ADDRESSING CURRENT PROPOSALS TO MONITOR SYSTEMIC RISK

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The recent financial markets crisis has demonstrated that a rapid and unexpected fall in asset prices can create widespread panic and real economic effects. While it is difficult to monitor risk in a system as large and complex as the U.S. financial system, and it is clear that some form of system-wide coordination is required to ensure economic stability, regulatory reform must allow for flexibility and require due diligence at transaction and enterprise levels.

RESEARCH FINDINGS

- The U.S. financial system is large, complex, and dynamic, and supports over $14 trillion of annual economic activity on a global scale through a wide variety of financial contracts that are regulated using several different types of mechanisms. This system, which finances more than 25 percent of world GDP, emerges from private, self-governed contracting that makes up about 49 percent of the activity in the system; lightly regulated contracting through public exchanges that makes up about 24 percent; and the rest by more heavily regulated contracting through financial intermediaries.

- There are over thirty different types of asset holders operating in the U.S financial system, and data on asset holding shows significant changes over the period 1960–2008.
  - There has been a great deal of innovation in financial products and services and a proliferation of new types of asset holders in the financial system.
  - There is a clear trend toward disintermediation, with asset holders making transactions directly in capital markets rather than using an intermediary such as a bank or insurance company, which creates pressure in these industries to restructure and consolidate, producing new sources of risk.
  - Governments (local, state, and federal) are increasingly backstopping the potential losses of household, business, and financial sector asset holders through a wide range of credit and insurance programs, such as mortgage and trade finance guarantees; deposit insurance; flood, crop, and other types of disaster-insurance programs; unemployment insurance; retirement programs; and so on.

- As the U.S. financial system has evolved and the number of asset holders has diversified, systemic risk has become more difficult to monitor and regulate on a centralized basis.

- Because financing growth and development involves considerable uncertainty, risk cannot be eliminated, but it can be mitigated. A "financial system" is a way of describing the contracting activities associated with investing the economic surpluses generated by more mature economic activities in new economic activities that will (hopefully) produce surpluses in the future. This "inter-temporal asset transformation" process is inherently risky for the simple reason that no one can predict future developments with certainty. However, these risks can be reduced if those who hold and manage assets are held responsible for prudently managing risk and they are knowledgeable about the factors that can affect risk levels.

- “Systemic risk” arises from interdependencies among financial and economic activities. Because financial and economic activities are so closely linked, disruptions in a financial system can have significant effects on real economic activity and asset holders must take an enterprise-wide approach to risk management. The risk that disturbances in one component of a system will spread to others is called “systemic risk.” Systemic crisis ensues when there are significant unexpected increases in the demand for liquidity and asset holders cannot sell their assets quickly enough at the right price to meet this demand. Changes in demand for liquidity can occur because an asset holder is insolvent, as the result of “contagion” where the problems of a weak asset holder spread to healthy asset holders through counter-party claims, or in response to disruptive events such as natural disasters.

- Is a “systemic risk regulator” a good idea? By definition, systemic risk only exists when a large number of contacting parties either behave imprudently or events disrupt their abilities to meet their obligations, at which time systemic risk can no longer be prevented, only stemmed. Hence, one cannot per se “regulate” systemic risk, and it is difficult to imagine how a single entity could be sufficiently omniscient to monitor, evaluate and regulate all the contracting and enterprise activity in a system as large and diversified as the U.S. financial system.

- Can a one-size-fits-all “systemic risk regulator” effectively govern a large, diverse financial system? When feeling threatened, we have a tendency to “rationalize” complexity by centralizing authorities and responsibilities into single hierarchically structured organizations—the political equivalent of “circling the wagons” when under attack. However well-intentioned, centralized authorities inevitably fail to mitigate risk in polycentric systems because information about the nature of risk is too idiosyncratic and widely distributed to be monitored, evaluated, or addressed by a single, centralized entity. The primary asset holders in the system are the entities that are best equipped to evaluate and manage risk. However, they must be held accountable for maintaining prudential standards by strong regulators with the expertise and tools to monitor fast-moving transaction flows. Market safety and soundness ultimately depends upon how prudently contracting parties assess and manage their unique circumstances: At present, there is no level of modeling sophistication that can replace due diligence and common sense at the contract (deal) level.

- An alternative proposal is to create a “council of regulators,” which should focus on the following activities:
  - Monitoring and testing the financial system under a variety of scenarios, such as the risk and regulatory impacts of innovation, technology, and other changes in financial services, as well as monitoring structural and economic changes in financial services business segments that have risk implications;
  - Facilitating orderly resolution of insolvent entities;
  - Work with asset holders to create layered public-private financial structures to address catastrophic risks, deal with crises, and so on;
  - Developing and testing policy and regulatory innovations.

- What can financial regulators do under current circumstances? The regulatory policies that best address risk are those that require economically prudent contracting, reduce costs, and enforce just and equitable contract laws. In addition to developing deep expertise in the area they supervise, regulators can do the following:
  - Collect and disseminate information about the economy, the financial system, and risk management practices so investors can make better-informed decisions.
  - Enforce contract laws and prudential standards.
  - Create and maintain a level playing field for all asset holders in the financial system.
  - Co-invest in tools and infrastructure that facilitate trading, clearing, settlement, conflict resolution, monitoring, and enforcement.
  - Convene intermediaries to promote adaptive innovations in the financial system and to clear bottlenecks that inhibit coordination.

— Encourage adaptability with the use of counter-cyclical policies that address fundamental sources of instability.
— Finally, a well-designed regulatory authority allows regulators to exercise good judgment in enforcing rules. Flexibility is required to avoid rigidities that impede industry adjustments to changing conditions such as price changes; technological, managerial, and marketing innovations; crises and disasters; changes in demand; or cycles of expansion and consolidation. Examples of flexible enforcement mechanisms include forbearance, temporarily suspending rules or relaxing enforcement, and granting tradable rights and permissions based on capital strength.

SUMMARY

The government's current approach to dealing with systemic risk—implicit and explicit guarantees and case-by-case bailout decisions—needs to change.

A better job can be done to mitigate systemic risk, but solutions must be based on well-informed estimates of vulnerabilities. Prudential and effective regulation in a polycentric system requires many different centers of specialized regulatory activity that can identify and adapt to change in asset holding and financials services and facilitate coordination based on common interest and general principles rather than common function and specific rules.

RECENT RESEARCH BY MARGARET POLSKI ON SYSTEMIC RISK

"Systemic Risk and the U.S. Financial System," *Mercatus on Policy* 53, May 2009.
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The Invisible Hands of U.S. Commercial Banking Reform: Private Action and Public Guarantees, Kluwer Academic Publishers, 2003.

MARGARET POLSKI IN THE NEWS ON SYSTEMIC RISK

"How Government Can Mitigate Systemic Risk Without Bailouts," The Heartland Institute, *Budget and Tax News*, August 1, 2009.

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