Guarding Against Systemic Risk: The Remaining Agenda[1]

Alan S. Blinder
Professor of Economics and Public Affairs
Princeton University

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The worst financial crisis since the 1930s changed academic, financial, regulatory, and political thinking in many ways. One is the realization that we allowed (or maybe even enabled) financial market participants to construct a system that was amazingly vulnerable—given the huge potential costs—to systemic risk. By now, almost five years after the world financial system nearly imploded, you might think we had fixed all that. Sadly, we have not. This short essay focuses on the unfinished business of systemic risk regulation. These are not the only post-crisis regulatory issues that remain unresolved, but they certainly rank among the most important.

Before going further, readers should be forewarned about the author's prejudices, which should perhaps be labeled more accurately as *post*judices—judgments reached *after* considering much logic, facts, and historical experience. I encapsulate these in five underlying assumptions:[2]

1. Finance does not appear to be self-regulating.
2. The case for *laissez-faire* in financial markets has been damaged beyond repair.

[1] This paper is based on a presentation at the Bank of Finland/SUERF conference in Helsinki in June 2013. I am grateful for comments received there.

[2] I first enunciated these assumptions at a Federal Reserve Bank of Boston conference on bank regulation in October 2009. The paper was subsequently published as Blinder (2010).

3. The costs of the financial calamity that began in 2007 were huge, probably far larger than all the efficiency gains from structured finance—forever.
4. We will not get rid of too-big-to-fail (TBTF) institutions, so we have to find ways of dealing with them.
5. Taxpayer interests must be protected.

I think only one of these (the fourth) should be considered at all controversial, though I know there are some who dispute the first two. Regardless, these are the maintained hypotheses that underpin this analysis.

Top items on the agenda

Seven items hold prominent places on the systemic risk agenda. I will discuss the first six of them briefly, and then concentrate on the seventh: proprietary trading by banks.

<u>Resolution authority</u>

One main problem with what are now called "systemically-important financial institutions (SIFIs) is that they are hard to resolve without either (a) imperiling large parts of the financial system or (b) burdening taxpayers with liabilities for potentially large bills. That's why we call them "too big to fail." But note that what we really mean by that well-worn phrase is too big to fail *messily*. The search for a workable resolution regime for SIFIs is a search for ways to euthanize such behemoths peacefully, should that become necessary.

In the United States, Title II of the Dodd-Frank Act of 2010 called for the creation of a new "orderly *liquidation* authority." Note the italicized middle word. When the U.S. Treasury made recommendations to Congress in 2009, it suggested giving the authorities a choice between either *resolving* a sick SIFI or *liquidating* it—whichever made most sense in the particular case.

Congress rejected the idea of choice, opting instead for a liquidation-only approach: "No more bailouts."

The Federal Deposit Insurance Corporation (FDIC) and the Bank of England recently unveiled very similar ideas for liquidating large, complex financial institutions.[3] While details matter a lot, the overriding concept is the Single Point of Entry approach. Under SPOE, the financial holding company should be structured (e.g., with enough long-term unsecured debt) so the parent can absorb all the losses in a liquidation procedure while the bank subsidiaries carry on as usual—or as close to "as usual" as possible. In particular, part of the idea is that bank depositors should not be "bailed in," which seems to run counter to at least some recent European practice. (But perhaps not to *future* practice.)

Things are naturally more complicated in the Eurozone because so many different countries are involved—and do not operate behind a Rawlsian veil of ignorance. Specifically, countries like Germany and Finland see themselves as far more likely to give than to receive assistance from the proposed Single Resolution Mechanism (SRM), whereas countries like Greece, Spain, and Portugal are more likely to be recipients than donors. The process may (or may not, we'll see) be stymied by Germany's insistence that such potential fiscal transfers are permissible only after treaty changes (and, of course, approval by the German Constitutional Court). So we may be waiting a long time for the SRM, which would mean that the TBTF problem will persist in the EU.

<u>Systemic risk monitor/regulator</u>

[3] See FDIC & Bank of England (2012). For a good and thorough explanation and evaluation of the U.S. version of SPOE, see Bipartisan Policy Center (2013).

According to an old saying, when the tide goes out, it reveals the rocks. But the rocks were, of course, present all along. One of the most shocking rocks that was revealed when the financial tide went out in 2008 was the absence, in most nations, of any regulatory agency responsible for system-wide risk. Instead, the international norm, certainly including in the United States, was regulatory "silos." Bank regulators watched over the banks; securities regulators minded the securities markets; basically no one monitored the derivatives markets; and so on.

