Finance

COLLEGE of BUSINESS at ILLINOIS

Systemic Risk in the Financial System

Charles M. Kahn

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How should society deal with systemic risk?

- Should systemic risk be regulated or should the financial system be redesigned?
- Which sources of systemic risk should be regulated?
- How can we design regulations that account for the fact that systemic risk drivers are continuously changing?

Compare with risk adjusted capital standards

- The idea: a financial institution's failure imposes costs on the economy.
- Therefore charge for riskiness of the institution's position:
- Deterrence and protection
- Risk charge lines up with likelihood of failure

Applied to systemic risks

- An institution’s failure is more damaging if it occurs when other institutions are failing.
- So measure sensitivity to others’ failure—particularly in extreme circumstances—and charge accordingly (CoVaR)

So a partial success:

- By adjusting standards existing framework can address some forms of systemic risk
- By looking for clues in pricing can even make some adjustment to innovations

But there are serious limits to this approach

- Relying on pricing in normal times to gauge risks in extreme circumstances
- Innovations likely to be mispriced—and great incentives to innovate.

Why is systemic risk a special regulatory problem?

- Externalities (market failure)
- Widespread, (so costly by definition)
- Affect the regulator’s ability to respond (time consistency)
- Therefore great incentives to exacerbate the problem

Time-inconsistency and moral hazard

- Part of regulation is punishment in hindsight
- Regulators find it easy to carry out these punishments when the economy is doing well, and undesirable when the economy is in trouble.

Too-big-to-fail vs. too-important-to-ignore

- Analogy to too-big-to-fail: individual financial institutions have incentives to make it impossible to close them
- But more extreme: Even small institutions have incentives to align their policies so that they fail together.

Implications for Debt

- Even if the equity holders can be forced to bear costs of financial failure
- Subsidies arise for debt holders in systemically important institutions.
- In the long run: distorts towards greater leverage and greater systemic importance

So some financial redesign is necessary

- Too-big-to-fail is real
- Some inherently systemic activities (running financial markets, acting as central counterparties) must be placed in regulated financial utilities, segregated from other financial activities

And regulators need humility

- Innovation and incentives mean systemic crises will arise
- Regulators need systems in place for prompt and efficient resolution

Summary and Speculation

- Regulators fold because of time inconsistency
- No reason to believe that can change, if institutions are sufficiently systemic

Summary and Speculation

- Can we reduce costs of systemic risk? Only imperfectly
  - Restricting combinations of certain kinds of business
  - Refining capital standards
  - Improving resolution regimes
- Size restrictions are a blunt tool, but may be an important component of the solution

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