

What is Systemic Risk?

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What went wrong with banking regulation?

- The focus of regulators was on microprudential regulation that involves ensuring no individual bank takes large risks
- This failed to prevent a financial crisis because it ignored systemic risk
- What are the sources of systemic risk?

Sources of systemic risk

1. Panics – banking crises due to multiple equilibria
2. Banking crises due to asset price falls
3. Contagion
4. Foreign exchange mismatches in the banking system

1. Banking panics

- Two equilibria:
 - If everybody thinks the banking system is sound then only the people who need money will withdraw
 - If everybody thinks others will withdraw then it is optimal to withdraw and the panic equilibrium is self-fulfilling
- This was economists' traditional view of financial crises, e.g. Friedman and Schwarz (1963)

- Formal model: Diamond and Dybvig (1983)
 - Solution: Deposit insurance eliminates the bad equilibrium and is costless
- Deposit insurance for retail deposits no longer effective in preventing panics
 - Growing importance of wholesale funding
- Guarantee all short term debt? – If there are other types of systemic risk may be very costly, e.g. Ireland

2. Banking crises due to asset price falls

- If the prices held by banks and other financial institutions fall then there can also be a banking crisis
- Possible reasons for asset price falls
 - a. Business cycle
 - b. Bursting of real estate bubbles
 - c. Mispricing due to limits to arbitrage
 - d. Mispricing due to “flash crashes”
 - e. Sovereign default

2a. Business cycle

- Between 1836 and 1914 the US had no central bank and during this time it had many crises
- Gorton (1988) found that panics in the U.S. in the late 19th Century were systematic events: whenever the leading economic indicator represented by the liabilities of failed businesses reached a certain threshold, a panic ensued
- See also Calomiris and Gorton (1991) and Calomiris and Mason (2003)

