Stress Test: Reflections on Financial Crises

Timothy F. Geithner
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A public servant shaped by crises
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Timothy (‘Tim’) Geithner, Secretary of the Treasury during President Barack Obama’s first term of office, has written excellent memoirs on the US financial and economic crisis in 2007–2009.

At the onset of the crisis, Geithner was President of the Federal Reserve Bank of New York, prior to his transfer to the Treasury at the beginning of 2009.

Geithner was regarded as a Wall Street ‘henchman’, a former banker, but in reality he had pursued his entire career preceding the ministerial portfolio in the public sector, largely in the Treasury. However, the bailouts of large banks during the crisis sustained the impression of a Wall Street background.

His key employers and supporters were, in the early stages of his career, Henry Kissinger and, subsequently, the former Secretaries of the Treasury Robert Rubin and Larry Summers. Of these, the latter was also a vital collaborator during the crisis.

Prior to becoming President of the New York Fed\(^1\), he had been moulded in the Japanese and Asian financial crises.

This career orientation was influenced by the reputation, due to his family background, of being ‘an Asia expert’. Mervyn King, former Governor of the Bank of England, later characterised Geithner by noting that he was present at all the crises, but did not cause them; they caused him.

Geithner has no background in research or economics, being an expert on international relations. He stresses his inexperience in politics before taking over the post of Secretary of the Treasury.

Wall of money

Drawing on his previous experience of crises, Geithner adopted a theory of wall of money as a means of halting financial crises. He describes this as an application of Colin Powell’s strategic doctrine under which the use of military force must be postponed as long as possible, but, when it is time to take action, it should occur with overwhelming force at one go, rather than gradually.

Geithner’s guiding principle in the 2007–2009 crisis was avoidance, in every possible way, of a situation similar to the Great Depression of the 1930s. The large wave of bank defaults could have easily led to such circumstances in the light of experiences from the 1930s. He likes to use a comparison with a fire. When the town is in flames, it is not advisable to focus on punishing the arsonists. All action must be subordinated to containment of the fire and the prevention of its spreading. Only after this has been done, should attention be concentrated on reforms aimed at preventing fires. This enables minimisation of the costs to society.

\(^1\) He was recommended as Fed President particularly by Summers, who regarded Geithner as one of those few who could intellectually challenge him, a comment that, according to Geithner, also tells much of Summers himself.
In managing the financial crisis, Geithner was constantly coming up against the view that bank rescues with taxpayers’ money only increase moral hazard among banks. He referred to representatives of this school of thought as Old Testament fundamentalists who preferred to punish instigators rather than prevent crises from spilling over. A considerably more reserved bailout policy was advocated by the Chair of the US Federal Deposit Insurance Corporation (FDIC), Sheila Bair, who also had a key role to play in the management of the crisis².

**Washington Mutual**

The financial crisis deepened dramatically, as no buyer could be found for Lehman Brothers investment bank and it was allowed to go bankrupt in September 2008 without government intervention. Geithner deems this a giant mistake, but describes a situation in which the authorities’ insufficient powers and a lack of political will rendered a rescue operation impossible. In a way, the final nail in the coffin was driven by the UK supervisor with its decision to reject the takeover bid for Lehman mounted by Barclays Bank.

According to Geithner, the failure of the Washington Mutual (WaMu) savings bank was eclipsed by Lehman.

In connection with the WaMu reorganisation, the FDIC wrote down assets of creditors other than depositors. It was not until this measure had been taken that the panic of debt investors expanded to commercial banks. Until the reorganisation of Washington Mutual, the financial crisis was seen as a problem of large Wall Street banks and investment banks. This was then followed by the collapse of Wachovia Bank. These incidents showed once and for all that the entire US banking sector was at risk.

The authorities had to broaden their publicly announced guarantees in order to keep the most significant banks afloat, but doubts about the risks inherent in banks remained simmering on the markets.

**Nationalisation of banks?**

At the time Geithner took on his responsibilities as Secretary of the Treasury, the bank rescue package (Troubled Assets Relief Program – TARP) and fiscal stimulus measures had already been decided in autumn 2008 with Hank Paulson as Secretary of the Treasury. It had originally been thought that TARP assets would be used for purchasing banks’ problem assets. However, by the beginning of 2009, some of these funds had been used for individual bailout operations, and Geithner saw the determination of proper purchase prices as a nearly insurmountable problem.

Using the remaining assets for bank recapitalisation began to surface as a much more effective solution. In support of this, Geithner developed the idea of a stress test to assess banks’ potential losses, in a scenario reminiscent of the 1930s Great Depression. Disclosure of the stress test results and, if necessary, further capital injections by the government could restore investor confidence in banks.

