International Systemic Risk: What is it and how can we control it?

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First, let's motivate why we regulate financial markets

Financial Markets Are Different

- Fundamentally linked to each other
- Bank assets
- Bank liabilities
- Fractional reserves and money creation
- Impact on money supply and interest rates

Simple Money Creation Example

- Assumptions
  - $100 injected into system
  - 20% reserve requirement
  - All excess reserves lent out

Simple Money Creation Example

Bank	Deposits	Required reserves	Excess reserves	Amount lent (money created)
A	$100.00	$20.00	$80.00	$80.00
B	80.00	$16.00	$64.00	$64.00
C	64.00	$12.80	$51.20	$51.20
D	51.20	$10.24	$40.93	$40.93
E	40.96	$8.19	$32.77	$32.77
		Etc.		
Total	500	100	0	400

Simple Money Creation Lessons

- Money multiplier (1/rr)
- Larger impact on money supply
- Interconnection between banks
- Who backs up deposits?

Financial Markets Fail
(sometimes)

- Assymetric information
  - Consumer protection
  - Conduct of businesses
- Moral hazard
- Externalities
  - Systemic risk
  - Macro-prudential risk

Thought question:

Why are financial institution failures different than for other businesses?

Financial Market Regulation

Goals of Financial Regulation

- Monitor the safety and soundness of institutions
- Ensure stability of overall financial system
- Ensure adequate consumer protection
- Ensure integrity and fairness of markets

Desirable Regulatory Characteristics
Government Accountability Office

- Clearly defined goals
- Appropriately comprehensive
- System focus
- Authoritative and accountable
- Flexible and adaptable

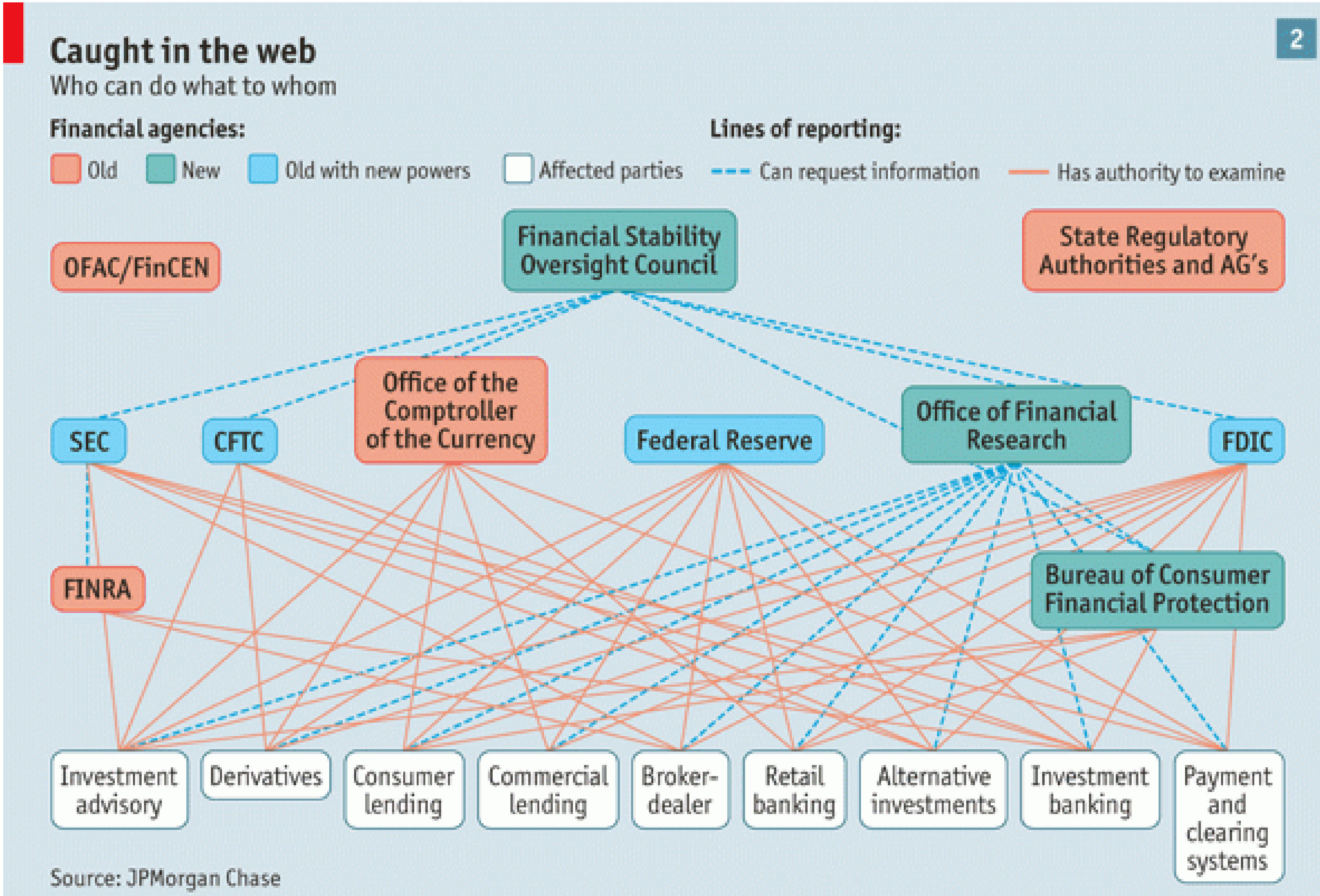
Desirable Regulatory Characteristics
Government Accountability Office