Table 1
National Banking Era (1865-1914) Panics

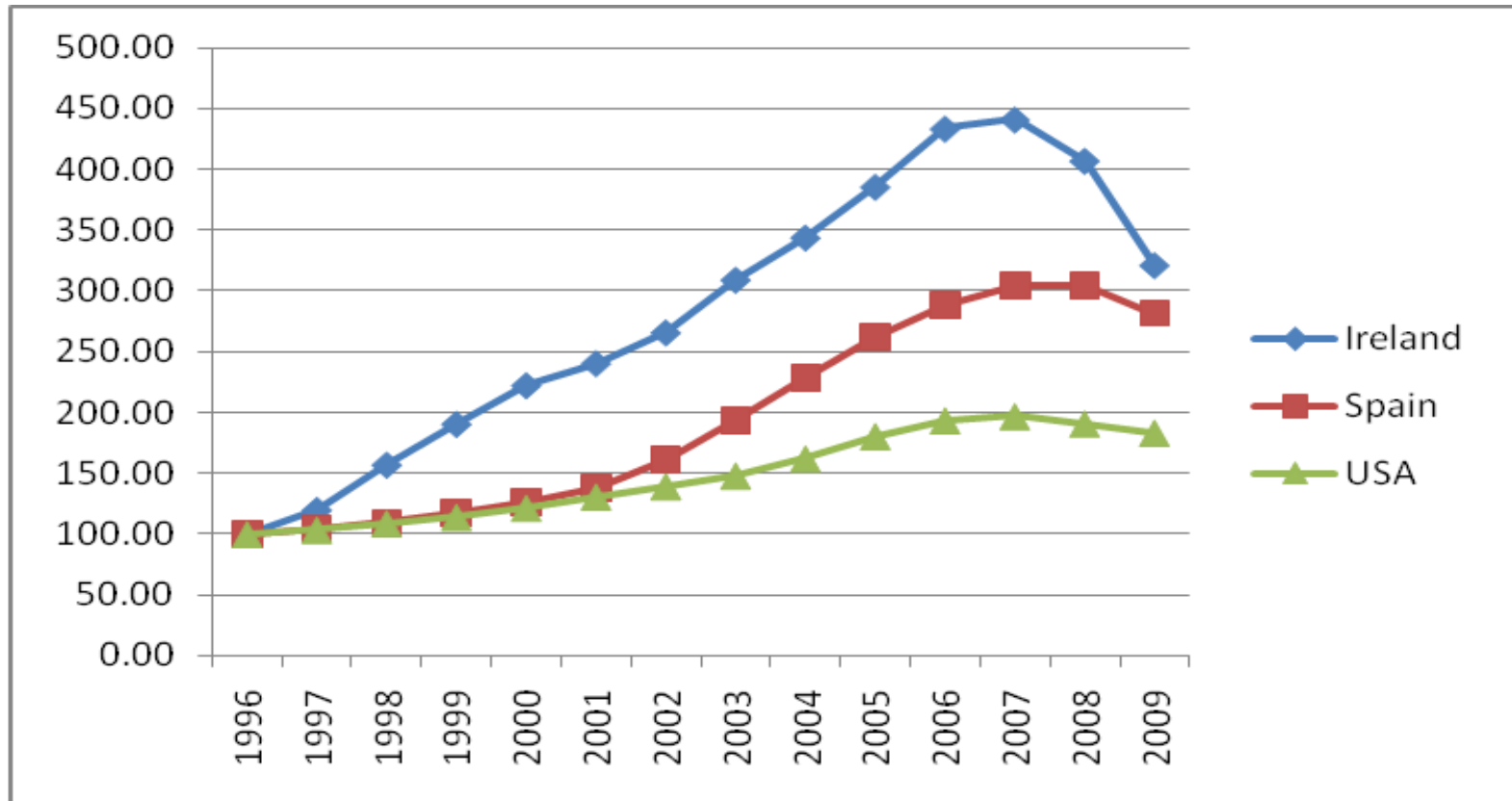
| NBER Cycle Peak.Trough | Panic Date | % Δ (Currency/ Deposit) | % Δ Pig Iron |
|---------------------------|---------------|-----------------------------------|---------------------|
| Oct. 1873.Mar. 1879 | Sep. 1873 | 14.53 | -51.0 |
| Mar. 1882.May 1885 | Jun. 1884 | 8.80 | -14.0 |
| Mar. 1887.Apr. 1888 | No Panic | 3.00 | -9.0 |
| Jul. 1890.May 1891 | Nov. 1890 | 9.00 | -34.0 |
| Jan. 1893.Jun. 1894 | May 1893 | 16.00 | -29.0 |
| Dec. 1895.Jun. 1897 | Oct. 1896 | 14.30 | -4.0 |
| Jun. 1899.Dec. 1900 | No Panic | 2.78 | -6.7 |
| Sep. 1902.Aug. 1904 | No Panic | -4.13 | -8.7 |
| May 1907.Jun. 1908 | Oct. 1907 | 11.45 | -46.5 |
| Jan. 1910.Jan. 1912 | No Panic | -2.64 | -21.7 |
| Jan. 1913.Dec. 1914 | Aug. 1914 | 10.39 | -47.1 |

Source: Gorton (1988)