In early 2009, the markets did not believe in the plan. Geithner was widely criticised for his presentation of the idea. Of the Obama administration advisors, Summers and Jeremy Stein supported the banking sector’s immediate reorganisation via temporary nationalisation, if necessary. They, however, backed Geithner’s plan, as Rahm Emanuel, White House Chief of Staff, made it clear that no new TARP application was to be submitted to Congress.

The huge criticism from the public towards the bank support was heightened by the fact that AIG, an insurance company bailed out by government funds, paid out bonuses while the rescue programme was still in operation and the authorities had no possibility of reversing them.

Nevertheless, given the severity of the scenario employed, the markets believed in the stress test results released in May 2009. Bank balance sheets turned out to be better than feared and TARP assets were sufficient for necessary recapitalisations in addition to the capital raised by banks themselves. Investor confidence in banks began to be restored. Taxpayers’ investments in the banks finally yielded profits.

Even so, critics of Geithner would have preferred allocation of support to mortgage debtors in difficulties rather than to banks. Geithner deplores the failure to do more for mortgage debtors, but absolutely considers the bank support and fiscal stimulus provided as being the most effective means of deploying taxpayer money. He

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²Her views are compiled in a book: Bair, S. (2012), Bull by the Horns: Fighting to Save Main Street from Wall Street and Wall Street from Itself, Simon and Schuster.
argues that fiscal stimulus to the economy and, through that channel, job creation were the best way of also helping mortgage debtors to service their debts.

**Capital, capital, capital**

Geithner ascribes the causes of the financial crisis to banks’ lean capital buffers and very short-term debt finance. These constituted a dangerous business model, permitted by the authorities. The crisis deepened upon investors’ realisation that a significant proportion of capital instruments eligible for fulfilling bank capital requirements did not provide safeguards against losses.

Behind the crisis, he sees a typical Minsky-style mania, dominated by a belief in the stabilisation of macroeconomic risks, as a consequence of which recessions would remain mild. This refers to the period of Great Moderation, well-known to macroeconomists.

Geithner also points to the statement made already pre-crisis by Vikram Pandit, who took over as chief executive at Citigroup during the crisis, that the corporate culture of Wall Street investment banks ‘went sour’ after their conversion into public corporations.

Instead, contrary to popular belief, he does not consider securitisation of bank loans and their sale to investors as being the root cause of the crisis, since this type of activity had long traditions in the United States.

Geithner also downplays the problem that is generally thought to emerge from large banks being incentivised to take big risks and increase their leverage because they enjoy implicit government support and, by extension, cheaper finance than other banks do. He points out that, in the absence of examples of government aid to big investment banks in US history, the high leverage and risks of Lehman Brothers, for instance, could not derive from such market expectations.

As President of the New York Fed in the run-up to the crisis, Geithner says he was continuously worried but, in retrospect, not nearly worried enough, about the adequacy of banks’ capital buffers. Following the crisis, much higher requirements for holding better-quality capital and quite new liquidity requirements have taken centre-stage in the reforms of banking regulation. According to Geithner, the United States was the strongest promoter of these reforms internationally. This led to the quick adoption of the Basel III accord.

Despite deeming Basel III the most important regulatory reform, Geithner devotes a lot of pages to describing the process of creating the Dodd-Frank Act implemented in the United States. He regrets that the Act failed to combine the different US organisations for financial supervision. In addition, faithful to his policy line, he is very critical of the rules concerning debt write-downs in a crisis situation, on account of their tendency to worsen the panic. He views the restrictions on the Fed’s crisis management powers as an error and believes it will be rectified going forward. He ended up supporting the limitations on proprietary trading by banks incorporated into the Dodd-Frank Act, the so-called Volcker Rule, as it eased the passage of the law. He finds logical the rationale for the Rule, under which banks should not use insured deposits for the riskiest securities trading.

**Alternative events in history**

Although Geithner could be challenged to debate the weights attached to the various causes of the crisis and the adequacy of the regulatory reforms undertaken, his thinking is admirably clear.

Geithner explains the political distaste for the successful US crisis management by the difficulty of popularising alternative courses of events in history and using them to reassure the public. With many citizens in distress and many bankers taken for apparent instigators of the crisis escaping unscathed, it is hard for people to accept an explanation that, had the measures not been taken, the economic catastrophe would have been much worse still for everybody. The paradox of crisis management is, in Geithner’s view, that the most unpleasant actions are the only right ones.

The title of the book (Stress Test) also refers to how personal resilience to stress can be stretched to the limit. Geithner turns out to be a sports freak, deriving pleasure from adrenalin, but not from being in the public eye. Without doubt, this book is likely to be one of the most important reviews and analyses of the global financial crisis.

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