

Systemic Risk Regulation and the “Too Big to Fail” Problem

By Borys Grochulski and Stephen Slivinski

A single regulator tasked with preventing threats to systemic stability would need to have considerable power and discretion.

But creating such a powerful entity could reinforce the moral hazard problem resulting from the idea that some firms are too big to fail.

The financial crisis that started in the summer of 2007 has spurred many academics and policymakers to suggest that a new “systemic risk regulator” (SRR) is necessary. The most extensive proposal to date was the one released by President Obama’s administration on June 17.¹

It would create a Financial Services Oversight Council chaired by the Secretary of the Treasury and composed of the heads of the major federal financial regulators. It also would assign the SRR function to the Federal Reserve, subject to the Council’s oversight. The goal of the SRR and the Council would be to prevent or mitigate a future financial crisis or systemic shock. To fulfill this goal, the Council and the Fed would be given substantial power to regulate and resolve trouble in systemically important financial institutions.

The question of what form the optimal regulation of the financial system should take is enormously complicated. What constitutes “systemic risk” is neither precisely understood nor widely agreed upon, so mitigating such risk is inherently difficult. Yet, perhaps more important, any proposal to give a regulatory body the task of heading-off threats to systemic stability must cope with how that entity would interact in practice with the market expectation of how the government treats firms deemed “too big to fail” (TBTF).

In this *Economic Brief*, we are not focused on discussing a particular policy proposal. Instead, our goal is to examine one narrow aspect of the interaction between an SRR and the market’s expectations about the government’s approach to TBTF firms, and to describe the consequences that might result. As we argue, there is a danger that tasking a government body with regulating systemic risk and giving it substantial discretion and power to act on what it sees as threats to market stability could actually exacerbate the marketplace behaviors that precipitated the creation of an SRR in the first place.

THE TBTF PROBLEM AND GOVERNMENT REGULATION OF RISK-TAKING

It is well-understood that the market’s perception of the TBTF status of some large financial institutions has profound effects on the risk-taking incentives of those institutions.² The TBTF perception can alter the relationship between the financial institutions’ cost of credit and the riskiness of the assets they fund with this credit. To see why, recall

that senior creditors take a loss on their investment only when the institution to which they have loaned money fails outright. If those bondholders perceive that the government views the failure of that firm as unacceptable, they can be practically assured repayment. This means that they are willing to extend credit to the financial institution cheaply since they expect to be made whole by the government in the case of the firm's inability to repay.

At the same time, the institution has the incentive to allocate the bondholders' funds to projects with a large profit potential regardless of the downside risk. This is because the upside value goes to the shareholders if the risk pays off, while the downside is borne by others. This creates a clear incentive to take on risks that are imprudent. This incentive is often referred to as the "moral hazard" problem.

The analog to this type of protection has been around for depository institutions for over seventy years. The government has made an explicit promise to make whole (most of) the depositors of thrifts and commercial banks through the Federal Deposit Insurance Corporation (FDIC). In recognition of the moral hazard problem this insurance creates, however, the government controls the risk-taking of these institutions through regulation and prudential supervision. Thus, regulation has been used to mitigate the moral hazard problem in the case of banks.

As we have come to witness during at least the past year-and-a-half, however, the government safety net actually extends beyond the regulated world of deposit-taking institutions. In fact, it now covers parts of the lightly regulated world of non-banks. It is quite clear now that market participants hold some expectation of government support of large or highly-interconnected non-banks should an institution like that face failure. Creating an SRR could turn the current implicit promise of assistance to large and important firms into an explicit one.

Recognizing the moral hazard problem that the expansion of the federal financial safety net creates for large non-banks, one could take a view that these institutions should now be regulated more heavily too. In this view, systemic risk provides an argument for why the government should take on oversight of all financial institutions that are considered too big or too important to be allowed to fail.

Yet curbing risk-taking by not only banks but by all systemically important institutions is a task of enormous scale and complexity. If one looks to more regulation as a critical element of the new regime of mitigating systemic risk, one should carefully consider what might happen if putting an air-tight seal on the economy's risk valve is simply too hard to implement in practice.

AN SRR MAY ENCOURAGE MORAL HAZARD

By definition, a risk-curbing SRR would need broad powers and access to taxpayer funds. The powers of the SRR would need to include designating firms as "systemically important" and regulating them – for instance, imposing more stringent capital and leverage ratio requirements than those imposed on the firms not deemed systemically important. In addition, an SRR could be given a mandate to deal with problems at firms designated as TBTF in order to avoid the threat that failure of such an institution could pose to the stability of the financial system as a whole. This mandate may include the power to resolve the firm, put the firm in receivership or conservatorship, or grant it taxpayer-funded loans, loan guarantees, or equity capital injections.

Also, due in part to the fact that precise measurement of a nebulous concept like "systemic risk" is not currently available or easy, the charter of the SRR would need to allow a significant amount of discretion in how the SRR deals with troubled financial institutions. This degree of discretion may amplify the moral hazard problem.

How could this happen? If the charter of a new regulator puts a strong emphasis on the SRR's role in preventing a future financial crisis alongside the regulation of risk-taking, the failure of a large institution would make the SRR look ineffective. It is probably a safe assumption that financial crises will occur in the future. Despite all its powers, the SRR is not likely to be able to control perfectly the risk exposures of important institutions – or, if it was able, it would drive the risky activity to another corner of the financial market that would itself then become systemically important.

It is now clear how such an SRR could strongly encourage moral hazard relative to today's standards. The more likely the government is to extend support to a firm in a crisis instead of winding it down, the more incentive the firm has to seek imprudent risk. This exacerbation of the moral hazard problem makes the task of curbing risk-taking even more difficult. And that, in turn, yields two possible results. It either makes the probability of the occurrence of the next financial crisis not smaller but larger – or it leads society to spend ever more resources to monitor risk-taking by financial institutions.

CONCLUSION

Threats of new financial crises will always be with us. How we prepare for them is an extremely complicated problem of great importance. In this *Economic Brief*, we highlight one major aspect of the problem of tasking a government agency with the power to intervene in markets to manage a difficult-to-define notion called "systemic risk."

The complexity of government regulation of risk-taking by depository institutions is dwarfed by the complex task of regulating risk-taking in the economy as a whole. Creating government agencies charged with controlling risk-taking everywhere in the economy can be dangerous. Such agencies would need to have considerable power and discretion. Yet that power and discretion can reinforce the moral hazard problem resulting from the idea that some firms are too big to fail. This could increase, not decrease, the amount and concentration of risk in the financial system – and is an issue that should be given careful consideration as policymakers debate the merits of adopting an SRR. ■

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ENDNOTES

¹ *Financial Regulatory Reform – A New Foundation: Rebuilding Financial Supervision and Regulation*. Washington, DC: Department of the Treasury, June 17, 2009.

² See Gary H. Stern and Ron J. Feldman. *Too Big to Fail: The Hazards of Bank Bailouts*. Washington, DC: Brookings Institution, 2004; and “The Role of the Safety Net in the Financial Crisis,” speech by Jeffrey M. Lacker to the Asian Banker Summit, May 11, 2009.

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