Reserve Bank of India Occasional Papers
Vol. 35 & 36, No. 1 & 2: 2014 & 2015

***The Courage to Act: A Memoir of a Crisis and its Aftermath,* by Ben Bernanke, 610 pp. W.W. Norton & Company (2015), US$ 35.**

Crises often resemble one another but each crisis is unique. In his memoirs, Ben Bernanke, former chairman of the United States Federal Reserve Board, takes us through his journey from his early days in Dillon, South Carolina to becoming one of the men on whose shoulders lay the responsibility of fighting the global financial crisis, a crisis similar in impact to the Great Depression yet dissimilar in its origin, character and eventual management.

Bernanke attempts to put his side of the story to a wider audience with this book. He presents a riveting account of the crisis which is rich in detail and yet manages to keep the reader suitably engaged. The professor in Bernanke is put on display when he explains esoteric concepts lucidly. With this book, Bernanke provides insights into the world of US monetary policymaking. *The Courage to Act* not only gives a glimpse of the tumultuous times faced by policymakers during the global financial crisis and how they responded to it but it is also a blow by blow account of how the crisis was managed. Bernanke attempts to explain the rationale behind the bailout of many financial institutions in the US during the crisis and more importantly he address the question of why Lehman could not be saved.

Trigger for the Global Financial Crisis

Many believe that the bankruptcy of Lehman Brothers in September 2008 was the trigger for the global financial crisis. However, Bernanke dispels this notion and claims that BNP Paribas' barring investors from withdrawing money from three of its funds backed by US sub-prime mortgages more than a year ago in August 2007 set in motion a chain of events which culminated in the bankruptcy of Lehman Brothers and almost brought down the financial architecture in the US.

Sub-prime lending and other vulnerabilities

Legislative changes in the latter half of the 1970s provided a fillip to lending in lower-income and minority communities which were previously excluded from formal credit by banks. Over time, changes to usury laws, advancements in technology and standardised scores eventually led to automation in lending decisions which in turn increased the attractiveness of sub-prime lending. With the advent of securitisation, financial institutions dealing in mortgage loans were able to sell their loans to third parties. These loans, often from different parts of the country, were then converted into marketable securities, sliced into segments, which were sometimes rated as safe and sold off to investors. On the other hand, mortgage originators started deviating from the traditional model of raising deposits to make loans and instead started relying more on wholesale short term money to fund mortgage loans. This arrangement seemed to be a win-win situation for everyone involved. Borrowers, even with poor credit histories, could get loans easily; standardisation allowed mortgage firms to service a wider customer base and securitisation allowed them to dispose of these securities to investors which in turn encouraged questionable and sometimes outright unethical lending practices by these firms. On the other hand, investors had access to seemingly highly rated assets with yields higher than those on government bonds. Lax and often fragmented regulations did little to mitigate the underlying vulnerabilities.

Credit ratings which had once facilitated investors in buying mortgage backed securities turned out to be a major source of information asymmetry when even highly rated securities faced losses causing investors and lenders to shun any kind of security backed by mortgages. In the meanwhile institutions which had used these securities as collateral to borrow in the short term money markets faced runs as lenders demanded more collateral or shortened the maturity of the loans forcing borrowers to sell assets to meet liabilities which in turn led to lower prices of these securities and hence more selling. In the end it was a race to the bottom. A relatively small problem which had originated in the US mortgage markets threatened the entire financial system.

Policymakers' Response

The Federal Reserve as the 'lender of last resort' had to intervene swiftly and forcefully to stem money markets from freezing, sometimes making innovative use of already existing arrangements and sometimes using special emergency powers balancing financial stability concerns while avoiding moral hazard and ensuring proper market functioning. The Federal Reserves' response had to be calibrated to ensure that its interventions were effective otherwise it risked losing credibility which would have worsened the crisis. To this end, Bernanke emphasizes the need for communication which is clear but also which allows manoeuvrability should the need arise.

