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Yale Program on Financial Stability

Lessons Learned

William “Bill” Dudley

By Sandra Ward

William “Bill” Dudley was the executive vice president of the Federal Reserve Bank of New York’s Markets Group from 2007–09 and vice chairman of the Federal Open Market Committee from 2009 to 2018. In January 2010, Dudley was named the 10th president of the New York Fed, succeeding Timothy Geithner. This Lessons Learned summary is based on an interview with Mr. Dudley.

During the Global Financial Crisis of 2007–09 (GFC), it was critical for the Fed to craft a lending facility that could provide banks with necessary funding without stigmatizing them and, at the same time, allow the Fed to provide liquidity without undermining its ability to manage the federal funds rate.

In late 2007, the wholesale credit markets had begun to tighten, and rates for interbank lending rose due to spillovers from the housing crisis. Despite this, few banks accessed the Federal Reserve’s discount window, its standing facility for overnight lending to depository institutions. Dudley discussed some reasons for this and how the Fed addressed this problem.

Dudley stressed the importance of removing the stigma associated with the Fed’s discount window as a way of making banks comfortable approaching the Fed for funding. The Term Auction Facility (TAF), implemented in December 2007, which Dudley was deeply involved with designing and implementing, proved to be the mechanism that encouraged banks to come to the Fed without fear of stigma. The auction format encouraged participation among many banks, and the lag between the auction date and the receipt of funds removed the sense of urgency often associated with such loans. Under TAF, loans were extended first for 28 days and later for 84 days.

Still, the Federal Reserve was limited by its operating framework from providing large amounts of liquidity to the banking system because of its mandate to manage the federal funds rate at a certain target.

Dudley observed:

Adding reserves through liquidity facilities potentially could undermine the ability to keep the funds rate at the target. The facilities, when they were rolled out, weren’t open ended and unlimited. They were always for a finite amount of dollars at the auction. That was always a little bit of a problem because it meant the Fed could always be one step behind the curve. You also couldn’t reassure people that if you needed the liquidity it’s absolutely going to be there.

The eventual passage of the TARP (Troubled Assets Relief Program) legislation in the fall of 2008 allowed the Federal Reserve to begin a scheduled plan to pay interest on reserves immediately and move to unlimited and open-ended liquidity facilities.

Noted Dudley:

The new regime of paying interest on reserves is much better, as it doesn't create an inherent conflict between providing liquidity to the system and maintaining control of monetary policy. You can now add as many reserves to the system as you want without that having consequences for the Fed's ability to target the federal funds rate.

Macroeconomic views need to be bolstered by an understanding of the markets.

An inherent blind spot in the workings of the Fed, according to Dudley, was its reliance on macroeconomic forecast models, in which the financial sector wasn't much of a factor.

Dudley pointed out:

The idea that bad things could happen in the financial sector and could spill over powerfully to the real economy wasn't how macroeconomists thought about things. There were many times I talked about how the economy could go south: How the housing market could turn down, and that could put pressure on the financial asset prices, and that could put pressure on financial institutions and the whole system could start to unwind.

There was considerable skepticism about how this could turn out very badly.

Nonbank financial institutions were a weak spot during the GFC and remain so today.

In 2007–09, the Federal Reserve didn't have supervisory authority over nonbank financial institutions; that remains true today, with very limited exceptions. And it was commonly acknowledged, as Dudley pointed out, that "the entity that did have the authority, the Securities and Exchange Commission, didn't put much emphasis on financial stability and safety and soundness." This led to a vacuum of information and other developments that exacerbated the GFC. Dudley explained:

There also wasn't a sense that the failure of a large securities firm [such as Lehman Brothers] would be devastating. There are a couple of reasons for that: one, there hadn't been financial securities firms of this size before. They were a product of the growth of the capital markets and the securitization markets in the 1980s and 1990s.

Goldman Sachs and Morgan Stanley were 10 to 20 times bigger than they were in the 1970s, maybe more than that. The one sizable securities firm that failed, and it was much, much smaller than the firms that failed in 2008, was Drexel Burnham Lambert [in 1990], and there was little contagion to other firms from that. The

world had changed [by 2007], but the regulatory regime had not kept up with that change. These entities were much bigger, much more interconnected, and much more systemic than previous firms had been back in the '70s and early '80s.

