Remarks at the 47th Annual Conference on
Bank Structure and Competition

Federal Reserve Bank of Chicago
Chicago, Illinois

May 6, 2011

Neel Kashkari

Note: At this time in 2011, Kashkari was a Managing Director at PIMCO.

Good afternoon. Thank you for that kind introduction. It is an honor to be here with you at this important conference.

People often ask me what surprised me during my three years in Washington. One of the pleasant surprises was the quality of the people I worked with at Treasury, the Federal Reserve Board and regional banks, as well as the other financial regulators. It was an extraordinary privilege for me to work with and learn from you, and to call you colleagues. I saw many outstanding people who are dedicated to public service work tirelessly and selflessly to try to stabilize the financial system during a time of national crisis. Those are examples of leadership and service that I will never forget. And now you have honored me again by inviting me to speak at your important conference. I am grateful for and humbled by your generosity. Thank you for this honor.

Financial regulators today are extremely busy implementing the many regulatory changes that Congress has specified in Dodd Frank, and trying to close the regulatory gaps exposed by the financial crisis. This conference is important to getting those regulations right—striking the right balance between safety and innovation—but it is also important to continue the analysis and research necessary to fully understand the causes of the most recent crisis so we can reduce the likelihood it is repeated.

I’d like to share with you my perspectives on the fundamental causes of the crisis, what they mean for regulation going forward and the many questions we still don’t have answers for. I will also discuss some concepts that could be important to protecting against a future extraordinary crisis. Then I look forward to taking your questions.

One of the most important lessons I learned in my three years at Treasury is that almost every issue is far more complex than it appears in the public arena. If the answers were easy or obvious, they would already have been implemented. Policymakers are trying to balance a wide range of competing issues and constraints: economic, legal and political. It is almost impossible for thoughtful outside observers to grasp all the nuances and intricacies that policymakers at the Federal Reserve, Treasury or the White House are wrestling with. This now is true for me too, since I am no longer in government. I now tend to give policymakers the benefit of the doubt that you are likely wrestling with important details I am unaware of as you reach your conclusions.

While that is generally true for policymaking, financial regulatory reform issues are especially complex and the risk of unintended consequences is high. It will take time for the markets to fully appreciate the effects of new regulations—likely for months or even years after they are put into effect.

Setting aside politics, why is regulatory reform so inherently difficult?

First, none of us can predict the future of the financial system any more than people could in the 1930s. As policymakers considered reforms during the Great Depression, no one could have predicted that MBSs, CDOs or SIVs would pose a danger to our financial system—because they didn’t even exist at the time. Consider that Fannie Mae was created during the Depression to help support mortgage finance. Its creators never imagined it would pose a systemic risk 80 years later. In fact, the only thing we know for certain about the next financial crisis is that it won't look like the most recent crisis.

Watching airport security procedures change in response to evolving terrorist threats reminds me of the challenges in designing regulations today in response to a recent crisis that we hope will be effective in preventing a future crisis. Has forcing people to take off their shoes as they pass through security caught any more shoe bombers? Has it made air travel safer?

We must also confront a second harsh reality that is rooted deep in human psychology: We've had periodic financial crises since the beginning of recorded financial history—virtually no country has been spared—and there will be financial crises for the rest of human history.

Preventing all future crises would only be possible if we were to eliminate innovation in the financial system—which no one wants because it would deprive our citizens of better jobs and a higher standard of living.

When we consider regulation, I believe it is important distinguish between what I will call a "normal" crisis, when an individual institution runs into trouble, which happens about once a decade, and an "extraordinary," systemwide crisis when the entire system is at risk. I believe the recent crisis was an example of an extraordinary crisis—a one-in-100-year event. Let's look at its root causes to understand why such exceptional crises are so difficult to prevent: Virtually the entire country believed that homeownership was the American dream and that nationwide, home prices would only go up. The latter assumption permeated the risk models of investors, banks, regulators and the ratings agencies. When that assumption proved false, the results were disastrous.

But could we even protect against such mistakes if we could identify them in advance? Imagine if then-Chairman Greenspan had stood up in 2005 and said, "We have a housing bubble. I am going to clamp down on mortgage lending." How would the country have reacted? Potential first-time homeowners, banks, minority groups, investors and many members of Congress would have been outraged, claiming he was preventing deserving families from achieving the American dream and at the same time restraining our economic growth.

