



# FS Insights

## Is a Systemic Risk Regulator the Savior of the Financial Services Industry?

Any mention of regulatory reform of the financial services industry inevitably turns to a discussion of systemic risk and, more specifically, the merits of assigning one agency with the title of “systemic risk regulator,” creating a systemic risk council with representatives from various agencies, or a combination of both, as suggested in the Obama administration’s regulatory reform proposal. As the regulatory reform debate intensifies, regulators past and present, politicians, industry representatives, economists and academics, among others, are weighing in with their views on this issue. At the heart of the debate are many fundamental questions. What is systemic risk? Do institutions give rise to systemic risk, or is it the activities they conduct? Does a systemic risk regulator create a moral hazard? What authorities are we willing to give to a systemic regulator? What do we really expect from a systemic risk regulator? Can a systemic risk regulator be effective? Will we be able to sleep better at night?

The importance of managing systemic risk is hardly a new concept in regulatory supervision. Examples of risk events in just the past 35 years that have prompted concerns far beyond a single institution are plentiful: Bankhaus Herstatt, Franklin National Bank, Continental Illinois, Barings Bank, Long-Term Capital Management, not to mention the myriad financial institutions bailed out in the current crisis in the name of systemic risk. And, of course, there is the one institution that was not — Lehman Brothers — although many would argue it should have been, thus highlighting the fact that it is not always clear when systemic risk is or is not present.

George Kaufman and Kenneth Scott, both members of the U.S. Shadow Financial Regulatory Committee,<sup>1</sup> equate systemic risk to the fear caused by a cry of “Fire!” in a crowded theater, but they add that unlike fire, “systemic risk” is less clearly defined.<sup>2</sup> The classic definition of

systemic risk refers to the probability of breakdowns in an entire system, as evidenced by a clustering of financial institution failures, nationally or globally. In this context, the failure of a market participant to honor its contractual obligations — let’s say these were credit default swaps — in turn causes a chain reaction of defaults across the industry because of the interconnectivity of the institutions, resulting in a system shutdown. Another definition of systemic risk emphasizes similarities in the risk exposures of multiple institutions — let’s say financial institutions everywhere invested in subprime mortgages — that may cause the market to respond to them similarly.<sup>3</sup> These two definitions raise two key questions:

- Do we want a systemic risk regulator to prevent the cascading failures of interconnected institutions that might argue for a regulator of systemically significant institutions? Of course, then either we would have to believe that the population of systemically significant institutions is static, or we would need to define criteria for institutions to move in and out of the population.
- Do we want a systemic risk regulator to ensure that a significant number of financial institutions do not participate in whatever activities follow subprime mortgages as the next industry debacle? Then, our focus would not be on specific financial institutions, but on the products and services they provide, the way that they offer them, and the concentrations such activities can create leading to unacceptable exposure to plausible scenarios outside of the ability of industry participants to control.

The answers to these questions are important because they can lead to two very different mandates for a so-called systemic risk regulator.

Let’s assume that we can define the criteria for designating (and redesignating) systemically significant institutions. Opponents of this approach, who include notable financial industry authorities such as former Federal Reserve Chairman and current member of the White House Economic Recovery Advisory Board, Paul Volcker, caution against

<sup>1</sup> The Shadow Financial Regulatory Committee is a project of the American Enterprise Institute for Public Policy Research and is a group of publicly recognized, independent experts on the financial services industry who meet regularly to study and critique regulatory policies affecting this sector of the economy.

<sup>2</sup> “What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?,” Kaufman, George G. and Scott, Kenneth E., *The Independent Review*, Vol. VII, No. 3, Winter 2003, ISSN 1086-1653, available at [http://www.independent.org/pdf/tir/tir\\_07\\_3\\_scott.pdf](http://www.independent.org/pdf/tir/tir_07_3_scott.pdf).