The news on this front has mostly been good, even though macroprudential regulation is still in its infancy. The U.S., for example, has set up a Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury and populated by all the financial regulators. A new division of the Federal Reserve Board staff in Washington essentially provides staff work for the FSOC (via the Chairman of the Fed), as does a new Office of Financial Research in the Treasury. Analogous organizations are popping up in Europe as well, e.g., the new Financial Policy Committee of the Bank of England and the expended regulatory powers of the ECB. While the world is not quite there yet, we are moving down the road in sensible ways.

Higher capital and liquidity standards

For a complex international negotiation, Basel III was accomplished amazingly quickly, though perhaps not all that well.

The good news is that banks will be compelled to hold substantially more and better capital (e.g., much more tangible common equity) and that there will be parallel minimum liquidity requirements. The latter are particularly important because, in my view, one thing we learned from the crisis is that it is not easy to distinguish between insolvency and illiquidity in practice, especially when markets are chaotic. For example, is it clear, even now, that Bear Stearns was illiquid but solvent whereas Lehman Brothers was insolvent? Another welcome feature of Basel III is the higher capital requirements now being imposed on SIFIs.

The bad news starts with the leisurely pace of implementation. It is understandable that the novel liquidity requirements are being developed and phased in gradually. After all, this work constitutes breaking new ground. But giving banks until 2019 to comply with the higher capital standard is embarrassing. Fortunately, many banks, especially American banks, are getting there way ahead of the Basel III schedule. The big debate, of course, is whether even Basel III sets capital requirements high enough.[4]

The other Basel III problems, in my view, are carried over directly from Basel II, and they are serious. One is the use of ratings from the rating agencies in risk-weighting assets. The other is allowing banks to use their own internal models to measure risk. Didn't the crisis teach us that both of these are folly?

Standardizing and exchange-trading derivatives

The news is much worse when it comes to the effort to standardize derivatives and trade them on organized exchanges. Dodd-Frank pushes markets in this direction, but probably not hard enough. For example, *by volume* (but not by riskiness), most OTC derivatives are exempt from Dodd-Frank restrictions. Besides, Dodd-Frank governs only the United States. Europe in general seems way behind on pushing derivatives into safer trading environments. Indeed, many European authorities, not to mention the big banks, have been in a long-running battle

[4] See, for example, Admati and Hellwig (2013).

with America's Commodity Futures Trading Commission over these matters, with the CFTC taking the more aggressive positions.

About a month before this conference, *The New York Times* entitled an editorial on this subject, "Derivatives reform on the ropes."[5] Since then, reform has taken a few more blows. This is disconcerting, given the key role that unregulated OTC derivatives played in propagating and magnifying the crisis. But it may not be surprising given the enormous amount of money at stake. After all, banks that can earn a king's ransom on some OTC products would earn nickels and dimes on standardized, exchange-traded products. They don't relish the prospect.

Traders' compensation

CEO compensation hogs all the headlines. The sheer size of the bonuses that pliant corporate boards routinely parcel out to their chief executives does seem obscene to many. But, as a famous U.S. Supreme Court justice once pointed out, obscenity is in the eye of the beholder. In my view, excessive CEO pay checks are mainly matters of CEOs extracting rents from powerless shareholders. They rarely if ever pose systemic risks. If this is true, then shareholders, not the government, should try to block outrageous pay packages.[6]

The *incentives* embedded in the way *traders* are compensated are another matter entirely. Before the crisis, it was common to give traders what I call "go-for-broke" incentives.[7] Specifically, winning bets would make traders fabulously wealthy by awarding them a non-trivial share of the profits on the upside. On the other hand, if they lost the firm's money, their bonuses would vanish, and they might (or might not) lose their jobs. But such losses were

[5] May 19, 2013.

[6] In the United States, Dodd-Frank included the so-called say-on-pay provision, giving shareholders a nonbinding vote on CEO pay. These votes were negative in only about 3% of cases in 2012. See Krueger (2013).

