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REDEFINING AND CONTAINING SYSTEMIC RISK

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TO CONTROL A THING PRESUPPOSES THE EXISTENCE OF A COMPREHENSIVE DEFINITION OF IT THAT LEADS TO A VERIFIABLE METRIC

Official Definitions of Systemic Risk Fail Both Tests

Focus on a perceived potential for substantial spillovers of institutional defaults across the financial sector and from this sector to the real economy

This Definition Has a Missing Element

Substantial Spillovers of actual defaults have remained largely hypothetical.

Why? Because authorities instinctively choose to intervene in the default process by supporting the credit of "systemically important " (SI) firms that allow themselves to become economically insolvent: They let difficult-to-fail (DFU)zombies exercise a loss-shifting "taxpayer put."

BECAUSE ACCEPTING BLAME IS UNCOMFORTABLE, BLAME AVOIDANCE DISTORTS PUBLIC POLICY DEBATES

- Official definitions of systemic risk lead naturally to the self-serving diagnosis that systemic risk <u>is caused by</u> defective risk management at DFU firms.
- This diagnosis supports a treatment plan that would: toughen capital requirements; redraw the boundaries of regulatory jurisdiction; and extend new powers to regulators (e.g., over executive compensation, derivatives trading, and insolvency resolution).
- This diagnosis and the treatment plan it implies are incomplete in that they fail to address the endogenous role that safety-net subsidies play in incentivizing firms to take political, economic, and organizational action to attain and strengthen DFU status.

CENTRAL-BANK (CB) DECISIONS WITH LONG-TERM CONSEQUENCES ARE MADE UNDER SEVERE POLITICAL PRESSURE TO DELIVER SHORT-TERM RELIEF TO DISTRESSED MARKETS AND INSTITUTIONS.

Mission: Maximize: NATIONAL WELFARE over time=W (goals, instruments)

Subject to restraints that transmitted by a CB's "Regulatory Culture".

- Restraints on authority
- Restraints on information available to CB
- Restraints on instruments CB can use
- Restraints on the extent that individual instruments can be used
- Restraints from political pressure and influence (multiple principals)
- Need to sort through contradictory norms imbedded in their nation's regulatory culture

THESIS: Incentive conflict expands subsidies, by facilitating influence and burden-avoidance opportunities for regulated firms and for less-regulated "shadow" competitors and affiliates.

INCENTIVE CONFLICT FEEDS MYOPIA AND LEADS CENTRAL BANKS TO RESCUE “SYSTEMICALLY IMPORTANT” ZOMBIE FIRMS AND COUNTRIES FROM CONSEQUENCES OF AGGRESSIVE RISK MANAGEMENT

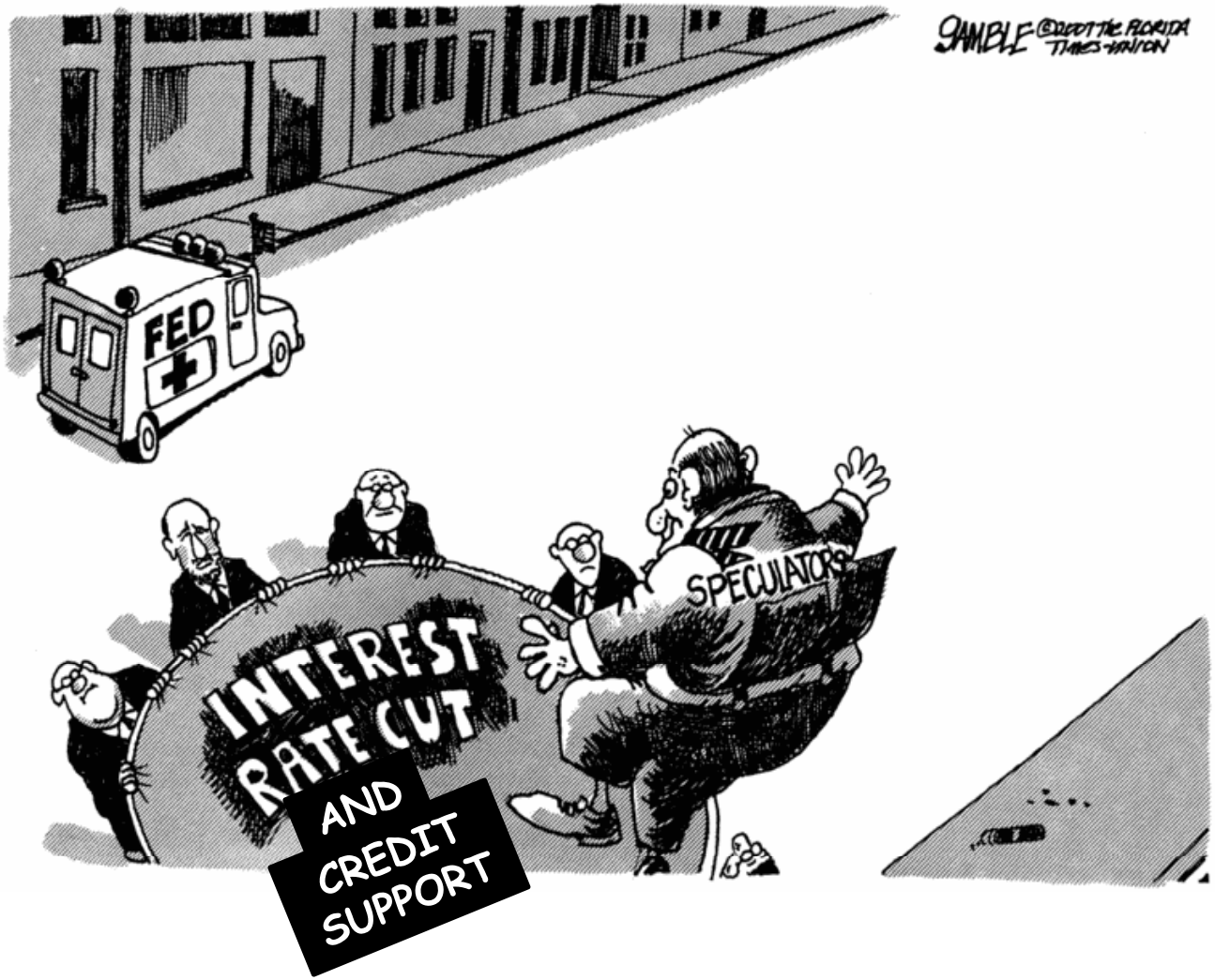
The verifiable additional symptom that SI FIRMS, SECTORS, AND COUNTRIES can command implicit and explicit life support from national safety nets official makes official definitions of systemic risk both inadequate and self-serving

