Reflections on Systemic Risk Regulation in Response to Karmel's Paper

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REFLECTIONS ON SYSTEMIC RISK REGULATION IN RESPONSE TO KARMEL’S PAPER

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In her very thoughtful article, Professor Karmel proposes the establishment of a systemic risk regulator modeled after the Government Accountability Office (GAO) or the Office of Management and Budget (OMB). The proposed systemic risk regulator would be primarily responsible for issuing warnings and making recommendations relating to systemic risks. It would have no regulatory and supervisory authority and would be highly independent with limited accountability. This essay takes a contrary position—that a systemic risk regulator that has no regulatory and supervisory functions and that is institutionally segregated or independent from those functions is unlikely to be effective and competent in policing systemic risks. It then discusses the information needs for systemic risk regulation and argues that systemic risk regulation and prudential regulation are closely interconnected and highly complementary. Finally, it briefly touches on the issue of accountability.

Systemic risk analysis is an information and data intensive endeavor. Thus, a crucial element in any institutional design for systemic risk regulation is how to collect and aggregate relevant information and make informed decisions in an efficient and effective manner.

Systemic risk regulation involves regular collection and analysis of a large amount of disparate information encompassing the entire financial system both at the macro- and micro-levels. At the macro-level, the information consists of those relating to macroeconomic conditions, financial markets and related infrastructures, payment and settlement systems, and the intersections between financial sectors and the real economy. At the micro-level, it involves regular collection and monitoring of a wide range of firm-level information, particularly for systemically important

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financial institutions, such as on- and off-balance sheet items with appropriate breakdowns of exposures and identification of counterparties, capital, liquidity and risk management, compensation, and governance practices.¹

In particular, systemic risk analysis often entails horizontal reviews of information across groups of financial institutions, focusing on particular risks or activities, common exposures, and “crowded trades,” preferably on a real-time basis.² A systemic risk regulator must possess deep market and institutional knowledge, analytical sophistication and supervisory expertise to be competent in carrying out such analysis.³ What makes this type of analysis particularly challenging in practice is the constantly changing and continuously evolving nature of the financial markets as a result of market movements, innovations and financial integration.⁴ New market developments appear to occur at an ever-accelerating pace. Even the most intimate and sophisticated market observers, regulators and market participants find it challenging to stay abreast of and comprehend the impact of these changes. The effects of the “originate to distribute” model of securitized credit intermediation and the accompanying explosive growth in subprime lending that contributed to the present financial crisis is one case in point.

Thus, whether the Federal Reserve adds a systemic risk function to its current supervisory and regulatory responsibilities, or a council of regulators aggregates their collective information and experience to serve the systemic risk role, ultimately, functional regulators must play a key role


in an effective systemic risk regulatory regime. A systemic risk regulator that has no supervisory and regulatory role could theoretically rely on data provided by the functional regulators, but the information would be derivative and may lag real-time events due to coordination issues. This could be problematic, particularly in times of crisis. Given that the U.S. regulatory framework will likely remain fragmented after the anticipated legislative reforms to financial regulation, a council of regulators would be conducive to the information aggregation process, whether as an advisory body to a systemic risk regulator or as a body with systemic risk authority itself.

Additionally, systemic risk regulation and functional regulation are closely interconnected and highly complementary. A distinct separation of systemic risk regulation and functional regulation runs the risk that neither regulatory function performs satisfactorily. In practice, most important macro-prudential instruments for systemic risk regulation have to work through the micro-prudential regulatory and supervisory process in a dynamic, tailored fashion in response to evolving market conditions and risk correlations over the economic cycle.

Theoretical literature on systemic risk regulation considers two dimensions: “cross-sectional dimension” and “time dimension.”