Since the financial crisis, the five big independent investment firms either failed (Lehman Brothers), were acquired by banks (Bear Stearns and Merrill Lynch), or gained bank-holding status (Morgan Stanley and Goldman Sachs). As a result, a big part of the regulatory issue resolved itself in the post-crisis period. However, according to Dudley, the nonbank sector continues to pose risks to the system, and that was evident in the most recent economic crisis prompted by the COVID-19 pandemic. He observed:

We saw the weakness in terms of the Fed's need to intervene in the Treasury market and buy massive amounts of Treasuries to help hedge funds unwind very leveraged trades, where they were long cash Treasuries and short Treasury futures. We saw it again when the Fed had to intervene to support the money market mutual fund industry. We saw it again in the Fed intervening to support the corporate bond market. Most of the financial difficulties we've seen during the current coronavirus pandemic are not in the banking sector. The regulatory oversight of the nonbank financial sector still looks quite weak.

The GFC could have been better contained and less severe if more creative actions had been taken sooner.

It is accepted knowledge that abuses in mortgage underwriting and the shoddy underwriting of securitized assets led to a disastrous chain of events. Dudley explained that adding fuel to the fire was that "banks were clearly undercapitalized relative to the risks they were running. Banks didn't have enough liquidity because their off-balance-sheet activities, the special investment vehicles (SIVs), came back on their balance sheets." Another weakness that Dudley pointed to was the interconnectedness of the financial system in 2007.

He offered that if the Fed had taken system-wide steps earlier, the crisis might have been less severe. He suggests that if the Fed had addressed the subprime mortgage market and required banks to raise more capital and to stop paying dividends sooner, they wouldn't have faced as serious a liquidity crunch as they did. Dudley admits that such actions "would have taken a lot of foresight and confidence" but thinks such steps could have led to the crisis being "better contained."

Understanding the linkages within the system and questioning broadly held assumptions are vital to avoiding problems in the future.

Dudley discussed how a key element of the GFC was the interconnectedness of the global financial system and how shocks in one area reverberated into other areas. It was a development that had largely gone unrecognized and consequently was not well understood at the time. Dudley believes that questioning widely held assumptions and examining the basis for those assumptions can uncover flaws that potentially could put the entire system at risk. It takes imagination and creativity, but Dudley believes it's a

necessary exercise to avert potential disaster. As an example, he recalled the widely held opinions regarding securities ratings:

One assumption that was held broadly was that the ratings of these securitized assets reflected their underlying riskiness. We found out that wasn't true. The assumption that the subprime market wasn't big enough to threaten financial stability turned out to be wrong. When people have strongly held assumptions, and those assumptions are generating a boom, and those assumptions subsequently turn out to be incorrect, you almost always are going to have a bust on the back end.

Thinking about how the whole system fits together is absolutely critical, as is understanding what assumptions might turn out to be wrong and, if they are wrong, what's likely to happen as a result.

Solutions should be carefully crafted to be useful and to instill confidence and credibility.

While most of the programs rolled out by government agencies were well designed and provided immediate relief, some were never utilized, raising the question of their usefulness. Dudley cautioned that government agencies need to be careful to design appropriate programs well suited to solving well-diagnosed problems to maintain confidence and credibility, especially when time is short and staff is stretched. He highlighted one example from the GFC that illustrated this point:

There was a money-market fund intervention called the MMIFF (Money Market Investor Funding Facility). I didn't think it was a very useful facility at the time, and I argued against implementing it, but I was overruled, and it was implemented, and it was never used.

It didn't cause any grave harm. But it did use up scarce staff resources and time. Also, I didn't want to do things that I didn't think were going to work because there was a credibility consequence to that. At present, in the current crisis, one of the facilities that has been introduced and where the jury is still out is the Main Street Lending Facility.

However, Dudley also emphasized that usage of the facility may not be the only measure of success: "In assessing the value of the Fed's liquidity facility, it's important not to assess it on how much it's used but assess it on how much it reassures people and changes the perception of risk." He described how the fact that the facility is cloaked in credibility from the very beginning itself has benefit:

The announcement of the intervention is going to precede the actual implementation by several weeks or even months, and so credibility is important to reassure people the fire engines are on their way and they will put out the fire. Even though they haven't arrived yet, people will feel more comfortable that the whole city block isn't going to burn down.

It's important to be cautious about making sure you got the diagnosis right and actually coming up with responses that are credible because the next time when you introduce a liquidity facility in a crisis, you want people to respond very positively to the announcement of the facility even before it's actually in place. I think the Fed has a good record in this regard, and that has made their inventions more effective.

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