2b. Bursting of real estate bubbles

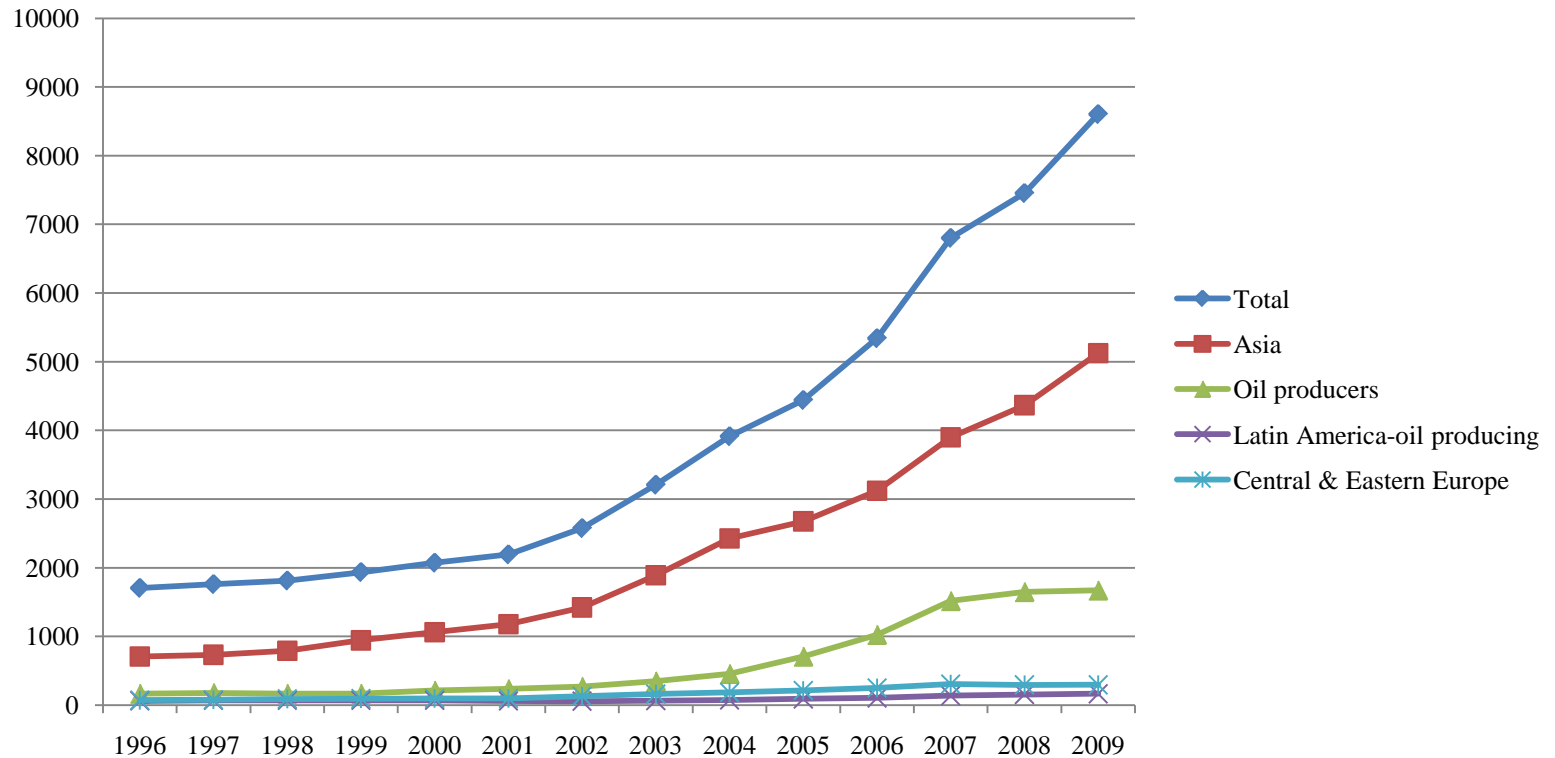
- Evidence from Reinhart and Rogoff (2009) suggests that historically this has been the most common cause of crises
- Current crisis is a good example of the effects of a collapse in real estate prices
- Apparent bubbles in real estate prices in Ireland, Spain, and the U.S.

Housing Prices in Ireland, Spain and the U.S.

