Chapter 5*
Managing Systemic Risk

Overview

We now know that guaranteeing the liabilities of major U.S. financial institutions seriously distorts the allocation of capital and competition among financial intermediaries. The guarantee provides these firms with an unfair advantage, because they can raise capital at a lower cost. Because the guarantee is so valuable and pervasive, these giant intermediaries face little market discipline and have a perverse incentive to expand their scope, scale, risk exposure, leverage, and financial interconnectedness. The result is that the economy at large suffers a triple whammy – massive taxpayer-financed bailouts, a less competitive and less efficient financial system, increasingly populated by firms that are deemed too-big-to-fail, and a greater likelihood of future economic and financial crises.

The Crisis

The short account of the current crisis is that a large number of banks and other major intermediaries managed to shift risks by exploiting loopholes in regulatory capital requirements to take an undercapitalized, highly leveraged, one-way bet on the economy -- particularly tied to residential real estate, but also to commercial real estate and consumer credit. They bet their houses on the persistence of favorable economic and financial conditions. This bet was financed largely by lenders who, because of government guarantees (such as insured depositors and uninsured large creditors of Fannie Mae, Freddie Mac, and too-big-to-fail banks that figured they would be bailed out no matter what), were more or less indifferent to the consequences if they were wrong. Things turned out for these lenders pretty much as expected. And given the bailout of creditors of virtually all the heavily exposed financial intermediaries, as necessary as it may have been ex post, the moral hazard from government guarantees has only gotten worse. The emergency mergers and acquisitions during the crisis have created even larger systemic institutions, exacerbating the problem. Even if many of these firms are well-run in the future, it would only take a few isolated cases to put the entire system at risk.

The Current Proposals

Both the House and Senate bills recognize the problem of having too-big-to-fail financial institutions. For example, the Senate bill states that "in order to prevent or mitigate risks to United States financial system stability and economic growth that could arise from the material financial distress or failure of large or complex financial institutions, the Agency shall establish prudential standards and reporting and disclosure requirements applicable to specified financial companies that— (1) are more stringent than those applicable to financial companies that do not present similar risks to United States financial system stability and economic growth; and (2)

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increase in stringency with the size and complexity of the specified financial company."[*] The House bill contains almost identical language.[†]

These stricter standards should include "(i) risk-based capital requirements; (ii) leverage limits; (iii) liquidity requirements; (iv) a contingent capital requirement; (v) resolution plan and credit exposure report requirements; (vi) prompt corrective action requirements; (vii) concentration limits; and (viii) overall risk management requirements."[‡] Other than the contingent capital requirement, the House bill is identical.[§] Both bills also call for a risk-based assessment on all financial institutions into a systemic fund to be used for future bailouts of the sector.

In addition, the House bill calls for a study of "the economic impact of possible financial services regulatory limitations intended to reduce systemic risk. Such study shall estimate the effect on the efficiency of capital markets, costs imposed on the financial sector, and on national economic growth, of—(1) explicit or implicit limits on the maximum size of banks, bank holding companies, and other large financial institutions; (2) limits on the organizational complexity and diversification of large financial institutions; (3) requirements for operational separation between business units of large financial institutions in order to expedite resolution in case of failure; (4) limits on risk transfer between business units of large financial institutions; (5) requirements to carry contingent capital or similar mechanisms; (6) limits on commingling of commercial and financial activities by large financial institutions; and (7) segregation requirements between traditional financial activities and trading or other high risk operations in large financial institutions."[**]

Evaluation of Current Proposals

In terms of the broad issues relating to systemic risk, the Congressional bills have it about right. The bills recognize that systemic institutions must be subject to higher standards and these increase in the degree of systemic risk. Moreover, these prudential standards cover all the likely suspects.

That said, from an economic point of view, the best solution to contain the excessive systemic risk created by too-big-to-fail financial institutions is to charge them for the implicit taxpayer guarantees they enjoy. They should pay what amounts to an insurance premium both for their expected losses in the event of failure (similar in theory, though not in practice, to the FDIC deposit insurance premium), and for expected losses when failure occurs in the context of a systemic crisis (broadly defined as the financial system as a whole becoming undercapitalized). To avoid these insurance premiums – which could also be charged in the form of increased capital ratios or deposit guarantee charges -- these firms will be encouraged to rethink their business models. In particular, they will have to consider reducing their scope, scale, risk exposures, leverage, and the interconnectedness, thus trading off the returns from such activities

[*] Senate bill, Sec. 105.
[†] H.R. 4183, Sec. 1103.
[‡] Senate bill, Sec. 107.
[§] H.R. 4183, Sec. 1104.
[**] H.R. 4183, Sec. 1112.

against the insurance premiums attached to them. Market discipline and managerial discretion would then work hand in hand with correct pricing of systemic risk to create a more stable and efficient financial architecture.

However, there are two difficulties. First and foremost, regulators can never perfectly measure bank risk, leverage or interconnectedness -- especially when institutions under scrutiny are complex and perform almost all possible financial intermediation activities. Simply, if regulation is based on noisy observables, these institutions have an incentive to undertake "regulatory arbitrage" and load up risks on the dimension where regulation is most imprecise. Hence, it is prudent to reduce the unavoidable noise in implementation of a systemic risk premium. Second, in the real political economy, the special interests that have enjoyed the benefits of taxpayer subsidies for years will try their best to retain them. Alternatives that reduce the systemic nature of any individual institution in the first place must therefore be considered.

To address both of these difficulties, a possible alternative is to force systemic financial firms – by fiat or through incentives -- to carve out activities that expose the taxpayer to excessive risk and place them in specialized, independent firms that are not likely to be bailed out and whose risks are more easily observed and regulated than financial conglomerates.

We can look to history for clues as to how to achieve this. In the wake of the banking crises of the 1930s and the Great Depression, the Glass-Steagall provisions of the Banking Act of 1933 created deposit insurance, an explicit government guarantee to stop bank runs. Because Congress understood that insurance goes hand in hand with excessive risk-taking, they set up four counteracting barriers: an insurance premium to be paid by banks more or less calibrated to expected losses; winding-down provisions and enhanced supervision of individual banks; requirements that banks maintain adequate liquidity and capital against possible credit losses; and ring-fencing the risk-taking activities of banks by separating commercial banking from investment banking, since the latter was considered more risky.

While there are many reasons for the relative stability of the U.S. financial system during the 50 years after the Great Depression, many analysts give substantial credit to the financial regulation that was enacted at that time. There is considerable debate about why this stability began to unravel in the 1980s, but the general consensus is that technology changed the nature of banking and therefore competition in the banking sector. Those changes led to substantial growth of the "shadow" banking system, consisting of investment banks carrying out banking-type functions, mutual funds, hedge funds, off-balance sheet vehicles and the like. The commercial banks themselves pushed aggressively into the shadow system, and the Glass-Steagall provisions became largely irrelevant. Deregulation gradually peeled away at Glass-Steagall restrictions until its formal repeal in 1999, but no new regulation was put in its place, leaving what was by now a hybrid system of commercial banking and shadow banking vulnerable to the too-big-to-fail problem of systemic financial firms.

Hence, we recommend an approach that reforms the regulation of 1930s to address the modern forms of banking but retains its sound economic principles of charging for government guarantees and limiting the attendant moral hazard problem. The following chapters discuss existing proposals for four major ways for regulators to reign in the too-big-to-fail institution: a systemic premium; capital and liquidity requirements; breaking up the institution; and imposing contingent capital requirements.