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INTERNATIONAL BANKING

Expert Analysis

Addressing the Conditions Leading To 'Systemic Risk' on a Global Basis

'Systemic risk" is one of the more ubiquitous buzz words arising out of the current economic climate. There has been much to say recently by those in the U.S. Congress, the executive branch and financial pundits about "systemic risk" and the perceived need for a systemic risk regulator in the United States.

What exactly is systemic risk? It is the risk that an entire system or market, such as the U.S. financial markets, will collapse, as opposed to the collapse of one entity within that system, such as one U.S. bank. Over the past year, the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") made various efforts to address systemic risk as the U.S. economy worsened. Federal Reserve Board chairman Ben Bernanke has spoken frequently about "macro prudential" measures for strengthening the "financial infrastructure."[1] The legislative proposals swirling around Congress all point to the Federal Reserve Board as the proposed systemic regulator for the U.S. financial system.

Yet, the U.S. financial system is just one component of the world's financial system. The International Monetary Fund (IMF) recently issued a series of staff reports regarding the current crisis, providing specific examples of how systemic risk assessment was ineffective or nonexistent in the run-up to the current crisis. IMF recommendations include a need by countries to step up financial systemic surveillance, expand the coverage of prudential regulation and designate systemic risk regulators.

Background

The staff reports[2] cover root causes of the current financial crisis, initial lessons learned and recommendations primarily from the standpoint of what has contributed to systemic risk and what can be done in the

KATHLEEN A. SCOTT *is counsel in the financial institutions practice at Arnold & Porter LLP in New York.*

By **Kathleen A. Scott**

future to better monitor systemic risk. In the Feb. 6, 2009, report, "Initial Lessons of the Crisis,"[3] the IMF staff focused on flaws at the government level —inadequate financial regulation, lack of preemptive macroeconomic policy responses to early warning signs and a deficit of coordination among regulators of large cross-border financial institutions. In its recommendations, the IMF staff focused more on long-term prevention rather than short-term

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cure. More in-depth papers addressed each of these themes separately.[4]

Inadequate Regulation

As with many of the other reports that have been issued regarding the causes of the crisis, the IMF staff criticized the lack of supervision, regulation or even knowledge of the workings of what it called the "shadow banking system"—those institutions that engaged in activities that a bank might engage in (except deposit-taking) but which were not otherwise regulated or only lightly regulated. These shadow institutions include mortgage brokers, private equity funds and other private asset pools.

While other reports have recommended blanket regulation at the federal level of some of these shadow institutions (some, such as mortgage brokers, may be regulated at the state level), the IMF staff recommended enlarging the "perimeter of regulation and supervision" to include these shadow institutions under the watchful eye of a "systemic stability regulator," which would evaluate which of these institutions contribute to systemic risk and only then subject the systemically important institutions to greater regulation such as enhanced capital and liquidity requirements.

Moreover, instead of focusing on a particular financial institution, regulators should focus on the risk of specific activities, and be able to adapt flexibly to address risk as systemic changes occur over time. Regulators should encourage incentives for financial institutions that foster systemic stability, discourage regulatory arbitrage, and vigorously enforce regulations aimed at strengthening systemic risk. This crisis has demonstrated that market discipline alone is insufficient.

While the IMF staff commended the regulators' use of all tools at their disposal in attempts to alleviate the current economic situation, the staff also raised a concern that the regulators may not have an exit plan for many of the ad hoc actions they took to slow the meltdown. A workable and realistic exit plan is needed so as to avoid the long-term consequences of risky assets being held on the books of central banks around the world.

The IMF staff targeted several additional regulatory inadequacies (and offered recommendations to address them), including:

- A failure by investors and regulators to address the conflicts of interest with credit rating agencies receiving high fees to provide ratings on increasingly complex financial instruments or to fully understand how little relation any credit rating had to default risk. Going forward, aside from a reduction in these conflicts of interest, there must be transparency of credit rating agencies' methodologies.
- The perception that there were institutions deemed too big to fail, which resulted in a failure to pay full attention to those institutions'

increasingly complex and illiquid assets. To address this issue, regulators should take action to discourage "mega-institutions" such as an increase in capital as systemic risk rises (and a re-calculation of risk weights to better address shifting risks during an economic cycle); instituting a supplementary leverage ratio that captures off balance sheet exposures; and making earlier intervention when warning signs of trouble appear.

• Regulations and policies that fed into the boom and exacerbated the bust such as employee compensation based upon generation of annual profits. Bonuses must be delinked from annual results, and supervisors should add compensation programs to risk management reviews.

• Regulators (and investors) with no real understanding of many of the complex structured products that financial institutions were using and thus had no ability to adequately evaluate their inherent risks. IMF staff recommended greater market transparency and improved and more frequent detailed information flow by both banks and systemically important non-banks about their products, valuation processes and risk management practices that will enable regulators to effectively assess institutional and systemic risk.

Deficient Policies

The IMF staff noted that the positive accomplishments of the good years preceding the crisis—with high productivity, low interest rates, stable inflation, and optimism for the future—may have lulled countries into a sense of complacency and fed the build-up of systemic risk. Some central banks, like the U.S. Federal Reserve Board, focused monetary policy on targeting inflation. The buildup of systemic risk from the increase in asset prices and leverage was underestimated, but it was thought that any risk would be moderated through lower interest rates.

