Systemic Enterprises under Supervision?

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1. Systemic Risk

Definition:

Systemic risk is the risk of collapse of the entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system (idiosyncratic event)

Systemic risk, therefore, refers to the **risks imposed by interlinkages and interdependencies** in a system or market, where a **trigger event** (economic shock or institutional failure) causes chain of bad economic consequences (also referred to as a **cascade or domino effect**). Consequences can include (a chain of) financial institution and/or market failures *(Schwarcz, 2008).*

Two dimensions of systemic risk **– cross sectional dimension** and **time dimension** with different policy implications.
Cross sectional dimension: idiosyncratic event triggers a systemic crisis.
Time dimension: progressive build up of financial risk during the business cycle (problem of procyclicality)

2. Theoretical Justifications for Regulation

Market failures

due to
- competitive distortions,
- externalities, e.g. systemic risk,
- asymmetric information (e.g. consumer protection) and
- production of public goods.

3. General principles of regulation

- Try to internalize the external effects of systemic risk
- Returns of regulation should exceed costs.

4. Basel on Global Systemically Important Financial Institutions

"During the recent financial crisis that started in 2007, the failure or impairment of a number of large, global financial institutions sent shocks through the financial system which, in turn, harmed the real economy. Supervisors and other relevant authorities had limited options to prevent problems affecting individual firms from spreading and thereby undermining financial stability. As a consequence, public sector intervention to restore financial stability during the crisis was necessary and conducted on a massive scale. Both the financial and economic costs of these interventions and the associated increase in moral hazard mean that additional measures need to be put in place to reduce the likelihood and severity of problems that emanate from the failure of global systemically important financial institutions (G-SIFIs)".

…

"The negative externalities associated with institutions that are perceived as not being allowed to fail due to their size, interconnectedness, complexity, lack of substitutability or global scope are well recognised."

Basel Committee on Banking Supervision (July 2011)

5. „Old“ Instruments to Deal with Systemic Risk

1. ***Lender of Last Resort Function of Central Banks (LoLR)***
   Designed to deal with systemic liquidity problems; not prepared to deal with solvency issues

2. ***Basel II***
   Designed to improve risk management and hold sufficient capital; gave incentives for higher leverage and regulatory arbitrage (shadow banking system)

3. ***Intensity of supervision based on systemically importance***

4. ***Deposit Guarantee Schemes (DGS)***
   Designed to maintain depositor confidence and to prevent bank runs. Danger: DGS may weaken market discipline!

6. „New“ Assessment Methodology for Global Systemic Importance

Basels Indicator-based measurment approach:

Selected indicators are chosen to reflect different aspects of what generates negative externalities and makes a bank critical for the stability of the financial system.

Indicators:

- size
- interconnectedness
- lack of substitues for their services
- cross-jurisdictional activity
- Complexity

Unintended consequence: creates competitive advantages and moral hazard!

7. „New“ Instruments to Deal with Systemic Risk

1. **More and better capital** (ok); capital surcharges for SIFIs (?)
2. **More and better liquidity** (!?), reduces maturity transformation
3. **Countercyclical capital buffers**, accounting rules and foreward looking provisioning (in practice not easy to implement; risk adverse supervisors!)
4. **Resolution regimes** (living wills, how to be handled in cross-border problem situations)
5. **Abolishment of adverse incentive structures** (pay and bonuses)
6. **More proactive supervision** of SIBIs (not very different to the past)
7. **Banking Levies and Financial Transaction Tax** (!?)

8. Risks of Basel III (1)

1. In the past, **highly regulated banks caused more financial crisis than unregulated institutions** (e.g. hedge fonds. Regulation so far has not succeeded very well in protecting the taxpayer!

2. **Supervisors tend to regulate the last crisis** (e.g. liquidity requirements and leverage ratio). But the next crisis will be different!

3. **Policy makers and regulators tend to overestimate the returns** of financial regulation, but underestimate the costs.

4. Even rechent experience shows that financial regulation is always confronted with **unintended consequences** (see e.g. Basel II).

5. It is hard to figure out **who will provide the huge sums of capital** (and bank debt) required to fulfil Basel III over the next five years given the economic and regulatory uncertainties and the poor earning pespectives of the banking industry.

8. Risks of Basel III (2)

6. **Regulatory arbitrage** between highly regulated banks and the shadow banking system, but also between jurisdictions (Asia vs. Europe) is an issue and can make the system even more instable.

7. The **new liquidity standards** define government bonds as the most liquid asset and put the financing of corporates and households by banks on disadvantage compared to government financing.

8. More and better capital, the new liquidity requirements, banking taxes aso. will increase real lending rates for corporates as well as housholds. This again will lead to less investment and consumption and **lower the medium-term growth and employment path**.

9. **Competitive disadvantages** also will occur due to the regulation between systems with more bank based intermediation like Europe and more capital market based systems like the US. SMEs will be more hampered than larger companies because they cannot lend on corporate bond markets.

8. Risks of Basel III (3)

10. The **assessment of systemically important banks without clear and convincing resolution system** and resolution tools **will create moral hazard** (in the sense that SIBIs will be able to refinance more cheaply than smaller banks because they will be regarded as too-big-to-fail).

11. More **supervision may also create moral hazard and reduce market discipline**. Market participants believe that the regulators will now be able to control risk-taking, and lenders are thus less wary that regulated entities are assuming unusual or excessive risks.

12. Last but not least, **monetary policy** (as well as fiscal policy) on both sides of the Atlantic **could contribute more to financial stability** then they actually do.