[7] There seems to be very little hard evidence on pre-crisis pay methods.

typically puny compared to the potential gains. This huge asymmetry between rewards for success and penalties for failure, coupled with the predilections of many young traders who self-select into this high-risk profession, created powerful incentives for excessive risk taking—excessive, that is, relative to what was in the best interests of either their superiors or their shareholders.[8]

More people are aware of this problem today than was true before the crisis, and regulatory authorities in a number of countries have taken useful actions by, for example, treating compensation incentives as one aspect of banks' risk-management examinations. They want to see compensation packages adjusted for the amount of risk taken, clawback provisions, more payments in restricted stock, and the like—all designed to reduce short-termism and make both traders and executives absorb more of the downside risk. On balance, substantial progress seems to have been made.[9] But, truth be told, pay incentives are very hard for governments to regulate. As memories fade, corporate boards will have to act more vigorously on compensation than they have in the past.

Rating agencies

Prior to the crisis, there were two big problems with the rating agencies. First, numerous laws, regulations, and contracts—not to mention Basel II risk-weights—assigned a critical, and sometimes decisive, role to the ratings given out by the agencies. In the United States, Dodd-Frank blissfully ended most of that. But Basel III continued the bad old traditions of Basel II. And that's the *good* news.

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[8] One exception: If CEOs and other top executives share in the trading profits, then they inherit some of the skewed incentives of the traders.

[9] See Financial Stability Board (2011) and Board of Governors of the Federal Reserve System (2011). I am grateful to Mark Carey for steering me to these documents.

The *bad* news is that nothing—I repeat nothing—has been done about the issuer-pays model for compensating rating agencies. I haven't heard anyone defend issuer-pays as a good idea in principle, and virtually everyone lists rating-agency failures as among the chief causes of the financial crisis. Yet, nearly five years after the Lehman bankruptcy and three years after the passage of Dodd-Frank, nothing has been done to fix, or even to ameliorate, the perverse incentives created when issuers pay the rating agencies for their work. It's as if the Titanic went down and nothing happened. I don't know whether to call this failure amazing or disgraceful. No doubt it's both.

Proprietary Trading by Banks

I will now concentrate on the seventh issue on the unfinished systemic risk agenda: What to do about proprietary trading by banks. I single this issue out for special attention not because it is the most important of the seven, but because of the time (June 2013) and place (Helsinki) of this conference. The EU announced in July 2013 that it would propose bank-structure rules, based on the Liikanen recommendations, in October.

Three basic approaches to limiting proprietary trading by banks have been offered—plus a fourth, which is to let the *status quo ante* prevail. The United States acted first with the Dodd-Frank Act (2010). It included the so-called Volcker Rule, which would force proprietary trading out of FDIC-insured banks. In the United Kingdom, the Independent Commission on Banking, led by John Vickers, recommended in 2011 that only normal retail and commercial banking activities be protected by the safety net, leaving other financial activities—including trading, but also other things—outside the "ring fence" that protects the core bank.[10] In the European

[10] Independent Commission on Banking (2011).

Union, the High-Level Expert Group headed by Bank of Finland Governor Erkki Liikanen recommended in 2012 that most trading be conducted in separately-funded subsidiaries, rather than in the banks themselves.[11] While the three approaches are all first cousins, there are some differences worth considering. I should reveal before going further that I am on record as favoring something akin to the Liikanen approach.[12]

I call the three approaches "first cousins" because they share (at least) two objectives. First, they seek to protect bank deposits from the risks of trading. Neither depositors nor the governmental authorities that insure them should be on the hook for trading losses. Second, they aim to keep trading under some sort of regulatory regime. What is less frequently recognized is that these two objectives might conflict.

Start with the Volcker Rule. Paul Volcker's original idea was that banks should not be allowed to use funds gathered from insured deposits for gambling. It is hard to argue with that position. As written into US law, the Volcker Rule would force proprietary trading out of banks, *with some exceptions*, e.g., dealing in Treasuries and market-making activities. Therein lies (part of) the rub. How do regulators distinguish*, in practice*, between market-making and proprietary trading? After all, the very same trade (buy X, sell Y) could fall within either category, depending on (a) the bank's other trading (and nontrading) activities and (b) the trader's intent—which the trader knows, but the regulators don't. This conundrum is one major reason why, after three years of struggling with the problem, U.S. regulators have still not been able to devise workable

[11] High-level Expert Group on reforming the structure of the EU banking sector (2012)

[12] Blinder (2010) was presented at the aforementioned October 2009 conference. It recommends separate trading subsidiaries, plus a ban on downstreaming capital from the parent to the trading sub.

regulations to put the Volcker Rule into effect. It is also the main reason why I recommended in 2009 that *all* trading activities be segregated into a separately-capitalized trading sub.