- Because conditions of widespread financial weakness are only a precondition for bailouts, empowering macroprudential regulators to monitor sectoral weakness addresses only HALF of the crisis-generating mechanism.

Systemic risk is also generated by government officials:

1. An unhealthy cross-agency and cross-country competition for regulatory clients ("turf")
2. Factors that make a firm or collection of firms politically or administratively difficult to fail and unwind (DFU)

CONFIDENCE IN PROMPT ARRIVAL OF RESCUE TEAMS TEMPTS DFU FIRMS TO TAKE OUTSIZED RISKS



PRECRISIS BUILDUP OF SYSTEMIC RISK

- The buildup of systemic risk in structured securitizations and shadow entities was generated by short-cutting and outsourcing due diligence in both the private and government sectors. While bubble was building, authorities failed to isolate and respond to the safety-net consequences of the all-to reversible risk transfers that fed it.
- As risky cash flows were engineered into highly rated tradable securities, Taxpayers were dragooned to serve as silent partners all along the chain of originating, valuing, selling, pooling, risk-rating, and insuring loans.
- The durability and worldwide extent of authorities' neglect should warn us that, to reduce the depth and frequency of future crises, it is not enough to improve the mechanics of risk control. A parallel effort must be made to rework the recruiting, training, missions, duties, and incentives of the system's operators.

DEEPLY INGRAINED LAYERS OF INCENTIVE CONFLICT WEAKEN ENFORCEMENT

1. Asymmetric Information and Uncertainty about what would be best for taxpayers (Creates Easy Alibis and Incentivizes Coverup)
2. Uncertain hold on positions (shortens horizons)
3. Reputational and Budgetary Damage Generated by Industry Criticism (Dysfunctional Accountability)
4. Role of Political Screening and Postgovernment Career Opportunities in Recruitment (Revolving Door)
5. Attraction of Passively Letting Firms Gamble for Resurrection
6. Budgetary Cost and Difficulties of Preparing Staff to Confront Administrative Difficulties of Resolving Complex Firms
7. Adverse Effect of Prudential Restraints on Macroeconomic Growth

- A Complete Program of Reform Should Mitigate These Difficulties by Improving Public & Private Compensation Structures, Performance Measurement, and Reporting Responsibilities.

NOT MEASURING DISTRIBUTION EFFECTS OF MYOPIC CENTRAL-BANK ACTIONS VIOLATES DUTIES OF LOYALTY, COMPETENCE, AND CARE GOVERNMENTS OWE TO ORDINARY TAXPAYERS

KEY STEP: BETTER PERFORMANCE MEASUREMENT AT SI FIRMS AND THEIR REGULATORS

- Layering of Blame for the Crisis Implies that Private and Government Sources of Systemic Risk must be monitored and policed jointly.
- Goal is to Make Taxpayers' Stake in the Safety Net Transparent.
- My Three-Part Proposal:
  1. Task managers of financial firms with reporting to their regulators interval estimates of the value of the safety-net subsidies they receive (This task could be streamlined by requiring particular types of securities to be issued.)
  2. Task the regulators with: (a) examining (i.e., challenging) these estimates and aggregating acceptable estimates across their clientele.
  3. Task regulators with reporting and justifying their estimates to a Safety Net Accountability Office (SAF) and task SAF with reporting the Aggregate Value of the Subsidies Publicly.

