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

<table>
<thead>
<tr>
<th>Bank</th>
<th>Deposits</th>
<th>Required reserves</th>
<th>Excess reserves</th>
<th>Amount lent (money created)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$100.00</td>
<td>$20.00</td>
<td>$80.00</td>
<td>$80.00</td>
</tr>
<tr>
<td>B</td>
<td>80.00</td>
<td>$16.00</td>
<td>$64.00</td>
<td>$64.00</td>
</tr>
<tr>
<td>C</td>
<td>64.00</td>
<td>$12.80</td>
<td>$51.20</td>
<td>$51.20</td>
</tr>
<tr>
<td>D</td>
<td>51.20</td>
<td>$10.24</td>
<td>$40.93</td>
<td>$40.93</td>
</tr>
<tr>
<td>E</td>
<td>40.96</td>
<td>$8.19</td>
<td>$32.77</td>
<td>$32.77</td>
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<tr>
<td></td>
<td>Etc.</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>500</td>
<td>100</td>
<td>0</td>
<td>400</td>
</tr>
</tbody>
</table>
Simple Money Creation Lessons

• Money multiplier \((1/\text{rr})\)

• 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!!!