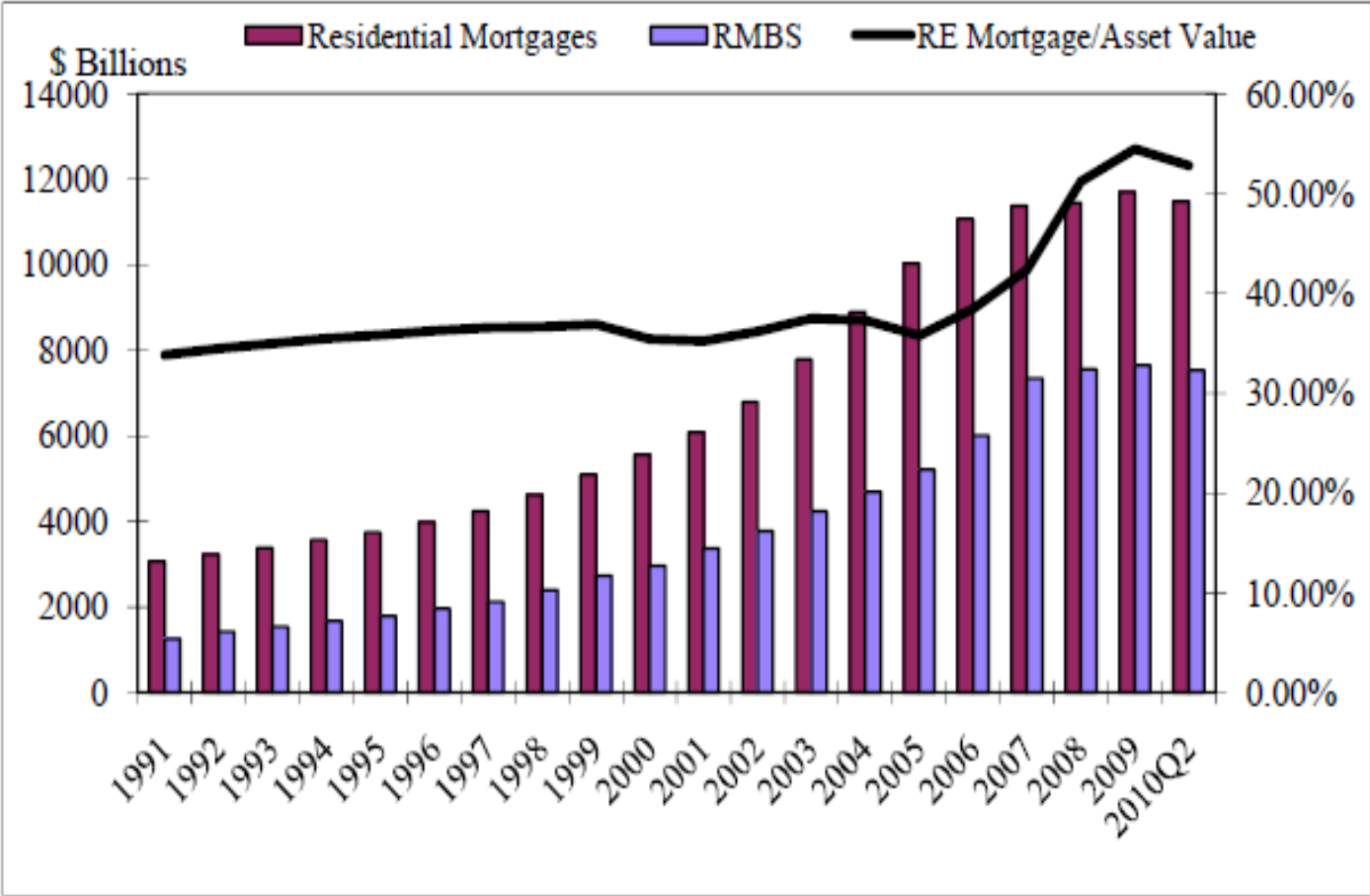


- What caused these bubbles?
- Returns on housing are positively serially correlated so in contrast to stocks the market is inefficient
- It appears that lowering interest rates at a time when property prices are rising rapidly can lead to a bubble
- Easy availability of credit due to large foreign exchange reserves of Asian central banks that resulted from IMF policies enacted during the 1997 Asian Crisis

Total Reserves in Billions of US \$ 1996-2009



U.S. Residential Mortgages



- Objective of policy should be to prevent bubbles occurring in the first place
- Use interest rate policy to prevent them?
 - Politically difficult?
 - Perhaps possible and desirable in homogenous economic areas/countries (e.g., Sweden, maybe U.K.) but problem of capital inflows if interest rates are raised
 - In large heterogeneous economies like China, the Eurozone and the U.S. raising interest rates will damage areas without bubbles and macro-prudential policies need to be relied upon to a greater extent

Macro-prudential policies 1

- First objective is to eliminate real estate bubbles by targeted intervention in property markets
 1. Reductions in loan-to-value ratios for hot real estate markets
 2. Increases in taxes on real estate transfers
 3. Increases in annual real estate taxes
 4. Direct restrictions on real estate lending
- Evidence from Korea, Hong Kong, Singapore suggest they work in the short run but not in the long run