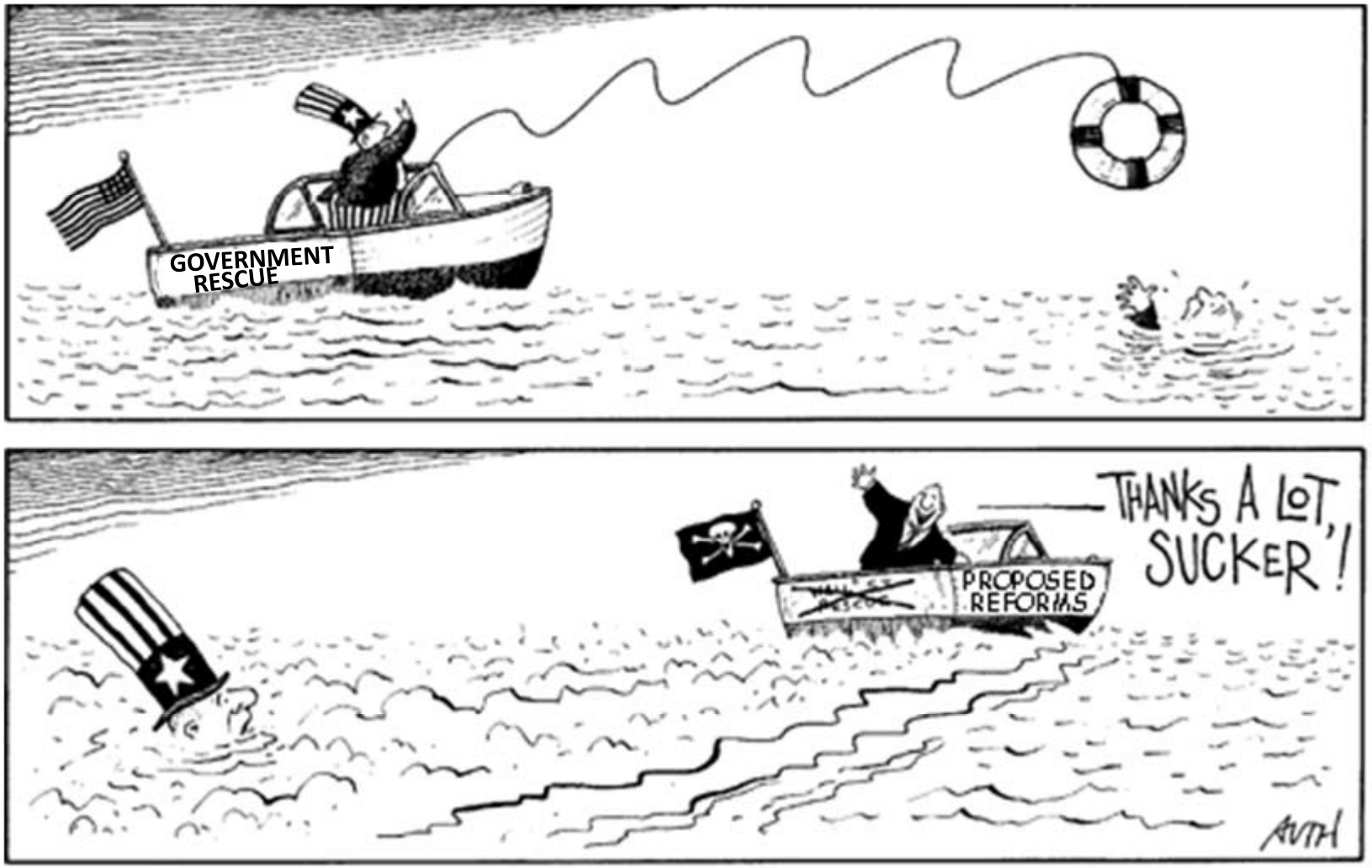
HOW TO MEASURE SUBSIDIES?

- ECONOMETRIC STRATEGIES FOR MEASURING SAFETY-NET SUBSIDIES ALREADY EXIST
- Statistical Methods for Estimating this value from balance-sheet and market Data Derive from Merton (1977, 1978):
  - Ronn-Verma (1986), Hovakimian-Kane (2000), and others extract it from stock prices
  - Eberlein and Madan (2010) extract it from prices of Equity options
  - Huang, Zhou, and Zhu (2009) use data on stock prices, credit spreads, and credit default swaps simultaneously.

WHY CREATE A SPECIALIZED INFORMATION AGENCY?

- SEPARATING ACCOUNTABILITY TO TAXPAYERS FOR MISMONITORING SAFETY-NET SUBSIDIES FROM ACCOUNTABILITY FOR POLICING THEM WOULD LESSEN OPPORTUNITIES FOR SUPERVISORS TO NEGLECT OR COVER UP EVIDENCE OF INSOLVENCY
- Accountability for each mission can be improved further by paying top financial regulators a fund of deferred compensation tied to relevant performance measures and by detailing fiduciary responsibilities to taxpayers in their oaths of office.

HIJACKING OF THE REFORM PROCESS



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GAPS IN THE GLOBAL FINANCIAL-INSTITUTION LIFEBOAT: LACK OF AUTHORITY TO CONDUCT OVERT CROSS-COUNTRY TAX-TRANSFER TRANSACTIONS.