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Mistakes at the Federal Reserve

Greg's Note: With the banking system going through a period of turmoil, the question of federal regulation will not be going away any time soon. Are market influences enough, or should the government be taking a closer look at how these banks do business. Fred Sheehan takes a look at what went on under Alan Greenspan's Fed and what should be done now. Enjoy, and send any comments to the managing editor here: greg@whiskeyandgunpowder.com

Whiskey & Gunpowder
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By Frederick J. Sheehan

First Step — Fire the Fed

Treasury Secretary Hank Paulson has proposed the Federal Reserve be given broad powers to regulate the financial industry. He could not have nominated a more incompetent body. The Coast Guard would do a better job.

Financial upheaval owes homage to derivatives that shrouded the massive growth in debt and leverage. This murky world inflated the incentives of those who ran the machinery over the cliff — bankers, mortgage brokers, law firms, appraisers, rating agencies, politicians, and on it goes. This is well known. Despite protestations, the parties knew they were behaving either recklessly or criminally at the time. The Federal Reserve encouraged them.

With a straight face, Hank Paulson proposes that the Fed quash future imbroglios. Yet the terracotta soldiers of Xian would bring more initiative to the assignment.

In September 1998, the Federal Reserve didn't have the slightest idea of how the banking system functioned; it hadn't the slightest idea of the banks' exposure to hedge funds; nor had it the slightest idea of the leverage within the financial system. Maybe these deficiencies are excusable, although the Federal Reserve was responsible for regulating bank holding companies (the holding companies being where much of the risk was housed). It is unpardonable in the aftermath, having learned of its own deficiencies, that the Federal Reserve made no effort to improve its oversight or to warn of the dangers it had recently discovered. Instead, the Fed encouraged devious practices.

In the first three weeks of September 1998, Long-Term Capital Management (LTCM), a Greenwich, Conn., hedge fund, lost half a billion dollars per week and everyone knew it. Except, possibly, Alan Greenspan. In mid-September, the Federal Reserve chairman told the House Banking Committee that "Hedge funds [are] strongly regulated by those who lend the money." On Sept. 21, LTCM lost $550 million. In a virtuoso rejection of every financial institution's model, all security prices went down. This is normal. In a panic, everyone sells.

The Fed's lackluster oversight was partly to blame. On May 2, 1998, Alan Greenspan gave a speech in which he emphasized the advantages of "private market regulation." Greenspan explained, "Rapidly changing technology has begun to render obsolete much of the bank examination regime established in earlier decades. Bank regulators are perforce now being pressed to depend increasingly on ever more complex and sophisticated private market regulation… One of the key lessons from U.S. banking history [is] that counterparty supervision is still the first line of regulatory defense." He also noted the Federal Reserve's decision to supervise "risk management procedures, rather than actual portfolios." The Fed now evaluated how banks monitored their own risks (e.g., their modeling techniques, the process used to monitor counterparties) in lieu of examining specific securities.

The Federal Open Market Committee (FOMC) held a conference call on Sept. 29, 1998. The staff and Federal Reserve governors briefed Greenspan on Long-Term Capital Management's counterparties — the banks that lent to LTCM. He was told that none of the banks, with the exception of Bankers Trust, had an up-to-date balance sheet for LTCM. Even this was "only a small piece of [Bankers'] whole action because so much of the latter is off balance sheet." When assets are off balance sheet, the bank's motivation to "strongly regulate" is diminished.

The Federal Reserve chairman was at a loss: "The question is why it happened in the first place. Is it just that the lenders were dazzled by the people at LTCM and did not take a close look?" Vice Chairman William McDonough replied there "was in place a credit system that made a great deal of sense." In the next sentence — which simply *cannot* have been an explanation of this sensible system — McDonough told the FOMC: "For at least some of the lenders, there was no initial margin requirement." McDonough went on to suggest the Federal Reserve might have taken more initiative: "We do not regulate the firm. But given the number of institutions they dealt with around the world, was there a way that should have enabled us to be more aware of their overall position? One is inclined to say, 'You bet.' But exactly how we could have done that I am not so sure."

This was not the time for the FOMC to design a regulatory apparatus, but the Greenspan Fed never did attempt to fill this gap. In retirement, Greenspan reminds his audiences that the Fed does not regulate hedge funds. True, but the Fed could have worked backward from the foundation that McDonough had suggested. (The SEC is responsible for monitoring broker-dealers. It, too, has failed miserably.) The need for adult supervision of banks was obvious when a staffer commented on the conference call, "It is something of a signature for [LTCM] to insist that if a counterparty wanted to deal with them, there would be no initial margin. Not many other firms have gotten away with that." For this reason alone, the Fed should have geared up its watchdogs to better monitor the suicidal banking system it regulated.