<sup>3</sup> Ibid.

explicitly designating “which institutions are in and which institutions are out” because of the signal this may send about which institutions are assured of official support.<sup>4</sup> This moral hazard or “too big to fail” issue evokes its own debate. Should we even have institutions that are so large and complex that their demise could threaten the financial industry and the economy as a whole? In recent congressional testimony, chairman of the Federal Deposit Insurance Corporation, Sheila Bair, argued for “creating incentives to reduce the size of systemically important firms” and devising baseline standards for curbing excessive risk-taking throughout the financial system.<sup>5</sup>

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For those who believe that the focus should not be on “flagging a handful of large institutions as too big to fail” but rather on reducing the likelihood of a systemic failure,<sup>6</sup> monitoring risks across the financial system becomes the priority. That presumably has always been a regulatory mandate, so what will a new regulatory body do that existing regulatory agencies have not been able to do? Maybe the job becomes a little bit easier if heretofore unregulated segments of the financial services industry are subjected to regulatory oversight; maybe repealing or loosening functional regulation — as is raised in the Obama administration’s regulatory reform plan — would help regulators see how risks extend across different legal entities and types of financial institutions. Perhaps, some argue, that vesting authority for overseeing systemic risk in a single agency is an improvement since it does not depend on multiple agencies effectively sharing information in a timely manner. However, the inability of existing regulators to collaborate, at least on a national level, seems a poor excuse for creating a new regulatory agency or broadening the authority of an existing regulator when communication protocols already exist or, where lacking, could easily be put into place.

*Striking the right balance between not permitting irresponsible behavior and allowing the free market to operate will remain a challenge, regardless of whether there is a systemic risk regulator.*

If the concern is that the existing agencies are not up to the challenge, the fact remains that there has been very little discussion during the regulatory reform debate about what tools and resources will be provided to the regulators to help them do their jobs better. Further, the likelihood that a single regulatory body would have the breadth of experience, skills and resources necessary to predict the next regulatory crisis seems unrealistic. This is one of the arguments being offered by those advocating a systemic risk council rather than a separate regulatory body, though as is the case with any regulatory reform debate, turf and self-preservation may strongly influence views. However, former Federal Reserve Chairman Alan Greenspan suggests the likelihood that any regulatory body will be able to foresee the next disaster is “without evidence.”<sup>7</sup>

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Another question that must be answered is what powers are we willing to give regulators in the interest of stemming systemic risk? Arguably, more and better use of the enforcement powers that regulators already have could have at least ameliorated the effect of the current crisis. However, the challenge regulators have always had is balancing their responsibilities with those of management and boards of directors. Are we now prepared to allow regulators to tell financial institutions that they categorically cannot offer certain products or services or to permit regulators to design the incentive compensation systems for the companies they supervise? This might make sense in a government-owned financial services industry, but presumably the goal of most countries that are now heavily invested in the financial services industry is to return ownership to the private sector. Striking the right balance between not permitting irresponsible behavior and allowing the free market to

<sup>4</sup>“Shaping Global Financial Reform: A Symposium for Private and Public Sector Leaders,” Washington, D.C., April 23, 2009, proceedings summarized by Mariya Deryugina on behalf of the Boston University *Review of Banking and Financial Law*.

<sup>5</sup> Statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation on Regulating and Resolving Institutions Considered “Too Big To Fail,” before the Committee on Banking, Housing and Urban Affairs, U.S. Senate; Room 538, Dirksen Senate Office Building, May 6, 2009.

<sup>6</sup>“Congress Wrestles With Systemic Risk Regulator,” Aguilar, Melissa, *Compliance Week*, March 24, 2009, comment attributed to Travis Plunkett, legislative director of the Consumer Federation of America.

<sup>7</sup>“No crystal ball for new U.S. risk overseer,” Greenspan, Alan, Drawbaugh, Kevin, June 3, 2009, available at [www.reuters.com](http://www.reuters.com).

operate will remain a challenge, regardless of whether there is a systemic risk regulator.

Beyond the issues and complications already mentioned, there remains the question of whether a systemic risk regulator that operates only on a national level can really be effective. Although calls for international coordination in crafting regulatory reform do not seem as loud as they were initially, as national (or regional in the case of the European Community) authorities seek to address issues within their own jurisdictions, the current financial crisis would seem to present strong enough evidence that risk does not stop at national borders. Therefore, regulators of multinational financial institutions must be in the position to understand risks across the entire network of a company, as well as to understand how market developments in any one jurisdiction may affect other markets.