Prudential regulation was viewed as being able to contain any risk connected with the buildup, but in the end, what regulation was in place proved woefully inadequate. The IMF targeted a lack of sufficient regulation, particularly over the shadow banking system, to deal with the crisis as a critical deficiency in countries' macroeconomic policies.

The first place to look for a solution should be stronger regulation and policies flexible enough to respond quickly to increases in systemic risk, such as an increase in capital requirements during the boom times and a decrease during downturns. Additional measures should be added when assessing risk during a boom, such as system-wide leverage, aggregate foreign exposure and the like.

In discerning if there is a buildup of systemic risk, regulators must keep in mind that every economic boom has its own unique elements. Whether there should be governmental intervention to slow the boom should depend on how a boom was financed and how risk was held. For example, the boom before this crisis was fueled by leveraged financing involving financial intermediaries, which were systemic risks that should have been addressed prior to the downturn.

Cross-Border Coordination

Cross-border coordination is part of what the staff refers to as "global architecture"—the "official mechanisms that facilitate financial stability and the smooth flow of goods, services and capital across countries."[5] It has four components: surveillance, multilateral coordination, financial regulation, and financing. The IMF staff identified deficiencies in all four components in this current crisis.

Surveillance is the monitoring of threats to external stability. Before the current crisis, systemic risk was significantly underestimated by regulators and international institutions such as the IMF. What warnings that were issued were not specific nor dire enough to grab the attention of the world's policy makers. Even warnings from the Bank of England and the Bank for International Settlements did not wake people up to the coming meltdown, albeit the warnings may have been buried in lengthy missives that garnered little attention at the time. Going forward, countries and organizations such as the IMF need to develop a system of coordinated surveillance of all systemic risk, including the implications of cross-border interactions.

Multilateral coordination concerns the institutional arrangements for policy action, During this economic crisis, the first instinct among countries was to protect their own financial institutions even if it caused negative consequences in other countries; for example, one country protects its banks with guarantees, then other countries experience runs on their banks.

Stronger global policy coordination is possible. More than just ongoing efforts at coordination are needed. In looking at possible solutions at greater global leadership during a crisis such as the current one, the IMF staff criticized the IMF itself as being ineffective for such a role, and recommended that IMF ministers and governors assert a greater role in working toward greater global cooperation and coordination.

Financial regulation is needed to address cross-border issues during a crisis. Even with international agreements in some areas, such as risk-based capital standards, each country has its own thresholds for intervention, determination of materiality of risks and different ways to resolve crises. One bank operating internationally can be subject to several different regulatory regimes and supervisory approaches. Of particular concern is cross-border bank resolution. Harmonizing insolvency regimes for large internationally active banks would go a long way toward more effective crisis management in the future, the staff recommended. Specifically, coordination is needed regarding early corrective actions, resolution tools, depositor and investor protection schemes, information exchange and possible loss-sharing arrangements.

The IMF staff recommended improvements in the current international cooperation agreements. In addition, they proposed the concept of an international bank charter that provides for regulators to share joint institution-wide risk-based examinations, remedial actions and burden sharing. As an alternative, host and home supervisors could agree on these issues and have a "college of regulators" arbitrate disputes.

Financing issues of concern to the staff centered around the absence of standing dollar liquidity facilities during this crisis (which caused a delay in responding to problems in the interbank market), the difficulty of emerging markets' access to liquidity and financing, and the reluctance by member countries to approach the IMF for funding. The staff argued that there was a real need for broad standby liquidity insurance in the private markets, and an expansion of the IMF's standby liquidity facility.

Conclusion

Lawmakers and regulators around the globe now have the opportunity to reform the financial system in order to be more effective at addressing systemic risk issues and should consider seriously the recommendations made by the IMF and others. For the U.S. Congress, all of the talk of addressing systemic risk and appointing a systemic regulator needs to be backed up by action—providing such a regulator with the legal authority, funding and other resources necessary to carry out its responsibilities.

However, a systemic risk regulator will not cure all troubles. Everyone associated with the financial system has responsibilities. Banks need to lend responsibly and not engage in risky transactions that no one understands, investors need to do their own adequate due diligence on potential investments, regulators must be hands on and vigilant, and consumers must finally realize that they cannot keep consuming on a grand scale indefinitely without being at the risk of being gobbled up themselves.

1. For example, Chairman Bernanke discussed these principles in a March 10, 2009, speech at the Council on Foreign Relations in Washington, D.C., "Financial Reform to Address Systemic Risk," which is available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.
2. The papers are available through www.imf.org.
3. "Initial Lessons of the Crisis," Feb. 6, 2009.
4. "Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management," Feb. 4, 2009; "Lessons of the Global Crisis for Macroeconomic Policy," Feb. 19, 2009; "Initial Lessons of the Crisis for the Global Architecture and the IMF," Feb. 18, 2009.
5. "Initial Lessons of the Crisis," page 8.