How likely is it that any regulator decades from now will be successful in first identifying and then pushing back against a cherished nationwide delusion?

Despite these shortcomings, we should without question take actions to fix the problems that led to the most recent crisis and try to make sensible reforms that reduce damage from future crises. But we should also recognize that none of us are omniscient and that the changes made today are unlikely to work as expected decades from now.

The good news is that the final tool to resolving a future extraordinary crisis is the U.S. Congress. To Congress' great credit, when policymakers asked for unprecedented TARP authority to prevent a financial collapse, they realized the danger and acted in just two weeks. That action was essential to preventing a collapse that would have brought far more job losses and foreclosures. It is likely the next time we face an extraordinary financial crisis, policymakers at the time will not have the necessary tools and Congress will again have to be part of the solution. Congressional involvement during a time of extreme crisis is appropriate.

I believe many of the tools created by Dodd Frank can be effective in dealing with an ordinary crisis when an individual institution runs into trouble. Unfortunately, I fear that we still don't know what to do about a future extraordinary crisis other than putting the balance sheet of the federal government behind the financial system.

For example, let's consider the complexities surrounding resolution authority.

Our society cherishes certain fundamental beliefs—such as our beliefs in free markets and fairness. If you take a risk, you should get the reward. But if you take a risk and you fail, you should bear the consequences. I certainly share these sentiments.

In that sense, resolution authority is very attractive. Regulators can fire the management of a failing firm, restructure its debt, forcing bond holders to take a haircut, and put the firm on sound financial footing—all without exposing taxpayers. Those are all noble objectives.

I believe such procedures can work—in an ordinary crisis—when a single firm runs into trouble, but the system is otherwise stable. The question is, would it work during an extraordinary crisis when the entire system is at risk of failure?

I ask myself if we had had resolution authority for investment banks and AIG during the fall of 2008—would we have actually used it?

I doubt it. Here's why. In an extraordinary crisis—such as the one we just faced—people don't know which institutions are healthy and which are weak. If we had resolved, say Citigroup, forcing large losses on its bondholders, how would bondholders of, say, Bank of America reacted? They would likely have been terrified that they were next, and they would likely have sold their debt to protect themselves, and in doing so caused a liquidity run that could have destabilized the institution. Banks have this peculiar weakness that when creditors get nervous and take action to protect themselves, they increase the likelihood that the crisis they fear actually happens.

This contagion is the challenge that in my judgment makes extraordinary crises so difficult to deal with. European policymakers are struggling with the risk of contagion today. If Greece is allowed to default, as we at PIMCO believe is necessary, how will creditors of Ireland and Portugal respond? Will those countries be immediately cut off from the financial markets? Where will the contagion dominos stop falling?

Hence, I believe we do not yet know what to do to deal with another truly systemwide crisis, other than to put the balance sheet of the federal government behind the financial system—which is what we did successfully this time. My suggestion is that we continue to work hard closing the regulatory gaps exposed by the crisis, but we should also be humble and honest about what we don't yet know. Much more research and reflection is needed to learn how to deal with extraordinary crises. Humility can help us to remain focused on these important issues and prevent us from gaining a false sense of security that we have solved all the problems.

In my view, our best hope to prevent a future systemic crisis is to institutionalize the lessons from this most recent crisis—lessons that the nation *can* suffer from a mass delusion and that markets, investors and policymakers *can* grossly misunderstand risk.

However, developing such a long-term memory, one that spans decades and even generations, is extremely challenging. Much of our society is driven by periodic performance measurements: quarterly reports for public companies, or 2- or 4-year election cycles for politicians. What institutions do we have that can remain vigilant for the next 100 years and raise a warning flag when a future generation is about to repeat our mistake?

Unfortunately, it is likely society itself will forget the lessons of the most recent crisis, which will then enable the conditions for a future crisis. For example, I find it remarkable that we experienced the unprecedented technology bubble in the late 1990s, and less than 10 years later didn't identify the housing bubble until it was too late. The bursting of the technology bubble was painful—especially for those speculating on tech stocks. But the recession it triggered was relatively moderate and the lessons clearly short-lived.

We often hear that some countries, such as Germany, are vigilant about inflation because their people have suffered from hyperinflation many decades ago, and the pain of those prior generations is still carried by their citizens today. In that sense, the painful lessons of inflation have been institutionalized in German society itself. That institutionalization reduces the likelihood that the policy mistakes that led to hyperinflation will be repeated.