Why has such a complicated idea gained so much traction in Washington, D.C., and other world capitals? The motivation — to protect the world economy from another meltdown such as the one that we are now experiencing — is sincere and well intended, but is the expectation realistic? As noted in a recent article by Alex Pollock, an American Enterprise Institute fellow and former president and CEO of the Federal Home Loan Bank, the desire to *do something* in the wake of a financial industry disaster generally leads to increasing regulation, creating new regulatory bodies or reorganizing existing ones “with greatly overstated

expectations about their future effectiveness.”<sup>8</sup> Pollock illustrates this view by referencing a statement made by Comptroller of the Currency John Skelton Williams in 1914, when the Federal Reserve System was created: “Financial or commercial crises seem to be mathematically impossible.”<sup>9</sup> Optimistic, to be sure, but untrue as we all know. This is not to suggest that there is not a need to pay more attention to systemic risk and the regulatory response to systemic risk or even that there is no merit in revamping or reorganizing regulatory agencies. However, lawmakers and regulators alike need to be realistic about what can be achieved. Merely anointing a systemic risk regulator will not save the financial services industry from every future disaster.

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For additional information on the status of global regulatory reform initiatives, please visit the [Regulatory Reform page on Protiviti’s website at www.protiviti.com/regulatoryreform](http://www.protiviti.com/regulatoryreform).

## Best Practices for Stress Testing

Stress tests have become a topic in the popular media. People who prior to the collapse of the financial services industry did not even know what a stress test was now debate whether the U.S. government and other governments have been tough enough in stress testing their banks. The failure of stress tests to predict the looming disaster, or at least prepare institutions in a more timely manner of its impending arrival, also has been a subject of much debate.

The Basel Committee on Banking Supervision, the multi-lateral body composed of senior officials responsible for banking supervision or financial stability from 27 developed countries, defines stress testing as a tool that supplements other risk management approaches, and measures and plays an important role in:

- Providing forward-looking assessments of risk
- Overcoming limitations of models and historical data
- Supporting internal and external communication
- Feeding into capital and liquidity planning procedures

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- Informing the setting of a bank’s risk tolerance
- Facilitating the development of risk mitigation or contingency plans across a range of stressed conditions<sup>10</sup>

<sup>8</sup> “Is a ‘Systemic Risk Regulator’ Possible?”, Pollock, Alex J., *The American*, May 12, 2009, available at [www.american.com](http://www.american.com). Remark attributed to Bernard Shull.

<sup>9</sup> “Is a ‘Systemic Risk Regulator’ Possible?”, Pollock, Alex J., *The American*, May 12, 2009, available at [www.american.com](http://www.american.com).

<sup>10</sup> “Principles for sound stress testing practices and supervision (May 2009),” available at [www.bis.org/press/p090520.htm](http://www.bis.org/press/p090520.htm).

Recently, the Basel Committee released what has been called a “damning indictment of the stress testing procedures adopted by global banks.”<sup>11</sup>

The range of weaknesses in financial institution stress testing practices identified by the Committee included:

- The failure at most banks to foster internal debate or challenge assumptions, even in the face of contradictory information or market signals
- The performance of stress tests by isolated stress test units that had little interaction with business and that may have been focused only on particular risks or products and not on taking a holistic view of the risks within an organization

<sup>11</sup>“Basel Committee slams banks’ stress testing,” Turner, Matt, May 21, 2009, *Wealth Bulletin*, available at [www.wealth-bulletin.com](http://www.wealth-bulletin.com).

- The lack of alignment between stress test results and management decision-making
- The failure to consider pipeline and warehousing, as well as other contingent risks
- The lack of a sufficiently broad range of scenarios along a spectrum of events and severity levels, including recession-type scenarios

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In an effort to address these weaknesses, the Committee has formulated 21 stress testing principles for large, complex financial institutions and their regulators. These principles are described in detail on the Committee’s website at [www.bis.org/press/p090520.htm](http://www.bis.org/press/p090520.htm).

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