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5. In the European Union, the proposed European Systemic Risk Board (ESRB) and the European System of Supervisory Authorities (ESSA) are institutionally inter-locked in that the members of the ESRB include the three Chairs of the ESSA. To ensure further coordination and cooperation with the national prudential regulators, a representative from one national supervisory authority for each EU country may attend the meetings of the ESRB, though they will have no voting rights.


sectional dimension refers to the distribution of risk within the financial system at a given point in time by acting on its inter-connectedness. A key policy concern of cross-dimensional dimension is how to address common exposures that could ripple through the system and impose stresses on a significant number of financial institutions. Time dimension relates to how aggregate risks evolve over time in an economic cycle. A key policy concern of time dimension is how to address the problems of pro-cyclicality. Both dimensions of systemic risk regulation require a calibrated approach through the regulatory and supervisory review process. For the cross-sectional dimension, capital, liquidity, and risk management requirements need to be tailored and dynamically adjusted based on the systemic significant of individual institutions. Further, the larger, more complex or systemically important financial institutions warrant particular attention. Examples of such calibration include a “systemic capital surcharge” or an institution-specific systemic insurance premium calculated along a spectrum, rather than based on categorical classification. For the time dimension, regulatory regimes for countercyclical capital buffers and more forward-looking countercyclical loan provisioning are currently under consideration by national regulators and international bodies. To reduce the amplitude of the economic and financial cycles, appropriate levels of buffers or provisioning may need adjustment over time.

To effectively identify emerging strains and imbalances and address them through proper regulatory calibration in a timely manner, a systemic risk regulator must have a deep knowledge and understanding of, and have regular and close contacts with, financial markets and intermediaries. In particular, to implement such calibrated prudential standards, a robust regime for systemic risk regulation must ensure that all systemically important financial institutions are subject to consolidated supervision. A systemic risk regulator that is functionally separate from the regulatory and supervisory process is unlikely to be competent in carrying out such an extraordinarily complex task.

Lastly, systemic risk regulation is a multifaceted and multidisciplinary task that requires policy coordination and cooperation involving many authorities with different perspectives and responsibilities, both domestically and internationally. 

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cally and internationally. For instance, to design a regulatory regime for dynamic loan provisioning would require the involvement of accounting standard setters, tax authorities and functional regulators. In particular, regardless of the institution framework for financial supervision, information-sharing and decision-making linkages between the central bank and other regulatory agencies are necessary to effectively identify and address systemic risks. In addition to its critical role as a lender of last resort, the Federal Reserve has broad expertise and deep knowledge in financial markets, infrastructures, and intermediaries. This is due to its role as an umbrella supervisor for bank holding companies, its role in the payment and settlement systems and its active monitoring of the capital markets in support of its monetary policy. Thus, as a practical matter, it is essential to have involvement of the Federal Reserve in systemic risk regulation, whether or not it is in the lead role.

INDEPENDENCE AND ACCOUNTABILITY

Professor Karmel’s proposal to establish a highly independent systemic risk regulator is rooted in the notion that prior to the recent financial crisis, prudential regulators were either subject to political interference or “captured” by the industries they regulated.

Agency independence has two dimensions—Independence from political interference and independence from industry interests. Critics of agency independence hold that independence could make agencies too powerful and jeopardize the democratic accountability of the regulatory process. In particular, without proper political oversight and control, independent agencies are prone to “regulatory capture.” Agencies that


11. See generally Cosmo Graham, Is There a Crisis in Regulatory Accountability?, in A Reader on Regulation (Robert Baldwin et al. eds., 1998); Barry M. Mitnick, The Political Economy of Regulation (1980); Katjia Sander Johannesen, AFK FORLAGET,
suffer from regulatory capture promote industry interests or individual private interests over the public interest. These justifiable concerns call for proper accountability arrangements as the countervailing power to agency independence. However, independence and accountability are not necessarily mutually exclusive. With properly designed accountability arrangements, independence and accountability can be highly complementary.12 Proper accountability arrangements reinforce an agency’s independence by enhancing its legitimacy and encouraging it to adhere to high standards of governance and performance. In addition, they enhance an agency’s integrity and thus reduce the possibility of regulatory capture.

Few will quibble with the notion that functional regulators made mistakes leading up to the financial crisis. However, the more likely causes were neither political interference nor regulatory capture, but rather an inability to comprehend what was occurring across the financial system due to regulatory fragmentation and a failure to detect certain signals that were clearly evident.

After many months of debate, there appears to be widespread consensus that a systemic risk regulator with a broad perspective and pervasive authority over financial market activity is necessary and advisable to ensure the stability of the financial system. It will be imperative that whatever agency performs this essential role operate under clear legislative mandates and to the full extent possible, free of political interference. That said, this essential function must be reportable to Congress and, ultimately, the American taxpayers who will bear the consequences of its actions.

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