The Volcker Rule raises another issue: If banks are banned from trading, the business will migrate elsewhere. Where? A reasonable guess is that unregulated hedge funds would take up much of the slack. Questions have been raised about whether such a change in the locus of financial trading would make it safer or riskier to society. My own answer is "probably safer," as long as no hedge fund is allowed to grow large enough to pose a systemic risk—the way Long-Term Capital Management did in 1998. That, in turn, requires regular reporting of positions to regulators, which many hedge funds abhor, *and* the authority to act if necessary, which the FSOC in the United States now has.

While Volcker wants to push bank holding companies (the American term) out of the trading business, the Vickers Commission would keep trading and other activities inside banking groups (the European term), but "ring fence" them away from normal banking activities such as deposit-taking and commercial lending. Taxpayers would then be off the hook for any trading losses but potentially on the hook for, say, the consequences of outsized loan losses. Notice two key differences between Vickers and Volcker—which is why they are cousins, not brothers. The Vickers approach keeps everything within the universal bank, whereas the Volcker approach expels proprietary trading. And the Vickers ring fence leaves a whole list of activities, not just trading, without a safety net.

The Liikanen group was, of course, aware of both of these ideas when it began its deliberations in February 2012. Its proposal begins with Volcker's premise that both depositors and taxpayers need to be protected from the risks posed by proprietary trading. But, unlike

Volcker, Liikanen decided that distinguishing between market-making and proprietary trading was too difficult, so (almost) *all* trading should be segregated into separately-capitalized subsidiaries. Liikanen did, however, make an exception for "hedged, client driven" transactions, which can remain within the bank. How the authorities are to decide which transactions are "hedged" and "client-driven" is a good question. Unlike Vickers, which ring-fences normal banking activities in, Liikanen pushes most trading out. But that seems like a minor detail. More significantly, the Liikanen proposal, like Vickers, would leave trading *inside* the banking group and hence subject to bank supervision.

As I suggested earlier, I have long favored the Liikanen approach—but with one important proviso. Under my proposal, but not under Liikanen, the parent banking group would be prohibited from downstreaming capital to its trading sub to cover losses. If trading losses became large enough, therefore, the sub would go bankrupt rather than receive capital injections from its parent. Such a ban on downstreaming would clearly render the parent company stronger and the trading sub weaker. That's a deliberate design feature. Counterparties who deal with the trading sub should know that neither the parent bank's capital nor deposit insurance stand behind it. They should also know—and regulators should make it crystal clear—that no trading sub will be allowed to grow too big to fail.

Under this proposal, trading subs would likely find it necessary to maintain large capital cushions, maybe even enough to earn them AAA ratings that their parents lack. All that capital, in turn, could make it expensive to keep trading operations inside universal banks.[13] As noted earlier, that high cost could send much trading activity to the hedge fund sector—where, as

[13] This assumes that enough imperfections vitiate the Miller-Modigliani considerations emphasized by Admati and Hellwig (2013).

suggested earlier, no hedge fund would be allowed to grow large enough to pose systemic risks. Besides, hedge funds being partnerships rather than corporations, their top managers have a great deal of what I've termed MOM ("my own money") at stake, instead of working exclusively with OPM ("other people's money"). That design feature likely makes them more risk averse, or at least more careful risk managers, than limited-liability corporations. Very few hedge funds, for example, operate with as much leverage as banks.

Last word

Prior to the crisis, systemic risk regulation was terrible—indeed, it hardly existed. There has been notable progress since then, but not nearly enough. In particular, the accomplishments to date seem like little to show for four years of intense work. (I date the beginning of the reform process from the end of the acute stage of the crisis.) Overall, I'd give a mediocre grade to the efforts of governments and regulatory bodies to contain systemic risk.

The French writer Jean Giraudoux once wrote that only the mediocre are always at their best. I hope mediocrity is not the best we can do here. For if we don't move ahead on the systemic risk agenda, we are likely to slip back. Voters are already forgetting what happened; they never understood the details or the remedies in the first place. But the financial industry does understand, doesn't forget, and knows where its self-interest lies. It also has political muscle—stemming from prodigious amounts of money—in all countries. Unless governments and regulators step in strongly to protect the public interest, this looks like an unfair fight.

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