class of depositor that clearly exerts a powerful element of market discipline on major banks. I have similar reservations about risk-based deposit insurance premiums on the grounds that they may simply be viewed by some as a license to be even more risk-prone in their activities.

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On the other hand, proposals to deal with the obvious abuses of the brokered deposit market, to find faster and surer ways to merge, close, or take over seriously troubled institutions, and to strengthen both the amount and structure of capital all warrant careful study in a context in which the 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) has already put in place a number of constructive reforms At the end of the day, however, the keys are the factors I cited earlier. abundant amounts of capital — especially equity-like and unencumbered debt capital — and a strong yet flexible supervisory apparatus.

The *final* myth I want to mention is the idea that central banks can "solve" financial disruptions simply by providing individual institutions or the market at large with ample liquidity. Before going into this subject further, it is important to recognize that the contemporary central bank can provide liquidity in *at least* two ways: one is the traditional lender of last resort function via the discount window, and the second is open market operations. Depending on the nature and source of the disruption, either or both may be appropriate and either or both can provide important elements of flexibility. However, in the face of major uncertainties — especially relating to the creditworthiness of major institutions — there is no guarantee that even the provision of generous amounts of central bank liquidity can necessarily prevent a "disruption" from becoming a "crisis." Larry Summers' paper makes it plain that others recognize this possibility when he raises questions about the extent of moral suasion (arm twisting) on major banks in the wake of the October 1987 market break. You will understand why I object to phrases like "arm twisting," but hope-

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fully you will also understand my conviction that in times of stress the central bank must be prepared to provide not just liquidity but also leadership — consistent, of course, with the exercise of individual credit and business judgments by particular institutions in the marketplace. But for observers and practitioners to assume that central banks have a magic wand of liquidity and moral suasion that can overcome each and every problem is simply wrong and, even worse, dangerous.

Having said all of that, there is another side to the lender of last resort issue that is raised in Ben Friedman's and Paul Krugman's papers. Specifically, Ben raises the specter that the central bank will have to "cave in" on inflation in order to avoid financial disorder while Paul suggests the possibility that the process of providing liquidity to contain a financial disruption could trigger an international run on the dollar. These dangers are very real, but I believe it is possible to provide needed amounts of liquidity in the short run without necessarily having to compomise the basic thrust of monetary policy, and I believe that the events of October 1987 can be looked at in precisely that light.

Needless to say, however, if a "disruption" tilts into a crisis, the balancing act becomes all the more difficult, although in those circumstances, immediate concerns about current and prospective inflation would be significantly dampened, if not eliminated

Conclusion

The focus of this article is diagnostic rather than remedial. Therefore I will not at this time attempt to outline a long or a short list of public or private initiatives that could reduce elements of fragility and volatility in financial markets. Nevertheless, throughout the text are numerous comments that point in the directions in which I believe public policy should be moving. More generally, I would offer two closing comments The first would be the importance of sound overall macroeconomic and structural policies, keeping in mind that the roots of many of the financial problems we have seen can be traced to the policy fundamentals — fundamentals that include the need to reform and modernize

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the structure of the financial system. The second would be that we not lose sight of the fact that the primary burden of securing the safety and integrity of financial institutions and markets lies not with the authorities but with financial market practitioners and most especially the directors and senior management of individual firms