Macro-prudential policies 2

- Second objective is to increase resilience of banking sector through countercyclical policies
 1. Capital requirements should be raised during booms so they can be relaxed in busts
 2. Similarly for reserve ratios particularly on real estate related loans
 3. Differentiated capital requirements and higher risk weights for real estate loans
- Some evidence these kinds of measures can help increase the resilience of the banking sector, e.g. Spain

- Global imbalances need to be reduced
 - Self-insurance by Asian countries through large reserves is optimal for them but very inefficient globally
- Reform governance structure of the IMF
 - Reduce European representation
 - End system of European Managing Director/US First Deputy
 - Increase East Asian influence
- Concerning Chinese reserve accumulation
 - Rmb as a reserve currency

2c. Asset mispricing due to limits to arbitrage

- Evidence was that not only did prices of securitized products seem very low but correlations between residential mortgage-backed assets, commercial mortgage-backed assets, and corporate credit securitizations markedly increased
- “Cash-in-the-market” pricing and limits to arbitrage
- The apparent mispricing contributed significantly to banks’ problems because of mark-to-market accounting

Possible solutions to mispricing due to limits to arbitrage

- TARP-type programs can help restore market functioning and correct pricing
 - Difficult to implement and uncertain effects
 - Should the Treasury or the central banks implement them?
- Mark-to-market may need to be suspended when markets are not efficient
 - For example, when there is significant divergence between market prices and model based prices (more than 2%)

2d. Asset mispricing due to “flash crashes”

- Around 60% of trading volume in the U.S. is by high frequency traders
- On May 6 2010 over 20,000 trades across more than 300 securities were executed at prices more than 60% away from their values just moments before. Many were executed at prices of a \$0.01 or less, or as high as \$100,000, before prices of those securities returned to their “pre-crash” levels.
- Should high frequency trading be regulated?

2e. Sovereign Default

- Problems in Greece in the first part of 2010 showed the difficulties associated with sovereign default within the Eurozone
- Problems in Ireland and Portugal have underlined the importance of this issue
- Political economy factors in Germany and other Northern European countries are key and quite uncertain

3. Contagion

- A very important systemic risk
- At least three different types:
 - Domino effects through the payments system or interbank markets
 - Common asset exposure
 - Uncertainty about how events will play out because of a lack of precedent
- Solution: High bank capital requirements?