While this most recent crisis inflicted significant pain on millions of Americans and, indeed, continues to, the pain was far less than it would have been had the financial system collapsed, which could have triggered another Great Depression. Stabilizing the financial system was absolutely the right thing to do, but I fear one result is that we've now reduced the likelihood that American society will retain these lessons, making it more likely that a future American generation will suffer from a mass delusion that leads to a future crisis.

If I am right that society itself won't retain the lessons, how can we institutionalize them?

One would normally look to universities as institutions to retain and pass along knowledge, but I fear that our universities have become too responsive to their customers, their students, to play this role. Business schools today adjust their curriculum to meet student demands. In the late 1990s, they all taught entrepreneurship. After Enron, they all focused on corporate ethics. Now they are all teaching courses on the financial crisis. In 10 years, they will be on to the next hot topic.

If neither society itself nor our universities are likely to retain and pass along these lessons, could our political system? Unfortunately, in my judgment, our executive and legislative branches are too consumed by day-to-day political demands to take such a long-term view. It is hard to get politicians to focus past the next election, let alone look ahead decades.

For example, President Reagan created the President's Working Group on Financial Markets (PWG) after the stock market crash of 1987, under the leadership of the Treasury Secretary, and comprising most federal financial regulators. But by the time Secretary Paulson joined Treasury in 2006, just 20 years later, the PWG had already fallen dormant. With Chairman Bernanke's help, they reenergized the PWG, which became an important coordinating body during the crisis, and it has now been reconstituted as the Financial Stability Oversight Council, which will hopefully remain a vigilant watchdog for the next hundred years. Congress is to be applauded for codifying this coordinating body in legislation and directing it to watch out for emerging threats to financial stability. But politics in Washington can change priorities—especially when markets and the economy appear calm. Note that the biggest regulatory topic in Washington and on Wall Street just before the financial crisis erupted was "capital markets competitiveness"—a fear that our markets were losing out to international competition because they were smothered under *too much* regulation.

While the FSOC has an important role to play, I believe our best hope for institutionalizing these important lessons lies within the financial regulators themselves, and indeed especially within the Federal Reserve System.

You have fought hard over many decades to establish and maintain your independence from day-to-day politics. Indeed, your monetary policy mandate requires you to look across decades and incorporate all that you have learned from past policy successes and failures. Given your large, highly trained staff of research and regulatory personnel, your independence from politics and your significant presence outside of Washington, I believe you have the best shot of maintaining your focus over decades. But it won't be easy. It would take a focused effort from your senior leadership, who would need to declare this a cross-generational priority for the system.

What are some of the ideas that could help institutionalize these important lessons within the Federal Reserve System? Here are just a few, but I'm sure you can come up with better ones:

1. You have a governing document called "The Purposes and Duties of the Federal Reserve System," which categorizes your duties into four areas: monetary policy, banking supervision, financial stability and providing financial services such as

the payments system. Perhaps these duties could be updated to specifically include retaining and passing forward the lessons of past crises?

2. Conferences such as this one could be another vehicle. The agenda of this year's conference is focused on designing and implementing new regulations. Perhaps future conferences could specifically include a session on institutionalizing these lessons?
3. During the crisis, a friend suggested I read John Kenneth Galbraith's 1954 book *The Great Crash*. I didn't have time to read it until after I left Washington. When I did read it, I couldn't believe how prescient it seemed—how modern society had repeated many of the same mistakes that led to the Great Depression. I also couldn't understand why this remarkable book hadn't been required reading when I attended business school, or even when I joined the Treasury. Perhaps there are a few such timeless pieces that could be required reading for every new financial regulator or policymaker? The challenge is how to prevent that reading list from being updated 20 years from now when someone decides these lessons are just outdated relics of an era long since passed.

The goal that I am describing should be to create institutional processes so that 50 or 100 years from now, the next time the entire country deludes itself that we have found a low risk source of easy wealth, someone in authority can stand up and say, "Wait, we have seen this movie before. It doesn't end well."

This is an aspirational goal and I know it won't be easy. And, indeed, as I indicated earlier, society may still not listen.

Thank you inviting me to join your important conference and for listening to my ideas. I hope you found them interesting. I am now happy to take your questions and have an active discussion with you.