ИНСТИТУТ ФИНАНСОВЫХ ИССЛЕДОВАНИЙ

Who will measure systemic risk?

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The crisis so severe, the world financial system is affected. The majority of researchers agree that systemic risk is one of the key factors of the global recession (in the developed economies, first of all). Separate regulators "could not see the wood for the trees", so overlooked the beginning of the crisis, despite that large financial information flows are processed daily. For instance, the IMF's vision of the economic turmoil is as follows: "a fragmented surveillance system compounded the inability to see growing vulnerabilities and links". Governments worldwide began to work out reforms aimed at mitigating systemic risk.

One of the systemic risk definitions[1] suggests that it has two effects: a) unexpected financial institution failures (including large-scale bankruptcies); b) domination of large financial institutions whose sole failure due to their size or interconnections to other institutions would create an unacceptable risk to the rest of the system. These two risks are interrelated because many large companies (including financial) are *too big to fail* (large interconnected institutions whose failure might affect the health of the system).

There are two different kinds of systemic risk regulation: the traditional oversight (micro-prudential bank surveillance, financial companies' transparency); and the new macro-prudential regulation designed to identify and minimize systemic risk. This risk is above and beyond the summation of those arising from individual financial institutions or markets. The main instrument of macro-prudential regulation is assessment of financial soundness indicators (risk sensitivity, financial leverage, liquidity indicators, savings market characteristics, etc.). This type of regulation should become an efficient mechanism of financial market seizure and crises prediction.

However, no workable macro-prudential regulatory framework has been established so far. Risk assessment based on macroeconomic stress tests under the Financial Sector Assessment Program (FSAP[2]) implemented by the IMF and World Bank jointly with national monetary regulators is the closest analogue of macro-prudential regulation. Other developments in this sector include creation of early crisis detection systems (mainly, macroeconomic) and VaR (*value-at-risk*) assessment for the financial sector. These are theoretical developments, and a potential regulator attempting to identify systemic risk without any workable model would look like an astronomer searching new stars with a few drawings and an unassembled telescope. The IMF and the Bank for International Settlements (BIS) have tackled the need

[1] Schapiro (2009)
[2] http://www.imf.org/external/NP/fsap/fsap.asp

to establish macro-prudential regulation, but their efforts to focus on regulatory models have been neglected.

As the crisis progressed, the situation changed, however. Heads of central banks[3], politicians[4] and leading economists[5] now insist that macro-prudential regulation is vital for the global financial system. Many economies are widely discussing the problem of systemic risk identification and minimization, the main point of these discussions being what state organ should handle this policy.

The US searches for organizational and political solutions. In mid-June, Obama's administration came with the proposition to give the Federal Reserve extensive powers to police risks across the financial sector. They mean to turn the Fed into a macro regulator to oversee subordinate regulatory bodies. The Fed powers will be controlled by the Financial Stability Oversight Council. Expanding the central bank's mandate for systemic risk management is not the only solution (although US Treasury Secretary Timothy Geithner says it is). There are proposals to set up a completely new regulator or a consultative council (committee) that would include major representatives of the existing regulators, and give them more powers than stipulated by Obama's plan. Nevertheless, the Fed top managers continue to prove that they are the best choice for financial soundness oversight. In early July, William Dudley, the Federal Bank of New York CEO, made an optimistic statement suggesting that the Fed would be able "to identify and burst asset bubbles" by expanding the range of credit policy instruments. It is hard to believe that inefficient information flow or lack of powers prevented the Fed from doing so before. It looks like its heads have not been resolute enough.

It is not difficult to create a regulator, it is difficult to establish a workable regulatory environment. Let us consider just a few critical points relating to the scientific base of regulation:

- Finance theory is poorly integrated with macro-economics[6]. There are several research attempts, but there are no ready-made recipes for crisis-prevention policies; it is not clear to what extent monetary policy should take into account bubbles;
- Systemic risk assessment methods and empirical approaches to crisis identification are imperfect from both theoretical and practical viewpoints. Previous attempts to minimize systemic risk in financial sector (Basel II) caused systemic risk to grow and financial system cyclic recurrence to increase[7];

[3] Landau (2009), Redrado (2009), Tumpel-Gugerell (2009)
[4] UK Conservatives actively use macro-prudential rhetoric ("U.K. Regulator Defends Its Role")
[5] Blinder (2009)
[6] De Grauwe (2009)
[7] Danielsson et al. (2001)

- Economic research hopelessly lags behind financial innovations[8]; with constantly renewed instruments and trends, the regulator will be always behind innovational leaders – the most progressive financial institutions. Financial innovation has largely impacted the financial system, making it more fragile,[9] and can be rightly named if not the reason, the main mechanism of the 2008-2009 crisis.

Thus, it is doubtful that a system for systemic risk identification and neutralization will be created in the coming years. And it is not important what body will handle it.

An institutional environment in which the state will be formally and informally forbidden to rescue lax financial institutions regardless of their size may be an alternative to new regulators. Not relying on the state support, financial institutions will not grow to the size when their bankruptcy endangers the system. It is utterly hard to create an environment like this, and even toughest rules could be cancelled by politicians who set them. Perhaps, the world financial system built on the no-state-support principle will develop slower and be less powerful and efficient than the system that existed until 2008, but it will surely prove safer in the long run.

[8] Frame, White (2004)
[9] Rajan (2005)

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