In the midst of the financial storm, the Federal Reserve faced the possibility of losing control of monetary policy. During the early part of the crisis, monetary policy goals seemed to be at odds with financial stability goals. While the Federal Reserve was forced to lend large amounts of money to reduce liquidity risks which the firms faced, it risked losing control over the federal funds rate due to intervention-induced high liquidity, a problem it solved by sterilised interventions initially and by paying interest on reserves later on in the crisis.

A period of apparent and uneasy calm prevailed after the rescue and eventual sale of Bear Stearns. All this while losses mounted on mortgage backed securities and the crisis eventually arrived at the steps of Lehman Brothers, Freddie Mac, Fannie Mae, Merrill Lynch, AIG, Washington Mutual and Citi Group among others. The failure of Lehman Brothers came to be one of the defining moments in the global financial crisis. With the bankruptcy of Lehman, rescue of Bear Stearns and Merrill Lynch, and with Goldman Sachs and Morgan Stanley changing their legal status from securities holding companies to bank holding companies, the era of independent investment banks came to an abrupt end.

Failure of Lehman was not a policy choice

With short term funding drying up, it was a race against time to save Freddie Mac, Fannie Mae and the world largest insurance company AIG. Keeping in mind the long term consequences of disruptions in short term money markets, the Federal Reserve wanted to keep it functioning. While Freddie and Fannie were put under conservatorship of the US government, the Federal Reserve lent US$ 85 billion to AIG. Bernanke strives to dispel the notion that Lehman was allowed to fail or that Lehman's failure was a policy choice. He argues that unlike the rescue of Bear Stearns, Lehman did not have any buyers who could take over its liabilities. Unlike Freddie and Fannie, Lehman also did not have funds approved by the US Congress and unlike AIG it did not have good collateral against which the Federal Reserve could have lent to it.

Given the magnitude of the aftermath of Lehman's failure, economic historians will debate whether Lehman could have been saved for a very long time to come. Whether history will judge Ben Bernanke's Federal Reserve with kindness or not is also a moot point. While Bernanke's arguments on why Lehman could not be saved will find many sympathizers, not everyone is likely to be entirely convinced. Even as Bernanke describes the unprecedented and creative use of regulatory dispensation and forbearance in bailing out to AIG especially in terms of the collateral accepted in granting the loan, the question of why the same tools were not used to the same extent in Lehman's case remains.

What the book offers

Bernanke's book has more to offer than just the narrative of the crisis and its management. It has commentary on the need for good policy communication, the contours of policy action during a crisis, human resource management, financial stability policy and its implementation, the need for a holistic approach to regulation and supervision, policy transparency, inflation targeting, unconventional monetary policy, quantitative easing and a whole host of other issues of interest to policymakers in general and to central banks in particular. Thus, this book has the potential to serve as an important guide. Bernanke calls for fiscal and monetary policy to act in unison and dispels the notion that monetary policy alone can shoulder the responsibility of re-energising US economic growth.

Bernanke could have used this book to serve as his swan song or a conduit for securing his legacy but he attempts to do neither. On the contrary, he acknowledges that no one can know for sure the extent to which monetary policy helped the economy. Like the Lehman episode, the title of Bernanke's book is likely to be hotly debated. It is true that policymakers at the Federal Reserve, US Treasury and other agencies sometimes had to act in the face of severe widespread criticism and even opposition from lawmakers; what is equally true is that the cost of inaction would have been unprecedented.

On being asked about the movie *Too Big to Fail,* in which Paul Giamatti portrayed Bernanke; Bernanke, having fought the crisis first hand, replied that he did not need to see the movie as he had seen the original. It will be hard for anyone to disagree.

Anand Shankar*

* Anand Shankar is a Research Officer in the Department of Economic and Policy Research, Reserve Bank of India.

Published by Michael D. Patra for the Reserve Bank of India and printed by him at Alco Corporation, Gala No. A-25, A Wing, Gr. Floor, Veerwani Industrial Estate, Goregaon (E), Mumbai-400063