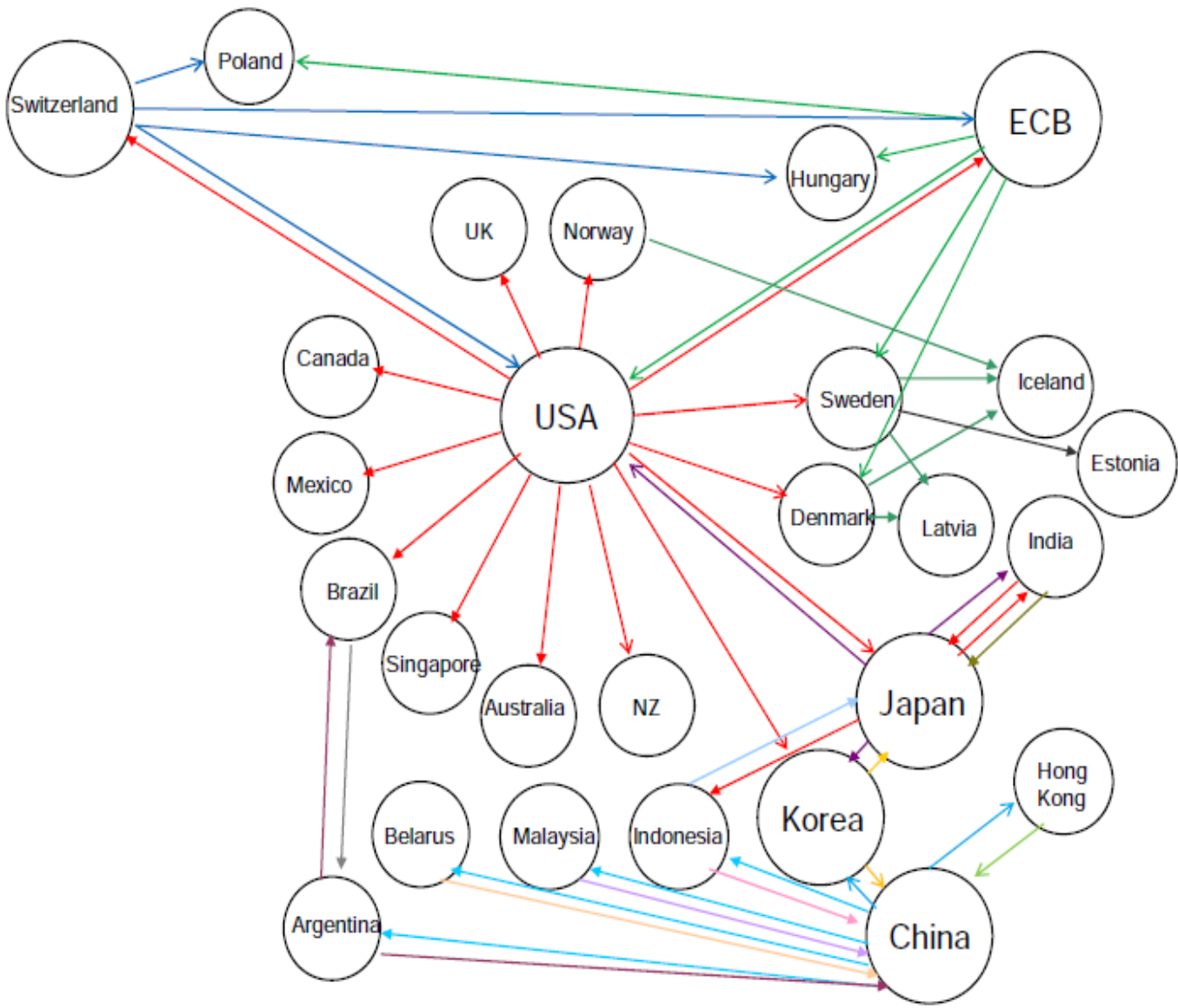
Resolution mechanism

- Large institutions are saved to avoid contagion at the cost of moral hazard
 - Large institutions hold less capital and are riskier as they internalize that they are “too big to fail”
- “Too big to fail” is not “Too big to liquidate”
- Government should orderly resolve failing institutions
 - Guarantee short term commitments to avoid contagion
 - The top 5 executives should be removed immediately
 - All employee pension claims should be eliminated
 - Over the next few years the bank should be liquidated

4. Foreign exchange mismatches

- A major factor in the 1997 Asian Crisis was the lack of access to foreign exchange by banks and firms in Thailand, Korea, Indonesia and other countries
- Prior to the current crisis many banks within Europe had made foreign currency loans funded by foreign currency deposits – when the crisis struck many deposits were not rolled over
- Largest liquidity shortage was \$400 billion dollars in the Eurozone, next was \$70 billion worth of euros in the U.S. and then \$30 billion of Sfrs in Eurozone

- Not a significant problem in the current crisis because central banks introduced foreign currency swaps
- There were four overlapping networks:
 - The Fed network to supply U.S. dollars
 - The ECB network to supply Euros
 - The Swiss Franc network
 - The Latin American and Asian networks



Solutions to foreign exchange mismatches

- IMF liquidity facility
 - Will it be like central banks' discount windows with stigma?
- Guaranteed swaps going forward is arguably a better solution and the G-20 is pursuing this

Concluding remarks

- Systemic risk is a complex phenomenon and our understanding of it is limited
- Other exacerbating factors
 - High leverage in financial services of firms
 - Compensation policies
- Checks and balances on central banks – how do we deal with divergence of opinion?

Further reading

- Allen, F. and E. Carletti (2010). “An Overview of the Crisis: Causes, Consequences and Solutions,” *International Review of Finance* 10, 1-27.
- Allen, F. and D. Gale (2007). *Understanding Financial Crises*, Clarendon Lecture Series in Finance, Oxford: Oxford University Press.
- Reinhart, C., and K. Rogoff (2009). *This Time is Different: Eight Centuries of Financial Folly*, Oxford and Princeton: Princeton University Press.