Comments on "Financial Intermediation and the Post-Crisis Financial System" by Hyun Song Shin

Donald L. Kohn[1]

Hyun Shin and his various coauthors have emphasized in a series of papers that practices within the financial system were hugely consequential for the buildup in risk-taking that preceded the current crisis and for the virulence of the subsequent pullback. In particular, the increase in leverage within the sector, the lengthening of intermediation chains, and the reliance on short-term financing that was subject to runs contributed to the vulnerability of the system and the severe aftereffects of its ensuing collapse. His analysis shows that we cannot look through the veil of finance, as was so common in our models and, to a lesser extent, in our thinking. His suggested reforms flow naturally from that diagnosis: Constrain leverage, especially in good times, and shorten intermediation chains.

I agree that the nature of the chains of interactions within the financial sector and the leverage and maturity mismatches were important factors in the buildup of imbalances and the difficult correction. And addressing these should contribute to a more robust financial system.

But, to an extent, leverage was a symptom rather than a cause of the underlying crisis. And I am not sure the accounting identity Shin uses, while a useful pedagogic device, illuminates the interactions within the financial sector and between that sector and the economy that led to the crisis. Treating symptoms helps, especially when the disease is complex and difficult to diagnose, but we also need to look for and treat the underlying causes, as I am sure Hyun agrees.

In my opinion, the root cause of the problems was the underpricing of risk as the financial sector interacted with nonfinancial sectors. On the lending side of the financial sector balance sheet, underpricing of loans relative to true risk resulted in a buildup of leverage in the household sector that left lenders vulnerable to declines in collateral values and debt servicing capacity. On the borrowing side, households ended up with some assets – like shares in money market mutual funds – that were not as liquid as they were thought to be; when money funds began to worry about the liquidity of their assets, like asset-backed commercial paper, and when households and businesses tried to use their perceived liquidity, the resulting fire sales accentuated asset price declines and transmitted problems from one sector to another.

The initial problems from the excessive risk buildup were exacerbated by the deleveraging that followed, including in the financial sector. Although there are many reasons that the deleveraging process has been so painful, one of the defining characteristics has been a sharp increase in uncertainty. Uncertainty is an aspect of every crisis, but it escalated to such an extreme degree in the summer of 2007 in response to an unexpected decline in housing prices that the financial system, which had been unusually stable and resilient, was pushed into a zone of increasing instability that in turn triggered an adverse feedback loop between the financial sector and the economy.

---

[1] Vice Chairman, Board of Governors of the Federal Reserve System

The views expressed are my own and do not necessarily reflect the views of the other members of the Board of Governors. Matthew Pritsker of the Board's staff contributed to these remarks.