

Viewpoint

One of a series of opinion columns by bankruptcy professionals

The Wild, Wild World Of 'Systemic Financial Risk'

By Scott Y. Stuart

The financial meltdown of 2008 has opened the doors of debate about how to assure this will not happen again. Assuming such a question can realistically be answered, at the heart of it all lies a term yet to be defined. That term, "systemic financial risk," has spawned a nationwide debate not only to come to grips with what it all means, but how to prevent it (whatever "it" is) from happening again.

The real issue with which policy and lawmakers are struggling is not only how to create an acceptable definition for this term, but to what extent regulation will play in an effort to prevent this kind of economic meltdown again. The debate is heated, and the opinions on how much regulation and where to place oversight power are unprecedented. While there may be no totally correct conclusion to this issue, there are important and legitimate questions that must be asked and answered before this nation journeys into places that may actually be more detrimental to economic growth.

At this point, there seems to be a consensus that the creation of a systemic-risk regulator of some kind is inevitable. That person or agency will likely have oversight over systemically important financial institutions. Here again, no real understanding of what those institutions will encompass has been defined. Is it the nation's largest banks, financially invested insurers or companies like CIT, which are pervasive in the middle and small markets?

Earlier this year, Robert E. Latin of the Brookings Institution journeyed to Capitol Hill to take on some of these issues. He offered substantive testimony to the Senate Committee on Homeland Security and Governmental Affairs. His insights provide a good glimpse of the many issues that need to be developed, debated and defined before pervasive regulation can occur.

The challenge, as noted by Latin, is balancing "the need to strengthen our financial and regulatory framework, so that we are far less exposed to the kind of financial and economic crisis we are now experiencing, without at the same time chilling innovation and prudent risk-taking that are essential for economic growth." The realization as a first step that regulation and risk must co-exist seems to be a good one.

Notwithstanding views such as Latin's, not everyone is convinced that a potential regulatory scheme is a good one. For example, Sen. Bob Corker, R-Tenn., recently

commented in a Newsweek story: "Today there's a whole lot more questions about what systemic risk is and which powers a regulator should have than there are answers." To validate that point, it seems that Treasury Secretary Timothy Geithner and Federal Reserve Chairman Bernanke are at odds over how to tackle these issues.

In late July, Geithner said that the Federal Reserve should create a single point of accountability for the consolidated supervision of all large, interconnected firms. This seems to put the power of monitoring systemic risk in the hands of the Fed, a position some say could potentially compromise monetary policy by compromising the Fed's independence.

Bernanke, offering a differing opinion of these issues, stepped away from the most pervasive forms of regulation. His view of the Fed's role is much more limited, with risk concentration being centered on the 19 firms that went through the government's "stress test" last spring. In an admission seemingly revealing about the Fed's capabilities, Bernanke testified that the Fed does not have the resources or authority to take "a holistic view of the whole system." The detail involved in such a path would obviously be enormous if not impossible to implement and monitor.

Perhaps the best way to address these thorny issues is to step back and accept some necessary premises about the economy in general. David C. John, a Heritage Foundation senior fellow, argues that systemic risk is a reality of life. The problem, he contends, is that systemic risk may best be identified when it occurs or afterwards. He further argues that even if identified, what of political interests and their ability to trump regulatory authority? He cites the Chrysler and General Motors experiences as a case in point on this very issue. Such arguments expose the many variables that exist in the debate and conclusions regarding how to manage systemic risk and how effective regulation will (or will not be) in this battle.

John steps back even further and posits three key points that should be considered before a regulatory scheme is adopted and implemented. First, he argues, in order for a new agency to be able to act effectively, the term "systemic financial risk" will have to be clearly defined. Second, he contends that no matter what regulation looks like, what is the breaking point at which the government is launched into action will also have to be defined.

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In other words, what will the standards of systemic risk be before the regulators act? Finally, John asks what new powers this regulator will have over already regulated financial institutions and those that have not in the past been subject to regulatory oversight.

In what is likely to be a major policy shift, systemic risk, once seemingly defined as institution-specific, is now moving towards assuring system-wide stability. Such regulation, however, is challenged on many levels, from definition to implementation. Most importantly, however, bubbles are normal in economies, and system-wide oversight while watching for systemic failure may very well chill a free-market economy from the genius of invention responsible for the industries of tomorrow. Surely this is not what risk oversight is meant to achieve, but it is certainly something that may occur.

Suffice it to say that opinions on these issues vary greatly. This is a debate not so much about regulation and what constitutes systemic risk, but about how government will oversee and involve itself where it has not done so in the past. The stakes of such policy considerations are great, and, if mishandled, may have the exact opposite effect intended. In a free-market economy, this should weigh most heavily in the administration's mind.

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