- Efficient and effective
- Consistent consumer and investor protection
- Independent and prominent
- Consistent oversight
- Minimal taxpayer exposure

Regulatory Gaps
Government Accountability Office Study

- Nobody assigned as systemic risk regulator
- Large, less regulated participants require attention
- Complex financial products difficult to regulate
- Accounting and auditing standards behind the curve
- Fragmented regulatory structure

A Simplified Regulatory Map



Source: The Economist; February 18, 2012

Some Policy Lessons

- Damage occurs in a bust, but die cast in preceding boom
- Need for greater regulatory vigilance and restrictions in good times
- Policymakers grappling with alternatives for enhancing countercyclical aspects of regulatory policy
- Rapid innovation and change represent economic opportunity, but also significant regulatory challenge

Two Broad Areas for Improvement

- Require more capital during booms

- Guard against heightened risk-taking and speculation during booms

Cyclicality in Bank Regulation
Insufficient Capital Requirements

- Statistical risk assessments often focus on recent history
- Appearance of low risk drives down required capital
- Metrics can feed industry bias toward low capital
- Judgment and conservatism often get little play
- Capital arbitrage (e.g. off-balance-sheet activities)

Cyclicality in Bank Regulation
Insufficient Restrictions on Risk-Taking

- Risk-taking and speculation accelerate during booms
- Regulation and supervisors could take some of the speculative heat out of boom periods
- Recent examples:
  - Home mortgage lending
  - Construction lending

Regulatory Challenge
Capital Requirements

- Modify capital requirements
- Dampen cyclicality in required capital
- Policymakers and regulators must stand strong against industry bias toward low capital in good times

Promoting Financial Stability
Easier Said Than Done

- Work needed for a more proactive regulatory regime

- Substantial obstacles remain
  - Difficulties in measuring risk
  - Tension with free markets
  - Political interference
  - Don’t stymie innovation

- Possible outcomes
  - Substantially more influential regulatory regime
  - Risk of repeat

Distinguish by Bank Size

- TBTF versus community banks
- Are we properly customizing regulations?
- Regulatory burden relief for community banks
- Benefits for small businesses

So, how do these challenges change when we try to regulate on an international scale?

Back to our topic…

Systemic Risk

- Potential collapse of the entire financial system
- Financial ***system*** instability
- Risks imposed by interlinkages and/or interdependencies
- Relate to money creation example

Too Big To Fail

- One firm poses systemic risk
- Sad irony of efforts to end TBTF
- How do we identify TBTF
  - Size?
  - Leverage?
  - Interconnectedness?
- Problem with firms identified TBTF

Too Big To Fail

- Advantages
  - Lower funding costs
  - Prestige/reputation
  - Greater access to regulators
- Disadvantages
  - Higher capital standards
  - May be broken up by government
  - Tighter regulatory oversight
  - Data availability

Irony of Micro vs. Macro Prudential Regulation

- Firm-level risk management should reduce probability of failure in normal times
- But could lead to instability during volatile times
- Stress testing firm and industry
- What if all firms are similarly diversified?
- How to address fiscal policy's contribution

Other Issues

- Reform pay structure
- Emphasize long-run view
- Overhaul risk management
- “The modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year.” –Alan Greenspan, October 2008

Thought Question:

What is international systemic risk?

Thought Question:

What does international systemic risk look like?

What can happen when financial or economic volatility builds?

Let’s look at a picture…

Scenes from Europe

What is some guidance for regulating across borders?

Basel III

- Three pillars:
  - Greater transparency
  - More disclosure
  - More effective firm-level risk management

- Improve capital and funding
- “Remove imperfections and enforce best practices”

International Financial Regulation

- Conflict of national vs. international
- Danger of regulatory arbitrage
- Banks are global in life…
- But international in death (40% of cost of AIG rescue went to non-U.S. counterparties)
- How do we incorporate international needs and avoid falling back on national regime?

International Financial Regulation

Unresolved questions

- How to set home-host responsibilities?
- Who is lender of last resort?
- How to stress test?
- How to link to other national policies?
- What to do about different cross-border standards (Dodd-Frank)?

Cross-border Resolution

- Internationally-consistent contingency and resolution plans
- Crisis management for large cross-border firms
- Minimize moral hazard and market disruption

Conclusion

- Financial system unique
- Regulatory reform difficult
- Danger of procyclicality
- TBTF institutions may get bigger
- Other countries may export risk

Thanks!!!