Reserve Bank of India Occasional Papers
Vol. 41, No. 2: 2020

Firefighting: The Financial Crisis and its Lessons by Ben S. Bernanke, Timothy F. Geithner and Henry M. Paulson, Jr., 230 pp., Profile Books Ltd, United Kingdom (2019), ₹499

The global financial crisis of 2008 inflicted tremendous pain on the global economy by disrupting economic activity and causing intense pessimism in the financial system. The worst recession, also known as the 'Great Recession', was triggered by the bursting of the housing bubble in the United States (US) and its spillover effects contaminated the global economy. Much has been written on the 'crisis' covering its genesis, aftermath and policy responses. But this book titled *Firefighting: The Financial Crisis and its Lessons*, written by the three architects of the American policy response to the crisis—Ben S. Bernanke, Chairman of the Federal Reserve (Fed); Henry M. Paulson, Jr., Treasury Secretary under George W. Bush, and Timothy F. Geithner, President of the Federal Reserve Bank of New York—provides a more authentic account of the way the crisis unfolded, its consequences, and the collaborative efforts made by the authors to deal with it. The authors also offer key lessons from their experience that might help to prevent and deal with future crises.

The authors argue that the turmoil in financial markets is usually self-adjusting, except for a few unusual cases, which require limited intervention by policymakers. However, the crisis of 2008 was the worst financial crisis since the Great Depression, which warranted extraordinary interventions from policymakers in the form of conventional and unconventional measures to stabilise the financial system. The crisis of 2008 was essentially a case of 'classic financial panic', a repeat occurrence since the dawn of modern banking. This time the crisis of confidence was triggered in mortgages. The authors profess that overleverage caused by excessive optimism during the period of boom coupled with risk transfer to non-banks, rapid financial innovations and absence of inter-regulatory coordination along with failure of regulatory authorities to keep up with changing market realities contributed

to the financial shocks of 2008. As the invisible hand of free markets failed to stop the financial collapse, the visible hand of the government had to intervene to stop the panic, restore confidence and fix the broken financial system. Eventually, normalcy was restored in the system due to the deployment of all feasible range of financial and economic weapons at the disposal of the policymakers. While the implementation of sweeping financial reforms has reduced the probability of another financial crisis in the near future, the occurrence of another crisis cannot be ruled out given the inevitability of panic and overconfidence in human beings.

The book consists of five chapters, starting with the genesis of the crisis in Chapter 1. Chapters 2 through Chapter 5 cover the crisis and the various policy responses undertaken from August 2007 to May 2009, and offer lessons and warnings for the future. The financial system is inherently fragile and vulnerable to panic because of its dependence on investor confidence which is evanescent. The authors discuss how in the years prior to the crisis, the US economy was characterised by excessive optimism resulting in a credit boom in the mortgage market, unsustainable growth in household mortgage debt, reckless expansion in credit facilities to less creditworthy borrowers, securitisation of mortgages with low ratings, and spreading of risk through mortgage-backed securities through financial innovation to the financial system. Overexposure of the financial system to unanticipated risks in the mortgage market and overleverage of systemically important financial firms, especially short-term liabilities, became the triggers for panic market reaction. Furthermore, lack of tougher and more pro-active regulators, failure of the supervisors to recognise the actual level of leverage, a fragmented financial regulatory system with no agency responsible for monitoring systemic risk combined with the migration of the leverage to unregulated shadow banks or non-banks made the fragile financial system susceptible to a disaster. The authors acknowledge that it is exceptionally hard to predict a financial meltdown and they were not sufficiently creative or forceful in taking actions to prevent those risks. There was also a failure of institutional organisation structure within the government and the politics of boom time was not conducive to reforming the system before the crisis. The crisis started to make an appearance with the end of the housing bubble. Creditors and investors

shunned not just subprime mortgages, they distanced themselves from anything associated with mortgages.

