Press Points for Chapter 2:

Systemic Risk and the Re-Design of Financial Regulation

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Key Points

- The recent crisis has triggered a flood of regulatory reform proposals to deal with systemic risks—the potential for distress in one institution to adversely affect others. However, details on many of these proposals are lacking.
- The chapter examines two of these proposals: a mandate for regulators to explicitly monitor systemic risks and the introduction of systemic risk-based capital surcharges that are commensurate with their contribution to systemic risk.
- The chapter argues that it is not enough to mandate that regulators "monitor" systemic connections, but that better tools would also be needed to combat systemic risks. Indeed, without such tools, regulators will have the tendency to be more lenient with systemic institutions in distress than others.
- While not necessarily endorsing the introduction of systemic risk capital surcharges, this chapter illustrates a practical methodology to compute such surcharges if this tool were to be used.
- The chapter also shows the importance of taking into account institutions' cross-border linkages, hence requiring supervisors in different countries to collaborate to design such surcharges.

The recent financial crisis has triggered a rethinking of the supervision and regulation of systemic interconnectedness—the notion that distress in one financial institution will negatively affect others. Although a flood of regulatory reform proposals has ensued, there is considerable uncertainty about how they can be practically applied. Thus, the chapter aims to contribute to the debate on systemic risk-based regulation in two ways. It formally examines whether a mandate, by itself, to explicitly oversee systemic risk, as envisioned in some recent proposals in the euro area, the United Kingdom, and the United States is likely to be successful in mitigating it. As well, it proposes a methodology to compute and smooth a systemic risk-based capital surcharge.

Regulatory Architecture

The chapter argues that an important missing ingredient from reforms that mandate regulators to look at systemic financial risks is the analysis of regulators' own incentives. This includes "regulatory forbearance"—that is, the regulator's incentive to keep institutions afloat when they should be unwound—which will likely vary across different allocations of the regulatory functions.

The chapter shows how adding a systemic risk monitoring mandate to the regulatory mix without a set of associated policy tools does not alter the basic regulator's incentives that were at the heart of some of the recent regulatory shortcomings. Regulators often have the incentive to keep an institution afloat, even when insolvent, because regulators strongly dislike closing institutions under their watch, especially because in some cases, given enough time, an institution may get back on its feet. Therefore, in the absence of concrete methods to formally limit a financial institution's systemic importance—regardless of how regulatory functions are allocated—regulators may tend to be more forgiving with systemically important institutions compared to those that are not. This is because the systemically important institutions will have a more damaging effect on other institutions under the regulators' purview.

For this reason, it is necessary to consider more direct methods to address systemic risks, such as instituting systemic-risk based capital surcharges, applying levies that are related to an institution's contribution to systemic risk or, perhaps, even limiting the size of certain business activities.

Systemic-Risk-Based Surcharges

While not necessarily endorsing the introduction of systemic risk-based capital surcharges, the chapter presents a methodology to calculate them. Underpinning this methodology is the notion that these surcharges should be commensurate with the systemic interconnectedness of financial institutions. The chapter presents two approaches to implement this methodology:

- Standardized Approach: under which regulators assign systemic risk ratings to each institution based on their relative systemic importance and then assess a capital surcharge based on this rating.
- Risk-Budgeting Approach: which borrows from the credit risk management literature and determines capital surcharges in relation to an institution's additional contribution to systemic risk and its own probability of distress.

The methodology also presents a way to remove the surcharges' potential procyclicality—the propensity to increase in an downturn and drop in an upturn—a counterproductive attribute associated with most risk-based capital charges,

The chapter also shows the importance of taking into account the cross-border linkages across institutions that would influence such a charge, hence requiring supervisors in different countries to work together to design such surcharges.