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Designing a Systemic Risk Regulator

STATUS: Launch November 1, 2009, with an expected term of one year

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ISI OVERSIGHT: Paul Siegert, ISI President and CEO

PROJECT DESCRIPTION: Current safety and soundness regulation mainly focuses on individual banks and insurers, rather than interactions between institutions and the health of the financial system as a whole. The recent financial crisis -- resulting in the rescue of big banks and insurers and pushing the economy into a recession -- revealed the gaps in the current regulatory system and the potential benefits of an improved regulatory system.

The goal of a systemic risk regulator would be to promote financial stability for the system by lessening the likelihood of a crisis. In particular, the failure of some large or interconnected financial institutions potentially can have a cascading effect and bring down its trading partners and creditors. In other cases, efforts by an institution to remain solvent might result in an abrupt drop in short-term funding, or liquidity, to other market participants.

If a systemic risk regulator were to successfully limit spillover risks and lessen the likelihood of asset bubbles forming, then the economy and financial industry might benefit from the creation of a systemic risk regulator. However, if regulation is too restrictive, financial innovation can be hampered, which can lower economic productivity. Moreover, some analysts remain skeptical that regulators will be able to identify the next financial crisis, and thus are unlikely to be of much assistance in preventing asset bubbles. To a large extent, the debate over the effectiveness of a systemic risk regulator centers on whether the problem of “too big to fail” would lessen or worsen.

A systemic risk regulator would likely extend regulation beyond the money center banks. The extent of federal assistance to non-bank financial firms was unanticipated and unprecedented. Federal assistance to AIG, the large insurance firm, and to money market mutual funds (through guarantees) prompts calls for federal regulation to reduce risks. Similarly, the “monoline” insurance companies that transformed themselves from municipal bond insurers into insurers of all types of financial debt were allowed to operate with too little capital, which diminishes the value of their insurance. (The conversion of most of the large investment banks into bank holding companies has already occurred.) Large hedge funds might also pose systemic risks.

In the recent crisis, policymakers and financial analysts and regulators lacked a full picture of the risks that were developing on and off the balance sheets of banks and large insurance companies. Two such risks are counterparty risks and fire-sale risk.

One role would be for the systemic regulator to collect information on counterparty risks, which arises when one institution owes money to or guarantees the obligations of another party. For example, AIG, a large insurance company, had written insurance

(technically “credit default swaps”) on private-label residential mortgage-backed securities held by banks and other financial institutions. The Federal Reserve stepped in to rescue AIG, which was unregulated at the federal level—insurers are only regulated at the state level—because of fears that AIG’s bankruptcy would otherwise either push its counterparties into insolvency or severely weaken them. Just how interconnected AIG was with the banking system and investment banks was not appreciated until AIG was already in deep distress. (The credit default market is largely unregulated. The Federal Reserve Bank of New York has subsequently pushed for the creation of clearing houses for the trading of these swaps, so that the clearing house is the counterparty for a trade. Clearing houses would then set collateral requirements and could be subject to capital requirements established by a systemic risk regulator rather than by its members.)

A systemic risk regulator could demand more information on general asset holdings, including mortgages and asset-backed securities, whether on the balance sheet or off-balance sheet in the form of structured investment vehicles (SIVs) or collateralized debt obligations (CDOs). Regulators’ focus on the health of individual institutions also contributed to too little attention on fire-sale risk. In illiquid markets, the forced or distressed sale of an asset may result in a significant price drop. That price drop, even if temporary, can affect the balance sheets of other firms, who may have to mark down the value of similar assets that they hold. The resulting mark downs can create capital pressures for those firms and might contribute to more fire sales. (The Federal Standards Accounting Board has issued new guidance on valuing assets in illiquid markets which attempts to address some of those problems.)

Because systemically important financial institutions pose more risk, regulators could require that they hold more capital than other banks. In addition, capital standards might better reflect credit, interest rate, and liquidity risks. For example, banks that rely more on short-term funding might be made to hold more capital, which would reduce the risk that they would be compelled to sell assets at fire sale prices during a financial crisis, when short-term funding contracts (roll-over risk). Similarly, banks that hold less liquid assets might face higher capital standards. Many analysts have also suggested that capital requirements be counter-cyclical. By requiring institutions to hold more capital in good times, firms would have a greater incentive to tighten lending standards. Asset bubbles, such as the recent one in housing, tend to form in period of strong economic growth (and low interest rates) and are supported by relaxation of credit standards. The buffers build up in the good times would allow firms to better withstand losses in the bad times without raising additional

capital. Allowing lower capital ratios in bad times would also reduce pressures for firms to cut back lending or to sell assets, which risks fire sales. Consequently, countercyclical capital requirement potentially could promote economic and financial stability.

SCOPE OF RESEARCH / METHODOLOGY

The purpose of this project is to examine the construction of a systemic risk regulator in greater detail. What is the most optimal design of such a regulator? What are the most effective metrics and stress tests available to the regulator in the presence of extreme risks? What is form and level of private reserves that should be required before social reserves are tapped? Should social reserves be constructed as formulaic or discretionary? If formulaic, what is the best design?

RESOURCES

To be determined by researchers.

TARGET RESULTS / BENEFITS

Create a model that can be reliably utilized by those responsible for catastrophic risk management. A potential benefit would be more realistic funding reserves for such risks and less dependence on government and taxpayers to absorb costs after such events.

TIMELINE

2010

BUDGET

\$117,000

¹Squam Lake Working Group on Financial Regulation, “A New Information Infrastructure for Financial Markets,” (working paper, Council on Foreign Relations Center for Geoeconomic Studies, February 2009);

www.cfr.org/content/publications/attachments/Squam_Lake_Working_Paper1.pdf

²John Heaton, Deborah Lucas, and Robert McDonald, “Is Mark-to-Market Accounting Destabilizing? Analysis and Implications for Policy,” (paper prepared for the Carnegie Rochester Conference on Public Policy, April 17-18, 2009);

www.carnegie-rochester.rochester.edu/april09-pdfs/HeatonLucasMcDonald.pdf