Another staff member enlightened the FOMC with a frightful prospect: "The counterparties…get comfortable with zero percent margin. But from the [financial] system's point of view, zero initial margin permits an essentially unlimited amount of leverage. There is no constraint other than the exhaustion on the part of the counterparties." Greenspan and Bernanke fiddled with their slide rules as financial derivatives grew to 10 times the world's GDP. In 2007, Bernanke should have known that banks, in a desperate attempt keep dancing, were borrowing at five percent to lend at four percent.

Greenspan was vexed: "It is one thing for one bank to have failed to appreciate what was happening to [LTCM], but this list of [banks without knowledge of LTCM's positions] is just mind-boggling." So boggled was the man that the Greenspan (and Bernanke) Fed allowed the banks to lever as never before and write $400 trillion worth of derivatives between then and 2008 — without so much as a dollar bill of reserves: Nor a peep that maybe these off-balance-sheet liabilities might bear closer attention.

A staff member described what he had learned on his field trip to LTCM. On Aug. 31, the hedge fund had a $125 billion balance sheet. It also had $1.4 trillion of off-balance-sheet assets. On Sept. 21, when it appears (from the transcript) the Fed first saw LTCM's balance sheet, its leverage was 55-to-1 and the "off-balance-sheet leverage was 100-to-1 or 200-to-1 — I don't know how to calculate it." He wasn't alone. Greenspan's "first line of regulatory defense" didn't know if LTCM was trading interest rate swaps or stolen cars. The models of LTCM's "counterparty supervision" were so "complex and sophisticated" that the hedge fund's portfolio had been translated into a Greek salad — gammas, thetas, and epsilons.

For practical purposes, LTCM had no capital by Sept. 29. It was not able to meet margin calls. The hedge fund had not been required to post margin, but was required to post collateral worth 100 percent of the assets it borrowed. Even this looked amateurish. Greenspan, a former director of J.P. Morgan, shared his view: "If I am a bank lender and I lend $200 million to a hedge find, ordinarily, I would be overcollateralized. I would hold more than $200 billion in, say, U.S. Treasury bills." Greenspan asked if the collateral was U.S. Treasuries. A staffer replied: "U.S. Treasuries, Danish government bonds, BBB credits — you name it." Beanie Babies were next on the list. The value of LTCM's collateral was falling. The balance sheets of the banks LTCM traded with were sinking.

A staffer explained the risk: "I'm going to say this in plain English. If markets keep moving away from [LTCM] in the wrong direction, their future exposure could be large and they might not have the collateral at that point in time to cover the exposure." McDonough had described the house of cards earlier: "The firm's position in a variety of instruments was very large. What my contacts were talking about was the effect that the failure of the firm would have on world markets if all these positions had to be dumped on the markets. People who thought they had an offsetting position with [LTCM] would suddenly find that they did not have one. They would suddenly find themselves with big open positions…" Globalization might end in a financial meltdown.

A Fed staffer thought the banks "were saying the right things in terms of the kinds of risk management processes they had in place" but "the question is how effectively the banks were actually implementing them…" The Fed staff had not taken the initiative to check. Greenspan was told the Federal Reserve had not examined the banks since December 1997. In Greenspan's remaining decade at the helm, his bureaucrats produced masterful studies on counterparty risk, but permitted the banks' risk models to optimize executive bonus compensation.

This is interesting, but not of great utility in 2008. The 1998 Fed weaknesses are important because the molehill grew into a mountain. Greenspan and Bernanke chaired the most egregious administrative failure in financial history. Paulson's proposal is on a par with Caligula's decision to name his horse consul.

In March 1999, Greenspan gave a speech on derivatives. He might have wandered onto the podium from Mars. Derivatives "are an increasingly important vehicle for unbundling risk." He doused the post-LTCM movement toward a better form of regulation: "Some may now argue that the periodic emergence of financial panics implies a need to abandon models-based approaches to regulatory capital and to return to traditional approaches based on regulatory risk schemes. In my view, this would be a major mistake." The regulators' risk models "are much less accurate than banks' risk measurement models." The Federal Reserve is not the institution to lead the much-needed bank regulation.

The nominal value of derivative contracts held by U.S. commercial banks (those over which the Fed has direct regulatory authority) leapt from $33 trillion at the end of 1998 to $101 trillion at the end of 2005, about the time Greenspan left office. We mustn't ignore Greenspan's successor: By the second quarter of 2007, 18 months later, these banks held $153 trillion in derivatives. The collapsing financial system is in the early stage of unwinding. Ben Bernanke has had time as Fed chairman to do something — anything — to slow the production of bad debt. Instead, the rate of financial claims in the economy accelerated.

The virtues of derivatives (their ability to diversify risk away from the banking system) received full approval from Greenspan and, more to the point, from his audiences. Bernanke is considered a monetary genius. Will we ever learn? Someday, we might ridicule, rather than praise, the Fed. On that day, it should be disbanded.

Regards,
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