The authors emphasise that even though recognising a crisis is challenging, it is very important to assess the severity of the crisis, as an overreaction may create a real moral hazard problem, while under-reacting can be costlier and more damaging. In the initial period of the crisis, or during 'the first flames' as the book calls it, the Fed adhered to conventional tools like the discount window for providing emergency liquidity to commercial banks and reduction of federal funds rate. Subsequently, the Fed decided to launch unconventional monetary policy tools such as the Term Auction Facility (TAF) to provide long-term lending to eligible banks at a market determined rate and forex swap lines to increase dollar liquidity with foreign central banks to limit the panic. The US Department of the Treasury also devised fiscal stimulus in the form of temporary tax cuts to support the market. However, as the unusual market conditions persisted, the Fed, with the support of the US Congress, decided to extend liquidity support to non-banks through the Term Securities Lending Facility (TSLF) using emergency lending power. Subsequently, the Fed also created a new lending facility for investment banks called the Primary Dealer Credit Facility (PDCF) for accepting a wider range of collaterals. The intervention through innovative lending facilities helped to rescue firms like Bear Stearns with the support of JP Morgan Chase. During the panic, some much criticised and unpopular interventions had to be resorted to by the authorities, including the nationalisation of systemic institutions Fannie Mae and Freddie Mac, which were constantly pushing the US Congress for more reforms to give more authority to the Fed and the Treasury.

The authors acknowledge that their aggressive interventions to stabilize the financial system also sent unintended messages to the market of higher fragility in the system and the market didn't breathe a sigh of relief. The demise of Lehman Brothers in September 2008 was the most consequential moment, which dramatically accelerated the crisis of confidence in every financial firm. Explaining the crises at Lehman and American International Group (AIG), the authors admit that failing to save AIG a day after Lehman's failure would have been calamitous. Despite concerted efforts from the Fed, the Lehman

filed for bankruptcy because of its financial unviability and lack of acceptable collaterals at its disposal. At the peak of the crisis, with a worsening state of the broader economy, the passage of the Troubled Asset Relief Programme (TARP) gave remarkably expanded powers to the Treasury to purchase toxic mortgage-backed securities and quell the panic. Subsequently, it was decided to inject capital directly into financial institutions from TARP cash to adequately capitalise the system.

As the global financial system was still unstable and the economy was deteriorating, additional measures were taken including in the form of liquidity support to the commercial paper market through purchases of commercial papers from eligible issuers under the Commercial Paper Funding Facility (CPFF), a coordinated interest rate cut by the major central banks (led by Fed), and reducing the policy rate to zero by the Fed. The new US government pursued a variety of aggressive measures to bring the economy back to life, including the largest fiscal stimulus bill in American history and the Treasury's effort at forcing partnership with the private sector to buy troubled assets under the Public-Private Investment Programme (PPIP). The authors emphasise that the Supervisory Capital Assessment Programme, or 'the stress test', was the culmination of a long series of emergency interventions. The better than expected results of the stress test along with the previous series of intervention measures restored confidence in the health of the banking system and reassured the market that there would be no more Lehman.

The concluding chapter of the book is cautionary, and discusses the devastating effects of a financial crisis, irrespective of the aggressive nature of interventions and financial strength and credibility of the financial system. To not have another financial crisis is the best outcome for any financial system; however, the occurrence of another crisis is unpreventable. What can and must be ensured is preventing the deepening of a crisis by empowering crisis managers with necessary enabling provisions by the government. The authors acknowledge that their forceful and effective response was made possible by the expanded powers provided to them by the US Congress during the crisis, which eventually controlled the panic. While better regulations and supervisory standards such as the Basel III regulatory framework would be helpful to

avoid panic in the future, the authors remain concerned about discontinuation of the new powers that were used to stabilize the system such as expiration of TARP, inoperative of 13(3) emergency authority of Fed, elimination of broad guarantee authority of Federal Deposit Insurance Corporation (FDIC), removal of Treasury's power to use the Exchange Stabilization Fund (ESF) to issue guarantees *etc.* Therefore, the authors insist on restoring the emergency tools of the authorities that helped to manage and contain the crisis of 2008.

The book provides an excellent narration of the 2008 financial crisis and the way it was managed. Beyond the narrative, the lessons drawn by the authors in battling the crisis can serve as an important guide to policymakers in general and central banks in particular. The advice related to the unconventional measures used in a crisis can supplement the Bagehot dictum for central banks. The authors are, however, at times appear prone to self-aggrandisement while responding to criticisms concerning their unpopular interventions. Nevertheless, their admission of not being sufficiently creative or forceful in their actions adds credibility to the analysis. The authors do offer a warning on the certainty of financial crises occurring in the future, and their advice to prepare better by providing stronger emergency time policy tools to the regulators should serve as a useful guide to contain vulnerability of the financial system.

Rasmi Ranjan Behera*

* Rasmi Ranjan Behera is a Research Officer in the Department of Economic and Policy Research, Reserve Bank of India.