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Financial Systemic Risk Regulators: Congress Is Asking the Wrong Questions

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Congress may be about to create a new financial regulator without fully understanding exactly what problem it is supposed to solve or how the new regulator is supposed to accomplish its mission.

Both Treasury Secretary Timothy Geithner and congressional leaders from both parties say that they will create a systemic risk regulator in their upcoming reform of the financial regulatory system. This is nothing really new, as former Treasury Secretary Henry Paulson included a similar entity in a financial regulatory reform proposal he made in early 2008.

Without firm direction and explicit delineation of its mission and its powers, the new regulator runs the risk of failing to prevent future systemic risks—if such a thing can actually be done.

Even worse, Congress could grant it such wide powers that the agency could intervene in just about any aspect of the financial industry, thus causing even more chaos and uncertainty than it prevents. It could also hinder the development of new products and other innovations if the agency develops an attitude that anything new may be risky.

The Danger of Systemic Risk. Systemic risk is a reality of life and a legitimate concern for regulators. In recent events, it is important because its presence was cited by both the Bush and Obama Administrations to justify bailouts of such financial institutions as AIG and Citibank as well as the establishment of the Troubled Asset Relief Program and many other recent programs.

It was also cited by the Federal Reserve to justify its intervention into failures of both Bear Stearns in 2008 and Long Term Capital Management, a hedge fund, in 2000. The painful reality of systemic risk was made abundantly clear when market reaction to the failure of Lehman Brothers and severe problems at a number of weak financial firms in September 2008 nearly caused a worldwide financial collapse.

However, recognizing that systemic risk can exist is a very different thing from knowing that it is present in a specific situation, and both are extremely different from actually knowing how to prevent it. Systemic risk may be best diagnosed either when it occurs or afterward. Even if systemic risk can be accurately identified, it is less certain that the political system will allow a regulator to act to address it if doing so would affect a politically sensitive part of the economy or one where powerful interests are involved. One has only to look at Chrysler and GM's experiences for such evidence.

This was especially true of the crisis that reached a peak last September. Analysts now discuss the fact that poor-quality housing loans were being made and that housing prices had reached unsustainable levels. But they fail to mention other factors, such as:

- For many years politically connected interests blocked attempts to regulate Fannie Mae and

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Freddie Mac, two of the companies most at fault in that developing situation,

- Many of the poor-quality loans were originated by unregulated mortgage brokers, or
- Homebuilders, realtors, financial institutions and advocates for lower- and moderate-income homebuyers all repeatedly opposed attempts to rein in housing.

Add in the role played by politically connected groups such as the credit ratings agencies, hedge funds, derivatives underwriters, mortgage brokers, etc., and the probability of a successful intervention before a crisis was reached drops still further. And that is ignoring the role played by the Federal Reserve's monetary policy and the general worldwide glut of savings.

The Wrong Discussion. The Washington discussion of a new regulator skipped over the question of what a regulator should actually do, instead moving directly to the question of how such a regulator should be organized and which, if any, of the existing regulators should be responsible for preventing future systemic risks.

Some—including, evidently, some people in the Treasury Department—want the Federal Reserve to have the responsibility, while others favor giving it to the Federal Deposit Insurance Corporation and still others favor a council of either existing regulators or outside experts.

However, this discussion misses three key points:

1. In order to properly direct the new agency to meeting its responsibilities, the phrase "systemic risk" will need to be carefully defined.
2. Even more important, just how is the new regulator, no matter how it is structured, supposed to identify and correct systemic risk? At what point is the regulator expected to act, and what standard of proof that systemic risk exists must it meet before then?
3. What new powers must this regulator have over both already-regulated types of financial institutions and those unregulated entities that may exist now or appear in the future? What are the costs and tradeoffs that come with such power? What alternatives are there?

An Agency with Unlimited Power? These are all points that legislators and financial experts should focus on instead of just which agency has the responsibility to prevent systemic risk. Failure to adequately define "systemic risk" will almost certainly result in legal challenges to its actions, while a poor understanding by all parties is likely to add a new level of uncertainty to both the industry and the financial regulatory system.

The most important question will be the scope that the agency has in meeting its responsibilities. To be successful, a systemic risk regulator would need so much power that its mere presence could profoundly change the financial world for the worse. It would be as destabilizing and potentially as dangerous as most instances of systemic risk.

The reason is simple: Most recent financial crises have involved either unregulated financial entities or products that are on the edge of the regulatory system. The only way that a systemic risk regulator can be successful is if it has the unilateral power to extend its reach to whatever financial entities capture its attention, ranging from hedge funds to small mortgage brokers to firms, financial products, and markets perhaps not even in existence today. This would be an ongoing process, for as new types of products and/or companies develop that have the potential to increase systemic risk, the regulator would need the ability to bring them under its oversight.

This expansion could be handled through additional legislation, but this would be time consuming and at the whim of the political process, during which systemic risk could develop. This leaves Congress with the alternative of creating a limited agency that is likely to fail in its efforts or an unlimited one of questionable legality. This last option would clearly be the worst possible outcome, as its unlimited powers would give the regulator the ability to selectively stifle innovation or put controls on financial institutions that make sense to the agency but may severely damage those firms' ability to compete in a global market.

A Treatment Worse Than the Disease? Systemic risk clearly exists, but creating a regulator that can limit it without seriously hindering financial

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innovations and the economic growth they produce will be difficult at best. As it discusses the issue, Congress should focus on what the agency is supposed to do and exactly what actions it can take to meet those goals. It may well be that the task is unrealistic and that a better course is to recognize that systemic risk may occur from time to time and create a process that liquidates problem companies in an orderly manner.

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